

[JOINT COMMITTEE PRINT]

**ESTIMATES OF
FEDERAL TAX EXPENDITURES
FOR FISCAL YEARS 2008–2012**

PREPARED FOR THE
HOUSE COMMITTEE ON WAYS AND MEANS
AND THE
SENATE COMMITTEE ON FINANCE

BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

Tax expenditure analysis can help both policymakers and the public to understand the actual size of government, the uses to which government resources are put, and the tax and economic policy consequences that follow from the implicit or explicit choices made in fashioning legislation. By developing a consistent, neutral and principled implementation of tax expenditure analysis, the Staff of the Joint Committee on Taxation (the "JCT Staff") therefore can provide Members of Congress with a vitally important analytical tool that they can employ in weighing the merits of both existing tax provisions and new legislative proposals.

Earlier this year, the JCT Staff introduced a new paradigm for the identification and classification of tax expenditures.¹ The new paradigm is designed to improve the utility of tax expenditure analysis and to reemphasize its neutrality. In particular, the new paradigm addresses the principal criticism of tax expenditure analysis as originally conceived and, by implication, as previously implemented by the JCT Staff—its reliance on a comparison of present law with a hypothetical and subjectively determined "normal" tax system.

In this pamphlet, we implement the new paradigm in presenting the annual list of tax expenditures required by the Congressional Budget and Impoundment Control Act of 1974.² Section I reviews our new approach, including its division of tax expenditures into two principal categories: tax expenditures that can be identified as exceptions to the general rules of the existing Internal Revenue Code ("Tax Subsidies"), and a new category that we have termed "Tax-Induced Structural Distortions." Section I also describes three subcategories of Tax Subsidies designed to facilitate the comparison of similar tax expenditures to one another. Sections II and III illustrate the application of these categories and subcategories to

¹ See Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08), May 12, 2008 (hereinafter cited as "JCT Reconsideration").

² Pub. L. No. 93-344 (herein, the "Budget Act"). The Budget Act requires the Congressional Budget Office ("CBO") and the United States Department of the Treasury (the "Treasury Department") annually to publish detailed lists of tax expenditures. In light of the traditional expertise of the JCT Staff in respect of revenue matters, and a separate statutory requirement that Congress rely on JCT Staff estimates when considering the revenue effects of proposed legislation, the CBO has always relied on the JCT Staff for the production of its annual tax expenditure publication. See P.L. 93-344 §201(g), codified at 2 USC 601(f); Joint Committee on Taxation, *Estimates of Federal Tax Expenditures*, October 4, 1972 (JCS-28-72), June 1, 1973 (JCS-20-73), July 8, 1975 (JCS-11-75), March 15, 1976 (JCS-5-76), March 15, 1977 (JCS-10-77), March 14, 1978 (JCS-9-78), March 15, 1979 (JCS-9-79), March 6, 1980 (JCS-8-80), March 16, 1981 (JCS-7-81), March 8, 1982 (JCS-4-82), March 7, 1983 (JCS-4-83), November 9, 1984 (JCS-39-84), April 12, 1985 (JCS-8-85), March 1, 1986 (JCS-7-86), February 27, 1987 (JCS-3-87), March 8, 1988 (JCS-3-88), February 28, 1989 (JCS-4-89), March 9, 1990 (JCS-7-90), March 11, 1991 (JCS-4-91), April 24, 1992 (JCS-8-92), April 22, 1993 (JCS-6-93), November 9, 1994 (JCS-6-94), September 1, 1995 (JCS-21-95), November 26, 1996 (JCS-11-96), December 15, 1997 (JCS-22-97), December 14, 1998 (JCS-7-98), December 22, 1999 (JCS-13-99), April 6, 2001 (JCS-1-01), January 17, 2002 (JCS-1-02), December 19, 2002 (JCS-5-02), December 22, 2003 (JCS-8-03), January 12, 2005 (JCS-1-05), April 25, 2006 (JCS-2-06), September 24, 2007 (JCS-3-07).

particular tax expenditures. Section IV discusses the methodology used to quantify the magnitude of tax expenditures, and Section V presents a comprehensive list of tax expenditures, identified and categorized under our new approach.

Tax expenditure analysis is (or should be) simply an analytical tool, not a criticism of current law or an expression of a normatively superior alternative tax system. By describing provisions of current law as Tax Subsidies or Tax-Induced Structural Distortions, and by quantifying (in the former case) the forgone revenues associated with that tax expenditure, this pamphlet provides policymakers with an analytical framework and with quantitative data that they can employ in judging the merits of each such item. It should be emphasized that there is a reason behind every Tax Subsidy or Tax-Induced Structural Distortion in the tax law, and that there are many other modes of analysis besides tax expenditure analysis that are relevant to the Members of Congress and others in weighing the value of each provision of the tax law. The inclusion in this pamphlet of an item as a tax expenditure therefore is not meant to convey that the provision in any fashion is necessarily problematic in the context of the larger policy issues that Congress considers in fashioning every piece of legislation.

I. THE NEW APPROACH

Background

The Budget Act defines tax expenditures as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”³ Although the Budget Act does not specify the baseline from which tax expenditures are determined, the JCT Staff has traditionally followed an approach consistent with the concept originated by Assistant Secretary for Tax Policy Stanley Surrey and first implemented in the Treasury Department’s annual financial report for the 1968 fiscal year.⁴ That report, prepared under Surrey’s guidance, implemented his earlier call for a “tax expenditure budget” that would encourage expenditure control and facilitate tax reform.⁵ Surrey hoped that a formal identification of tax expenditures as substitutes for direct spending would reveal them to be poorly targeted or inefficient when compared either to direct government spending or (in most cases) to no spending at all.⁶ He further believed that a more rigorous examination of tax expenditures, as if they were spending requests, would demonstrate that many of these provisions conflict with the goal of an equitable, efficient and administrable income tax system. The 1968 Treasury Report therefore sought to identify “the major respects in which the current income tax bases deviate from widely accepted definitions of income and standards of business accounting and from the generally accepted structure of an income tax.”⁷

The 1968 Treasury Report did not include a comprehensive description of the definitions and standards, or the “generally accepted structure of an income tax,” that served as its baseline for the identification of tax expenditures. In fact, the only features that the 1968 Treasury Report explicitly included in the “accepted structure” of an income tax are the personal exemptions and graduated rates for individuals and the existence of a separate corporate tax. Surrey later observed that the early Treasury Reports had relied

³ Budget Act, sec. 3(3).

⁴ United States Department of the Treasury, *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1968* (Washington, D.C., Government Printing Office, 1969) (herein, the “1968 Treasury Report”). For its reports on the 1972 and 1974 fiscal years, the Treasury Department collaborated with the JCT Staff.

⁵ Stanley S. Surrey, Excerpts from remarks before The Money Marketeers on *The U.S. Income Tax System—the Need for a Full Accounting*, November 15, 1967, in the 1968 Treasury Report, *supra*, at 322; see also Stanley S. Surrey, *Pathways to Tax Reform* (Cambridge, Mass., Harvard University Press, 1973) at 30–49 (describing uses of a tax expenditure budget).

⁶ Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures*, at 32–37 (Cambridge, Mass., Harvard University Press, 1985).

⁷ 1968 Treasury Report, *supra*, at 327. Consistent with Surrey’s goal of expenditure control, both the 1968 and later Treasury Reports, and the JCT Staff Reports since 1975, have presented tax expenditures in the same functional categories under which direct expenditures are classified in the Federal budget.

in part on the Haig-Simons definition of personal income,⁸ but this definition provides only a general framework for analysis and says nothing about most of the structural issues that must be decided under any income tax law, such as the rate structure, the proper taxpaying unit and the proper accounting period. Surrey therefore refined the Haig-Simons definition by incorporating what he described as “widely accepted” definitions and standards and “generally accepted” structural features. Thus, he treated certain items, such as the failure to tax imputed rent from owner-occupied homes, as part of the normal tax baseline “where the case for their inclusion in the income base stands on relatively technical or theoretical tax arguments.”⁹ His baseline included the personal exemptions and graduated rates for individuals, on the grounds that those features were “part of the structure of an income tax based on ability to pay,”¹⁰ and he included a separate corporate income tax in the baseline on the grounds that U.S. tax policy had accepted the concept, notwithstanding strong arguments that integrated taxation of corporations and shareholders would better implement the Haig-Simons ideal. Numerous other structural issues were revealed only through his choices for the list of tax expenditures.¹¹

Although the Treasury Department substantially abandoned this original approach during the Reagan Administration in favor of a “reference law” baseline,¹² the JCT Staff has used a “normal tax” baseline similar to Surrey’s since 1975. As explained in the JCT Staff’s 2007 report, the determination of whether a provision is a tax expenditure has been made on the basis of a concept of income that is larger in scope than “income” as defined under general U.S. Federal income tax principles.¹³ The features of that normal tax baseline have been described in detail in each annual report, and the JCT Staff has used its judgment in distinguishing between those income tax provisions (and regulations) that can be viewed as a part of normal income tax law and those special provisions that result in tax expenditures.

The concept of a normal tax baseline as the underpinning of tax expenditure analysis has evoked serious and continuous criticism, however, since its introduction in the late 1960s.¹⁴ Numerous tax academics and policy experts have rightly observed that the ideal “normal” tax system does not correspond to any generally accepted formal definition of net income. Instead, many observers view tax expenditure analysis, in the form envisioned by Stanley Surrey, as

⁸ Under this definition, personal income is “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” Henry Simons, *Personal Income Taxation* (University of Chicago Press, 1938). Regarding Surrey’s reliance on the Haig-Simons definition, see Stanley S. Surrey and Paul R. McDaniel, *Tax Expenditures, supra*, at 3 (“Tax expenditure analysis, as applied to a particular tax, requires an understanding of the normative structure of that tax in order to determine whether a provision is a part of the structural or the tax expenditure component. In the U.S. analysis of income tax expenditures, the normative concept of net income is based on the Schanz-Haig-Simons economic definition of income. . . .”).

⁹ 1968 Treasury Report, *supra*, at 329.

¹⁰ 1968 Treasury Report, *supra*, at 329.

¹¹ Some items were omitted from the list for practical reasons, such as the perceived difficulty of estimating the magnitude of the subsidy (e.g., accelerated depreciation) or the relatively small size of the subsidy.

¹² JCT Reconsideration, at 25.

¹³ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures*, September 24, 2007 (JCS-3-07).

¹⁴ See, e.g., Boris I. Bittker, *Accounting for Federal “Tax Subsidies” in the National Budget*, 22 *National Tax Journal* 244 (1969); JCT Reconsideration at 29-33.

a thinly veiled agenda for a specific form of tax reform. Under this view, the normative tax system is not simply an analytical tool but is also an aspirational goal of the political process.

Tax expenditure analysis cannot serve as an effective and neutral analytical tool if the premise of the analysis (the validity of the "normal" tax base) is not universally accepted. The "normal" tax is admittedly a commonsense extension (and cleansing) of current tax policies, and not a rigorous framework developed from first principles. As a result, the normal tax cannot be defended from criticism as a series of ultimately subjective or pragmatic choices, and its use as a baseline has diminished the utility of tax expenditure analysis.

The JCT Staff has therefore undertaken a reconsideration of the principles of tax expenditure analysis, in order to improve the doctrine's utility to policy makers and reemphasize its neutrality. In *A Reconsideration of Tax Expenditure Analysis*, we presented a new approach for the identification and classification of tax expenditures.¹⁵ Central to this new approach is our division of the universe of such provisions into two main categories: tax expenditures in a narrow sense (as explained below), which we label "Tax Subsidies," and a new category that we have termed "Tax-Induced Structural Distortions." The two categories together cover much the same ground as the current definition of tax expenditures and in some cases extend the application of the concept further. The revised approach does so, however, without relying on a hypothetical "normal" tax to determine what constitutes a tax expenditure, and without holding up that "normal" tax as an implicit criticism of present law. The result should be a more principled and neutral approach to the issues. The two categories of tax expenditures, Tax Subsidies and Tax-Induced Structural Distortions, are intended to be as transparent and objective as possible.

Tax Subsidies

Our approach to Tax Subsidies (that is, tax expenditures in the narrow sense) builds loosely on the work of Seymour Fiekowsky and others, by defining a Tax Subsidy as a specific tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law (not a hypothetical "normal" tax), and that collects less revenue than does the general rule.¹⁶ A negative Tax Subsidy is the converse case of an exception to the general rule that results in the collection of more revenue than does the general rule.¹⁷ In practice, our conception of the compilation of general rules that together comprise our baseline for identifying Tax Subsidies corresponds to the "reference tax" baseline that the Treasury Department currently uses in its tax expenditure analyses.

The Tax Subsidy paradigm is constructed by asking what constitutes the general rule, and what the exception, under actual present law. Our determination of Tax Subsidies thus is made, not

¹⁵ JCX-37-08, May 12, 2008.

¹⁶ Fiekowsky, *The Relation of Tax Expenditures to the Distribution of the "Fiscal Burden,"* 2 Canadian Taxation 211, 215 (1980); see also OMB, *The Budget of the United States Government, Fiscal Year 1983—Special Analyses G-5* (1982).

¹⁷ Although the Budget Act does not require the identification of negative tax expenditures, we have presented a number of negative Tax Subsidies in Section V for completeness and to facilitate understanding of the Tax Subsidy paradigm.

by reference to an alternative and hypothetical "normal" tax chosen by the JCT Staff, but rather by reference to the general rules of the Internal Revenue Code itself, along with its legislative history and similar straightforward tools for identifying legislative intent. This definition does not require the kinds of normative judgments required to construct the "normal" tax base. It is not, however, automatic in application. For example, there will be occasional uncertainty as to whether there is a clear general rule of current tax law.

We have further divided the Tax Subsidy category into three subcategories with a view to facilitating consensus on the principles that are relevant to the evaluation of a particular Tax Subsidy. The first subcategory, Tax Transfers, generally includes payments made to persons without regard to their income tax liability, usually because there was no income tax liability to begin with, or because the person's income tax liability was eliminated by another Tax Subsidy. In contrast, Tax Subsidies other than Tax Transfers only reduce (or increase, in the case of negative Tax Subsidies) a taxpayer's income tax liability. Tax Transfers are the clearest examples of hybrid tax/spending programs, i.e., they are essentially direct government spending programs that use the tax system for distribution.

The Social Spending subcategory includes both Tax Subsidies that often are intended to subsidize or induce behavior unrelated to the production of business income and Tax Subsidies related to the supply of labor. The charitable contribution deduction is an example of a provision in this subcategory.

The third subcategory, Business Synthetic Spending, includes Tax Subsidies intended to subsidize or induce behavior directly related to the production of business or investment income, but excludes any Tax Subsidies related to the supply of labor. In cases where a provision has potentially both business and nonbusiness statutory incidence, we classify the provision based on a judgment about the effect and/or the intent of the provision. When legislative intent is not readily discernible, the item generally will be classified according to whether or not it is linked directly to production of business income.

All Tax Subsidies raise questions of equity, efficiency and ease of administration. The three subcategories can be useful to suggest that these factors may have different weights across the different subcategories. For example, targeting and incentive effects are likely to be most important in the evaluation of a Tax Transfer intended to aid low-income persons. Effects on income distribution may be less important, however, to the evaluation of a Social Spending provision than is its efficacy in achieving a specific societal goal. For an item in the Business Synthetic Spending subcategory, concerns regarding certainty and economic efficiency may be more relevant than for items in the other two subcategories. Tradeoffs among competing goals are a necessity in the design of any tax provision. The subcategories of Tax Subsidies are intended simply to assist policymakers in making and understanding these tradeoffs.

As a result of the new approach, new provisions are included as Tax Subsidies, such as the "last in first out" (LIFO) and "lower of

cost or market" (LCM) methods of accounting, the section 164 deduction for foreign taxes, certain exceptions to the definition of unrelated business taxable income of exempt organizations, and the allowance of a deduction under section 212 for investment expenses incurred by individuals. Examples of negative tax expenditures include the taxation of gain realized by foreign persons on disposition of U.S. real property under section 897, and the phaseout of the personal exemption and disallowance of the personal exemption and standard deduction against the alternative minimum tax.

Tax-Induced Structural Distortions

Some important provisions identified as tax expenditures under our old approach cannot easily be described as exceptions to a general rule of present law. This may be the case because the general rule is not clear. Alternatively, the provision itself may constitute the general rule, or at least a key element of the Code. In either case, such a provision cannot properly be classified as a Tax Subsidy in the narrower sense described above. Instead, we have created for these provisions a second major category of tax expenditures labeled Tax-Induced Structural Distortions.

Tax-Induced Structural Distortions are structural elements of the Internal Revenue Code (not deviations from any clearly identifiable general tax rule and thus not Tax Subsidies) that materially affect economic decisions in a manner that imposes substantial economic efficiency costs. While both Tax Subsidies and Tax-Induced Structural Distortions result in economic inefficiencies, those distortions cannot be removed in the case of Tax-Induced Structural Distortions simply by reverting to the general rule of present law, because Tax-Induced Structural Distortions are too firmly embedded in the design of present law to be teased out in this manner.

Importantly, the identification of Tax-Induced Structural Distortions does not depend simply on the magnitude of their efficiency costs or on the amount of revenue lost as a result of the provision. The deduction for home mortgage interest, discussed in Section II.B.1 below, is arguably one of the larger tax expenditures in terms of both its revenue cost and its economic inefficiency. The economic distortions associated with this provision could be reversed, however, by treating home mortgage interest in the same manner as other types of personal interest expense, i.e., as non-deductible under the general rule of section 163(h). As a result, we classify the home mortgage interest deduction as a Tax Subsidy, rather than a Tax-Induced Structural Distortion. (In analyzing the tax policy issues raised by the deduction, however, we would employ the same efficiency considerations as might be applied to a Tax-Induced Structural Distortion along with other relevant criteria.)¹⁸

In contrast, the ability to defer inclusion for income tax purposes of certain "active" earnings of foreign corporations owned by U.S. persons is an example of a provision that has been treated as a tax expenditure, but that is not classified as a Tax Subsidy under our new approach, because present law is ambiguous as to what con-

¹⁸ See Joint Committee on Taxation, *Tax Expenditures for Health Care* (JCX-66-08), July 30, 2008.

stitutes the general rule for taxing foreign earnings. Instead, we classify the deferral rules as a Tax-Induced Structural Distortion. In June of this year, the JCT Staff published a pamphlet examining the efficiency costs posed by the current system of deferral and presenting two paradigmatic alternatives to address these concerns: a dividend exemption system and a system of full inclusion.¹⁹

A second example is the differential treatment of debt and equity. The distinction between debt and equity is a Tax-Induced Structural Distortion, because it provides a tax incentive to business firms to leverage their capital structures, but it is not a Tax Subsidy because there is no clear consensus as to what general rule of tax law, if any, the debt-equity distinction might violate. Moreover, as is the case for the deferred taxation of the earnings of foreign corporations, the distortions introduced by the debt-equity distinction cannot be eliminated simply by reverting to a general rule; at present, there is no general rule in the Code for the treatment of the cost of capital.

While tax expenditure analysis can be helpful in identifying efficiency, equity, ease of administration and design issues, our definition of Tax-Induced Structural Distortions focuses only on the substantive criterion of efficiency. There are at least three reasons for this decision. First, efficiency is an inherently more neutral construct than is equity (and possibly simplicity), and our overriding objective in rethinking tax expenditures is to move to an approach that most observers can accept as neutral and principled. Second, most tax expenditures that are particularly troubling for equity (or other) reasons will be described as Tax Subsidies. Finally, most of the important structural ambiguities in the Code today relate to the taxation of capital income (that is, business or investment income); efficiency goals loom largest in this context.

In a few cases we have identified items as Social Spending or Business Synthetic Spending, in addition to discussing them as Tax-Induced Structural Distortions. We do so partly for consistency with prior presentations, and partly because changes that might be made to conform to a more general rule of the Code would not wholly eliminate the efficiency issues associated with the structural item. For example, the lower tax rates for certain capital gains and dividends earned by individuals could be conformed to the more generally applicable rates. However, such a change would not eliminate other structural distortions related to capital gain and loss recognition, such as deferral and the ability to elect to recognize losses without recognizing gains, and (pointing in the other direction) the inability to deduct net capital loss against ordinary income. Nor would it address certain other structural issues that have been said to relate in part to the treatment of capital gains and dividends, such as the lack of indexation for inflation, the bunching of income resulting from deferral, and the potential double taxation of corporate income in the case of dividends or gains with respect to corporate equity.

¹⁹ Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCX-55-08), June 25, 2008.

Negative tax expenditures vs. compliance or enforcement provisions

As discussed in *A Reconsideration of Tax Expenditure Analysis*, special provisions of the tax law that increase the tax burden above what the general rules would impose constitute negative tax expenditures. One example of a negative tax expenditure is section 162(m), which generally disallows deductions by publicly traded corporations for applicable remuneration paid to covered employees in excess of \$1 million. Because this provision is an exception to the general rule in section 162(a)(1), which permits a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered," and the provision increases the tax burden on certain publicly traded companies, it is treated as a negative tax expenditure.²⁰

In contrast, special provisions of the law the principal purpose of which is to enforce general tax rules, or to prevent the violation of other laws, are not treated as negative tax expenditures even though they may increase the tax burden for certain taxpayers. For example, section 382, an exception to the general rule that allows corporate net operating loss carryforwards to offset current income, was enacted to "preserve the integrity of the carryover provisions."²¹ Section 382 is generally intended to enforce the principle that losses should not be transferred between taxpayers; thus, it is not treated as a negative tax expenditure,^{21A} even though it reduces an otherwise allowable deduction.²² Similarly, the wash sale rules in section 1091, which prevent taxpayers from recognizing losses when there has been no substantive change in their property holdings, exist for the purpose of supporting the integrity of the realization rules and, therefore, are not treated as a negative tax expenditure.

Likewise, tax rules designed to support the enforcement of other laws are not treated as negative tax expenditures. For example, section 1287, which denies capital gains treatment for certain obligations not in registered form, is not treated as a negative tax expenditure. Section 1287 was enacted (along with other provisions) to make bearer bonds less attractive and thereby reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.²³ Similarly, the section 162(f) disallowance of a deduction for fines and penalties, even those that might be viewed as ordinary and necessary business expenses, is not a negative tax expenditure. Permitting a deduction of a fine or pen-

²⁰ See Section II.B.5 of this pamphlet for a more complete discussion.

²¹ S. Rep. No. 99-313, 99th Cong. 2d. Sess. at 230 (1986); Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 294.

^{21A} Accordingly, the exceptions from the loss limitation rules for corporations in bankruptcy are not treated as tax expenditures under the new methodology; as they are merely exceptions to the compliance provision of section 382.

²² When section 382 was enacted, the legislative history explained that the limitations imposed by section 382 apply when shareholders who bore the economic burden of a corporation's net operating losses no longer hold a controlling interest in the loss corporation. "In such a case, the possibility arises that new shareholders will contribute income-producing assets (or divert income opportunities) to the loss corporation, and the corporation will obtain greater utilization of its carryforwards than it could have had there been no change in ownership." S. Rep. No. 99-313, *supra*, at 232; *General Explanation of the Tax Reform Act of 1986, supra*, at 295.

²³ S. Rep. No. 97-494 (Vol. 1), at 242 (1982); Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, at 190.

alty, effectively reducing the burden on the business on which such fine or penalty is imposed, would undermine the policy that led to the imposition of the fine or penalty; the disallowance of the deduction backstops the penalty policy and is not treated as a negative tax expenditure.

II. TAX SUBSIDIES

A. Tax Transfers

The Tax Transfer subcategory comprises the seven provisions in the Code that provide for refundable tax credits. In general, tax credits provide a dollar for dollar reduction in a taxpayer's tax liability, and the benefit of a tax credit typically is limited to tax liability. Thus, if the amount of tax credits available to a taxpayer exceeds the amount of such taxpayer's tax liability, the excess normally is not refunded to the taxpayer (although the excess sometimes may be carried to another year in which the taxpayer has tax liability). In the case of a "refundable tax credit," that is, a tax credit that is refundable to a taxpayer in excess of such taxpayer's tax liability, the payment to the taxpayer of the amount by which the credit exceeds the taxpayer's tax liability is effectively a transfer payment from the government to the taxpayer.

The Tax Transfer provisions are examples of hybrid tax/spending programs; each is essentially a direct spending program that uses Code concepts to determine eligibility for the refund and tax system infrastructure to deliver funds. Five of the Tax Transfer items (the portions of the child tax credit, earned income tax credit, recovery rebate credit, credit for purchase of health insurance by certain displaced persons, and the first-time homebuyer credit that are refundable in excess of tax liability) are based on perceived needs of individuals as measured by income. In most cases, these credits are phased out for higher-income taxpayers. The other two Tax Transfer items (a provision enabling certain corporations to monetize AMT credits and research credits and the refund of the deemed tax payment to the allocatee of qualified forestry conservation bond limitation) are in effect transfer payments to businesses. To the extent a portion of a refundable tax credit offsets tax liability, that portion is not treated as a Tax Transfer but is treated as Social Spending or Business Synthetic Spending.

Tax transfers to individuals

Section 24, the child tax credit, provides a tax credit of \$1,000 for each qualifying child under the age of 17 of a taxpayer. Section 32, the earned income credit, provides a credit to certain low and moderate income workers. Eligibility for the earned income credit is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the credit is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income. Section 6428 provides for the taxable year beginning in 2008 a "recovery rebate" for individuals. The amount of the rebate is a function of several variables (e.g., filing status, number of children, and the amount of quali-

fyng income). Section 35 provides a credit for 65 percent of the health insurance costs of eligible recipients of trade adjustment allowances under the Trade Act of 1974 and eligible Pension Benefit Guaranty Corporation pension recipients. Section 36 provides a credit of up to \$7,500 to first-time homebuyers. The first-time homebuyer credit is recaptured over 15 years and is effectively an interest-free, 15-year loan to the first-time homebuyer. All of the Tax Transfers to individuals are credits that are refundable in excess of the taxpayer's tax liability.

Tax transfers to businesses

Section 168(k)(4) allows corporations to elect to increase the limitation under section 38(c) on the use of research credits or section 53(c) on the use of minimum tax credits in lieu of taking a special depreciation deduction for certain property. The increases in the allowable credits are refundable in excess of tax liability. In effect, this provision permits certain corporations to "monetize" AMT and research tax credits. The result is a transfer payment from the government to eligible corporations. Because all of the revenue loss from the provision is attributable to the monetization of research tax credits, the line item on Table 1 is labeled "Refundable research tax credits," and there is no reference to AMT credits.²⁴ Section 54B(h)(1) allows a qualified issuer that receives an allocation of qualified forestry conservation bond limitation to elect to be treated as if it had made a tax payment in the prior year equal to 50 percent of its allocation of such limitation. Section 54B(h)(2) provides that the Secretary may not use the deemed tax payment as an offset or credit against any tax liability of the qualified issuer and requires the Secretary to refund such deemed payment to the qualified issuer. In effect, the provision allows qualified issuers to elect to receive a transfer payment. Although businesses cannot be qualified issuers (only States, political subdivisions or instrumentalities of States, and section 501(c)(3) organizations are qualified issuers), the transfers likely benefit businesses by facilitating the sale of land from businesses to qualified issuers.

B. Social Spending Examples

1. Deduction for mortgage interest on owner-occupied residences

The line item for "deduction for mortgage interest on owner-occupied residences" comprises the deductions permitted by section 163(h)(2)(D) and (h)(3) for "qualified residence interest" that is paid or accrued on "acquisition indebtedness" and "home equity indebtedness." Acquisition indebtedness is indebtedness (up to a maximum of \$1 million) that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and is secured by such residence; home equity indebtedness includes any other indebtedness (up to a maximum of \$100,000) that is secured by a qualified residence.²⁵

²⁴ In addition, the AMT portion of the provision represents a refund of previously paid taxes, and is distinguishable from the research and development credit acceleration in this respect.

²⁵ Sec. 163(h)(3). Qualified residence interest also includes certain premiums paid for qualified mortgage insurance.

The deduction for mortgage interest on owner-occupied residences is an exception to the Code's general rule of non-deductibility for personal interest, reflected in the section 163(h) denial of a deduction for "personal interest" expense.²⁶ Personal interest is defined in section 163(h)(2) to include any interest that would otherwise be allowable as a deduction, but to exclude (in addition to qualified residence interest) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee), investment interest described in section 163(d), and interest taken into account under section 469 in computing income or loss from a passive activity. Thus, for individuals, sections 163(h)(1) and (h)(2) evidence a general rule under which interest expense is not deductible unless it is associated with the production of business or investment income. (More broadly, sections 163(h), 212 and 262, among others, can be said to evidence a general rule for individuals that expenses associated with the production of income are deductible from gross income, while personal, living, and family expenses generally are not.)²⁷ For that reason, the deduction for mortgage interest is treated as a tax expenditure under the revised tax expenditure definition.²⁸ The deduction was also classified as a tax expenditure under the prior JCT Staff approach, but on the basis that it was an exception to the "normal" income tax principle that individuals may deduct only the interest on indebtedness incurred in connection with a trade or business or an investment.²⁹

As discussed in *A Reconsideration of Tax Expenditure Analysis*, owner-occupied housing preferences such as the mortgage interest deduction could rationally be categorized either as Social Spending or Business Synthetic Spending, depending on whether one views home ownership as primarily a consumption activity or as a substitute for an income-producing investment.³⁰ On balance, we believe that they are better described as Social Spending. Because the Code ignores imputed income from owner-occupied housing, our categorization gives minimal weight to the substitutability of owner-occupied housing for an income-producing investment. Moreover, treating the home mortgage interest tax expenditure as Social Spending acknowledges that preferences for owner-occupied hous-

²⁶ Exclusions are also provided for interest payable under section 6601 with respect to delayed payments of estate tax and interest allowable as a deduction under section 221 with respect to certain educational loans.

²⁷ See section 212 (allowing a deduction for ordinary and necessary expenses of an individual for the production or collection of income) and section 262 (denying deductions for personal, living, and family expenses except where expressly provided by the Code).

²⁸ The \$1 million cap on acquisition indebtedness and the \$100,000 cap on home equity indebtedness are considered reductions in the mortgage interest tax expenditure and are not treated as negative expenditures.

²⁹ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007–2011* (JCS–3–07), September 24, 2007, at 5. Both the Code itself and the "normal" tax principles underlying the prior JCT approach to tax expenditures deviate from a pure Haig-Simons definition of income by excluding imputed income from owner-occupied housing (that is, an amount equal to the rent that the taxpayer would pay for the residence to a third party in an arm's-length transaction). Under the Haig-Simons definition of taxable income, a deduction would also be permitted for interest on indebtedness incurred to acquire or carry the residence, as a cost of producing the imputed income. However, the exclusion of imputed income from owner-occupied housing has long been viewed as an administrative necessity, because it is too difficult to measure. The second-best solution (from the perspective of tax administration) is to both exclude the imputed income and deny any deduction for home mortgage interest. Both the general rules of the Code and the "normal" tax underlying the prior JCT Staff approach reflect this second-best solution.

³⁰ JCT Reconsideration, at 45.

ing reflect a social policy agenda that transcends the tax law.³¹ Finally, while preferences such as the mortgage interest deduction undoubtedly provide a benefit to some types of businesses (home builders and real estate agents, for example), we believe that the benefits to these groups are a secondary result of a policy primarily intended to benefit individual homeowners.

Owner-occupied housing preferences reflect social policies, but also raise very important economic efficiency concerns. We classify these preferences as Tax Subsidies, rather than Tax-Induced Structural Distortions, solely because these items can be identified as exceptions to a clear general rule (the nondeductibility of expenses for personal consumption). This classification is not intended to detract from analysis of these preferences as having material economic efficiency consequences for the capital stock of the United States.

2. Exclusion of employer-provided health care benefits

The exclusion for employer-provided health care is the largest Tax Subsidy³² and represents by far the largest portion of total tax expenditures for health.³³ In part, this is because there is no dollar limit on the amount of employer-provided health coverage that is excludable from gross income. An employee can exclude from income both employer-provided accident or health insurance under section 106(a) and employer-reimbursed medical expenses under section 105(b).³⁴ The exclusion applies both where employers absorb the cost of their employees' medical expenses not covered by insurance (i.e., a self-insured plan) and where employers pay all or a portion of the health insurance premiums for their employees. Active employees participating in a cafeteria plan may also pay their share of premiums on a pre-tax basis through salary reductions, which are treated as employer contributions and are also excluded from gross income under section 106(a).

The Tax Subsidy included in this line item also includes health reimbursement arrangements ("HRAs") and flexible spending arrangements ("FSAs"). HRAs are employer-maintained arrangements that reimburse employees for medical expenses. Coverage under an HRA is excludable under 106(a), and benefits paid pursuant to an HRA are excludable under section 105(b). Flexible spending arrangements ("FSAs") are typically funded on a salary reduc-

³¹ See, e.g., H.R. Rep. 99-426, 99th Cong. 1st Sess. (December 7, 1985), at 297 and S. Rep. 99-313, 99th Cong. 2nd Sess. (May 29, 1986), at 804 ("encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest").

³² The line item for "Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums" in Table 2 includes the exclusion of employer-provided accident or health insurance, the exclusion of employer-reimbursed medical expenses, health reimbursement arrangements and flexible spending arrangements. The JCT Staff method for measuring the tax expenditure for this exclusion differs from that of the Treasury Department, as the JCT Staff method includes the effects of "tax form behavior." In particular, the JCT Staff method assumes that when taxpayers are denied an exclusion for employer-provided health care, they will deduct the expenses under section 213 to the extent that those expenses exceed 7.5 percent of adjusted gross income.

³³ See Joint Committee on Taxation, *Tax Expenditures for Health Care* (JCX-66-08), July 30, 2008, for a comprehensive discussion of these provisions.

³⁴ Section 7702B(a) specifies that long-term care contracts are treated as accident and health insurance contracts and are thus eligible for exclusion under section 106(a). Section 7702B(b) specifies that amounts received under eligible long-term care contracts are treated as amounts received for personal injuries and sickness and thus are eligible for exclusion under section 105(b).

tion basis under a cafeteria plan that satisfies section 125. The compensation that is forgone as well as the reimbursements for medical care paid from FSAs are excluded from gross income.

The exclusion from gross income for employer-provided health care benefits is an exception to the Code's general rule that all compensation for services constitutes gross income.³⁵ The value of health care benefits that an employer provides to its employees constitutes gross income to each employee in this general sense. Fringe benefits are included in an employee's gross income unless specifically excluded under a provision in the Code.³⁶ For this reason, the provisions that exclude employer-provided health care benefits from income are exceptions to the general rule and are Tax Subsidies under our revised classification.³⁷

As discussed in *A Reconsideration of Tax Expenditure Analysis*, fringe benefits could rationally be categorized either as Social Spending or as Business Synthetic Spending. We have included the exclusion for employer-provided health care in the Social Spending category, however, rather than in the Business Synthetic Spending category, because the exclusion is generally viewed as affecting labor supply more than general business decisions.³⁸ The exclusion of employer-provided health care can be traced back to the 1940's, when employers offered fringe benefits in order to attract labor in a period of tight wage controls. Legislative and executive branch histories of the enactment and implementation of these exclusion provisions support the argument that these provisions were adopted primarily to affect the price and supply of labor.³⁹ In addition, the legislative history of more recently enacted health care related tax provisions supports the conclusion that Congressional intent is to assist in the provision of health coverage, rather than to subsidize or induce behavior directly related to the production of business income.⁴⁰

³⁵ Under section 61(a)(1), gross income includes "compensation for services, including fees, commissions, fringe benefits, and similar items."

³⁶ See Treas. Reg. sec. 1.132-6(c) ("the value of any fringe benefit that would not be unreasonable or administratively impracticable to account for is includible in the employee's gross income").

³⁷ This exclusion was also included as a tax expenditure under the prior JCT approach, but on the basis that it was an exception to the "normal" tax principle that all employee compensation is includable in gross income. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011* (JCS-3-07), September 24, 2007, at 3. Under the prior JCT methodology, the normal structure of the individual income tax included the assumption that "[a]ll employee compensation is subject to tax unless the tax code contains a specific exclusion for the income." *Id.* "Under normal income tax law, the value of employer-provided accident and health coverage would be includable in the income of employees, but employers would not be subject to tax on the accident and health insurance benefits (reimbursements) that they might receive." *Id.* at 4, footnote 7.

³⁸ See JCT Reconsideration at 45.

³⁹ Sections 105 and 106 were added with the 1954 revision of the Internal Revenue Code. Prior to the revision, payments made under a contract of insurance were exempt under the employer pension provisions of the Code. The addition of sections 105 and 106 granted "equal tax treatment to sickness and accident benefits financed by employers whether paid under insured and noninsured plans." H.R. 8300, as reported by the House Committee on Ways and Means; H.R. Rep. 1337, 83d Cong. 2d Sess. (March 9, 1954), at 15.

⁴⁰ An example is the enactment of a deduction for self-employed health insurance in the Tax Reform Act of 1986. The Senate Finance Committee reported that "Congress was aware that access to employer health plans is lowest with small employers. . . . The need for adequate health coverage is so important that Congress believed it was essential to encourage a narrowing of the gap in health coverage." H.R. 3838, as reported by the Senate Committee on Finance; S.Rep 99-313, 99th Cong. 2d Sess. (May 29, 1986), at 666.

3. Exclusion of interest on State and local bonds

The exclusion from gross income provided in section 103 for interest on State and local bonds is a major exception to the general rule of section 61 that interest is includible in gross income. This exclusion is not required by the U.S. Constitution;⁴¹ instead, its principal purpose is to serve as a federal subsidy to State and local governments.⁴² By exempting interest on State and local bonds from Federal income tax, and thereby increasing the after-tax yield on such bonds, Congress enables the State and local issuers to pay lower interest rates to holders of the bonds. As a result, State and local governments can finance various projects at a reduced cost.

The exclusion for each type of tax exempt bond or tax credit bond is treated as a Tax Subsidy and is categorized as Social Spending or Business Synthetic Spending based on the purpose for which the exclusion was granted, as evidenced by the types of activities permitted to be financed through the issuance of that type of bond. Where a single type of bond can finance multiple kinds of activities or issuers, the classification is based on the predominate type of activity or issuer that is subsidized. Bonds that primarily finance governmental functions or benefit not-for-profit users are classified as Social Spending. Bonds that support borrowers that are in private, for-profit businesses are classified as Business Synthetic Spending.

The Tax Subsidies for the following types of tax-exempt and tax credit bonds are classified as Social Spending:

- Clean renewable energy bonds (including New CREBs);⁴³
- Qualified energy conservation bonds;⁴⁴
- Qualified private activity bonds for owner-occupied housing;⁴⁵
- Qualified private activity bonds for student loans;
- Qualified zone academy bonds;⁴⁶
- Qualified private activity bonds for private nonprofit and qualified public educational facilities;⁴⁷
- Qualified private activity bonds for private nonprofit hospitals;

⁴¹ In 1988, the U.S. Supreme Court rejected the argument that the doctrine of intergovernmental tax immunity prevents Congress from taxing interest on State and local bonds. See *South Carolina v. Baker*, 485 U.S. 505, 524–525 (1988) (“We see no constitutional reason for treating persons who receive interest on government bonds differently than persons who receive income from other types of contracts with the government, and no tenable rationale for distinguishing the costs imposed on States by a tax on state bond interest from the costs imposed by a tax on the income from any other state contract.”)

⁴² In practice, the exclusion also subsidizes higher-bracket investors. See Joint Committee on Taxation, *Present Law and Issues Relating to Infrastructure Finance* (JCX–83–08), October 24, 2008, at 21–27. To this extent, the Tax Subsidy might be characterized as Business Synthetic Spending. We believe it impractical, however, to divide the Tax Subsidy along these lines.

⁴³ CREBs and New CREBs are treated as social spending because two-thirds of the allocation goes to government bodies and public power.

⁴⁴ In the case of qualified energy conservation bonds, 70 percent of the allocation is used for what would otherwise be governmental bonds.

⁴⁵ Proceeds from the issuance of these bonds are used to finance loans to individual homeowners.

⁴⁶ The proceeds from these bonds go to public schools.

⁴⁷ The relevant provisions provide for the issuance of section 501(c)(3) bonds for education (nonprofit) and section 142 bonds for qualified public educational facilities (part of a public school owned by a private, for-profit corporation). Because the bulk of the cost relates to nonprofits, we categorize the item as Social Spending (although a portion could be categorized as Business Synthetic Spending).

- Private activity bonds for veteran's housing; and⁴⁸
- Public purpose State and local governmental bonds.

The Tax Subsidies for the following types of tax exempt and tax credit bonds are classified as Business Synthetic Spending:

- Qualified private activity bonds for rental housing;
- Small issue qualified private activity bonds;
- Qualified private activity bonds for green buildings and sustainable design projects;
- Qualified private activity bonds for highway projects and rail-truck transfer facilities;⁴⁹
- Qualified private activity bonds for airports, docks and mass-commuting facilities;
- Qualified private activity bonds for energy production facilities; and
- Qualified private activity bonds for sewage, water and hazardous waste facilities.

4. Deduction for nonbusiness State and local government income taxes, sales taxes, and personal property taxes

Section 164 provides a deduction for certain state and local personal property taxes, real property taxes, and sales taxes paid by both business and nonbusiness taxpayers. We treat only the deductions allowed to nonbusiness taxpayers as tax expenditures.⁵⁰

Section 164 can be seen as providing both an explication of and an exception to the general rule of sections 162 and 212, under which expenses are deductible to the extent that they are ordinary and necessary expenses of a business or are directly related to the production of income. With respect to State and local taxes paid in connection with a trade or business or in connection with an income producing activity, section 164 arguably provides duplicative authority for a deduction that is already authorized by section 162 or 212, respectively. The first sentence in the flush language in section 164(a) provides support for this reading by clarifying that taxes not enumerated in section 164 are deductible if they are an expense described in section 162 or 212: “[i]n addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income).” Thus, the plain language of the Code acknowledges that business-related taxes do not necessarily require special enumeration in section 164 to be deductible. Nonbusiness taxes, however, are only deductible to the extent provided in section 164. Because nonbusiness taxes require a special rule authorizing their deductibility, the deductions are Tax Subsidies.⁵¹

⁴⁸ Proceeds from the issuance of these bonds are used to finance loans to individual homeowners.

⁴⁹ While highway projects typically are governmental, the projects financed by these bonds are owned and/or operated by private entities.

⁵⁰ The deduction for real property taxes by nonbusiness taxpayers is carried as a separate line item: “deduction for property taxes on real property.”

⁵¹ The Treasury Department, using a reference law baseline, justifies treating the nondeductibility of nonbusiness State and local taxes other than on owner-occupied homes as a tax expenditure by noting that “taxpayers may deduct State and local income taxes and property taxes even though these taxes primarily pay for services that, if purchased directly by taxpayers,

We classify the deduction for nonbusiness State and local income, sales, and personal property taxes as Social Spending, because it is not directly connected with the production of income. The deduction can also be viewed, however, as a means of sharing revenue with State and local governments, by enabling those governments to impose taxes at higher rates than might otherwise be acceptable if such taxes were not deductible for Federal income tax purposes.⁵² To the extent that State and local tax revenues are used to subsidize business activities (as opposed to providing services to persons other than businesses), we recognize that a deduction that makes such taxes more palatable might be seen as a subsidy for income producing activities. Nevertheless, because there is no direct link between the deduction in section 164 for nonbusiness State and local income, sales, and personal property taxes and State and local spending on businesses, we do not attempt to break out business-subsidy effects or to split the item between the Social Spending and Business Synthetic Spending categories.

5. Section 162(m)

As noted in Section I, we treat section 162(m), which disallows deductions by publicly traded corporations for applicable remuneration paid to covered employees in excess of \$1 million, as a negative tax expenditure. Section 162(m) is an exception to the general rule in section 162(a)(1), which permits a deduction for the ordinary and necessary expenses of a business, including “a reasonable allowance for salaries or other compensation for personal services actually rendered.” Because the special rule in section 162(m) may have the effect of increasing the tax burden on certain publicly traded companies, we treat it as a negative tax expenditure.

The stated purpose of section 162(m) is to effect a reduction in executive compensation, a social policy related to the distribution of income and not to its production; accordingly, we classify section 162(m) as Social Spending.⁵³ Other negative tax expenditures that impose limits on the deductibility of executive compensation, e.g., section 280G, denying a deduction for any “excess parachute payment,” evidence a similar social policy and are thus classified in the same manner.

would not be deductible.” *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009*, at 316. Treasury acknowledges, however, that this analysis is undermined by the somewhat tenuous nature of the link between the amount of State and local taxes paid and State and local services consumed. See *id.*

⁵²A 1964 Senate Finance Committee Report notes that the deduction for State and local taxes is an important means of accommodation to take into account the fact that both State and local governments on one hand and the Federal government on the other hand tap the same important revenue source. See S. Rep. 88-830, 88th Cong., 2d Sess., reprinted in 1964-1 C.B. (pt. 2) 505, 558. The report concludes that a failure to provide deductions for such taxes could mean a combined burden of income taxes which in some cases would be extremely heavy. *Id.*

⁵³See *Reconciliation Recommendations of the Committee on Ways and Means*, Ways and Means Committee Print 103-11 (May 18, 1993) (“Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited to \$1 million per year.”)

C. Business Synthetic Spending Examples

1. Last in First Out ("LIFO") method of inventory accounting

The Code generally does not permit the indexing of income for inflation, or the deferral of income recognition, due to increases in the value of a taxpayer's assets, when property is in fact sold for cash.⁵⁴ The allowance of the last in first out ("LIFO") method of accounting for inventory is an exception to the general Code rules for tax accounting. We treat the allowance of the LIFO method as a Tax Subsidy because it is inconsistent with the Code's general implementation of the realization principle. Within the larger category of Tax Subsidies, we categorize the LIFO method as Business Synthetic Spending, because it benefits a select group of business taxpayers.

Treasury regulations under section 471 require businesses to use inventory accounting if the production, purchase, or sale of merchandise is an income producing factor.⁵⁵ The purpose of inventory accounting is to match the costs of items purchased (or manufactured) at different times with the proceeds of items sold during the year, in order to determine taxable income for the year and determine the cost for tax purposes of the inventory on hand at the end of one year and start of the next. The regulations permit a number of different methods including the first in first out ("FIFO") method that matches sales of items during the year with the cost of the earliest acquired (and typically least expensive) items of inventory. As a factual presumption, it is likely that firms endeavor to sell their earliest produced items of inventory, to minimize "staleness" and similar issues.

Section 472 of the Code authorizes the LIFO method of accounting.⁵⁶ This method has the effect of treating the most recently purchased (or manufactured) goods as having been sold during the year, by matching sales revenue during the year with the cost of the most recently acquired (and typically the most expensive) items of inventory. A taxpayer takes into account the costs of earlier-acquired items only to the extent that it has reduced its inventory at year end below its inventory at the prior year end (resulting in greater gain, if those earlier costs were lower than the more recent costs). Among other requirements, the availability of the LIFO method is conditioned on a taxpayer employing that method for financial accounting purposes as well; Congress believed that the re-

⁵⁴ The indexing of rate brackets does not specifically allow the exclusion or deferral of income and is only an indirect method of addressing inflation. The allowance of a lower rate on certain capital gains has been described as a partial relief from inflation, but it is not targeted to that effect.

⁵⁵ Section 471 authorizes the Secretary of the Treasury to "require the use of inventories when necessary to determine the income of any taxpayer, on such basis as the Secretary may prescribe conforming as nearly as may be to the best accounting practices in the trade or business, and as most clearly reflecting income."

⁵⁶ The predecessor of Section 472, permitting the LIFO method to be used by any taxpayer, in accordance with regulations prescribed by the Secretary, was added to the Code in 1939. Prior to that time, the method was allowed under 1938 law only in limited industries. See S. Rep. No. 648, 76th Cong., 1st Sess., 1939-2 C.B. 524, 528; H.R. Rep. No. 2330, 75th Cong. 3d Sess., 1939-1 C.B. 817, 819. Even after the general provision was enacted, the rules under regulations evolved over time to expand the types of items and the nature of LIFO pools that are permitted. See, e.g., Tovig and Herndon, *Inventories: General Principles; LIFO Method*, BNA Tax Management Portfolios 578-3rd at A-47 et seq. Section 473 provides additional rules for "qualified liquidations" of LIFO inventories, and section 473 provides a simplified dollar-value LIFO method for certain small businesses.

sulting tension between a taxpayer's desire to minimize tax liability and the taxpayer's desire to present its financial results in the most favorable light possible would serve to minimize the attractiveness of the LIFO method for tax purposes.⁵⁷

The LIFO method in effect allows the deferral of income attributable to any increase in the price of goods since the earliest inventory items were acquired. In practice, this deferral often extends for many decades.⁵⁸ Moreover, this deferral is available only to taxpayers that maintain inventories, and that are not required to employ a different accounting method in respect of those inventories. (Dealers in securities, for example, maintain inventories but may not use the LIFO method.) The LIFO method deviates from the Code's norm of requiring an annual accounting for accretions in wealth, as measured by actual realization events. It has been said that the purpose of the LIFO method is to adjust for inflation, but the LIFO method also defers the recognition of income that is attributable to factors other than inflation, such as price increases due to increased demand or advances in product quality. The Code does not provide a similar adjustment for inflation or increased costs against the income of taxpayers that cannot keep inventories of tangible goods using the LIFO method. The LIFO method thus favors a relatively small segment of taxpayers in particular types of industries. Moreover, the use of this method may contribute to inefficient behavior by taxpayers who use LIFO, such as the retention of inventories at higher levels than they otherwise might choose, to avoid invading LIFO "layers" and matching lower, earlier years' incurred costs against current sale proceeds.⁵⁹

2. Tax credits for electricity production from renewable resources

Section 45 provides a tax credit for the production of electricity at qualified facilities from certain renewable resources, including wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, and qualified hydropower production.⁶⁰ Qualified facilities are, generally, facilities placed in service prior to a designated sunset date that generate electricity using qualified renewable resources. The amount of the credit varies depending on the type of renewable re-

⁵⁷ See Secs. 472(c) and 472(g); see S. Rep. No. 648, 76th Cong., 1st Sess., 1939-2 C.B. 524, 528; see also H.R. Rep. 98-432 (Part 2), 98th Cong., 2d Sess. (March 5, 1984) at 1381-1382; S. Rep. 98-169 (Vol. I), 98th Cong., 2d Sess. (April 2, 1984) at 486-487; and H.R. Rep. 98-861, 98th Cong., 2d Sess. (June 23, 1984) at 897-898.

⁵⁸ See, e.g., Leslie J. Schneider, *Federal Income Taxation of Inventories*, at section 10.01[1] (2007): "Theoretically, use of the LIFO method results only in a deferral of taxes. However, as long as inflation continues and a taxpayer's LIFO inventories remain relatively constant or increase in size, the tax deferral is perpetual and tends to become 'permanent.'"

⁵⁹ See Edward D. Kleinbard, George A. Plesko, and Corey M. Goodman, *Is it Time to Liquidate LIFO?* 113 Tax Notes 237 (Oct. 16, 2006); Micah Frankel and Robert Trezevant, *The Year-End LIFO Inventory Purchasing Decision: An Empirical Test*, 69 Accounting Review 382 (1994). In certain extreme situations, such as purported acquisitions that did not amount to real ownership, or acquisitions of items that clearly were not intended for use in the business, courts have disallowed the addition of the items to inventory for LIFO purposes. However, those cases do not address less dramatic actions such as simply avoiding a shift to a more efficient inventory practice that might reduce ending inventory, such as "just in time" inventory management. For some of the cases and for arguments made in favor of the LIFO method, see The LIFO Coalition, *Memorandum to Senators Charles E. Grassley and Max Baucus*, June 26, 2006 (2006 TNT 125-18).

⁶⁰ Section 45 also provides a credit for the production of coke feedstock and certain types of coal.

source: electricity produced at wind, closed-loop biomass, geothermal, and solar facilities receives twice the credit rate relative to electricity produced at facilities using other renewable resources. Depending on the resource and the date a qualified facility was placed in service, the credit is available for five or ten years from the placed-in-service date. To be eligible for the credit, the taxpayer must sell the electricity to an unrelated person. The amount of the credit is phased out as the market price of electricity exceeds certain threshold levels.

We treat the tax credit for production of electricity from renewable resources (and virtually all other tax credits in the Code) as a Tax Subsidy.⁶¹ Section 45 credits arise in connection with the conduct of a taxpayer's trade or business, and are made available to the producer only where the taxpayer sells electricity to an unrelated party. To reflect the fact that the credit is made available to businesses to subsidize an income-producing activity, we place the credit in the Business Synthetic Spending subcategory. Energy Tax Subsidies that are claimed by consumers (e.g., the tax credits for energy efficiency improvements to existing homes and alternative technology vehicles) are treated as Social Spending.

Our categorization of section 45 production tax credits as Business Synthetic Spending, and, more generally, all of our categorizations of energy Tax Subsidies are not intended to suggest any conclusions as to the economic incidence of those Tax Subsidies, or their underlying policy goals. Arguments can be made, for example, that the section 45 credit ought to be treated as Social Spending, insofar as a policy subsidizing electricity production from renewable resources appears to help reduce the country's dependence on fossil fuels and thus might be viewed as desirable for national defense or environmental reasons (policies one might consider "social" as opposed to "business"). On the other hand, the energy credits that are claimed by consumers might be viewed as subsidies to businesses based strictly on their economic incidence; for example, a car maker might be able to charge a higher price for a hybrid vehicle because of the availability of a tax credit to the purchaser. In every case, the subcategories of Tax Subsidies that we employ are intended simply to assist the Congress in comparing like Tax Subsidies to one another.

3. Tax exemption for certain organizations

Since the inception of the Federal income tax, Congress has exempted certain types of organizations from taxation. The benefit of tax exemption is extended under the Code to groups as diverse as charitable organizations, social welfare organizations, mutual or cooperative telephone and electric companies, small non-life insurance companies, cemetery companies, and credit unions. Section 501(a) is the operative provision of the Code providing tax exemption for organizations described in sections 401(a), 501(c), and 501(d).

For governmental organizations and entities organized exclusively for charitable, religious, educational, or like purposes, the

⁶¹The foreign tax credit is the one exception to this rule. We treat the foreign tax credit, which is intended to eliminate double taxation of foreign-source income of U.S. taxpayers, as a provision that effectuates a general rule of the Code.

general rule of tax exemption may be explained based on the nature of the organization's activities. These organizations are not subject to tax under the general tax rules as they are engaged in activities that are not primarily intended to be income-producing. For example, charitable organizations may be viewed as serving the public or providing services that otherwise would be provided by the government and, for this reason, are not appropriate subjects of taxation.⁶² One example is a section 501(c)(3) public service organization the activities of which are directed exclusively at serving the poor, such as a tax-exempt soup kitchen or homeless shelter.⁶³ The general rules relating to these organizations require that their activities primarily accomplish governmental or charitable purposes.⁶⁴ To prevent unfair advantage of a tax-exempt organization over a taxable business, the Code generally taxes the income of otherwise tax-exempt organizations that is derived from a trade or business unrelated to the organization's exempt purpose.⁶⁵ However, there are numerous exceptions that allow for otherwise unrelated business taxable income to escape taxation. These exceptions include certain passive income that arguably may relate to business activities, such as royalties or rents received from licensing trade names or other assets typically used in a trade or business, as well as other passive income such as certain dividends and interest.⁶⁶ Other exceptions include income derived from certain research activities,⁶⁷ and income from certain trade show and fair activities.⁶⁸ Because the general rule of the Code is to tax income derived from a trade or business unrelated to an organization's exempt purpose, these exceptions to the taxation rules for unrelated business taxable income are classified as Business Synthetic Spending.

Other organizations exempt from tax under section 501(a) arguably have a direct business analog or compete with for-profit organizations organized for similar purposes. These include small insurance companies,⁶⁹ mutual or cooperative electric companies,⁷⁰ State credit unions,⁷¹ and Federal credit unions.⁷² The tax exemption for

⁶² See, e.g., H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938) ("The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of general welfare.")

⁶³ Although the legal meaning of the term charity has been broadened over time, even the earliest interpretations of the tax exemption for charitable organizations included organizations that provide for the relief of the poor. See, e.g., Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 Florida L. Rev. 419, 429 N.30 (1998) (noting that the Treasury regulations interpreting the Revenue Acts of 1918, 1921, 1924, 1926, 1928, 1932, 1934, 1936, and 1938 all construed charity in the ordinary and popular sense, providing that "[c]orporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor.").

⁶⁴ Treas. Reg. sec. 1.501(c)(3)-1(b)(1)(iii) (providing that an organization is regarded as operating exclusively for exempt purposes "only if it engages primarily in activities which accomplish" exempt purposes).

⁶⁵ Secs. 511-14.

⁶⁶ Secs. 512(b)(1)-(3).

⁶⁷ Secs. 512(b)(7)-(9).

⁶⁸ Sec. 513(d).

⁶⁹ Sec. 501(c)(15).

⁷⁰ Sec. 501(c)(12).

⁷¹ Sec. 501(c)(14).

⁷² Sec. 501(c)(1).

these organizations represents a departure from the general rule that business income is subject to tax.⁷³

For example, from the perspective of their customers, credit unions are engaged in activities that are functionally indistinguishable from business activities conducted by other participants in the financial services industry (that is, the financial services offered by a credit union are identical to the services that customers ordinarily would purchase from a taxable banking institution). The tax exemption for credit unions is intended to subsidize or induce the organization of credit unions in order to serve the credit and savings needs of their membership, a segment of the population that Congress concluded was underserved by traditional financial services firms.⁷⁴ That observation explains the rationale for the Tax Subsidy, but does not contradict the conclusion that exempting from tax the providers of these services that ordinarily are provided by participants in the private economy does constitute a Tax Subsidy.

Because the tax exemptions for Federal and State credit unions directly induce behavior related to the production of business income, these exemptions are treated as Tax Subsidies in the Business Synthetic Spending category. It could be argued that this Tax Subsidy should be classified as an item of Social Spending (because its ultimate purpose is to encourage that such services be made broadly available), but because the direct beneficiary of the exemption is the financial institution that enjoys the tax exemption, the stronger nexus appears to be with the Business Synthetic Spending category.

4. Foreign investment in U.S. real estate

The Code generally excludes from taxable income any gain or loss on the sale or exchange of property by foreign persons,⁷⁵ unless the gain or loss is effectively connected with the conduct of a trade or business in the United States. The requirement that foreign persons include gains and losses on dispositions of U.S. real property interests ("USRPIs") under section 897 is an exception to this general rule of the Code and is treated as a negative tax expenditure.

Section 897(a) provides that gain or loss from the disposition of a USRPI by a nonresident alien individual or a foreign corporation is taken into account as if such person were engaged in a trade or business within the United States during the year of the disposition and as if such gain or loss were effectively connected with that trade or business.⁷⁶ A USRPI generally includes an interest in real

⁷³ See sec. 61(a)(2) (gross income includes "income derived from business").

⁷⁴ "[C]redit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means." H.R. Rep. No. 105-472, sec. 2(4), at 1-2 (1998).

⁷⁵ See sec. 871(a)(1) (applicable to nonresident alien individuals) and sec. 881(a) (applicable to foreign corporations). Sec. 871(a)(2) imposes tax on capital gains of foreign individuals present in the United States for 183 or more days during a taxable year.

⁷⁶ A foreign person is generally subject to taxation under the same rules applicable to U.S. persons on income that is effectively connected with a trade or business conducted in the United States. See sec. 871(b) (applicable to nonresident alien individuals) and sec. 882(a) (applicable to foreign corporations).

property,⁷⁷ an interest in personal property associated with the use of the real property,⁷⁸ and an interest in a domestic corporation that was a U.S. real property holding corporation ("USRPHC") at any time during the shorter of the taxpayer's holding period or the five-year period preceding the disposition of the interest.⁷⁹

Section 897 increases the tax burden on foreign investors in U.S. real property above that imposed by the general rules of the Code with respect to capital gains of nonresidents and, for that reason, is treated as a negative tax expenditure. For example, a foreign investor generally is not taxable on the sale of stock in a U.S. corporation. However, if the U.S. corporation was a USRPHC at any time during the shorter of the foreign investor's holding period or the five-year period preceding the sale of the stock, income from the sale of stock will be subject to tax as if the income were effectively connected with the conduct of a U.S. trade or business. We have included section 897 in the Business Synthetic Spending category, because it relates directly to the production of business or investment income, in this case by foreign investors in U.S. real property.

⁷⁷Sec. 897(c)(6)(A) provides that an interest in real property includes fee ownership and co-ownership of land or improvements, leaseholds of land or improvements, and options to acquire land or improvements, and options to acquire leaseholds of land or improvements. Treas. Reg. sec. 1.897-1(c)(1) provides that a USRPI is "any interest, other than an interest solely as a creditor."

⁷⁸Sec. 897(c)(6)(B) provides that real property includes "movable walls, furnishings, and other personal property associated with the use of the real property."

⁷⁹Sec. 897(c)(2) provides that a USRPHC is any corporation that holds USRPIs if the fair market value of its USRPIs equals or exceeds 50 percent or more of the aggregate fair market value of its USRPIs, its interests in real property located outside the United States, and its other assets that are used or held for use in a trade or business. Look-through rules apply in determining a corporation's USRPIs.

III. TAX-INDUCED STRUCTURAL DISTORTIONS

Tax-Induced Structural Distortions are inseparable structural elements of the Code that materially affect economic decisions in a manner that imposes substantial economic efficiency costs.⁸⁰ Like Tax-Induced Structural Distortions, Tax Subsidies also can result in economic inefficiencies, but in the case of Tax-Induced Structural Distortions, these inefficiencies cannot be removed simply by reverting to the general rule of present law. Instead, addressing the economic distortions attributable to Tax-Induced Structural Distortions requires a more fundamental reexamination and redesign of present law. We hope that our identification of Tax-Induced Structural Distortions as a distinct category of tax expenditures, and our focus on possible institutional responses that address their efficiency costs, will permit a neutral formulation of both the tax policy issues that they raise and the range of legislative alternatives that might be considered.

We briefly describe below some examples of Tax-Induced Structural Distortions. While these elements can be described as distinct features of the Code, their interaction is complex and the distortive effect of each element is difficult to isolate. For the same reason, addressing the distortion associated with one element requires consideration of its interaction with the others.

The examples that follow all relate to the taxation of capital income (that is, business or investment income). This reflects the fact that a practical implementation of capital income taxation generally is thought to be more difficult than the development of a comprehensive labor income tax. Nonetheless, these examples will be expanded in our subsequent work to include some labor income structural distortions, in particular those relating to the tax treatment of education and similar investments in "human capital."

Entity Classification and the Corporate Income Tax. Taxpayers who wish to conduct business through an entity (rather than as a sole proprietorship) choose either a taxable entity (generally a corporation) or a passthrough entity (such as a partnership). There is no general rule of entity taxation evident from the Code. To the contrary, two very different paradigms are offered, each with a number of variations.⁸¹ As a practical matter, businesses that ex-

⁸⁰ As discussed in Section I, our definition of Tax-Induced Structural Distortions focuses on the substantive criterion of efficiency for several reasons. First, efficiency is an inherently more neutral construct than is equity (and possibly simplicity). Second, many tax expenditures that raise principally equity (or other) issues are classified as Tax Subsidies. And third, as described in this section, most of the important structural ambiguities in the Code today relate to the taxation of capital income (that is, business or investment income), and efficiency goals loom largest in this context.

⁸¹ Passthrough entities include partnerships (including limited liability companies taxable as partnerships), subchapter S corporations, and certain entities that are entitled to deduct dividends paid to shareholders or are otherwise subject to special regimes under which they generally do not pay corporate tax (e.g., regulated investment companies (RICs), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs) and cooperatives). A

Continued

pect to raise equity capital in the public markets must choose the corporate form. The economic consequences of this choice are distorted, however, by the substantial inefficiencies of the corporate tax regime—an inherently distortive element of the Code that also magnifies the distortions of other features, as discussed below.

In form, at least, business income earned through a corporation is taxable at two levels—first at the corporate level, when earned, and subsequently at the shareholder level, when distributed as a dividend. In practice, however, present law does not always result in the actual payment of two levels of tax on corporate earnings; instead, the tax at either or both levels may be eliminated or substantially reduced by other features of the Code. Thus, the shareholder-level tax is eliminated entirely for corporate income distributed as dividends to tax-exempt shareholders (such as charitable organizations), and may be substantially reduced even for amounts distributed to taxable shareholders by the lower rates applicable to dividends paid to individuals and to amounts treated as capital gains (e.g., amounts paid in certain stock redemptions).⁸² (The effects of these lower rates are discussed further below.)

Alternatively, the corporate-level tax may be eliminated entirely, where corporate earnings are paid as deductible interest to investors in corporate debt, or substantially reduced by other features of the Code, such as accelerated depreciation and the deferral of foreign earnings. (These elements are also discussed further below.) In fact, present law can result in no tax at all, at either level, where corporate earnings are paid as deductible interest to tax-exempt investors in corporate debt.

The differences in the treatment of capital income that are directly attendant on the corporate income tax—whether relating to the form of the investment or the characteristics of the investor—significantly distort the allocation of capital. To the extent that the corporate form actually results in two levels of tax, the increase in the cost of capital can lead to lower aggregate capital formation, reducing future output and productivity. At the same time, the desire to avoid double taxation leads businesses to seek opportunities to reduce one or both levels of tax. A business may choose to finance new investment by retaining earnings in the corporation, rather than distributing those earnings to shareholders, in order to take advantage of differences in the relative tax situations of the corporation and its shareholders; this behavior distorts the allocation of capital to the extent that a corporation's investment opportunities are more limited than those of its shareholders.⁸³ Alter-

description of the various types of business entities, some of their principal characteristics, and some considerations that relate to their differences can be found at Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity* (JCX-48-08), June 4, 2008.

⁸²The dividends-received deduction available to corporate shareholders also reduces the effective tax rate on dividend income received by corporations, but its purpose is to avoid greater-than-double taxation of corporate earnings by minimizing the effect of tax imposed at two or more corporate levels.

⁸³A shareholder may prefer earnings retention (subject to the effects of the accumulated earnings tax and personal holding company rules), if the shareholder expects to defer tax on capital gains for a substantial period or to hold his stock until death (so that appreciation can be passed to his heirs free of individual income tax). There may also be an incentive to retain earnings if the corporation's effective tax rate on reinvestment is lower than the shareholder tax rate on distributed earnings. On the other hand, if the shareholder's tax rate is significantly lower than the corporation's effective tax rate—for example, if the shareholder is a tax-exempt entity or is entitled to a corporate dividends-received deduction or to the lower rates on dividends paid to

natively, businesses increasingly choose to organize in noncorporate rather than corporate form, notwithstanding potential restrictions on their access to the capital markets;⁸⁴ or a business in corporate form may choose to raise capital by issuing debt rather than equity, with the distortions discussed further below.

There is no obvious solution to these problems. While the corporate tax could be eliminated entirely, it still would be necessary to choose from among the various passthrough alternatives; moreover, passthrough treatment may be unworkable for some types of businesses, such as publicly traded corporations with complex business operations. Alternatively, these distortions could be mitigated by making adjustments within the corporate tax regime to reduce or eliminate the separate corporate and shareholder levels of tax (referred to as “corporate integration”), but this too involves significant policy decisions.⁸⁵ Elimination of the corporate tax distortion thus requires careful consideration regarding the situations in which at least one level of tax should be collected and the level (corporate or shareholder) at which that tax should apply.

Differential Treatment of Debt and Equity Capital. As indicated above, the fact that interest is generally deductible while dividends are not encourages corporations to finance investments with debt rather than equity capital in order to reduce the corporate-level tax.⁸⁶ This incentive is increased by the availability of tax-exempt and foreign investors; where corporate earnings are paid as deductible interest to tax-exempt or foreign holders of corporate debt, no U.S. tax is paid at either the corporate or the investor level (although the investor may incur some foreign tax on the interest received).

Clearly, there are non-tax reasons to finance investment at least partially with debt, including the potential to generate a higher rate of return on equity capital if the investment succeeds. However, the additional tax incentive to raise capital in the form of debt encourages higher leverage levels than would exist absent the tax inducement. The tax inducement to over-leverage increases both the risk of financial distress and the tolerance of corporate eq-

individuals, or if the distribution can be structured as a stock redemption eligible for capital gains rates and basis recovery—there may be a tax incentive to distribute earnings or a reduced incentive to retain earnings.

⁸⁴ See U.S. Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness Background Paper*, July 23, 2007 (hereinafter “Treasury Conference Background Paper”), Table 3.1, at 13, reporting that net business income earned through flowthrough entities represented 51 percent of all business net income in 2004 and noting that the importance of flow-through businesses to the U.S. economy has been growing steadily over the last several decades.

⁸⁵ For a more extensive discussion of the background, issues and alternatives with respect to corporate integration, see Organization for Economic Co-operation and Development, *Fundamental Reform of Corporate Income Tax* (OECD Tax Policy Studies No. 16, 2007); Edward D. Kleinbard, *Designing an Income Tax on Capital in Taxing Capital Income* 165, 172 (Henry J. Aaron et al., eds. 2007); Joint Committee on Taxation, *Present Law and Background Relating to Selected Business Tax Issues*, JCS-41-06 (September 19, 2006); Michael J. Graetz and Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (Tax Analysts, 1998); and Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures*, JCS-1-89 (January 18, 1989).

⁸⁶ See Treasury Conference Background Paper, Table 4.1, at 24, (estimating that the effective marginal tax rate on new investment financed by debt is - 2.2 percent, while the effective marginal tax rate on new investment financed by equity is 39.7 percent); and Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform* (October 2005), (estimating that the effective tax rate on debt-financed corporate capital income is - 6.4 percent, and the effective tax rate on equity-financed corporate capital income is 36.1 percent).

uity owners for operational risk (by reducing the extent to which their equity capital is at stake).

The distortions introduced by the debt-equity distinction cannot be eliminated simply by reverting to a general rule; at present, there is no general rule in the Code for accounting for the cost of capital. While there is general agreement that a uniform approach to the cost of capital would be desirable, designing such an approach requires numerous decisions, including the amount and timing of any deduction for the cost of capital, the treatment of derivative instruments, and coordinating rules for taxing the return on capital to the investor.

The Realization Principle. The imposition of tax under the Code is predicated in most cases on a realization event, such as the sale or exchange of an asset.⁸⁷ The purpose of the realization requirement is to match the payment of tax with the taxpayer's receipt of funds. The effect, however, is that gains and losses are not taken into account as they economically accrue. Instead, taxpayers can determine when gains or losses are recognized, encouraging "cherry-picking" among assets and the timing of realizations to maximize tax benefits.

More broadly, the ability to defer recognition of gain induces taxpayers to hold assets they otherwise would sell in order to defer (and effectively reduce) the tax associated with a realization event. (Losses, on the other hand, are more valuable when recognized currently.) This "lock-in" effect reduces capital flow to economically superior investments.⁸⁸ As the economist Paul Samuelson observed over twenty years ago:

Taxes which people can and will avoid by changing their behavior give an illusion of being unburdensome, precisely because they can be avoided. The truth is just the opposite: per dollar of revenue collected, such "voluntary taxes" do the maximum harm and are to be avoided; they occasion the greatest distortions and do so without achieving the purpose of releasing to the government real resources.⁸⁹

For financial instruments other than debt, a consequence of the realization principle is to defer taxation of (and thus systematically undertax) time value of money returns until disposition. For debt instruments, this return is appropriately taxed on an accrual basis, e.g., under the original issue discount rules. The disparity, however, between the treatment of debt and non-debt returns distorts the allocation of investment capital by discouraging taxable investors from purchasing debt and encouraging the proliferation of de-

⁸⁷ The most notable exception to this general principle is the mark-to-market rule of section 475, which requires dealers in securities to recognize gain or loss on securities (other than securities held for investment) "as if such security were sold for its fair market value on the business day of [the] taxable year." Section 877A, which requires individuals who are relinquishing U.S. citizenship or residence to mark all of their assets to market upon expatriation, is the most comprehensive mark-to-market requirement of present law.

⁸⁸ See, generally, David B. Bradford, *Fixing Realization Accounting: Symmetry, Consistency, and Correctness in the Taxation of Financial Instruments*, 50 Tax Law Review 731 (1995); Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 American Economic Review 167 (1991).

⁸⁹ Paul A. Samuelson, *Theory of Optimal Taxation*, 30 Journal of Public Economics 137, 141 (1986).

rivative instruments that provide debt-like returns without the higher tax burden.

In theory, an accrual (or mark-to-market) system of taxation—under which taxpayers would value assets periodically and reflect accrued gains and losses in income—would reduce the inefficiencies associated with a realization-based system. In practice, however, a comprehensive mark-to-market regime is widely thought to be unadministrable, due to the difficulties associated with valuing assets for which there is no market trading (generally, nonfinancial assets). The values of financial assets, on the other hand, are more likely to be ascertainable, whether by virtue of market trading or through the use of valuation models. Moreover, imputing a time value return to non-debt financial instruments is both conceptually and practically feasible.⁹⁰ As a consequence, proposals for eliminating the distortions attributable to the realization principle typically focus on financial assets.

Lack of Indexation for Inflation. The general rules of the Code do not account for the effect of inflation on the return on investment.⁹¹ The failure to index asset bases means that gain attributable solely to inflation is taxed when an asset is sold, and real economic gain is effectively overtaxed. Conversely, the failure to index debt (i.e., to reflect the fact that inflation benefits borrowers by permitting repayment with cheaper dollars) results in an overstatement of the cost of capital. The combination of these factors encourages underinvestment in capital assets and overleveraging of investments.

Indexation presents both conceptual and practical issues, however, for which there are no obvious solutions.⁹² For example, the indexation of asset bases would need to be considered in the larger context of the disparity between tax and economic depreciation (discussed further below).⁹³ Indexation of debt is complicated by the difficulty of determining the extent to which nominal interest rates already anticipate or compensate for inflation; yet indexing asset bases without indexing debt could inappropriately benefit taxpayers who borrow to purchase indexed assets.⁹⁴ Indexing also would be administratively complex, particularly in circumstances involving tiered entities or transactions that increase or decrease a taxpayer's basis at different points in time; the inclusion of parallel adjustments for deflation, while theoretically appropriate, could also add significantly to the complexity.

Asymmetrical Treatment of Losses. The treatment of income and loss under the Code is asymmetrical in the sense that income is taxed in full when realized, while losses are frequently limited, de-

⁹⁰ See H.R. 4912, introduced on December 19, 2007 by Rep. Neal; Joint Committee on Taxation *Present Law and Analysis Relating to the Tax Treatment of Derivatives* (JCX-21-08), March 4, 2008 at 32-34.

⁹¹ The indexation of the rate brackets, the personal exemption and the standard deduction does not specifically allow the exclusion or deferral of income and is only an indirect method of addressing inflation. The allowance of a lower rate on capital gains has been described as a partial relief from inflation, but is not targeted to that effect.

⁹² Some of these issues have been raised in connection with certain past proposals to adopt some forms of indexation. See, e.g., New York State Bar Association, Tax Section, Ad Hoc Committee on Indexation of Basis, *Report on Inflation Adjustments to the Basis of Capital Assets* (June 27, 1990) (hereafter New York State Bar Report on Inflation Adjustments).

⁹³ See discussion of accelerated depreciation, *infra*.

⁹⁴ While lenders may be overtaxed absent inflation adjustments, this result may be mitigated by a "clientele effect" in which tax exempt or low taxed persons disproportionately take such positions. See, e.g. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* (November 1984) Vol. II Chapter 9.03, at 194.

ferred or disallowed. Most importantly, a corporation generally pays tax currently on the net income from its operations, but a net operating loss will generate tax benefits only to the extent that it can be carried back or forward into years in which the corporation has taxable income.⁹⁵ Numerous other loss limitations apply on a transactional basis or with respect to certain categories of losses, such as the limitations on use of capital losses under section 1211.⁹⁶

A tax system that is not neutral between gains and losses effectively alters the expected payout of a given investment. The government shares in the gains of the investment (lowering the expected value of the upside), but limits its participation with respect to losses (increasing the expected cost of the downside). This problem in turn is exacerbated by a progressive rate structure, because in that case losses, even when deductible, typically will give rise to tax benefits (through offset or refund) at a lower tax rate than the tax rate imposed on highly successful investments.⁹⁷

On the one hand, it may be unreasonable or undesirable to expect that the government would accept an unlimited risk of loss; the presence of a tax “penalty” for incurring losses can be viewed as a decision by the government not to participate fully in excessively risky behavior. On the other hand, loss limitations that are too severe may discourage risk taking (including entrepreneurial activities), raise the cost of capital for certain investments, and influence decisions regarding the mix of investment choices.⁹⁸

In theory, the distortion caused by the asymmetrical treatment of gains and losses could be mitigated by reducing or eliminating restrictions on the use of losses (and in the latter case, providing refunds where losses exceed gains in a given tax year). For the most part, however, the existing loss limitations serve an anti-avoidance purpose or prevent the losses themselves from becoming a tradable commodity.⁹⁹ More broadly, loss limitations also serve to moderate other non-economically neutral features of the Code, including some of the credits, deductions, and opportunities for deferral (and in particular the incentives for leveraging that move equity investments closer in economic consequence to options) that we have classified as tax expenditures because they are exceptions to the Code’s general rules. Addressing the asymmetrical treatment

⁹⁵ Sec. 172(b) provides for carryback of losses to the two tax years preceding the year of loss, and carryforward of losses for up to 20 years.

⁹⁶ For corporations, section 1211(a) allows capital losses only to the extent of capital gains. Section 1212(a) provides that corporate capital losses can be carried back three years and forward five years. For individuals, section 1211(b) allows capital losses to the extent of capital gains plus \$3,000. Section 1212(b) provides that noncorporate taxpayers can carry capital losses forward indefinitely. Other loss limitations include section 382 (limiting corporate losses where there is an ownership change), section 262 (disallowing most personal losses), section 469 (limiting passive activity losses), section 267 (limiting deductions with respect to transactions between related taxpayers), and section 165(d) (allowing gambling losses only to the extent of gambling gains).

⁹⁷ William M. Gentry and R. Glenn Hubbard, *Tax Policy and Entrepreneurial Entry*, American Economic Association Papers and Proceedings, Vol. 90, No. 2, 283 (May, 2000).

⁹⁸ A seminal paper on this issue is Evsey D. Domar and Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 *Quarterly Journal of Economics* 388 (1944). A recent paper is Rosanne Altshuler, Alan J. Auerbach, Michael Cooper, and Matthew Knittel, *Understanding U.S. Corporate Tax Losses*, NBER Working Paper Series 14405 (2008) at 1-2. See also David A. Weisbach, *The (Non)Taxation of Risk*, 58 *Tax. L. Rev.* 1 (2004) (discussing various risk and payoff scenarios with and without taxation).

⁹⁹ Section 382 limits the ability of new owners to benefit from pre-ownership change losses.

of losses could require coordinating modifications to those provisions.

Preferential Rates for Capital Gains and Certain Dividends. The distortive effects of each of the foregoing elements (the corporate tax, the debt-equity distinction, the realization principle, the failure to index, and the asymmetrical treatment of losses) are complicated by the Code's provision of preferential rates for both capital gains and (since 2001) dividends derived by individuals. We treat these preferential rates as Tax Subsidies, because these incentives could be reversed by conforming the tax rates on capital gains and dividends to the more generally applicable rates. We classify these items as Business Synthetic Spending or Social Spending (in the case of the preferential treatment of capital gains on housing), because they encourage investment in the types of assets that can benefit from the preferential rates.

Nonetheless, these preferential rates can fairly also be analyzed as Tax-Induced Structural Distortions, to the extent that these provisions can be presented as partial correctives to other problems in the taxation of capital income that would be exacerbated in their absence, which problems in turn are not so easily reversed by conforming them to a general rule. That is, these preferences both have substantial efficiency effects and interact directly with other distortive elements of the Code that are themselves Tax-Induced Structural Distortions.

The efficiency costs associated with the taxation, and particularly the non-uniform taxation, of capital income are well documented.¹⁰⁰ The distortions created by non-uniform taxation of capital income persist, even though the overall effective marginal tax rate on capital investment has been found to be relatively low, and capital gains taxes in particular can often be postponed indefinitely by virtue of the realization principle.¹⁰¹ This paradox of a major distortion in the context of a relatively low overall effective marginal tax rate is explained by (in addition to the use of debt financing and the choice of passthrough business entities, as discussed above) investors' ability to defer (and thus reduce) taxes on accrued capital gains and to recognize losses selectively, subject to loss limitations (see discussion of the realization principle above); dampened dividend payouts during periods when dividends are taxed similarly to ordinary income may also contribute to this result. This avoidance behavior, including the "lock-in" effect for asset holders and the artificially low payouts of dividends, is itself an indication of inefficiency as investors make decisions based on post-tax rather than pre-tax rates of return.

On the other hand, the preferential treatment of dividends and capital gains can be seen as mitigating the distortions resulting

¹⁰⁰ Three recent examinations of this subject are Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform* (October, 2005); Jane G. Gravelle, Congressional Research Service, *Capital Income Tax Provisions and Effective Tax Rates* (January, 2005); and papers found in Henry J. Aaron, Leonard E. Burman, and C. Eugene Steuerle, editors, *Taxing Capital Income*, Urban Institute Press (2007).

¹⁰¹ In addition to the marginal effective rate differentials cited in the Treasury Background Paper, the Congressional Budget Office, in *Taxing Capital Income: Effective Rates and Approaches to Reform* (2005), calculated the effective marginal tax rate on capital to be approximately 14 percent. The highest effective marginal rates on capital income apply to income derived from equity-financed corporate investment. The CBO found a wide dispersion for differences in debt versus equity financing in the corporate context, housing versus non-housing investments, and corporate versus noncorporate investments.

from the taxation of corporate earnings at both the corporate and shareholder levels; the matching of the rate for dividends with the rate for capital gains may also mitigate incentives for corporations to structure distributions in one form or the other. The lower rates for capital gains are sometimes defended on the basis that they mitigate the "lock-in" effect of the realization principle and the failure of the Code to index gains for inflation. The policy issues implicated by the treatment of capital gain and dividend income, and the taxation of capital income generally, have been the subject of numerous incremental or comprehensive proposals.¹⁰²

Accelerated Depreciation. The depreciation rules of the Code distort the allocation of capital by departing in several respects from real economic depreciation (meaning an asset's real useful life and rate of depreciation). On the one hand, a variety of special exceptions for particular types of property,¹⁰³ and the failure to reflect accurately many assets' real economic lives,¹⁰⁴ results in both different cost-recovery periods for assets with identical economic lives and different cost-recovery methods for assets that decline in value at the same rate. On the other hand, the Code's depreciation provisions include a number of rules of administrative convenience that group assets into a limited number of categories (for example, three-year property, five-year property, and seven-year property) based on the class lives of those assets and provide uniform cost-recovery rules for the asset categories.¹⁰⁵ These rules result in uniform cost-recovery periods for assets with different economic lives, and uniform cost-recovery methods for assets that decline in value at different rates.

The mismatch between tax depreciation and real economic depreciation contributes to the inefficient allocation of capital. For example, as between two assets with the same economic lives that provide the same pre-tax return on investment, a taxpayer will prefer to invest in the asset for which the Code (or a revenue procedure) provides a shorter cost-recovery period and, consequently, a lower effective tax rate. Similarly, as between two assets with different economic lives that provide the same pre-tax rate of return and for which the Code prescribes the same cost-recovery period, the asset with the longer economic life is tax-advantaged.¹⁰⁶ As a result of

¹⁰² Comprehensive governmental reform proposals, some of which directly or indirectly have drawn from tax expenditure analyses, that have focused on the treatment of capital income include Department of the Treasury, *Blueprints for Basic Tax Reform* (January 17, 1977); Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* (November, 1984); and President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (2005). Recent comprehensive nongovernmental proposals include Edward D. Kleinbard, *Rehabilitating the Business Income Tax* (The Hamilton Project 2007).

¹⁰³ We have identified these exceptions as Tax Subsidies, because they are exceptions from identifiable general rules that apply to otherwise similar properties. Examples include the special recovery periods for energy specific items, the 15-year recovery period for restaurant property, and the seven-year recovery period for motorsports entertainment complexes.

¹⁰⁴ Section 168 provides different cost-recovery periods for property based on the "class life" of such property. Most MACRS recovery periods originally were established through IRS administrative guidance (Rev. Proc. 87-56, 1987-2 C.B. 674). In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property as part of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 6253 (1988).

¹⁰⁵ Section 168(b)(1) provides as a general cost recovery rule the 200 percent declining balance method switching to the straight-line method for the first taxable year for which using the straight-line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance.

¹⁰⁶ For example, section 168 provides that property with a class life of more than four but less than 10 years is classified as "5-year property" and prescribes a five-year recovery period.

these distortions, capital is drawn away from tax-disfavored assets and toward tax-favored investments, even though the tax-favored investments may be less productive.¹⁰⁷

Deferral of Tax on Foreign Earnings. For U.S.-owned multinational businesses, the deferral of tax on the earnings of foreign corporate subsidiaries can substantially reduce the effective rate of corporate-level tax. The United States employs a “worldwide” tax system, under which U.S. resident individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned directly or through a pass-through entity such as a partnership is taxed on a current basis; however, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. The basic deferral rule in turn is circumscribed by the anti-deferral rules of subpart F of the Code, which provide that a domestic parent corporation is subject to U.S. tax on a current basis with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries.¹⁰⁸

As we have previously described,¹⁰⁹ the taxation of domestic corporations on worldwide income, coupled with the deferral treatment of foreign subsidiary earnings, raises several important and related economic efficiency concerns. First, the differing treatment of domestic and foreign corporations creates an incentive for a multinational group to locate its parent company offshore. This distortion of the residency decision further affects countries’ tax bases, necessitating higher or lower taxes than would otherwise occur, with the resulting distortions that such other taxes may create. Second, deferral implies a conditionally different tax rate on foreign active business income than the rate that applies to domestic income, and this difference may affect the type and location of business investment when compared either to a wholly domestic enterprise, or to a wholly foreign one. Taxpayers may choose lower-earning investments which benefit from deferral, at the expense of higher-earning investments on which income recognition cannot be deferred, with collateral effects on the domestic rate of growth of income. Third, and related to the foregoing, U.S. firms may have an incentive under present law not to repatriate certain “active” foreign earnings to the United States.¹¹⁰ In other words, the potentially lower effective tax rate available for investments offshore af-

The effective tax rate on the returns of an asset with a class life of nine years (which is depreciated in five years under the Code) is lower than the rate imposed on returns on assets with a five-year class life.

¹⁰⁷ While it is difficult to generalize about the consequences of the depreciation structural distortion, one consequence might be a systemic overinvestment in equipment. Cf. Jane Gravelle, *Depreciation and the Taxation of Real Estate*, CRS Report for Congress, at 10–11 (May, 1999) (indicating that the depreciation rules result in lower effective tax rates for equipment as compared to structures).

¹⁰⁸ To mitigate double taxation of foreign source income, the United States allows a domestic corporation to claim a credit for foreign income taxes paid by it and by its foreign subsidiaries, subject to certain limitations. In addition, U.S. tax law imposes an exit tax when a U.S. company decides to sidestep U.S. taxation by migrating its tax residence from the United States to a foreign jurisdiction through a “corporate inversion” transaction.

¹⁰⁹ See Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment* (JCX-55-08), June 25, 2008.

¹¹⁰ A taxpayer whose foreign tax credit position leaves it vulnerable to U.S. residual taxation may refrain from repatriating income back to the United States.

fects the location of both “new” investments and reinvestments of amounts previously earned offshore.¹¹¹

There appear to be two possible—but polar opposite—solutions to these distortions. The first possible solution is to move towards a “territorial” system in which active foreign income is fully exempt from U.S. taxation. The second is to move towards a “full inclusion system” in which all foreign source income is currently taxed, without regard to the active or passive character of the income. A territorial approach would exempt from U.S. tax those active foreign earnings that are repatriated as dividends. A full inclusion approach would tax all foreign earnings currently, regardless of whether the earnings are repatriated.

Both of these alternatives would reduce the current disincentive to repatriate low-taxed foreign earnings, but would do so through vastly different mechanisms and would have different ancillary consequences. Under either approach, the repatriation tax is eliminated, and there is no longer any U.S. tax motivation to keep low-taxed foreign income offshore. The effects of the two alternatives on the initial locational decision are not clearly equivalent, however, and the two options differ materially in other respects. Moreover, the two may have different implications for the international competitiveness¹¹² of different U.S. industries.¹¹³

¹¹¹In addition, deferral may create what may be called “second order” distortions of taxpayers’ choices. Rules created to protect the policy of deferral for active income or the determination of taxpayers subject to the worldwide regime may result in economically inefficient business structures or investment decisions as taxpayers try to qualify their income as the result of an active business or qualify their investment as not resident in the United States.

¹¹²The phrase “international competitiveness” has no technical meaning in economics and, consequently, is subject to a wide range of interpretations. See Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991.

¹¹³In addition, there may be different implications for companies in the same industry. For example, some companies export goods and services from the United States without a presence, or substantial presence, overseas, while other companies export from the United States by relying heavily on foreign branches and/or controlled foreign entities. Businesses make this choice based on both institutional and tax factors, and companies within the same industry may choose very different structures for their overseas presence. The choice between full inclusion and a territorial system for the treatment of foreign source income would affect these companies very differently.

IV. MEASUREMENT OF TAX EXPENDITURES

Tax expenditure calculations generally

A tax expenditure is measured by the difference between tax liability under present law and the tax liability that would result from a recomputation of tax without benefit of the tax expenditure provision. Taxpayer behavior is assumed to remain unchanged for tax expenditure calculation purposes.¹¹⁴ This assumption is made to simplify the calculation and conform to the presentation of government outlays. This approach to tax expenditure measurement is in contrast to the approach taken in revenue estimating; all of our *revenue* estimates do reflect anticipated taxpayer behavior.

The tax expenditure calculations in this report are based on the January 2008 Congressional Budget Office revenue baseline and JCT Staff projections of the gross income, deductions, and other activities of individuals and corporations for calendar years 2008–2012, for both positive and negative tax expenditures. These projections are used to compute tax liabilities for the present-law revenue baseline and tax liabilities for the alternative baseline that assumes that the tax expenditure provision does not exist.

Internal Revenue Service (“IRS”) statistics from recent tax returns are used to develop projections of the tax credits, deductions, and exclusions that will be claimed (or that will be denied in the case of negative tax expenditures) under the present-law baseline. These IRS statistics show the actual usage of the various tax expenditure provisions. In the case of some tax expenditures, such as the earned income credit, there is evidence that some taxpayers are not claiming all of the benefits to which they are entitled, while others are filing claims that exceed their entitlements. The tax expenditure calculations in this report are based on projections of actual claims under the various tax provisions, not the potential tax benefits to which taxpayers are entitled.

Some tax expenditure calculations are based partly on statistics for income, deductions, and expenses for prior years. Selective accelerated depreciation is an example. Calculations for a number of tax expenditures are based on the difference between tax depreciation deductions under present law and the deductions that would have been claimed in the current year if various investments in the

¹¹⁴An alternative way to measure tax expenditures is to express their values in terms of “outlay equivalents.” An outlay equivalent is the dollar size of a direct spending program that would provide taxpayers with net benefits that would equal what they now receive from a tax expenditure. For positive tax expenditures, the major difference between outlay equivalents and the tax expenditure calculations presented here is an accounting for whether a tax subsidy converted into an outlay payment would itself be taxable, so that a gross-up might be needed to deliver the equivalent after-tax benefits. Until recently, the Treasury Department presented estimates of outlay equivalents in the President’s budget in addition to presenting estimates in the same manner as the JCT Staff.

current year and all prior years had been depreciated using the Modified Accelerated Cost Recovery System (“MACRS”).¹¹⁵

Each tax expenditure is calculated separately, under the assumption that all other tax expenditures remain in the Code. If two or more tax expenditures were estimated simultaneously, the total change in tax liability could be smaller or larger than the sum of the amounts shown for each item separately, as a result of interactions among the tax expenditure provisions.

Year-to-year differences in the calculations for each tax expenditure reflect changes in tax law, including phase outs of tax expenditure provisions and changes that alter the Code’s general rules, such as the tax rate schedule, the personal exemption amount, and the standard deduction. Some of the calculations for this tax expenditure report may differ from estimates made in previous years because of change from a norm-based approach to a Code-rule-based approach, changes in law and economic conditions, the availability of better data, and improved measurement techniques.

Tax expenditures versus revenue estimates

A tax expenditure calculation is not the same as a revenue estimate for the repeal of the tax expenditure provision, for three reasons. First, unlike revenue estimates, tax expenditure calculations do not incorporate the effects of the behavioral changes that are anticipated to occur in response to the repeal of a tax expenditure provision.¹¹⁶ Second, tax expenditures are concerned with changes in the reported tax liabilities of taxpayers.¹¹⁷ Because tax expenditure analysis focuses on reported tax liabilities as opposed to Federal government tax receipts, there is no concern for the short-term timing of tax payments. Revenue estimates are concerned with changes in Federal tax receipts that are affected by the timing of all tax payments. Third, some of the tax provisions that provide an exclusion from income also apply to the Federal Insurance Contribution Act (“FICA”) tax base, and the repeal of the income tax provision would automatically increase FICA tax revenues as well as income tax revenues; this FICA effect would be reflected in revenue estimates, but is not considered in tax expenditure calculations. There also may be interactions between income tax provisions and other Federal taxes such as excise taxes and the estate and gift tax.

Our tax expenditure calculations assume that, if a tax expenditure provision were repealed, the repeal would take effect for taxable years beginning at the latest in the calendar year that precedes the first fiscal year for which we are making tax expenditure calculations. Thus in the case of this year’s pamphlet, our projection for a given provision for fiscal years 2008 through 2012 compares present law to an alternative under which the respective tax expenditure is eliminated for calendar years 2007 through 2012.

¹¹⁵ These selective depreciation tax expenditures are in Table 3.

¹¹⁶ An exception to this absence of behavior in tax expenditure calculations is that a taxpayer is assumed to make simple additions or deletions in filing tax forms, what we refer to as “tax form behavior.” Thus a taxpayer that is eligible for one of two alternative credits is assumed to file for the second credit if the first credit is eliminated.

¹¹⁷ As noted above, reported tax liabilities may reflect compliance issues, and thus calculations of tax expenditures reflect existing compliance issues.

This approach tends to produce a full year effect in the first year (for this report, fiscal year 2008) for tax expenditures.¹¹⁸

On the other hand, such full year effects in the first fiscal year are not common for revenue estimates. For example, because most individual taxpayers have taxable years that coincide with the calendar year, the actual repeal of a provision affecting income taxes most likely would be effective for taxable years beginning after December 31 of a certain year, say, 2007. However, the Federal government's 2008 fiscal year begins October 1, 2007. Thus, the revenue estimate for repeal of a provision at the end of calendar year 2007 would show a smaller revenue gain in the first year, fiscal 2008, than in subsequent fiscal years.

A revenue estimate might also reflect some delay in the timing of the revenue gains as a result of the taxpayer tendency to postpone or forgo changes in tax withholding and estimated tax payments, and very often repeal or modification of a tax provision includes transition relief that would not be captured in a tax expenditure calculation.

Individual income tax

Under the JCT Staff methodology, the Code's general rules governing the individual income tax include the following major components: one personal exemption for each taxpayer and one for each dependent, the standard deduction, the existing tax rate schedule, the opportunity to elect any filing status that the taxpayer is eligible for, and deductions for investment and certain employee business expenses. Most other tax benefits to individual taxpayers are classified as exceptions to the Code's general rules.

We view the personal exemption and the standard deduction as defining the zero-rate bracket that is a part of the Code's general rules. An itemized deduction that is not necessary for the direct generation of income is classified as a positive tax expenditure, but only to the extent that it, when added to a taxpayer's other itemized deductions, exceeds the standard deduction. In addition, the phase out or disallowance of personal exemptions under both the regular income tax and the alternative minimum tax ("AMT"),¹¹⁹ (and the standard deduction under the AMT), as well as the denial of deduction for investment expenses not in excess of investment income,¹²⁰ are presented as negative tax expenditures.

¹¹⁸ Tax expenditures that expire early in the period covered by our report may have other timing effects that affect whether a full year's effect is shown for any given year.

¹¹⁹ Thus phase out of the personal exemption under the regular income tax, and disallowance of personal exemptions and the standard deduction under the AMT, are deemed negative tax expenditures. While in other contexts it may be reasonable for an analysis to view the exemption under the AMT as equivalent to personal exemptions plus the standard deduction, we do not make that equivalency judgment here because that would be a policy call, rather than the rule-based identification of tax expenditures presented in this pamphlet. Such a reconciliation may be helpful for policy analysis, and when such equivalency is invoked, the effect of disallowance of personal exemptions and the standard deduction under the AMT is attenuated.

¹²⁰ This item has two offsetting components: the denial (whether through an itemization requirement and/or an adjusted gross income floor test) of investment expenses (interest-related and other) not in excess of investment income is a negative tax expenditure, while present law's allowance of some non-interest related investment expenses without an investment income limitation is viewed as a positive tax expenditure. For other miscellaneous expenses that are deductible with itemization, the present law approach is viewed as the Code's general rule in reconciling expenses that do not have a direct link with income with the burden that such expenses may place on taxpayers.

All employee compensation is subject to tax unless the Code contains a specific exclusion for the income. Specific exclusions for employer-provided benefits include the following: coverage under accident and health plans,¹²¹ accident and disability insurance, group term life insurance, educational assistance, tuition reduction benefits, transportation benefits (parking, van pools, bicycles, and transit passes), dependent care assistance, adoption assistance, meals and lodging furnished for the convenience of the employer, employee awards, and other miscellaneous fringe benefits (e.g., employee discounts, services provided to employees at no additional cost to employers, and *de minimis* fringe benefits). Each of these exclusions is classified as a Social Spending tax expenditure in this report.

Under the general rules of the Code, employer contributions to pension plans and income earned on pension assets would be taxable to employees as the contributions are made and as the income is earned, and employees would not receive any deduction or exclusion for their pension contributions. Under present law, employer contributions to qualified pension plans and employee contributions made at the election of the employee through salary reduction are not taxed until distributed to the employee, and income earned on pension assets is not taxed until distributed. The tax expenditure for "net exclusion of pension contributions and earnings" is computed as the income taxes forgone on current tax-excluded pension contributions and earnings less the income taxes paid on current pension distributions (including the 10-percent additional tax paid on early withdrawals from pension plans).

Under present law, social security and tier 1 railroad retirement benefits are partially excluded or fully excluded from gross income.¹²² Under the general rules of the Code, retirees would be entitled to exclusion of only the portion of the retirement benefits that represents a return of the payroll taxes that they paid during their working years. Thus, the exclusion of social security and railroad retirement benefits in excess of payroll tax payments is classified as a Social Spending tax expenditure.

All Medicare benefits are excluded from taxation. The value of Medicare Part A insurance generally is greater than the Health Insurance ("HI") tax contributions that enrollees made during their working years, the value of Medicare Part B insurance generally is greater than the Part B premium that enrollees must pay, and the value of Medicare Part D (prescription drug) insurance generally is greater than the Part D premium that enrollees must pay. The exclusion of the value of Medicare Part A insurance in excess of HI tax contributions is classified as a tax expenditure, as is the exclusion of the value of Medicare Part B insurance in excess of Part B premiums, and the exclusion of the value of Part D insurance in excess of Part D premiums.

¹²¹ Present law contains an exclusion for employer-provided coverage under accident and health plans (sec. 106) and an exclusion for benefits received by employees under employer-provided accident and health plans (sec. 105(b)). These two exclusions are viewed as a single tax expenditure. Under the general rules of the Code, the value of employer-provided accident and health coverage would be includable in the income of employees, but employees would not be subject to tax on the accident and health insurance benefits (reimbursements) that they might receive.

¹²² For taxpayers with modified adjusted gross incomes above certain levels, up to 85 percent of social security and tier 1 railroad retirement benefits are includable in income.

Public assistance benefits are excluded from gross income by statute or by IRS regulations. Table 2 contains Social Spending tax expenditure calculations for workers' compensation benefits, special benefits for disabled coal miners, and cash public assistance benefits (which include Supplemental Security Income benefits and Temporary Assistance for Needy Families benefits).

The individual income tax does not include in gross income the imputed income that individuals receive from the services provided by owner-occupied homes and durable goods.¹²³ Accordingly, we do not classify this exclusion as a tax expenditure.¹²⁴ The measurement of imputed income for tax purposes presents administrative problems and its exclusion from taxable income may be regarded as an administrative necessity.¹²⁵ Under the general rules of the Code, individuals would be allowed to deduct only the interest on indebtedness incurred in connection with a trade or business or an investment. Thus, as explained above in Section II.B.1, the deduction for mortgage interest on a principal or second residence is classified as a tax expenditure.

For reasons of administrative feasibility, the general rules of the Code tax capital gains in full in the year the gains are realized through sale, exchange, gift, or transfer at death. Thus, the deferral of tax until realization is not classified as a tax expenditure, but reduced rates of tax, further deferrals of tax (beyond the year of sale, exchange, gift, or transfer at death), and exclusions of certain capital gains are classified as tax expenditures.¹²⁶ Because of the same concern for ease of administration we also interpret the Code as not providing for any indexing of the basis of capital assets for changes in the general price level (although the indexing of the personal exemption, the standard deduction, and tax rate brackets applicable to individuals are regarded as part of the general rules of the Code, consistent with concerns about ability to pay and progressivity.)¹²⁷ Thus under the general rules of the Code, the income tax is levied on nominal capital gains as opposed to real gains in asset values.

There are many types of State and local government bonds and private purpose bonds that qualify for tax-exempt status for Fed-

¹²³ The National Income and Product Accounts include estimates of this imputed income. The accounts appear in U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, published monthly. However, a taxpayer-by-taxpayer accounting of imputed income would be necessary for a tax expenditure calculation.

¹²⁴ The Treasury Department provides a tax expenditure calculation for the exclusion of net rental income of homeowners that combines the positive tax expenditure for the failure to impute rental income with the negative tax expenditure for the failure to allow a deduction for depreciation and other costs.

¹²⁵ For a discussion of ease of administration, see Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08), May 12, 2008. If the imputed income from owner-occupied homes were included in adjusted gross income, it would be proper to include all mortgage interest deductions and related property tax deductions as part of the normal income tax structure, because interest and property tax deductions would be allowable as a cost of producing imputed income. It also would be appropriate to allow deductions for depreciation and maintenance expenses for owner-occupied homes.

¹²⁶ The issue of deferral, as well as other distortions in the current system of taxing capital gains, is discussed in Section III on Tax-Induced Structural Distortions.

¹²⁷ A discussion of the complexity of indexing can be found in New York State Bar Association, Tax Section, Ad Hoc Committee on Indexation of Basis, *Report on Inflation Adjustments to the Basis of Capital Assets*, June 27, 1990. Also, for neutrality any indexing of business assets should be comprehensive and also apply to liabilities. Thus at a minimum both interest income and interest expense should be indexed, as described in Department of The Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, November 1984, Vol. 1, Chapter 6, Section III.

eral income tax purposes. Tables 2 and 3 contain a separate tax expenditure listing for each type of bond, and we classify these items as Social Spending or Business Synthetic Spending according to whether the provision primarily subsidizes bonds linked to for-profit business activity.¹²⁸

Under our interpretation of the general rules of the Code, compensatory stock options are subject to regular income tax at the time the options are exercised and employers would receive a corresponding tax deduction.¹²⁹ The employee's income would be equal to the difference between the purchase price of the stock and the market price on the day the option is exercised. Present law provides for special tax treatment for incentive stock options and options acquired under employee stock purchase plans. When certain requirements are satisfied, (1) the income that is received at the time the option is exercised is excluded for purposes of the regular income tax but, in the case of an incentive stock option, included for purposes of the AMT, (2) the gain from any subsequent sale of the stock is taxed as a capital gain, and (3) the employer does not receive a tax deduction with respect to the option.

We therefore view the special tax treatment provided to the employee as a tax expenditure, and a calculation of this Social Spending tax expenditure is contained in Table 2. However, it should be noted that the revenue loss from the special tax treatment provided to the employee is accompanied by a significant revenue gain from the denial of the deduction to the employer. The negative tax expenditure created by the denial of the deduction for employers is now incorporated in the calculation of the tax expenditure.

The individual AMT and the passive activity loss rules reduce the magnitude of the positive tax expenditures to which they apply. For example, the AMT reduces the value of the deduction for State and local income taxes (for those taxpayers subject to the AMT) by not allowing the deductions to be claimed in the calculation of AMT liability. Similarly, the passive loss rules defer otherwise allowable deductions and credits from passive activities until a time when the taxpayer has passive income or disposes of the assets associated with the passive activity. In one case the restrictive effects of the AMT are presented separately because there are no underlying positive tax expenditures reflecting these effects: the negative tax expenditures for the AMT's disallowance of personal exemptions and the standard deduction. We do not classify exceptions to the individual AMT and the passive loss rules as tax expenditures because the effects of the exceptions already are incorporated in the calculations of related tax expenditures.

Business income taxation

Regardless of the legal form of organization (sole proprietorship, partnership, or S or C corporation), the same general principles are used in the computation of taxable business income. Thus, most business tax expenditures apply equally to unincorporated and incorporated businesses.

¹²⁸ The classification of bond provisions is explained in Section II.B.3.

¹²⁹ If the option has a readily ascertainable fair market value, the Code's general rules tax the option at the time it is granted and the employer would be entitled to a deduction at that time.

One of the most difficult issues in defining tax expenditures for business income relates to the tax treatment of capital costs. Under present law, capital costs may be recovered under a variety of alternative methods, depending upon the nature of the costs and the status of the taxpayer. For example, investments in equipment and structures may qualify for tax credits, expensing, accelerated depreciation, or straight-line depreciation.

The Code's general rules for capital cost recovery arguably are accelerated in many applications when compared to economic depreciation (particularly if the effects of inflation are ignored.) These outcomes are not identified as Tax Subsidies because such results reflect the Code's general rules, but the tax depreciation rules are separately analyzed as a Tax-Induced Structural Distortion.

A Business Synthetic Spending tax expenditure has been measured for depreciation in those specific cases where the tax treatment of a certain type of asset deviates from the overall treatment of other similar types of assets. For example, the tax treatment of leasehold improvements of commercial buildings is depreciated using a recovery period of 15 years, while the general treatment of improvements to commercial buildings (e.g., owned commercial buildings) is a 39 year recovery period. In this case, the difference between depreciation (in this case straight line) using 15 years and 39 years for the recovery period represents Business Synthetic Spending. Thus, we generally classify as Business Synthetic Spending those cases where cost recovery allowances are more favorable than the allowances provided under MACRS.

As indicated above, we do not view the Code's general rules as requiring indexing of the basis of capital assets. Thus, this tax expenditure analysis does not take into account the effects of inflation on tax depreciation. Again, present law's treatment of inflation is best analyzed as a Tax-Induced Structural Distortion.

We follow several accounting standards noted in, or supporting, the Code's general rules in evaluating the provisions in the Code that govern the recognition of business receipts and expenses. The general rules of the Code are assumed to require the accrual method of accounting, the standard of "economic performance" (used in the Code to test whether liabilities are deductible), and the concept of matching income and expenses. Tax provisions that do not satisfy all three standards are viewed as tax expenditures. For example, the deduction for contributions to taxpayer-controlled mining reclamation reserve accounts is viewed as a tax expenditure because the contributions do not satisfy the economic performance standard. As another example, the deductions for contributions to nuclear decommissioning trust accounts and certain environmental settlement trust accounts are not viewed as tax expenditures because the contributions are irrevocable (i.e., they satisfy the economic performance standard). However, present law provides for a reduced rate of tax on the incomes of these two types of trust accounts, and these tax rate reductions are viewed as tax expenditures. In addition, the *ad hoc* indexing permitted by use of the LIFO and lower of cost or market accounting methods are viewed as exceptions to the general rule that the Code does not permit indexing of business income items.

We accept as general rules of the Code the carryback and carryforward of net operating losses. The JCT Staff also assumes that the limits on the number of years that such losses may be carried back or forward were chosen for reasons of administrative convenience and compliance concerns and may be assumed to represent the Code's general rule. Exceptions to the general limits on carrybacks and carryforwards are viewed as tax expenditures.

Corporate income tax

The income of corporations (other than S corporations) generally is subject to the corporate income tax. In the Code's realization-based system, the corporate tax is viewed as being part of the general rules in order to ensure comprehensive taxation of income and progressivity. The corporate income tax includes its own graduated tax rate schedule. We classify the lower tax rates in the schedule as a tax expenditure because they are intended to provide tax benefits to business with small profits and, unlike the graduated individual income tax rates, are not related directly to concerns about ability of individuals to pay taxes or progressivity.

Exceptions to the corporate AMT are not viewed as tax expenditures because the effects of the AMT exceptions are already incorporated in the calculations of related tax expenditures.¹³⁰

Certain income of passthrough entities is exempt from the corporate income tax. The income of sole proprietorships, S corporations, and partnerships, is taxed only at the individual level. Certain other entities are entitled to deduct dividends paid to shareholders or are otherwise subject to special regimes under which they generally do not pay corporate tax (such as RICs, REITs, REMICS and cooperatives). The special tax rules for these passthrough entities are not classified as tax expenditures because the tax benefits are available to any entity that chooses to organize itself and operate in the required manner, although the general issue of entity choice is discussed in Section III as a Tax-Induced Structural Distortion.

Nonprofit corporations that satisfy the requirements of Code section 501 also generally are exempt from corporate income tax. The tax exemption of certain nonprofit cooperative business organizations, such as trade associations, is not treated as a tax expenditure for the same reason applicable to for-profit pass-through business entities. With respect to other nonprofit organizations, such as charities, tax-exempt status is not classified as a tax expenditure because the nonbusiness activities of such organizations generally must predominate and their unrelated business activities are subject to tax. Imputed income derived from nonbusiness activities conducted by individuals or collectively by certain nonprofit organizations is judged to be outside the Code's general rules. However, the ability of donors to such nonprofit organizations to claim a charitable contribution deduction is a tax expenditure, as is the exclusion of income granted to holders of tax-exempt financing issued by charities. In addition, nonprofit entities are discussed as one of the Business Synthetic Spending areas in Section II.

¹³⁰ See discussion of individual AMT above.

Comparisons with Treasury Department

The JCT Staff and Treasury Department lists of tax expenditures differ in four respects. First, the Treasury Department uses a different classification of those provisions that can be considered a part of what they refer to as “reference income tax law” under both the individual and business income taxes. The JCT Staff methodology using the Code’s general rules often involves a broader definition of what constitutes a tax expenditure. Thus, the JCT Staff list of tax expenditures includes some provisions that are not contained in the Treasury Department list. The cash method of accounting by certain businesses is an example. The Treasury Department considers the cash accounting option for certain businesses to be a part of reference income tax law, but the JCT Staff methodology treats it as a tax expenditure because it is viewed as a departure from the Code’s general rule for matching income and expenses.

Second, the JCT Staff and Treasury Department reports of tax expenditures span slightly different sets of years. The Treasury Department’s report covers a seven-year period—the last fiscal year, the current fiscal year when the President’s budget is submitted, and the next five fiscal years, *i.e.*, fiscal years 2007–2013. The JCT Staff report covers a recent fiscal year and the succeeding four fiscal years, *i.e.*, fiscal years 2008–2012 in the case of this pamphlet.

Third, the JCT Staff list excludes those provisions that are projected to result in revenue changes below a *de minimis* amount, *i.e.*, less than (plus or minus) \$50 million over the five fiscal years 2008 through 2012. The Treasury Department rounds all yearly projections to the nearest \$10 million and excludes those provisions that round to zero in each year, *i.e.*, provisions that result in less than \$5 million in revenue loss in each of the years in the period 2008 through 2012. Finally, the JCT Staff approach, unlike the Treasury Department report, now formally integrates negative tax expenditures into its standard presentation.¹³¹

In some cases, two or more of the tax expenditure items in the Treasury Department list have been combined into a single item in our list, and vice versa. The descriptions of some tax expenditures also may vary from the descriptions used by the Treasury Department.

Quantitatively de minimis tax expenditures

The following tax provisions are viewed as tax expenditures by the JCT Staff but are not listed in Tables 1, 2, or 3 because the projected revenue changes for fiscal years 2008 through 2012 are below a *de minimis* amount, \$50 million:

International affairs

- Miscellaneous exclusions (e.g., bond income of residents of the Ryuku Islands, certain wagering income, certain communication satellite earnings, earnings from railroad rolling stock)

Energy

- Expensing of tertiary injectants

¹³¹The Treasury Department analysis includes some tax expenditures that are negative, but the negativity seems to result from timing effects associated with expired or expiring provisions.

- Credit for production of electricity from qualifying advanced nuclear power facilities
- Credit for producing oil and gas from marginal wells
- Credit for the residential purchase of qualified photovoltaic and solar water heating property
- Credit for the construction of energy-efficient new homes
- Partial expensing of investments in advanced mine safety equipment
- Credit for costs incurred in training qualified mine rescue team employees
- Credit and deduction for small refiners with capital costs associated with EPA sulfur regulation compliance
- Credits for biodiesel and renewable fuels
- Energy research credit
- Seven-year MACRS Alaska natural gas pipeline
- Seven-year MACRS natural gas gathering line

Natural resources and environment

- Timber mineral royalty and timber gain of real estate investment trusts

Agriculture

- Cash accounting for agriculture
- Deferral of tax on gains from the sale of stock in a qualified refiner or processor to an eligible farmer's cooperative

Financial institutions

- Bad debt reserves of financial institutions
- Exclusion of investment income from structured settlement arrangements

Other business and commerce

- Deferral of gain on sales of property to comply with conflict-of-interest requirements
- Exclusion of income from discharge of indebtedness incurred in connection with qualified real property
 - Reduced rates of tax on gains from the sale of self-created musical works
 - Amortization of expenses for the creation or acquisition of musical compositions
 - Alaska Native Corporation trusts

Community and regional development

- Five-year carryback period for certain net operating losses of electric utility companies

Social services

- Exclusion of restitution payments received by victims of the Nazi regime and the victims' heirs and estates

Health

- Archer medical savings accounts

Income security

- Credit for the elderly and disabled
- Credit for new retirement plan expenses of small businesses

Veterans' benefits and services

- Burial expenses for veterans

General purpose fiscal assistance

- American Samoa economic development credit

Tax expenditures for which quantification is not available

The following tax provisions are viewed as tax expenditures by the JCT Staff but are not listed in Tables 1, 2, or 3 because the projected revenue changes are unavailable (a provision that is a negative tax expenditure is indicated by an “*”):

International affairs

- Branch profits tax*
- Deduction for U.S. employment tax paid under section 3121(1) agreements for employees of foreign affiliates
- Doubling of tax rates on citizens and corporations of certain foreign countries*

Energy

- 50-percent expensing of cellulosic biofuel plant property
- Accelerated deductions for nuclear decommissioning costs
- IGCC and advanced coal credit

Natural resources and environment

- Exception to partial interest rule for qualified conservation

Agriculture

- Deduction for distributions of non-member sourced income by farmer's cooperative
- Agricultural security credit
- Exceptions from dealer disposition definition
- Exception from interest calculation on installment sales for small dispositions
- Single purpose agricultural or horticultural structures

Commerce and housing

- Amortization of organizational expenditures
- Deferral of prepaid subscription income
- Deferral of prepaid dues income of certain membership organizations
- Amortization of partnership organization and syndication fees
- Unrecaptured section 1250 gain rate (section 1(h)): applies to depreciation taken on real property
- Nonrecognition of in-kind distributions by regulated investment companies in redemption of their stock
- Special discount rate rule for certain debt instruments where stated principal amount is \$2.8 million or less

- Deduction for investment expenses*¹³²
- Tax treatment of convertible bonds
- Treatment of loans under life insurance and annuity contracts and 401(k) plans
 - Net operating loss—deviations from general rule of two-year carryback/twenty-year carryforward
- Exemption for cemetery companies
- Certain exceptions to the UBTI rules:
 - Passive income gains
 - Income from certain research
 - Trade shows and fairs
 - Bingo games
 - Pole rentals
 - Sponsorship payments
 - Real estate exception to the debt-financed income rules
- Specific identification of sold equities

Community and regional development

- Exemption for electric and telephone cooperatives
- Three-year carryback of small business' and farmers' casualty losses attributable to Presidentially declared disaster

Employment

- Allowance of 80-percent deduction for right to purchase tickets or stadium seating
- Disallowance, limitation, and heightened substantiation for certain business deductions (e.g., entertainment, gift, cell phone expenses)

General purpose fiscal assistance

- Exclusion of Guam, American Samoa, and Northern Mariana Islands income
- Exclusion of U.S. Virgin Islands income
- Exclusion of Puerto Rico income

Cross-reference of prior and current approaches

This section cross-references all the items contained in last year's pamphlet.¹³³ In general, bond items contained in last year's pamphlet have been categorized as Social Spending items in Table 2 if they predominantly benefit a governmental function or not-for-profit users; other bond items have been categorized as Business Synthetic Spending in Table 3. All National Defense items are classified here as Social Spending in Table 2; the two deferral items in International Affairs are no longer considered tax expenditures but are discussed as Tax-Induced Structural Distortions in Section III

¹³²This item has two offsetting components: the denial (whether through an itemization requirement and/or an adjusted gross income floor test) of investment expenses (interest-related and other) not in excess of investment income is a negative tax expenditure, while present law's allowance of some non-interest related investment expenses without an investment income limitation is viewed as a positive tax expenditure. For other miscellaneous expenses that are deductible with itemization, the present law approach is viewed as the Code's general rule in reconciling expenses that do not have a direct link with income with the burden that such expenses may place on taxpayers.

¹³³All items referred to in this section were presented in Joint Committee on Taxation, *Estimates of Federal Tax Expenditure for Fiscal Years 2007-2011*, (JCS-3-07), September 24, 2007.

of this pamphlet, while the foreign earned income exclusion and the allowance for Federal employees abroad are presented also in Table 2, and the inventory property sales provision is a Business Synthetic Spending item in Table 3. The General Science, Space, and Technology items are in Table 3, and the Energy items from last year's pamphlet are shown in Table 2, if they are statutorily targeted at consumers, with other items now located in Table 3.

Previously presented Natural Resources and Environment items are now in Table 3, with one of the bond items now presented in the Community and Regional Development section of Table 3. All Agriculture items are presented as Business Synthetic Spending provisions in Table 3. Housing items from the Commerce and Housing area are classified as Social Spending items in Table 2, while the non-housing Commerce and Housing items are now in Table 3 with some exceptions.¹³⁴ Fringe benefit and compensation items previously presented in the Transportation and Education, Training, Employment, and Social Services categories can be found in those same functional categories in Table 2. Other Transportation and Community and Regional Development items are now in Table 3. The work opportunity credit and the credit for orphan drug research are shown in Table 3; all other Education, Training, Employment, Social Services, and Health tax expenditures from last year's pamphlet are identified in the same functional categories as Social Spending in Table 2. All Medicare, Income Security, Social Security and Railroad Retirement, Veterans' Benefits and Services, and General Purpose Fiscal Assistance items are classified as Social Spending in Table 2. The refundable portions of the child tax credit and the earned income credit are now presented separately in Table 1, while the corresponding nonrefundable components are presented in Table 2, with the items keeping their respective functional categories of Social Services and Income Security.

¹³⁴ Certain depreciation items, previously classified as tax expenditures, are not classified in this new approach as Tax Subsidies; to preserve continuity with prior presentations, they are shown separately in Table 4. Accelerated depreciation also is discussed in Section III as a Tax-Induced Structural Distortions.

V. TAX EXPENDITURE TABLES

Tax expenditures are grouped in Tables 1–3 in the same functional categories as outlays in the Federal budget. Calculations are shown separately for individuals and corporations. Those tax expenditures that do not fit clearly into any single budget category have been placed in the most appropriate category.

Table 1 contains Tax Transfer provisions. These are Tax Subsidies that effectively operate as hybrid tax/spending programs; each is essentially a direct spending program that uses Code concepts to determine eligibility for the refund and tax system infrastructure to deliver funds.

Tables 2 and 3 identify Social Spending and Business Synthetic Spending tax expenditures, respectively.

Table 4 presents major items previously classified as tax expenditures but not classified in this new approach as Tax Subsidies. Some of these items are discussed in Section III on Tax-Induced Structural Distortions.

Table 5 presents projections of tax return information for each of nine income classes on the number of all returns (including filing and nonfiling units), the number of taxable returns, the number of returns with itemized deductions, and the amount of tax liability.

Table 6 provides distributional estimates by income class for some of the tax expenditures that affect individual taxpayers, including for the first time this year the negative tax expenditure for the phase out and disallowance of personal exemptions and standard deductions. Not all tax expenditures that affect individuals are shown in this table because of the difficulty in making reliable estimates of the income distribution of items that do not appear on tax returns under present law.

TAX TRANSFERS

Table 1.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total 2008–12
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	
Natural Resources and Environment											
Refund of deemed tax payment to allocattee of qualified forestry con- servation bond limitation		0.3									0.3
Commerce and Housing											
<i>Housing:</i>											
Refundable first-time homebuyer credit						(1)	(1)	(1)	(1)	(1)	(1)
<i>Other business and housing:</i>											
Refundable research tax credits ² ..	(3)	0.5									0.4
Education, Training, Employment, and Social Services											
<i>Social services:</i>											
Refundable tax credit for children under age 17 ⁴						20.3	18.8	18.0	7.3	3.9	68.3
Health											
Refundable credit for purchase of health insurance by certain displaced workers						(1)	(1)	(1)	(1)	(1)	(1)
Income Security											
Refundable earned income credit ⁴						42.4	44.3	45.3	41.7	41.0	214.7
Refundable recovery rebate						(1)	(1)	(1)	(1)	(1)	(1)

¹ Refundable portion combined with nonrefundable portion for respective items and presented in Table 2.

² Transfer is limited to research credits that would otherwise expire.

³ Positive tax expenditure of less than \$50 million.

⁴ Nonrefundable amounts are included in Table 2.

NOTE.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

SOCIAL SPENDING

Table 2.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total 2008–12
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	
National Defense											
Exclusion of benefits and allowances to armed forces personnel						3.6	3.9	4.1	4.4	4.5	20.5
Exclusion of military disability benefits						0.2	0.2	0.2	0.2	0.2	1.0
Deduction for overnight-travel expenses of national guard and reserve members						(1)	0.1	0.1	0.1	0.1	0.3
Exclusion of combat pay						1.4	1.3	1.1	0.9	0.9	5.6
International Affairs											
Exclusion of certain allowances for Federal employees abroad						0.9	0.9	1.0	1.0	1.1	4.9
Exclusion of foreign earned income ² :											
Housing						0.8	0.9	0.9	1.0	1.1	4.7
Salary						4.1	4.3	4.5	4.7	4.9	22.5
Energy											
Credit for energy efficiency improvements to existing homes						0.8	0.3	1.0	.....	.....	2.1
Credits for alternative technology vehicles	0.1	(1)	(1)	(1)	(1)	0.2	0.2	0.2	(1)	(1)	1.0
Credit for holders of clean renewable energy bonds	(1)	0.1	0.1	0.1	0.1	(1)	(1)	(1)	(1)	(1)	0.5
Exclusion of energy conservation subsidies provided by public utilities						(1)	(1)	(1)	(1)	(1)	0.1
Credit for holder of qualified energy conservation bonds	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.1
Commerce and Housing											
Housing:											
Deduction for mortgage interest on owner-occupied residences						67.0	80.1	89.4	99.8	107.3	443.6

SOCIAL SPENDING—Continued

Table 2.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total 2008–12
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	
Deduction for property taxes on real property						24.6	15.9	13.4	26.6	31.6	112.0
Increased standard deduction for real property taxes						0.9	2.5	0.4			3.7
Exclusion of capital gains on sales of principal residences						16.8	15.8	16.9	19.3	20.9	89.9
Exclusion of interest on State and local government qualified private activity bonds for owner-occupied housing	0.4	0.4	0.4	0.4	0.5	0.9	0.9	1.0	1.1	1.2	7.1
Deduction for premiums for qualified mortgage insurance						(1)	0.1	0.2	0.2		0.5
Exclusion of income attributable to the discharge of principal residence acquisition indebtedness ..						0.2	0.3	0.2	0.2	0.1	1.1
First-time homebuyer credit ³						0.3	13.6	-0.5	-1.9	-1.7	9.9
Transportation											
Exclusion of employer-paid transportation benefits						4.0	4.1	4.3	4.9	5.2	22.4
Community and Regional Development											
Empowerment zone tax incentives	0.4	0.4	0.2	(1)	(1)	0.4	0.4	0.2	0.1	0.1	2.2
Renewal community tax incentives	0.3	0.2	0.1	0.1	0.1	0.4	0.3	0.1	0.1	0.1	1.8
New markets tax credit	0.4	0.4	0.4	0.4	0.4	0.5	0.6	0.6	0.5	0.5	4.8
Expensing of environmental remediation costs ("brownfields")	0.1	0.1	(1)	-0.1	-0.2	0.1	0.1	(1)	-0.1	-0.1	0.2
District of Columbia tax incentives	(1)	0.1	(1)	(1)	(1)	0.1	0.2	0.1	0.1	0.1	0.8
<i>Disaster relief:</i>											
Katrina emergency act	0.1	(1)	(1)	(1)	(1)	0.1	(1)	(1)	(1)	(1)	0.2
Gulf opportunity zone	0.3	(1)	0.1	(1)	(1)	1.3	0.6	0.4	0.3	0.2	3.3

Kansas disaster relief	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.1
Midwest disaster relief	0.3	0.2	0.2	0.3	.....	0.9	0.1	0.1	0.1	0.1	2.2
National disaster relief	0.8	1.1	0.7	0.2	.....	1.2	0.8	0.5	0.1	.....	5.3
Education, Training, Employment, and Social Services											
<i>Education and training:</i>											
Deduction for interest on student loans						0.8	0.9	1.0	0.5	0.4	3.7
Deduction for higher education expenses						1.2	2.5	0.7	.....	.....	4.5
Exclusion of earnings of Coverdell education savings accounts						0.1	0.1	0.1	0.2	0.2	0.6
Exclusion of interest on educational savings bonds						(1)	(1)	(1)	(1)	(1)	(1)
Exclusion of scholarship and fellowship income						1.8	1.9	2.0	2.1	2.2	10.1
Exclusion of income attributable to the discharge of certain student loan debt and NHSC educational loan repayments						0.1	0.1	0.1	0.1	0.1	0.4
Exclusion of employer-provided education assistance benefits						0.8	0.8	0.9	0.9	0.9	4.3
Exclusion of employer-provided tuition reduction benefits						0.2	0.2	0.2	0.2	0.2	1.0
Parental personal exemption for students aged 19 to 23						1.3	0.4	(1)	0.3	0.4	2.4
Exclusion of interest on State and local government qualified private activity bonds for student loans	0.1	0.2	0.2	0.2	0.2	0.4	0.4	0.4	0.5	0.5	3.0
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit and qualified public educational facilities	0.8	0.8	0.9	1.0	1.0	2.0	2.1	2.2	2.5	2.6	16.0
Credit for holders of qualified zone academy bonds	0.1	0.2	0.2	0.2	0.2	.....	.....	.....	.....	.....	1.0
Deduction for charitable contributions to educational institutions	0.4	0.4	0.5	0.5	0.5	6.0	6.3	6.6	7.0	7.7	35.9

SOCIAL SPENDING—Continued

Table 2.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total 2008–12
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	
Above-the-line deduction for teacher classroom expenses						0.2	(1)				0.2
Credits for tuition for post-secondary education ² :											
Hope credit						2.7	1.8	2.0	2.6	2.7	11.8
Lifetime learning credit						1.9	1.2	2.0	2.8	2.9	10.8
Exclusion of tax on earnings of qualified tuition programs ² :											
Prepaid tuition programs						0.1	0.1	0.1	0.2	0.2	0.6
Savings account programs						0.5	0.5	0.8	1.1	1.3	4.1
<i>Employment:</i>											
Exclusion of employee meals and lodging (other than military)						0.9	1.0	1.0	1.0	1.1	5.1
Exclusion of benefits provided under cafeteria plans ⁴						33.6	36.8	40.3	44.8	45.9	201.4
Exclusion of housing allowances for ministers						0.6	0.6	0.7	0.7	0.7	3.3
Exclusion of miscellaneous fringe benefits						6.3	6.4	6.6	7.5	8.0	34.8
Exclusion of employee awards						0.2	0.2	0.2	0.2	0.2	0.9
Exclusion of income earned by voluntary employees' beneficiary associations						2.0	2.1	2.1	2.2	2.3	10.7
Special tax provisions for employee stock ownership plans (ESOPs)	0.9	1.0	1.1	1.2	1.2	0.5	0.5	0.5	0.5	0.5	6.9

Deferral of taxation on spread on acquisition of stock under incentive stock option plans and employee stock purchase plans ² :											
Deferral of taxation on spread on acquisition of stock under incentive stock option plans*	-0.9	-0.9	-0.9	-1.0	-1.0	0.3	0.3	0.3	0.3	0.2	-3.3
Deferral of taxation on spread on employee stock purchase plans*	-0.2	-0.2	-0.2	-0.3	-0.3	0.1	0.1	0.1	0.1	0.1	-0.6
Disallowance of deduction for excess parachute payments (applicable if payments to a disqualified individual are contingent on a change of control of a corporation and are equal to or greater than three times the individual's annualized includible compensation) ^{5*}	-0.2	-0.2	-0.2	-0.2	-0.2						-1.0
One million dollar cap on deductible compensation for covered employees of publicly held corporations ^{5*}	-0.5	-0.5	-0.5	-0.5	-0.5						-2.6
<i>Social services:</i>											
Nonrefundable tax credit for children under age 17 ^{6,7}						27.3	27.1	27.2	14.1	9.4	105.1
Credit for child and dependent care and exclusion of employer-provided child care ⁸						3.1	2.6	2.6	2.5	2.4	13.2
Credit for employer-provided dependent care						(1)	(1)	(1)	(1)	(1)	0.2
Exclusion of certain foster care payments						0.7	0.7	0.8	0.8	0.9	3.9
Adoption credit and employee adoption benefits exclusion						0.4	0.4	0.4	0.1	(1)	1.3
Deduction for charitable contributions, other than for education and health ⁹	2.4	2.5	2.6	2.6	2.7	34.4	35.9	37.7	40.2	43.9	204.9
Credit for disabled access expenditures	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.3

SOCIAL SPENDING—Continued

Table 2.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total 2008–12
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	
Health											
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums ¹⁰						116.8	127.4	136.9	145.0	154.2	680.3
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare						2.1	2.2	2.3	2.5	2.6	11.7
Exclusion of health insurance benefits for military retirees and retiree dependents enrolled in Medicare						1.2	1.3	1.4	1.7	1.9	7.5
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed						4.4	4.8	5.2	5.8	6.3	26.4
Deduction for medical expenses and long-term care expenses						9.2	10.6	12.2	16.4	19.4	67.9
Exclusion of workers' compensation benefits (medical benefits)						8.1	8.8	9.5	10.3	11.2	47.8
Health savings accounts						0.5	0.7	0.9	1.2	1.6	4.9
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit hospital facilities	0.6	0.6	0.7	0.7	0.8	1.5	1.6	1.7	1.9	2.0	12.1
Deduction for charitable contributions to health organizations	0.3	0.3	0.3	0.3	0.3	3.9	4.0	4.3	4.6	5.0	23.2
Credit for purchase of health insurance by certain displaced persons ³						0.1	0.1	0.2	0.2	0.2	0.7

Medicare													
Exclusion of Medicare benefits:													
Hospital insurance (Part A)							21.9	23.7	25.7	30.1	33.1	134.4	
Supplementary medical insurance (Part B)							14.6	16.0	17.7	21.1	23.5	92.9	
Prescription drug insurance (Part D)							4.5	5.3	5.9	6.9	6.8	29.3	
Exclusion of certain subsidies to employers who maintain pre- scription drug plans for Medi- care enrollees							1.1	1.1	1.1	1.1	1.1	5.4	
Income Security													
Exclusion of workers' compensation benefits (disability and survivors payments)							2.7	2.7	2.7	3.0	3.1	14.2	
Exclusion of damages on account of personal physical injuries or physical sickness							1.5	1.5	1.5	1.6	1.6	7.7	
Exclusion of special benefits for dis- abled coal miners							(1)	(1)	(1)	(1)	(1)	0.2	
Exclusion of cash public assistance benefits							3.0	3.0	3.1	3.4	4.4	16.9	
Net exclusion of pension contributions and earnings:													
Plans covering partners and sole proprietors (sometimes referred to as "Keogh plans")							9.7	9.8	13.9	18.1	19.9	71.4	
Defined benefit plans							42.4	42.8	42.7	42.6	42.4	212.9	
Defined contribution plans							51.2	55.2	68.1	77.8	89.1	341.4	
Individual retirement arrangements ² :													
Traditional IRAs							13.8	15.6	17.0	15.5	16.2	78.0	
Roth IRAs							2.5	3.1	3.8	4.9	6.0	20.3	
Credit for certain individuals for elective deferrals and IRA con- tributions							0.8	0.8	0.8	0.8	0.8	4.1	
Exclusion of other employee benefits:													
Premiums on group term life in- surance							2.6	2.7	2.7	2.7	2.7	13.4	
Premiums on accident and dis- ability insurance							2.9	3.0	3.1	3.3	3.5	15.8	

SOCIAL SPENDING—Continued

Table 2.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total 2008–12
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	
Additional standard deduction for the blind and the elderly						2.0	1.9	1.8	2.2	2.6	10.5
Deduction for casualty and theft losses						0.2	0.2	0.2	0.2	0.3	1.2
Nonrefundable earned income credit ⁷ ..						6.2	6.3	6.4	7.9	8.7	35.4
Recovery rebate ³						95.0	20.4				115.4
Phase out of the personal exemption and disallowance of the personal exemption and the standard deduction against the alternative minimum tax*						-11.1	-35.7	-64.5	-54.8	-44.2	-210.2
Exclusion of survivor annuities paid to families of public safety officers killed in the line of duty						(1)	(1)	(1)	(1)	(1)	0.1
Exclusion of disaster mitigation payments	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.2
Social Security and Railroad Retirement											
Exclusion of untaxed social security and railroad retirement benefits						24.2	25.7	27.8	34.1	35.3	147.1
Veterans' Benefits and Services											
Exclusion of veterans' disability compensation						3.6	3.7	3.8	4.1	4.2	19.4
Exclusion of veterans' pensions						0.1	0.1	0.1	0.1	0.1	0.6
Exclusion of veterans' readjustment benefits						0.4	0.5	0.8	1.0	1.2	3.9
Exclusion of interest on State and local government qualified private activity bonds for veterans' housing	(1)	(1)	(1)	(1)	(1)	0.1	0.1	0.1	0.1	0.1	0.4

General Purpose Fiscal Assistance											
Exclusion of interest on public purpose State and local government bonds	7.4	7.7	8.0	8.4	8.8	19.0	19.7	20.4	23.2	24.0	146.6
Deduction of nonbusiness State and local government income taxes, sales taxes, and personal property taxes ...	.....	.....	.....	.....	.....	48.0	37.0	33.8	57.0	66.4	242.1
Interest											
Deferral of interest on savings bonds ...	.....	.....	.....	.....	.....	1.2	1.2	1.2	1.3	1.3	6.2

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

² In prior tables, this provision was presented on a consolidated basis.

³ Includes both refundable and nonrefundable amounts.

⁴ Estimate includes amounts of employer-provided health insurance purchased through cafeteria plans and employer-provided child care purchased through dependent care flexible spending accounts. These amounts are also included in other line items in this table.

⁵ Estimate does not include effects of changes made by the Emergency Economic Stabilization Act of 2008.

⁶ Tax expenditure estimate includes amounts used to offset income taxes and amounts used to offset other taxes.

⁷ Refundable amounts are in Table 1.

⁸ Estimate includes employer-provided child care purchased through dependent care flexible spending accounts.

⁹ In addition to the general charitable deduction, the tax expenditure accounts for the higher percentage limitation for public charities, the fair market value deduction for related-used tangible personal property, the enhanced deduction for inventory, the fair market value deduction for publicly traded stock and exceptions to the partial interest rules.

¹⁰ Estimate includes employer-provided health insurance purchased through cafeteria plans.

NOTE.—Details may not add to totals due to rounding. An “*” indicates a negative tax expenditure for the 2008–12 period.

Source: Joint Committee on Taxation.

BUSINESS SYNTHETIC SPENDING

Table 3.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	2008–12
International Affairs											
Inventory property sales source rule exception	6.8	7.0	7.2	7.4	7.6	.....	.....	.....	.....	.....	36.0
Deduction for foreign taxes instead of a credit	0.2	0.2	0.2	0.2	0.3	(1)	(1)	(1)	(1)	(1)	1.3
Interest expense allocation:											
Unavailability of symmetric world-wide method*	-2.2	-2.5	-2.7	-2.9	-0.5	.....	.....	.....	.....	.....	-10.8
Separate grouping of affiliated financial companies	1.0	1.1	1.2	1.3	1.4	.....	.....	.....	.....	.....	6.0
Apportionment of research and development expenses for determination of foreign tax credits	0.3	0.3	0.3	0.3	0.4	.....	.....	.....	.....	.....	1.6
Special rules for interest-charge domestic international sales corporations	0.4	0.5	0.5	0.1	0.1	.....	.....	.....	.....	.....	1.6
Taxation of real property gains of foreign persons*	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)	-0.3
Tonnage tax	0.1	0.1	0.1	0.1	0.1	.....	.....	.....	.....	.....	0.5
General Science, Space, and Technology											
Credit for increasing research activities	4.9	5.6	3.6	2.8	2.2	0.1	0.1	(1)	(1)	(1)	19.5
Expensing of research and experimental expenditures	3.1	4.8	5.6	6.7	7.8	0.1	0.1	0.1	0.1	0.2	28.3
Energy											
<i>Energy related credits:</i>											
Credit for enhanced oil recovery costs	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.2
Credit for producing fuels from a non-conventional source	0.1	0.1	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.6

Credits for alcohol fuels ³	0.1	0.1	0.1	(1)	.....	.....	.....	.....	.....	.....	0.3
Energy credit (section 48):											
Solar	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Geothermal	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Fuel cells	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Microturbines .....	.....	.....	.....	.....	.....	(1)	(1)	(1)	(1)	(1)	(1)
Credits for electricity production from renewable resources (sec- tion 45):											
Wind	0.6	0.8	0.9	0.9	0.9	(1)	(1)	(1)	(1)	(1)	4.1
Closed-loop biomass	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	(1)
Geothermal	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.2
Qualified hydropower	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.1
Solar (limited to facilities placed in service before 1/1/ 06)	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.1
Small irrigation power	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.1
Municipal solid waste	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.2
Open-loop biomass	0.3	0.4	0.3	0.2	0.2	(1)	(1)	(1)	(1)	(1)	1.5
Credits for investments in clean coal facilities	0.2	0.2	0.2	0.1	0.1	.....	.....	.....	.....	.....	0.8
Coal production credits:											
Refined coal	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.1
Indian coal	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.1
Credit for the production of en- ergy-efficient appliances	0.1	0.1	0.1	(1)	.....	.....	.....	.....	.....	.....	0.3
Credits for alternative technology vehicles:											
Hybrid vehicles	(1)	(1)	(1)	(1)	(1)	0.2	0.2	0.2	0.1	(1)	0.9
Other alternative fuel vehicles	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.1
Credit for clean-fuel vehicle refuel- ing property	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.1
Residential energy efficient prop- erty credit .....	.....	.....	.....	.....	.....	(1)	(1)	.....	.....	.....	0.1
New energy efficient home credit ..	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.1
<i>Energy-related exclusions from income:</i>											
Exclusion of interest on State and local government qualified pri- vate activity bonds for energy production facilities	(1)	(1)	(1)	(1)	(1)	0.1	0.1	0.1	0.1	0.1	0.6

BUSINESS SYNTHETIC SPENDING—Continued

Table 3.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	2008–12
<i>Energy-related deductions:</i>											
Deduction for expenditures on energy-efficient commercial building property	(1)	0.1	0.1	0.1	0.1	(1)	(1)	(1)	(1)	(1)	0.2
Eight-year inclusion from sale of electric transmission assets to independent utilities	0.3	0.2	(1)	-0.1	-0.1	(1)	(1)	(1)	(1)	(1)	0.3
Expensing of exploration and development costs:											
Oil and gas	2.1	3.0	1.7	0.4	0.4	(1)	(1)	(1)	(1)	(1)	7.2
Other fuels	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.3
Excess of percentage over cost depletion:											
Oil and gas	1.3	1.4	1.4	1.4	1.4	(1)	(1)	(1)	(1)	(1)	7.1
Other fuels	0.1	0.1	0.1	0.1	0.1	(1)	(1)	(1)	(1)	(1)	0.8
Amortization of geological and geophysical expenditures associated with oil and gas exploration	0.1	0.2	0.2	0.2	0.2	(1)	0.1	0.1	0.1	0.1	1.3
Amortization of air pollution control facilities	0.1	0.1	0.1	0.2	0.2	(1)	(1)	(1)	(1)	(1)	0.6
Depreciation recovery periods for energy specific items:											
Five-year MACRS for certain energy property (solar, wind, etc.)	0.2	0.1	0.1	0.1	0.1	(1)	(1)	(1)	(1)	(1)	0.5
10-year MACRS for smart electric distribution property	(1)	(1)	(1)	(1)	(1)	0.1	(1)	(1)	(1)	(1)	0.1
15-year MACRS for certain electric transmission property	(1)	0.1	0.1	0.2	0.2	(1)	(1)	(1)	(1)	(1)	0.6

15-year MACRS for natural gas distribution line	0.1	0.1	0.1	0.1	0.1	(1)	(1)	(1)	(1)	(1)	0.6
Election to expense 50 percent of qualified property used to refine liquid fuels	0.4	1.1	0.9	0.8	0.6	(1)	(1)	(1)	(1)	(1)	3.8
Exceptions for publicly traded partnership with qualified income derived from certain energy-related activities						0.4	0.4	0.5	0.6	0.6	2.6
Natural Resources and Environment											
Special depreciation allowance for certain reuse and recycling property	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.1
Expensing of exploration and development costs, nonfuel minerals	0.1	0.1	0.1	0.1	0.1	(1)	(1)	(1)	(1)	(1)	0.5
Excess of percentage over cost depletion, nonfuel minerals	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	1.2
Expensing of timber-growing costs	0.2	0.2	0.2	0.2	0.2	(1)	(1)	(1)	(1)	(1)	1.1
Special rules for mining reclamation reserves	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.2
Special tax rate for nuclear decommissioning reserve funds	0.7	0.8	0.8	0.9	1.0						4.2
Exclusion of contributions in aid of construction for water and sewer utilities	(1)	(1)	(1)	(1)	(1)						0.2
Exclusion of earnings of certain environmental settlement funds	(1)	(1)	(1)	(1)	(1)						0.1
Amortization and expensing of reforestation expenditures	(1)	(1)	(1)	(1)	(1)	0.1	0.1	0.1	0.1	0.1	0.5
Gain or loss in the case of timber, coal, or domestic iron ore						0.4	0.4	0.4	0.4	0.4	2.1
Special tax rate for qualified timber gain	(1)	0.1	(1)	(1)	(1)						0.1
Treatment of income from exploration and mining of natural resources as qualifying income under the publicly-traded partnership rules						(1)	(1)	(1)	(1)	(1)	0.1
Agriculture											
Expensing of soil and water conservation expenditures	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.2

BUSINESS SYNTHETIC SPENDING—Continued

Table 3.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	2008–12
Expensing of the costs of raising dairy and breeding cattle	(1)	(1)	(1)	(1)	(1)	0.1	0.1	0.1	0.1	0.1	0.5
Exclusion of cost-sharing payments	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	1.0
Exclusion of cancellation of indebtedness income of farmers .....	.....	.....	.....	.....	.....	0.1	0.1	0.1	0.1	0.1	0.5
Income averaging for farmers and fishermen .....	.....	.....	.....	.....	.....	(1)	(1)	(1)	(1)	(1)	0.2
Five-year carryback period for net operating losses attributable to farming	(1)	0.1	0.1	0.1	0.1	(1)	0.1	0.1	0.1	0.1	0.7
Expensing by farmers for fertilizer and soil conditioner costs	(1)	(1)	(1)	(1)	(1)	0.2	0.1	0.1	0.1	0.1	0.6
Commerce and Housing											
<i>Financial institutions:</i>											
Exemption of credit union income	1.4	1.5	1.6	1.7	1.8	.....	.....	.....	.....	.....	7.9
<i>Insurance companies:</i>											
Exclusion of investment income on life insurance and annuity contracts	2.6	2.7	2.7	2.8	2.9	26.8	27.5	28.2	28.9	29.7	154.8
Small life insurance company taxable income adjustment	0.1	0.1	0.1	0.1	0.1	.....	.....	.....	.....	.....	0.3
Special treatment of life insurance company reserves	2.0	2.1	2.2	2.3	2.4	.....	.....	.....	.....	.....	11.0
Special deduction for Blue Cross and Blue Shield companies	1.0	1.0	1.1	1.1	1.1	.....	.....	.....	.....	.....	5.3
Tax-exempt status and election to be taxed only on investment income for certain small property and casualty insurance companies	0.1	0.1	0.1	0.1	0.1	.....	.....	.....	.....	.....	0.3

Interest rate and discounting period assumptions for reserves of property and casualty insurance companies	0.6	0.6	0.7	0.7	0.7	.....	.....	.....	.....	.....	.....	3.2
15-percent proration for property and casualty insurance companies	0.3	0.3	0.3	0.4	0.4	.....	.....	.....	.....	.....	.....	1.7
<i>Housing:</i>												
Credit for low-income housing	4.8	5.1	5.5	5.9	6.3	0.6	0.6	0.7	0.7	0.7		30.9
Credit for rehabilitation of historic structures	0.3	0.3	0.3	0.4	0.4	0.1	0.1	0.1	0.2	0.2		2.4
Credit for rehabilitation of structures, other than historic structures	(1)	(1)	(1)	1.0	1.0	0.1	0.1	0.2	0.2	0.2		2.8
Exclusion of interest on State and local government qualified private activity bonds for rental housing	0.2	0.2	0.2	0.3	0.3	0.6	0.6	0.6	0.7	0.7		4.5
<i>Other business and commerce:</i>												
Exclusion of interest on State and local government small-issue qualified private activity bonds ..	0.1	0.1	0.1	0.1	0.2	0.3	0.3	0.3	0.4	0.4		2.4
Carryover basis of capital gains on gifts .....	.....	.....	.....	.....	.....	2.5	1.8	14.3	14.6	3.5		36.7
15-year recovery period for:												
Leasehold improvement property	0.4	1.0	1.0	0.6	0.5	0.5	1.2	1.2	0.7	0.7		7.7
Restaurant property	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1		1.2
Retail improvements	(1)	(1)	(1)	0.1	0.1	(1)	(1)	(1)	0.1	0.1		0.4
Retail motor fuels outlets	0.1	0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.1	0.1		1.5
Seven-year recovery period for motorsports entertainment complexes	(1)	0.1	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)		0.2
Deferral of gain on non-dealer installment sales	1.1	1.2	1.3	1.4	1.5	0.5	0.5	0.6	0.7	0.7		9.5
Deferral of gain on like-kind exchanges	3.0	3.0	3.1	3.2	3.3	1.1	1.1	1.2	1.1	1.1		21.2
Expensing under section 179 of depreciable business property	1.0	1.0	0.5	-0.1	-1.4	4.4	4.1	2.0	-0.5	-5.8		5.2

BUSINESS SYNTHETIC SPENDING—Continued

Table 3.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	2008–12
Amortization of business startup costs	(1)	(1)	(1)	(1)	(1)	0.8	0.9	0.9	1.0	1.0	4.6
Reduced rates on first \$10,000,000 of corporate taxable income	3.3	3.3	3.2	3.2	3.2	(1)	(1)	(1)	(1)	(1)	16.3
Exemptions from imputed interest rules	(1)	(1)	(1)	(1)	(1)	0.5	0.5	0.5	0.5	0.6	2.6
Expensing of magazine circulation expenditures	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.1
Special rules for magazines, paperback book, and record returns	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.2
Completed contract rules	0.5	0.5	0.6	0.6	0.7	(1)	(1)	(1)	(1)	(1)	3.0
Cash accounting, other than agriculture	(1)	(1)	(1)	(1)	(1)	0.9	0.9	1.0	1.0	1.1	5.0
Credit for employer-paid FICA taxes on tips	0.3	0.3	0.3	0.3	0.4	0.2	0.2	0.2	0.2	0.2	2.6
Deduction for certain film and television production costs	0.2	0.2	(2)	(2)	(2)	(1)	(1)	(2)	(2)	(2)	0.1
Deduction for income attributable to domestic production activities	5.5	6.0	7.3	8.6	9.4	1.8	2.0	2.7	3.5	3.9	50.7
Credit for the cost of carrying tax-paid distilled spirits in wholesale inventories	(1)	(1)	(1)	(1)	(1)	.....	.....	.....	.....	.....	0.1
Reduced rates of tax on dividends and long-term capital gains .....	.....	.....	.....	.....	.....	150.2	148.1	161.6	107.5	100.6	668.1
Exclusion of capital gains at death .....	.....	.....	.....	.....	.....	26.5	28.3	30.4	37.6	45.2	168.0
Expensing of costs to remove architectural and transportation barriers to the handicapped and elderly	(1)	(1)	(1)	(1)	(1)	0.1	0.1	0.1	0.1	0.1	0.6

Reduced tax rate on small business stock gains						0.5	0.5	0.5	0.5	0.4	2.4
Distributions in redemption of stock to pay death taxes						0.3	0.3	0.3	(1)	0.5	1.3
Ordinary gain or loss treatment for sale or exchange of Fannie Mae and Freddie Mac preferred stock by certain financial institutions	2.6	0.4	0.2	0.1			0.1	(1)	(1)	(1)	3.4
Inventory methods and valuation:											
Last in first out	3.5	3.7	3.9	4.1	4.3	0.5	0.5	0.5	0.6	0.6	22.2
Lower of cost or market	2.2	0.3	0.4	0.4	0.5	0.6	0.1	0.1	0.1	0.1	4.8
Specific identification for homogeneous products	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.2
Exclusion of gain or loss on sale or exchange of brownfield property											
60-40 rule for gain or loss from section 1256 contracts	(1)	(1)	(1)	(1)	(1)						0.1
Net alternative minimum tax attributable to depreciation adjustment and net operating loss limitation*	0.1	0.1	0.1	0.1	0.1	2.2	2.1	2.4	1.8	1.9	10.8
Exclusion of interest on State and local qualified private activity bonds for green buildings and sustainable design projects	-0.7	-0.7	-0.6	-0.6	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-3.6
Transportation											
Credit for certain expenditures on railroad track maintenance	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.1
Deferral of tax on capital construction funds of shipping companies	0.1	0.1	(1)	(1)	(1)						0.2
Exclusion of interest on State and local government qualified private activity bonds for highway projects and rail-truck transfer facilities	0.1	0.1	0.1	0.1	0.1						0.5
Community and Regional Development											
Accelerated depreciation for business property on Indian reservations	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	0.1
	0.2	0.2	0.1	-0.1	-0.2	0.1	0.1	(1)	-0.1	-0.1	0.2

BUSINESS SYNTHETIC SPENDING—Continued

Table 3.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012

[Billions of dollars]

Function	Corporations					Individuals					Total
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	2008–12
Credit for Indian reservation employment	(1)	(1)	(1)	.....	.....	(1)	(1)	(1)	.....	.....	0.2
Exclusion of interest on State and local government qualified private activity bonds for private airports, docks, and mass-commuting facilities	0.3	0.3	0.3	0.3	0.3	0.7	0.7	0.7	0.8	0.9	5.4
Exclusion of interest on State and local government qualified private activity bonds for sewage, water, and hazardous waste facilities	0.2	0.2	0.2	0.2	0.2	0.4	0.4	0.4	0.5	0.5	3.1
Education, Training, Employment, and Social Services											
<i>Employment:</i>											
Work opportunity tax credit	0.5	0.5	0.6	0.5	0.4	0.1	0.1	0.1	0.1	0.1	3.1
Health											
Credit for orphan drug research	0.3	0.3	0.3	0.4	0.4	(1)	(1)	(1)	(1)	(1)	1.7

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

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

³ In addition, the credit from excise tax for alcohol fuels results in a reduction in excise tax receipts, net of income tax effect, of \$13.6 billion over the fiscal years 2008 through 2012.

NOTE.—Details may not add to totals due to rounding. An “*” indicates a negative tax expenditure for the 2008–12 period.

Source: Joint Committee on Taxation.

MAJOR PROVISIONS NOT CLASSIFIED AS TAX SUBSIDIES

Table 4.—Tax Expenditure Estimates By Budget Function, Fiscal Years 2008–2012¹

[Billions of dollars]

Function	Corporations					Individuals					Total 2008–12
	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	
International Affairs											
Deferral of active income of controlled foreign corporations	9.6	10.5	11.3	12.1	12.9	.....	.....	.....	.....	.....	56.4
Deferral of active financing income of controlled foreign corporations	2.6	2.9	1.0	.....	.....	.....	.....	.....	.....	.....	6.5
Commerce and Housing											
<i>Housing:</i>											
Depreciation of rental housing in excess of alternative depreciation system	0.4	0.5	0.5	0.5	0.5	3.8	4.1	4.8	4.9	4.8	24.9
<i>Other business and commerce:</i>											
Depreciation of buildings other than rental housing in excess of alternative depreciation system	0.9	1.7	1.7	1.1	1.1	0.7	1.4	1.4	0.9	0.9	12.1
Depreciation of equipment in excess of the alternative depreciation system	32.6	20.7	6.3	13.5	18.6	6.9	4.4	1.3	2.9	3.9	111.1

¹These calculations are provided for historical comparison. The deferral calculations use full inclusion of the income of controlled foreign corporations as the standard, and the depreciation calculations use straight-line depreciation as the standard.

NOTE.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

Table 5.—Distribution by Income Class of All Returns, Taxable Returns, Itemized Returns, and Tax Liability at 2007 Rates and 2007 Law and 2007 Income Levels ¹

[Money amounts in millions of dollars, returns in thousands]

Income Class ²	All Returns ³	Taxable Returns	Itemized Returns	Tax Liability
Below \$10,000	28,213	164	427	– \$7,010
\$10,000 to \$20,000	22,240	4,997	1,059	– 16,542
\$20,000 to \$30,000	16,542	7,845	1,815	– 8,413
\$30,000 to \$40,000	14,599	9,180	2,904	6,349
\$40,000 to \$50,000	12,532	9,211	3,599	18,889
\$50,000 to \$75,000	21,923	19,210	9,307	77,056
\$75,000 to \$100,000	13,976	13,498	8,265	87,698
\$100,000 to \$200,000	19,207	19,066	15,529	259,101
\$200,000 and over	5,566	5,554	5,143	625,936
Total	154,798	88,723	48,046	\$1,043,065

¹Tax law as in effect on December 31, 2007 is applied to the 2008 level and sources of income and their distribution among taxpayers.

²The income concept used to place tax returns into classes is adjusted gross income (“AGI”) plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers’ compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

³Includes filing and non-filing units. Filing units include all taxable and nontaxable returns. Non-filing units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

NOTE.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

Table 6.—Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2007 Rates and 2007 Income Levels¹

[Money amounts in millions of dollars, returns in thousands]

Income Class ²	Medical Deduction		Real Estate Tax Deduction	
	Returns	Amount	Returns	Amount
Below \$10,000	853	\$8	3	(3)
\$10,000 to \$20,000	1,329	11,308	211	27
\$20,000 to \$30,000	1,433	11,221	709	129
\$30,000 to \$40,000	1,352	9,316	1,635	357
\$40,000 to \$50,000	1,219	8,551	2,406	636
\$50,000 to \$75,000	2,296	15,760	7,339	2,880
\$75,000 to \$100,000	1,204	10,311	7,160	3,364
\$100,000 to \$200,000	923	10,237	13,998	11,583
\$200,000 and over	93	719	2,843	5,434
Total	10,702	\$77,431	36,304	\$24,411

Footnotes appear at the end of the table.

Table 6.—Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2007 Rates and 2007 Income Levels ¹—Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class ²	State and Local Income, Sales and Personal Property Tax Deduction		Charitable Contributions Deduction	
	Returns	Amount	Returns	Amount
Below \$10,000	13	(³)	11	\$1
\$10,000 to \$20,000	305	\$12	219	22
\$20,000 to \$30,000	992	77	771	113
\$30,000 to \$40,000	2,248	255	1,791	338
\$40,000 to \$50,000	3,149	520	2,541	651
\$50,000 to \$75,000	8,985	2,805	7,538	2,706
\$75,000 to \$100,000	8,321	3,693	7,269	3,254
\$100,000 to \$200,000	15,304	15,307	14,401	11,236
\$200,000 and over	4,037	24,468	4,903	22,580
Total	43,354	\$47,137	39,442	\$40,902

Footnotes appear at the end of the table.

Table 6.—Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2007 Rates and 2007 Income Levels¹—Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class ²	Child Care Credit		Earned Income Credit ⁴	
	Returns	Amount	Returns	Amount
Below \$10,000 .....	.....	.....	5,795	\$6,660
\$10,000 to \$20,000	215	\$57	6,575	17,091
\$20,000 to \$30,000	817	453	4,767	12,631
\$30,000 to \$40,000	812	511	3,937	7,100
\$40,000 to \$50,000	563	308	2,167	2,867
\$50,000 to \$75,000	1,274	686	827	738
\$75,000 to \$100,000	1,007	538	9	13
\$100,000 to \$200,000	1,316	701	(⁵)	1
\$200,000 and over	264	138	.....	.....
Total	6,269	\$3,391	24,076	\$47,102

Footnotes appear at the end of the table.

Table 6.—Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2007 Rates and 2007 Income Levels¹—Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class ²	Untaxed Social Security and Railroad Retirement Benefits		Child Tax Credit ⁴	
	Returns	Amount	Returns	Amount
Below \$10,000	73	\$2	215	\$296
\$10,000 to \$20,000	7,663	2,613	2,894	1,519
\$20,000 to \$30,000	4,506	4,980	4,033	4,517
\$30,000 to \$40,000	3,168	4,333	3,984	5,794
\$40,000 to \$50,000	2,724	3,902	3,373	5,409
\$50,000 to \$75,000	4,829	5,562	6,087	10,202
\$75,000 to \$100,000	2,571	1,008	4,708	8,105
\$100,000 to \$200,000	2,577	757	6,242	9,546
\$200,000 and over	842	300	17	11
Total	28,952	\$23,456	31,553	\$45,402

Footnotes appear at the end of the table.

Table 6.—Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2007 Rates and 2007 Income Levels¹—Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class ²	Education Credits		Student Loan Interest Deduction	
	Returns	Amount	Returns	Amount
Below \$10,000	1	(³)	13	\$1
\$10,000 to \$20,000	492	\$103	212	13
\$20,000 to \$30,000	901	379	433	33
\$30,000 to \$40,000	894	456	700	61
\$40,000 to \$50,000	819	459	745	85
\$50,000 to \$75,000	1,487	914	1,593	213
\$75,000 to \$100,000	1,370	1,040	1,166	127
\$100,000 to \$200,000	1,217	899	1,679	271
\$200,000 and over	(⁵)	(³)	(⁵)	(³)
Total	7,180	\$4,250	6,541	\$804

Footnotes appear at the end of the table.

Table 6.—Distribution by Income Class of Selected Individual Tax Expenditure Items, at 2007 Rates and 2007 Income Levels¹—Continued

[Money amounts in millions of dollars, returns in thousands]

Income Class ²	Mortgage Interest Deduction		Phase Out of the Personal Exemption and AMT Disallowance of the Personal Exemption and the Standard Deduction	
	Returns	Amount	Returns	Amount
Below \$10,000	5	(³)	1	(⁶)
\$10,000 to \$20,000	266	\$73	9	-\$4
\$20,000 to \$30,000	736	321	5	-3
\$30,000 to \$40,000	1,566	842	(⁵)	(⁶)
\$40,000 to \$50,000	2,307	1,513	(⁵)	(⁶)
\$50,000 to \$75,000	6,998	7,062	37	-25
\$75,000 to \$100,000	6,821	8,150	95	-82
\$100,000 to \$200,000	13,510	28,868	984	-1,028
\$200,000 and over	4,059	19,771	4,359	-10,168
Total	36,269	\$66,600	5,491	-\$11,310

¹ Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

² The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

³ Positive tax expenditure of less than \$500,000.

⁴ Includes the refundable portion.

⁵ Less than 500 returns.

⁶ Negative tax expenditure of less than \$500,000.

NOTE.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.