



Federal Accounting Standards Advisory Board

Tax Expenditure Task Force

Recommendations to the FASAB for Developing
Standards to Integrate Tax Expenditure Information into
the Government-wide Financial Report

December 8, 2015

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December 8, 2015

Chairman Allen and Members of the FASAB:

Thank you for the opportunity to share our insights and recommendations with you regarding how the Board can improve federal financial reporting by incorporating tax expenditure information into federal financial reports.

Tax expenditures have historically received little focus in general purpose federal financial reporting, yet have similarities to federal spending in their impact on service efforts, costs, fiscal sustainability, and the financial condition of the United States government.

There are a number of unique inherent challenges associated with reporting quantitative tax expenditure information in the government-wide financial report, including identifying and measuring tax expenditures in the tax code; fundamental differences among experts regarding the measurement of tax expenditures; interactions among tax provisions; calculating and summing the overall magnitude and financial impact; auditing tax expenditure estimates; data availability, timeliness, and quality; underlying behavioral and economic assumptions; significant judgments; and the inability to validate and revise estimation methodologies for many tax expenditures based on actual transactions.

The Task Force discussed these challenges in its deliberations. We weighed the challenges and costs of implementing various options against the potential benefits and improvements that could be realized if such options were implemented. Our primary areas of focus and discussion were: 1) discussing user information needs, 2) understanding the quality and nature of tax expenditure financial information, and 3) determining the appropriate nexus of tax expenditure information to the financial statements.

To best meet users' information needs and ensure that government-wide financial reporting includes important information on tax expenditures to assist readers in evaluating their existence, purpose, costs, and impact on the financial condition and service efforts of the United States government; we are issuing three consensus recommendations to the Board, along with a fourth recommendation regarding three options for consideration by the Board. Each recommendation includes a related appendix illustration. Our three options pertain to the presentation of tax expenditure estimates within the government-wide financial report; this area required extensive Task Force deliberation, and may generate extensive Board deliberations and commentary from respondents. Accordingly, to better inform the Board's deliberation process as it relates to the fourth recommendation, we have also included the following information in this report for consideration: 1) our rationale for each option, 2) the pros and cons of each option pertaining to the presentation of estimates, and 3) Task Force member endorsements of each option.

In developing consensus on the content and recommendations in this report, Task Force members offered a range of perspectives and areas of expertise. While there were areas of compromise and disagreement among Task Force members, we are pleased that there was Task Force consensus on three of the four recommendations. With respect to the fourth

recommendation, the Task Force believes that sharing our rationale and considerations for each of the three options will ultimately provide a more comprehensive and useful set of information for the Board to consider, thereby streamlining the deliberations process and enabling the Board to comprehensively consider the costs and benefits of the alternatives available, as it moves forward with the standards-setting process.

The Task Force members believe that its recommendations offer an effective and reasonable approach to greatly improving the quality and content of the government-wide financial report and, ultimately, improving public understanding of the existence of tax expenditures; and their purpose, costs, and impact on the fiscal sustainability, financial condition, and service efforts of the United States government.

Disclaimer:

Appendix V identifies the task force members and their organizations. Views expressed in this report represent the Task Force members' views and not necessarily those of their organization.

Executive Summary

The objective of the Tax Expenditures Task Force was to assess how best to integrate tax expenditure information into federal financial reports. To help achieve this objective, meet users' information needs, and ensure that government-wide financial reporting includes information on tax expenditures to assist readers in evaluating their existence, purpose, costs, and impact on the financial condition and service efforts of the United States government; we are issuing four recommendations to the Board, including three consensus recommendations and a fourth recommendation for which options are provided to the Board. The fourth recommendation pertains to the presentation of tax expenditure estimates within the government-wide financial report. Each recommendation includes a related appendix illustration.

Recommendation 1—Introduction Section for the Proposal (Consensus): To accompany the future Board proposal with an Introduction Section which will aid respondents' understanding of tax expenditures, their definition, why they are important, how estimates are prepared by Treasury, and considerations for understanding how estimates can and cannot be used and interpreted. The Task Force has drafted an illustration of this recommendation, which we endorse for the Board's use.

Recommendation 2—Financial Report Narrative (Consensus): To require the integration of certain narrative disclosures regarding tax expenditures within Notes 1 (summary of significant accounting policies) and 18 (collections and refunds of Federal revenue) to the Financial Statements, and the Management's Discussion and Analysis (MD&A) section of the government-wide financial report, including 1) the definition of tax expenditures, 2) their purpose, 3) their impact on and treatment within the Federal Budget process, and 4) their impact on the government's financial position and fiscal sustainability.

Recommendation 3—Hyperlinks to Existing Publications (Consensus): To require the use of hyperlinks within the MD&A section and Notes to the Financial Statements, informing users of other online sources of information where readers of the government-wide report may go to examine more detailed information regarding the magnitude of tax expenditures, including estimates published annually by Treasury's Office of Tax Policy.

Recommendation 4—Estimates: Options for Board Consideration

(Option 4A): To encourage the inclusion within the *Other Information* section of the government-wide financial report of tax expenditure estimates published annually by Treasury's Office of Tax Policy on Treasury's website.

(Option 4B): To require the inclusion within the *Required Supplementary Information* section of the government-wide financial report of tax expenditure estimates published annually by Treasury's Office of Tax Policy on Treasury's website.

(Option 4C): To neither encourage the inclusion of tax expenditure estimates in the *Other Information* section nor require the inclusion of tax expenditure estimates in the *Required Supplementary Information* section, and focus exclusively on narrative content and links to other resources for comprehensive reporting of estimates.

Background

The Board rated tax expenditures a priority in 2013 and approved the Tax Expenditure Project beginning in the spring of 2015. Through this project the Board will assess what information readers of federal financial reports need regarding tax expenditures to aid in understanding the financial operations of government. To inform the Board's decision-making process, a Tax Expenditures Task Force comprising individuals with extensive knowledge and experience with regard to tax expenditures and tax policy, as well as individuals with extensive financial reporting and auditing experience was formed. Because most stakeholders will not be as knowledgeable of tax expenditures, the Task Force was asked to develop a paper explaining tax expenditures. See [Appendix I: Illustration of Recommendation 1](#) to review this paper, which also serves to provide additional context and background surrounding this project and the subject matter.

Recommendations

Recommendation 1 (Consensus): To accompany the future Board proposal with an Introduction Section which will aid respondents' understanding of tax expenditures, their definition, why they are important, how estimates are prepared by Treasury, and considerations for understanding how estimates can and cannot be used and interpreted. This common understanding should enhance the quality of responses to any future Board proposal. In developing the Introduction Section, the Task Force attempted to present needed information in a comprehensive, balanced, neutral, and plain-language manner.

The Task Force unanimously supports this recommendation and the drafted illustration (see [Appendix I: Illustration of Recommendation 1](#)).

Recommendation 2 (Consensus): To require the integration of certain narrative disclosures regarding tax expenditures within Notes 1 (summary of significant accounting policies) and 18 (collections and refunds of Federal revenue) to the Financial Statements, and the MD&A section of the government-wide financial report, including 1) the definition of tax expenditures, 2) their purpose, 3) their impact on and treatment within the Federal Budget process, and 4) their impact on the government's financial position and fiscal sustainability.

The Task Force unanimously supports this recommendation, which is illustrated at [Appendix II: Illustration of Recommendations 2 and 3](#). This illustration is provided in tracked changes and based on the MD&A section and Notes 1 and 18 included in the Fiscal Year 2014 Financial Report of the U.S. Government. Such illustrations will enable the Board to visualize the value and impact of this information.

The Task Force believes that these narrative disclosures will greatly improve users' awareness and understanding of tax expenditures. The Task Force is mindful of the need to avoid extensive and voluminous disclosures. The Task Force believes that disclosures of the definition, purpose, and impact of tax expenditures can be integrated into the financial statement notes and MD&A in a succinct manner. Moreover, such disclosures can be integrated into existing sections of the government-wide financial report at a minimal cost and without significant audit implications.

Recommendation 3 (Consensus): To require the use of hyperlinks within the MD&A section and Notes to the Financial Statements, and/or other sections of the government-wide report, thereby informing readers about other online sources of information where readers of the government-wide report may access more detailed information regarding the magnitude of tax expenditures, including estimates published annually by Treasury's Office of Tax Policy.

The Task Force unanimously supports this recommendation, which is illustrated at [Appendix II: Illustration of Recommendations 2 and 3](#). This illustration is provided in tracked changes and based on the MD&A and Notes 1 and 18 included in the Fiscal Year 2014 Financial Report of

the U.S. Government. Such illustrations will enable the Board to visualize the value and impact of requiring the inclusion of these external references.

While Notes to the Financial Statements do not currently include footnotes, we have included a footnoted hyperlink to the Office of Tax Policy's annual estimates within Appendix II for illustrative purposes. Treasury may wish to use embedded hyperlinks within the text of the Notes and other sections or other methods which would serve an identical purpose. Otherwise, providing external resources and hyperlinks within the MD&A section may sufficiently enable users to locate more detailed information about tax expenditures.

The inclusion of external hyperlinks and resources within the government-wide financial report will enhance users' awareness of tax expenditures and enable those who wish to examine more detailed information to easily access and review such information. Including hyperlinks can be done at a minimal cost and without significant audit implications.

Recommendation 4 (Options Regarding the Presentation of Estimates): The Task Force developed the following options pertaining to the inclusion within the government-wide financial report of tax expenditure estimates published annually by Treasury's Office of Tax Policy on Treasury's website. These options address the placement of information desired by most Task Force members (accompanied by explanatory text).

Option 4A: To encourage the inclusion of tax expenditure estimates within the *Other Information (OI)* section of the government-wide financial report.

Option 4B: To require the inclusion of tax expenditure estimates within the *Required Supplementary Information* section of the government-wide financial report.

Option 4C: To neither encourage the inclusion of tax expenditure estimates in the *OI* section nor require the inclusion of tax expenditure estimates in the *Required Supplementary Information* section, and focus exclusively on narrative content and links to other resources for comprehensive reporting of estimates.

Task Force Member Preferences/Endorsements of Options

Section updated on 12/15/2015: [Click here](#) to see Errata Sheet on p. 40 of this file.

Option A: Messrs. Bell, Bixby, and Edwards; Ms. Kearney; Messrs. Morgan and Murrin; and Mses. Taber and Valentine

Option B: Mr. McTigue, and Mses. Sergent and Thornton

Option C: Messrs. Dietz and McClelland

Abstain: Mr. Weiner

Additional Discussion and Rationale, Including the Pros and Cons of Options A, B, and C

A majority of the Task Force supports providing information that enables readers to understand the general magnitude of the impact that tax expenditures have on the annual revenues of the

federal government. There are several options available to the Board for achieving such an objective. Listed below are two key questions and answers provided by the Task Force to be considered by the Board in determining how best to achieve this objective:

Q1) *What is the appropriate nexus of tax expenditure estimates to the financial statements (whether estimates should be included in Basic Information, the Required Supplementary Information section, OI section, or the MD&A section)?*

A1) Option A: Other Information

Task Force members supportive of Option A (encouraging the inclusion of tax expenditure estimates within the *OI* section of the government-wide financial report) were primarily concerned about the extent of judgment and subjectivity inherent in identifying and measuring tax expenditures. They were also concerned about the quality, timeliness, and availability of reliable data upon which estimates are based. Further, the existing differences in the list of tax expenditures identified by two credible sources of tax expenditure estimates – Treasury’s Office of Tax Policy and the Joint Committee on Taxation – may be confusing to some readers. Additionally, estimation methodologies for certain tax expenditures can neither be tested nor improved over time by way of assessing their historical performance against tax return data or transactions. Assessing historical performance for certain tax expenditure estimates requires the use of data that are not collected on tax returns at all and are not based on recordable transactions that actually occurred. Therefore, data upon which certain estimates are based must always be estimated.

These conditions pose unique challenges impeding Treasury’s ability to 1) identify a generally accepted universe of tax expenditures; 2) develop estimates generally accepted as reliable, fair, and correctly measured; and 3) include estimates within *Required Supplementary Information* or *Basic Information* without negative and/or potentially unresolvable audit challenges. Accordingly, Option A—as illustrated in [Appendix III: Illustration of Recommendation 4 - Option A for Board Consideration](#)—avoids additional costs and audit challenges of including tax expenditure estimates in the *Required Supplementary Information* section while also providing information that enables readers to understand the general magnitude of the impact that tax expenditures have on the federal government’s annual revenues.

Option B: Required Supplementary Information

Task Force members supportive of Option B (requiring the inclusion of tax expenditure estimates within the *Required Supplementary Information* section of the government-wide financial report)—as illustrated in [Appendix III: Illustration of Recommendation 4 – Option B for Board Consideration](#)—were concerned with the primary purpose of the government-wide financial report, which is to inform users of matters impacting the government’s results of operations and financial condition. The exclusion of information about the magnitude of tax expenditures from the *Required Supplementary Information* section of the government-wide financial report—which may be in excess of one trillion

dollars—may be inconsistent with the overall purpose of the government-wide financial report. Inclusion of such estimates in this section (as opposed to the *OI* section) has audit and cost implications; however, the audit procedures set forth in the standards applying to *Required Supplementary Information* are less extensive and costly than those set forth in the standards for auditing *Basic Information*.¹ Moreover, subjecting these estimates to these limited procedures may ultimately result in improvements to their informational value as well as improvements to underlying estimation processes and controls behind the numbers over time. Ultimately, any estimates contained within *Required Supplementary Information* cannot impact the audit opinion on the government-wide financial report. Given the magnitude of these estimates, Task Force members supportive of Option B find it to be beneficial and prudent to elevate tax expenditure estimates to a status which ensures their inclusion in the government-wide financial report each year and subjects them to some level of audit procedures.

Option C: Excluded from the Government-Wide Financial Report

Task Force members supportive of Option C (neither encouraging the inclusion of these estimates in *OI* section nor requiring the inclusion of tax expenditure estimates in *Required Supplementary Information*) are concerned that including certain tax estimates within the government-wide financial report—regardless of the location of their placement—will yield additional costs that result in minimal improvements or benefits, given the availability of these estimates in other government reporting. Supporters of Option C share the concerns of other Task Force members regarding the audit implications and challenges that impede Treasury’s ability to provide a universe of estimates that are generally accepted as reliable, accurate, and fair. Auditors must consider the representational faithfulness of estimates; however, the characteristics of tax expenditure estimates vary dramatically. While some are directly observable on tax forms, others are not. Even when the data for tax expenditure estimates are directly observable, the counterfactual behavior of taxpayers if those provisions are removed is also not directly observable. Supporters of Option C endorse Recommendations 2 and 3 (requiring the user of hyperlinks to direct users to external reports, including estimates published annually by Treasury’s Office of Tax Policy) and believe that those recommendations enable users to quickly access more complete reports. Such reports are sufficient to enable the general public to understand and assess the magnitude of the impact of tax expenditures on the financial condition of the government. Specifically, they provide a level of detailed information regarding the relevant tax law, estimating assumptions and methodology, and underlying data that would be necessary for readers to understand the nature of tax expenditure estimates and how they can and cannot be used and interpreted.

Q2) What are user information needs with respect to how tax expenditures relate to a) government performance, b) the current financial condition of the government, c) future/deferred assets and liabilities, and d) long-term fiscal projections and trends?

¹ See American Institute of Certified Public Accountants (AICPA) Codification of Statements on Auditing Standards for Auditing (AU-C) Section 730, *Required Supplementary Information*, paragraph 05.

A2) The Task Force unanimously agrees that the government-wide financial report should make readers aware of what tax expenditures are, their purpose, how they are treated in the Federal Budget process, their impact on the government's financial position, and the availability of other external sources and more detailed information. While the Task Force members did not reach unanimous agreement on how to do so, they unanimously support providing users with a sense of the magnitude of tax expenditures either in the *OI* section, the *Required Supplementary Information* section, or by otherwise directing users to other external sources of more detailed information (including estimates). Such information could enable users to assess 1) the efficiency and effectiveness of achieving specific public goals through the use of tax expenditures, 2) the extent to which tax expenditures impact the current financial condition of the government, and 3) understand how tax expenditures may impact long-term fiscal projections and the deficit in future years.

Q3) *Should a total tax expenditure estimate be reported? Why does Treasury elect to not include a total for all tax expenditures? What are the challenges in calculating a meaningful total?*

A3) Several Task Force members believe that it would be useful to present an amount representing total tax expenditures to facilitate comparisons with other “bottom line” totals. Other members believe that a total is unnecessary and potentially misleading and that readers can gain a sense of the magnitude of tax expenditures by reviewing some of the major tax expenditures on the list. This disagreement is further complicated because existing estimates are calculated in a manner such that the sum of tax expenditures is not the same as the total tax expenditure.

The Congressional Budget Office has estimated that for all tax expenditures, interactions are offsetting under current tax law. In that environment, a simple sum of each tax expenditure estimate can provide a reasonable estimate of the total. However, changes in the tax law or the set of provisions that are considered to be tax expenditures could alter the offsetting nature of the interactions in future years.

In its reporting for the Federal Budget, Treasury does not include a grand total of tax expenditures for the following reason:

“An important assumption underlying each tax expenditure estimate reported ... is that other parts of the Tax Code remain unchanged. The estimates would be different if tax expenditures were changed simultaneously because of potential interactions among provisions. For that reason, this document does not present a grand total for the estimated tax expenditures.”

These interactions can theoretically both increase and decrease the estimated revenue effects of tax expenditures. For example, the individual itemized deductions for charitable contributions, mortgage interest expense, and state and local taxes are all tax

expenditures. When considered jointly their effect on revenue is less than when they are considered in isolation. This is because as the provisions interact it becomes more likely that that taxpayers' optimal choice would be to claim the standard deduction which caps the total revenue for itemized deductions at a value significantly less than the total of itemized deductions. In contrast, due to the progressive rate schedule, considering the elimination of multiple income exclusion provisions simultaneously would push many taxpayers into higher tax brackets, thereby increasing the combined estimate for income exclusions relative to the sum of each of the individual tax expenditure estimates for exclusions when considered in isolation.

With the 169 provisions that are currently classified by Treasury as tax expenditures, a multitude of potential interactions exists, and Treasury's tax models cannot simultaneously consider all of the tax expenditures effectively automate all of the potential interactions. Treasury has indicated that they have not estimated the interaction effects that would be needed to calculate a total for all tax expenditures, and simply summing the current estimates is inappropriate since such a total would implicitly assume that all of the interactions offset each other. Further, due to other demands placed on the Office of Tax Analysis, Treasury has indicated there are no current plans to undertake the extensive modeling that would be necessary to calculate a meaningful comprehensive total.

Q4) *How might accounting standards and the reporting of tax expenditure financial information evolve over time?*

A4) The Task Force recognizes that there are significant challenges associated with estimating tax expenditures and integrating them into the financial statements; however, several Task Force members are hopeful and supportive of efforts that may evolve the presentation of this information over time in phases.

The consensus recommendations made by the Task Force here are a first step. Further most Task Force members support the inclusion of single-year major tax expenditure estimates in the *OI* section along with other pre-existing *OI* disclosures (e.g., Other Claims for Refunds, Tax Assessments, Tax Gap), which are included in the government-wide financial report due to the importance of the topic, but which are not discretely associated with information presented in the basic financial statements, note disclosures, or RSI.

Looking forward, the Board may wish to evaluate whether existing tax expenditure concepts and estimates produced by law as part of the federal budget process provide the most appropriate measures for the government-wide financial report. Some Task Force members support potentially drawing more discrete connections between tax expenditure estimates and the financial statements over time, provided that sufficient time and resources have been spent and/or are available to assure that estimates currently developed as part of the federal budget process are representationally

appropriate and relevant to financial statements, and auditable. Other Task Force members support consideration of next steps with the understanding that doing so will require sufficient time and resources being made available. The Board may wish to consider beginning by presenting tax expenditure information in *OI*, and potentially transitioning to *Required Supplementary Information* once appropriateness, relevance, and auditability of the information in the context of the government-wide report have been assessed and resolved, and perhaps eventually developing standards for recognition and measurement of tax expenditures within *Basic Information*. The Board should be aware that these issues may be difficult or costly to resolve, and they may not be resolvable.

Some Task Force members also support broadening the scope of how measures of tax expenditures are integrated into the government-wide financial report over time. While most of the Task Force recommends beginning with a single-year historical perspective to provide additional context to the Statement of Net Cost and Statement of Operations and Changes in Net Position each reporting year, some Task Force members also strongly encourage the Board to explore the feasibility and relevance of integrating tax expenditure estimates into the government's Balance Sheet (current perspective) and Statement of Long Term Fiscal Projections (long-term/future perspective) in the future. Some members also encourage the Board to consider presentation and disclosure of tax expenditures in conjunction with the Board's other projects related to presentation and disclosure of the government's costs and revenues. The basis for this belief is that, as these standards evolve, it would be important to rationalize differences in the level of detail and manner of presentation and disclosure of actual expenditures and tax expenditures, to provide a comprehensive view of all of the costs and revenues of government.

Appendices

Appendix I: Illustration of Recommendation 1

Introduction Section of the Exposure Draft

Purpose

In light of the Board's mission to improve federal financial reporting, it is paramount that such reporting assists report users in evaluating the service efforts, costs, accomplishments, and fiscal sustainability of the federal government and in understanding how these efforts and accomplishments have been financed. Tax expenditures have historically received little focus in general purpose federal financial reporting, but do have similarities to federal spending in their impact on service efforts, costs, accomplishments, and fiscal sustainability. Establishing reporting requirements with respect to this topic requires an understanding of tax expenditures, the methods used to estimate income tax expenditures, and considerations in using those estimates.

This section provides an overview of tax expenditures to aid respondents in considering the Board's proposal. Specifically, this section:

1. defines tax expenditures and describes the six types of tax expenditures,
2. provides context with respect to the purpose of tax expenditures, why tax expenditures are important, and the relationship of tax expenditures to government performance, taxpayer behaviors, and the economy; and
3. summarizes how tax expenditure estimates are prepared by U.S. Department of the Treasury (Treasury). This ultimately impacts how tax expenditure estimates can be used and interpreted.

Background

The Congressional Budget and Impoundment Act of 1974 (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 liability." (Section 3(3) of Public Law 93-344)

Generally, tax expenditures are provisions in the tax law available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to stimulate behavior that will accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production.

Tax expenditures are "revenue losses" in that the provisions reduce income taxes owed and, therefore, revenue collected. Tax expenditures resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, tax expenditures are not treated the same as federal spending for budgetary or financial reporting

purposes.² Tax expenditures are not subject to the annual budget process and can only be removed or changed through tax legislation. Tax expenditure estimates are not explicitly displayed in the Statements of Net Cost or Changes in Net Position. While tax expenditures help determine the government's net revenue, they are generally not separately disbursed or accounted for in Treasury's books and records.

How Tax Expenditures Are Identified

The first step in identifying tax expenditures is determining what the tax baseline is so that the provisions considered “special” (see definition above) can be distinguished from those provisions consistent with a baseline tax system. For the federal income tax, the baseline tax system is a comprehensive income tax with certain practical provisions that are generally accepted as being part of a baseline tax system. Accordingly, provisions such as the personal exemption, standard deductions, deductions of expenses incurred in earning income, and a progressive rate structure are considered to be part of the baseline tax system for measurement purposes.

Judgments about such provisions are based on a general consensus view of analysts regarding practical provisions of a baseline tax system versus “special” provisions that constitute a tax expenditure. For example, the personal exemption and standard deduction is viewed as defining a zero-rate bracket that is part of baseline tax law as are the other graduated rate brackets in the individual income tax. In contrast, the child tax credit is considered a tax expenditure because it provides a “special” benefit that would not exist under baseline tax law.

After determining the baseline tax system, the credits, deductions, special exceptions and allowances that reduce tax liability below the level implied by the baseline tax system are then considered to be tax expenditures. See [Appendix A](#) for a list of the largest income tax expenditures, ranked by fiscal year 2016 revenue effect.

Types of Tax Expenditures

There are six types of tax expenditures—exclusions, exemptions, deductions, credits, preferential rates, and deferrals. Table 1 describes each and provides an example.

² In certain cases a tax preference may provide cash in the form of a refundable tax credit even if the taxpayer owes no tax. The budget records payments to taxpayers for refundable tax credits (such as earned income tax credits) that exceed the taxpayer's tax liability as outlays. As such, a portion of this type of tax preference is reported as outlays in the budget to the extent payments exceed the taxpayer's liability, whereas the portion offsetting the taxpayer's liability reduces budget revenues but is not explicitly reported in the budget.

Table 1: Examples of Provisions That Are Tax Expenditures When They Are Exceptions to the Normal [Baseline] Tax Structure

Tax expenditure	Description	Examples
Exclusion	Excludes income that would otherwise constitute part of a taxpayer's gross income.	Employees generally pay no income taxes on contributions their employers make on their behalf for medical insurance premiums.
Exemption	Reduces gross income for taxpayers because of their status or circumstances.	Taxpayers may be able to reduce their tax liability if they have a dependent who is a child aged 19 through 23 and is a full-time student.
Deduction	Reduces gross income due to expenses taxpayers incur.	Taxpayers may be able to deduct state and local income taxes and property taxes.
Credit	Reduces tax liability dollar-for-dollar. Additionally, some credits are refundable meaning that a credit in excess of tax liability results in a cash refund.	Taxpayers with children under age 17 potentially can qualify for up to a \$1,000 partially refundable, per child credit, provided their income does not exceed a certain level.
Preferential tax rate	Reduces tax rates on some forms of income.	Capital gains on certain income are subject to lower tax rates under the individual income tax.
Deferral	Delays recognition of income or accelerates some deductions otherwise attributable to future years.	Taxpayers may defer paying tax on interest earned on certain U.S. savings bonds until the bonds are redeemed.

Source: [GAO-13-167SP](#): Guide for Evaluating Tax Expenditures.

In considering these six types note that it may be possible to achieve certain public policy outcomes in a variety of ways. For example, it may be possible for some public policy purposes to be achieved through a preferential rate, a deduction, or a credit. Because a variety of approaches can produce the same cash effect, the types are different in form rather than substance.

Most reports do not categorize tax expenditures by type. The types are presented to aid in understanding the mechanisms used to establish preferences.

Budget Act Requirements and History

The term “tax expenditures” was introduced in 1967 by Assistant Secretary for Tax Policy, Stanley Surrey, in a speech calling for a “full accounting” of them. Following his speech, estimates were prepared by the U.S. Department of the Treasury (Treasury) and later by the Joint Committee on Taxation (JCT) of the U.S. Congress.

In 1974, the Budget Act charged the House and Senate Budget Committees with the duty “to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies” to Congress on a recurring basis. The Budget Act further required that the annual President’s Budget include tax expenditure estimates.³

Estimates are now available annually from both the JCT⁴ and the President’s Budget.⁵ Each JCT report contains a discussion of the concept of tax expenditures, identification of new tax expenditures enacted into law, a general explanation on how the committee staff measures tax

³ Kleinbard, Edward. Tax Expenditure Framework Legislation, *Research Paper Series and Legal Studies Research Paper Series, Paper No. C10-1*. USC Center in Law, Economics and Organization. 2010.

⁴ See <https://www.jct.gov/publications.html?func=select&id=5> for JCT Publications on Tax Expenditures. As of July 17, 2015 estimates for fiscal years 2014-2018 were available in JCX-97-14.

⁵ See https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/ap_14_expenditures.pdf for the Fiscal Year 2016 President’s Budget. The Analytical Perspectives, Chapter 14 provides estimates for fiscal years 2014 through 2024. (Last accessed July 17, 2015.)

expenditures, estimates of tax expenditures, and distributions of selected individual tax expenditures by income class.

Treasury prepares estimates provided in the President's Budget. These estimates are for the current fiscal year and the ten years following the current fiscal year. The estimates are intended to support budget analysis and are a measure of the economic benefits that are provided through the tax laws to various groups of taxpayers and sectors of the economy. The estimates also may be useful in assessing the efficiency and effectiveness of achieving specific public goals through the use of tax expenditures. Treasury provides the tax expenditure estimates before the end of each fiscal year and makes them available on the Treasury website before the President's Budget is issued.⁶

Government Performance Reporting for Tax Expenditures

The Government Performance and Results Act of 1993 (GPRA) originally put in place a framework for performance planning and reporting, and the GPRA Modernization Act of 2010 (GPRAMA) has significantly enhanced the statutory framework.⁷ The GPRAMA framework aims at taking a more crosscutting and integrated approach to focusing on results and improving government performance. The Office of Management and Budget (OMB) is required to coordinate with agencies to establish federal government priority goals—otherwise referred to as cross-agency priority (CAP) goals.⁸ GPRAMA requires certain agencies to identify a subset of agency goals as agency priority goals (APG) which reflect the highest priorities of each agency. Fully implementing GPRAMA requirements could provide the foundation for reviewing tax expenditure performance and assessing their contributions toward federal goals. GPRAMA requires OMB to identify tax expenditures that contribute to the CAP goals. In addition, OMB guidance has directed agencies to identify tax expenditures that contribute to their APGs since 2012 and to their strategic objectives since 2013.⁹

However, the executive branch still has not completed actions necessary to assess the outcomes of tax expenditures and their contributions to CAP goals and APGs.¹⁰

How the Department of the Treasury Prepares the Administration's Estimates

As noted in the definition above, tax expenditures arise from special provisions allowing an exclusion, exemption, or deduction from gross income, a credit, a preferential rate of tax, or a deferral of liability. Deciding whether a provision of tax law is a special exception to the baseline income tax system is a matter of judgment. The baseline used by the Treasury to identify these special exceptions is adapted from a comprehensive income tax approach in which income is the sum of consumption and the change in net wealth in a given period of time with certain

⁶ See <http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx> for the latest estimates of tax expenditures. (Last accessed September 22, 2015.)

⁷ Pub. L. No. 103-62, 107 Stat. 285 (Aug. 3, 1993) and Pub. L. No. 111-352, 124 Stat. 3866 (Jan. 4, 2011).

⁸ OMB set the first interim CAP goals in 2012 and identified the next set of CAP goals in March 2014, which it is to update every 4 years.

⁹ OMB, Circular A-11 (2015).

¹⁰ GAO, *Managing for Results: Implementation of GPRA Modernization Act Has Yielded Mixed Progress in Addressing Pressing Governance Challenges*, [GAO-15-819](#) (Washington, D.C.: Sept. 28, 2015).

departures.¹¹ This baseline assumes an individual income tax and a separate corporate income tax.¹²

Preparing tax expenditure estimates requires consideration of certain information about the economy, presently and in the future. The Treasury estimates for economic activity are consistent with the economic assumptions in the President's Mid-Session Review of the prior year's budget and reflect current law as of July 1.¹³

Each tax expenditure is measured by the difference between tax liability under current law and the tax liability that would result if the tax expenditure provision were repealed and had never existed. It is assumed that there is no behavioral response to the elimination of the provision and taxpayers simply recalculate their tax in the absence of the provision in question. Thus, tax expenditures calculate revenues forgone by the existence of the rule but not necessarily the amount of revenue that would be raised if it were repealed. For example, the ability to deduct mortgage interest expense on owner-occupied housing is considered to be a tax expenditure. The tax expenditure estimate reports the revenue change that would occur if this deduction were repealed but it does not take into account any revenue effect that might occur as a result of most changes in the taxpayers' behavior, such as taxpayers' decisions to own homes. However, in recalculating the tax due in the absence of this deduction, the tax expenditure estimate does assume the taxpayer would switch from itemizing deductions to claiming the standard deduction if that were tax minimizing in the absence of the ability to deduct mortgage interest on an itemized return.

When possible, the Treasury uses samples of tax returns provided by the Internal Revenue Service as the basis for tax expenditure estimates. For provisions benefiting individual tax filers the Individual Tax Model (ITM) Tax Calculator is often used. The ITM is based upon a stratified sample of individual tax returns that represent the entire tax filing population. This sample is augmented by additional data to represent the U.S. population. The ITM projects these individual records forward consistent with the Administration's economic forecast. The ITM Tax Calculator allows the computation of tax for each record under differing tax laws.

For example, the Lifetime Learning tax credit is considered a tax expenditure because the baseline tax system would not allow credits targeted at particular activities, investments, or industries. Treasury uses the ITM Tax Calculator to compute tax liability for each filing unit under current law and current law with the Lifetime Learning tax credit removed.

As another example, the exclusion of public assistance benefits is considered a tax expenditure because transfers from the Government would be considered income to the taxpayer under the baseline tax system. Since tax records do not record the receipt of these types of benefits, Treasury estimates the value of this tax expenditure by supplementing historical Bureau of Economic Analysis National Income and Product Accounts data with U.S. Department of Health and Human Services and state expenditure data to determine the total forecasted value of public assistance transfers to taxpayers under current law over the budget window. The tax

¹¹ For example, one major departure is that income is taxable only when it is realized in exchange. Thus, the deferral of tax on unrealized capital gains is not regarded as a tax expenditure. Another example is that values of assets and debt are not generally adjusted for inflation.

¹² Treasury and the Joint Committee on Taxation differ in the assumed baseline from which tax expenditures are measured. For a summary of the differences see Altshuler, Rosanne and Robert Dietz. "Reconsidering Tax Expenditure Estimation." *The National Tax Journal*, June 2011, 64 (2, Part 2), 459-490.

¹³ "Current law baseline" refers to the budget estimates prepared by the Administration based on laws enacted at the time they are prepared. If a provision will expire or change under currently enacted law then the baseline projections reflects the effects of that expiration or change.

expenditure is calculated by multiplying the aggregate public transfers by an estimate of the average effective tax rate for tax filers receiving public assistance benefits.

The Treasury estimates the cash effect of each tax expenditure. Some tax expenditures represent deferrals of taxation (a tax not paid in the current tax year will be paid in a future tax year when the deferral reverses). Estimates for such deferrals are based on the net tax effect of current year deductions or exclusions and reversals of prior year deferrals included in current year taxable income.¹⁴ For example, defined contribution employer plans are estimated as the net tax effect of current year contributions excluded from income and income reported upon withdrawals from plans.

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 baseline income tax structure, such as the tax rate schedule, the personal exemption amount, the standard deduction, and other factors. For example, the dollar value of tax expenditures tends to increase and decrease as tax rates increase and decrease, respectively, without any other changes in law.

Understanding Estimates

Tax expenditure estimates are developed to aid policymakers. It is important to understand that they are not transaction-based amounts. The estimates are updated annually using the best available data and models. However, data limitations and resource constraints are inherent in the process. For example, some data collected on tax returns are not available in time for the annual estimates; other data are not collected on tax returns at all and must always be estimated.

The major considerations regarding the estimates are identified below.

Not Necessarily Equivalent to Forgone Revenue. Estimates should be regarded as approximations. As with expenses incurred with spending programs, tax expenditure estimates do not necessarily equal the change in the deficit¹⁵ that would result from repealing these special provisions because:

- a. eliminating a tax expenditure may have incentive effects that alter economic behavior, and
- b. tax expenditures are interdependent even without incentive effects.

Difficulty in Calculating Totals. A total for the estimated tax expenditures is not provided in the President's Budget because each tax expenditure is estimated independently assuming other parts of the Tax Code remains unchanged. The estimates might be different if two or more tax expenditures were changed simultaneously because of potential interactions among provisions. Nonetheless, other experts do present a total summing the separate estimates. The Congressional Budget Office has modeled the interaction of the ten largest tax expenditures in the individual income tax law and found

¹⁴ To complement these estimates Treasury also reports a discounted present-value estimate of the future net revenue effects for the tax expenditure activity in the most recently concluded calendar year.

¹⁵ Note that repealing certain spending programs would also not reduce the deficit by the amount of spending because of interaction with other programs and the tax system. For example, Social Security benefits may be taxed so that eliminating the benefits would also reduce tax revenue and possibly increase spending in other benefit programs. Thus, the change in the deficit would be smaller than the direct spending eliminated through the adjustment to the Social Security program.

that interactions that overstate the effect are similar in size to interactions that understate the effect.¹⁶ As a result, they conclude that the total is a meaningful estimate for the general magnitude of tax expenditures under current tax law. If the law changes in significant ways the interactions may not result in offsetting over- and understatements of the effect to the same extent.

Completeness. As noted earlier, significant judgment is required to identify special provisions of the income tax code. Given the complexity of the tax code, differences in judgment lead some to include provisions in tax expenditure lists that others would exclude and vice versa. In addition, special provisions can be included in taxes other than income taxes (for example, payroll or excise taxes) but these generally are not included in reports on tax expenditures.

Expiring Provisions. Estimates are based on tax law enacted as of July 1 of the reporting year and assume that any provisions scheduled to expire will expire. As noted above, provisions likely to be extended are ignored for estimation purposes until such legislation is actually enacted. In other words, estimates are based on current law rather than analyzing policy outcomes likely to occur. As a result, an extensive knowledge of tax policy may be required in order to understand multi-year tax expenditure projections when provisions are scheduled to expire or when provisions of previous legislation are phased in.

Alternatives. Estimates involve significant judgment and, as a result, there are alternative approaches to estimation. For example, alternatives regarding the application of marginal tax rates, treatment of related tax provisions, or selection of a different baseline (such as a consumption tax rather than an income tax) would impact tax expenditure estimates. In addition, while estimates are provided for the cash (current revenue) effect for each of the ten fiscal years covered by the projections, a present value alternative that considers the full life cycle of the taxable activity may be more useful for tax expenditures involving deferrals or other long-term revenue effects. For such tax expenditures, the present value effects are important because deferrals will reverse in later years and a present value estimate for the activity in the current calendar year would include this activity.

See [Appendix A](#) for a list of the largest income tax expenditures and the related Treasury estimates, ranked by fiscal year 2016 revenue effect.¹⁷ Please note the aforementioned considerations when reviewing these estimates.

¹⁶ Congressional Budget Office. *The Distribution of Major Tax Expenditures in the Individual Tax System*. May 2013.

¹⁷ See <https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2017-11132015.pdf> for a complete listing of tax expenditures reported and estimated by Treasury in September, 2015.

Appendix A: Largest Tax Expenditures

<u>Largest 20 Tax Expenditures, Fiscal Years 2016 and 2015 (Ranked by Revenue Effect)</u>		
	2016 (dollars, in billions)	2015 (dollars, in billions)
I Exclusion of employer contributions for medical insurance premiums and medical care	\$ 211.0	\$ 201.5
I Exclusion of net imputed rental income	101.1	97.9
I Capital gains (except agriculture, timber, iron ore, and coal)	92.8	85.7
C Deferral of income from controlled foreign corporations (normal tax method)	67.8	64.6
I Defined benefit employer plans	66.6	66.6
I Defined contribution employer plans	64.7	62.1
I Deductibility of mortgage interest on owner-occupied homes	62.4	58.9
I Step-up basis of capital gains at death	58.3	54.9
I Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	51.4	48.4
B Deductibility of charitable contributions, other than education and health	44.2	40.9
I Capital gains exclusion on home sales	40.6	37.2
I Deductibility of State and local property tax on owner-occupied homes	33.1	31.1
B Exclusion of interest on public purpose State and local bonds	31.7	29.4
I Self-Employed plans	28.0	25.5
I Social Security benefits for retired workers	26.9	25.8
I Treatment of qualified dividends	25.5	25.7
I Child credit (1)	24.0	24.0
B Exclusion of interest on life insurance savings	18.9	17.5
I Individual Retirement Accounts	16.9	16.4
B Deduction for US production activities	15.7	15.2
Key: I = Individual; C = Corporate; B = Both Corporate and Individual		
FASAB analysis based on U.S. Department of Treasury's Tables of Estimates from the Fiscal Year 2017 Tax Expenditures (September 2015) Source: These estimates are prepared annually by Treasury for inclusion in the President's Budget. There are 169 provisions that are currently classified by Treasury as tax expenditures. Estimates and descriptions of each of the 169 provisions classified as tax expenditures, including the 20 presented here, are made available at http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx .		
(1) The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in billions of dollars) is as follows: 2015 \$27.0 and 2016 \$27.0 All revenue loss estimates have been rounded to the nearest \$100 million.		

Appendix II: Illustration of Recommendations 2 and 3

MANAGEMENT'S DISCUSSION AND ANALYSIS

Introduction

[Abridged]

Mission & Organization

[Abridged]

The Government's Financial Position and Condition

[Abridged]

Fiscal Year 2014 Financial Statement Audit Results

[Abridged]

Accounting Differences Between The Budget and the Financial Report

[Abridged]

Illustration of Recommendations 2 and 3 continues on the following page

The Government's Net Position: "Where We Are"

The Government's financial position and condition have traditionally been expressed through the *Budget*, focusing on surpluses, deficits, and debt. However, this primarily cash-based discussion of the Government's net outlays (deficit) or net receipts (surplus) tells only part of the story. The Government's accrual-based net position, (the difference between its assets and liabilities), ~~and~~ its "bottom line" net operating cost (the difference between its revenues and costs), and tax expenditures (revenue losses attributable to special tax code provisions) are also key financial indicators.

Costs and Revenues: "What Went Out & What Came In"

The Government's *Statement of Operations and Changes in Net Position*, much like a corporation's income statement, shows the Government's "bottom line" and its impact on net position (i.e., assets net of liabilities). To derive the Government's "bottom line" net operating cost, the *Statement of Net Cost* first shows how much it costs to operate the federal government, recognizing expenses when incurred, regardless of when payment is made (accrual basis). It shows the derivation of the Government's *net cost* or the net of: (1) gross costs, or the costs of goods produced and services rendered by the Government, (2) the earned revenues generated by those goods and services during the fiscal year, and (3) gains or losses from changes in actuarial assumptions used to estimate certain liabilities. This amount, in turn, is offset against the Government's taxes and other revenue reported in the *Statement of Operations and Changes in Net Position* to calculate the "bottom line" or *net operating cost*.¹⁸

Table 4: Gross Cost, Revenues, Net Cost, and Net Operating Cost							
Dollars in Billions	2014		2013		Increase / (Decrease)		
	\$		\$		\$	%	
Gross Cost	\$	(4,251.4)	\$	(3,940.9)	\$	310.5	7.9%
Less: Earned Revenue	\$	417.9	\$	415.5	\$	2.4	0.6%
Gain/(Loss) from Changes in Assumptions	\$	(3.5)	\$	(131.2)	\$	127.7	97.3%
Net Cost	\$	(3,837.0)	\$	(3,656.6)	\$	180.4	4.9%
Less: Taxes and Other Revenue	\$	3,066.1	\$	2,842.5	\$	223.6	7.9%
Unmatched Transactions and Balances	\$	(20.4)	\$	9.0	\$	29.4	326.7%
Net Operating Cost	\$	(791.3)	\$	(805.1)	\$	(13.8)	(1.7%)

Table 4 shows that the Government's "bottom line" net operating cost decreased slightly from \$805.1 billion in FY 2013 to \$791.3 billion in FY 2014. This \$13.8 billion (1.7 percent) decrease is attributable to a number of offsetting revenue and cost changes over the past fiscal year as summarized in the following.

Gross Cost and Net Cost

The *Statement of Net Cost*, starts with the Government's total gross costs of \$4.3 trillion dollars, subtracts revenues earned for goods and services provided (e.g., Medicare premiums, national park entry fees, and postal service fees), and adjusts the balance for gains or losses from changes in actuarial assumptions used to estimate certain liabilities, including federal employee and veterans benefits to derive its net cost of \$3.8 trillion, a \$180.4 billion increase (4.9 percent) over FY 2013.

Typically, the Government's net cost is impacted by a variety of offsetting increases and decreases. The more significant drivers affecting the change in net cost during FY 2014 were:

- The loss on changes in assumptions associated with the Government's civilian and military benefits programs amounted to \$3.5 billion in FY 2014 as compared to \$131.2 billion in FY 2013, representing a \$127.7 billion decrease in net cost. Agencies administering these types of programs employ a complex series of assumptions, including but not limited to interest rates, beneficiary eligibility, life expectancy, medical cost levels, compensation levels, disability claims rates, and cost of living to make annual actuarial projections of their long-term benefits liabilities. The Department of Veterans Affairs (VA) and the Office

¹⁸ As shown in Table 4, net operating cost includes an adjustment for unmatched transactions and balances, which represent unreconciled differences in intragovernmental activity and balances between Federal agencies. These amounts are described in greater detail in the Other Information section of this *Financial Report*.

of Personnel Management (OPM) reported significant decreases in losses from changes in these assumptions for FY 2014;

- Most of the Department of the Treasury’s (Treasury’s) \$131.2 billion net cost increase is attributable to the effect of changes in the fair value of Treasury’s investments in two GSEs – Fannie Mae and Freddie Mac – and to the decrease in dividend receipts from the GSEs¹⁹;
- \$55.8 billion and \$39.4 billion net cost increases at the Department of Health and Human Services (HHS) and the Social Security Administration (SSA), respectively, primarily due to cost increases of the benefits programs that these agencies administer (HHS – Medicare and Medicaid programs, SSA – Old Age Survivors and Disability Insurance (OASDI) programs);
- a \$46.4 billion cost increase at the Department of Education, largely associated with increases in the projected long-term costs of its direct student loan programs due to changes in the types and availability of repayment plans and increases in default rates²⁰; and
- a \$26.5 billion decrease at the Department of Labor, primarily due to decreases in unemployment benefits provided under existing legislation and lower levels of unemployment as compared to FY 2013.²¹

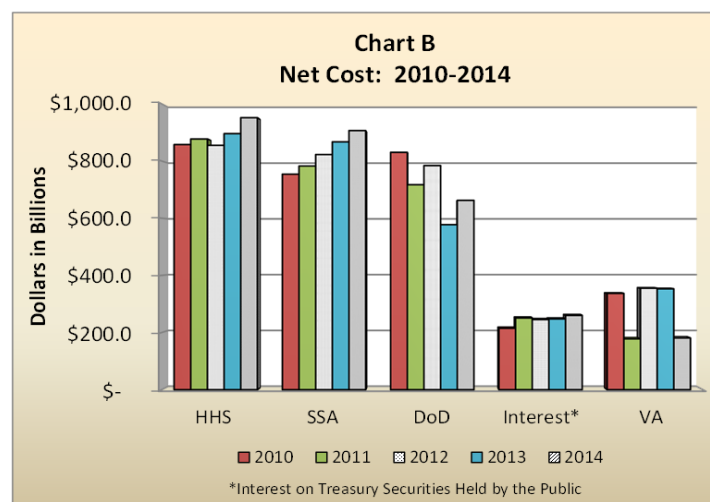
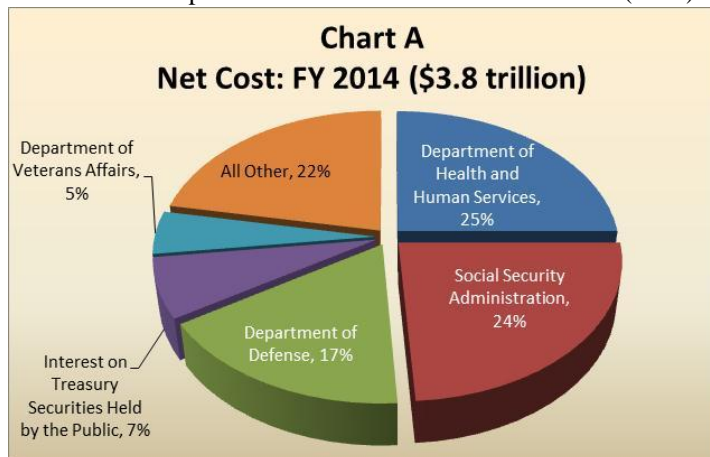


Chart A shows the composition of the Government’s net cost. In FY 2014, two-thirds of total net cost came from DOD, the Social Security Administration (SSA), and the Department of Health and Human Services (HHS). These three agencies have consistently incurred the largest agency shares of the Government’s total net cost in recent years (Chart B). As indicated above, HHS and SSA

net costs for FY 2014 (\$951.5 billion and \$906.4 billion, respectively) are attributable to major social insurance programs administered by these agencies. The *Statement of Social Insurance (SOSI)* and the related information in this *Financial Report*, including the broader discussion of the Government’s long-term fiscal projections, discuss the projected future revenues, expenditures, and sustainability of these programs in greater detail. DOD’s net costs of \$662.3 billion relate primarily to operations, readiness, and support; personnel; research; procurement; and retirement and health benefits. Chart A shows that the Department of Veterans Affairs (VA) as well as interest on debt held by the public contributed an additional combined 12 percent, and the other agencies included in the Government’s FY 2014 Statement of Net Cost accounted for a combined 22 percent of the Government’s total net cost for FY 2014.

Taxes and Other Revenues - Getting to the “Bottom Line”

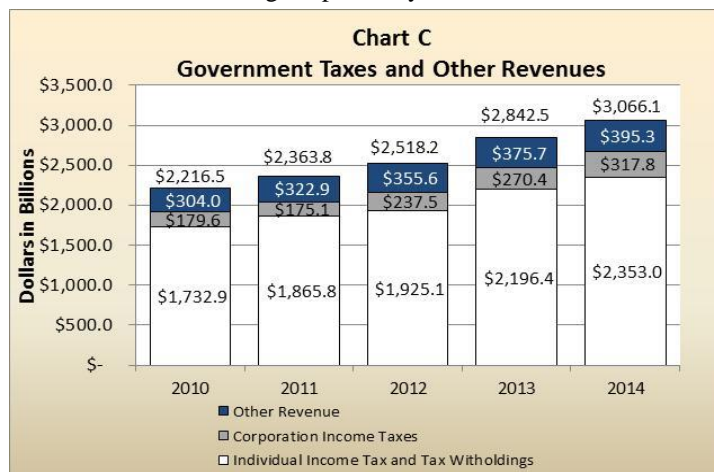
¹⁹ Department of the Treasury FY 2014 Agency Financial Report, p. 22-23. See also Note 9 – Investments in GSEs – of this *Financial Report*.

²⁰ Department of Education FY 2014 Agency Financial Report, p. 30

²¹ Department of Labor FY 2014 Agency Financial Report, p. 27

As noted earlier, taxes and other revenues from the *Statement of Operations and Changes in Net Position* are deducted from total net cost to derive the Government's "bottom line" net operating cost. Chart C shows that increases in each of the three taxes and other revenue categories shown - individual income tax and withholdings, corporation income taxes, and other revenue - combined to increase total Government taxes and other revenues by \$223.6 billion (7.9 percent) to nearly \$3.1 trillion for FY 2014. This change is primarily attributed to an overall increase in individual and corporation income tax collections.²² As noted in the earlier discussion of budget receipts, these increases largely stem from a stronger economy and growth in wages and salaries, as well as and the expiration of certain tax provisions. Earned revenues from Table 4 are not considered "taxes and other revenue" and, thus, are not shown in Chart C. Individual income tax and tax withholdings and corporation income taxes accounted for about 77 percent and 10 percent of total revenue, respectively in FY 2014; other revenues from Chart C include excise taxes, unemployment taxes, and customs duties.

As previously shown in Table 4, the increase in taxes and other revenues more than offset the increase in net costs, resulting in a slight total net decrease of \$13.8 billion (1.7 percent) in the Government's net operating cost from \$805.1 billion for FY 2013 to \$791.3 billion for FY 2014.



Tax Expenditures – Impact on “What Came In” and “The Bottom Line”

Generally, tax expenditures are provisions in the tax law available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to stimulate behavior that will accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production.

Tax expenditures are “revenue losses” in that the provisions reduce taxes owed and, therefore, revenue collected. Tax expenditures resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, tax expenditures are not treated the same as federal spending for budgetary or financial reporting purposes.²³ Tax expenditures are not subject to the annual budget process and can only be removed or changed through tax legislation. Tax expenditure estimates are not explicitly displayed in the Statements of Net Cost or Changes in Net Position. While tax expenditures help determine the government’s net revenue, they are generally not separately disbursed or accounted for in Treasury’s books and records. Hence, tax expenditure estimates do not appear in the net operating cost calculation in Table 4 above.

These and other issues concerning tax expenditures, including tax expenditure estimates, are discussed in greater detail within an annual report published by Treasury’s Office of Tax Policy.²⁴

[Also refer readers to additional discussion in either RSI and/or OI.]

Assets and Liabilities: “What We Own and What We Owe”

[Abridged]

²² Department of the Treasury FY 2014 Agency Financial Report, p. 28

²³ In certain cases a tax preference may provide cash in the form of a refundable tax credit even if the taxpayer owes no tax. The budget records payments to taxpayers for refundable tax credits (such as earned income tax credits) that exceed the taxpayer’s tax liability as outlays. As such, a portion of this type of tax preference is reported as outlays in the budget to the extent payments exceed the taxpayer’s liability, whereas the portion offsetting the taxpayer’s liability reduces budget revenues but is not explicitly reported in the budget.

²⁴ Department of the Treasury Fiscal Year 2017 Tax Expenditures Report

The content here was prepared by the FASAB Tax Expenditures Task Force exclusively for purposes of illustrating Task Force proposals and for generating Board discussion.

The Long-Term Fiscal Outlook: “Where We Are Headed”

[Abridged]

Systems, Controls, and Legal Compliance

[Abridged]

Financial Management Progress and Priorities

[Abridged]

Additional Information

[Abridged]

Illustration of Recommendations 2 and 3 continues on the following page

United States Government Notes to the Financial Statements for the Years Ended September 30, 2014, and 2013

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

[Abridged]

B. Basis of Accounting and Revenue Recognition

These financial statements were prepared using U.S. GAAP, primarily based on Statement of Federal Financial Accounting Standards (SFFAS). Under these principles:

- Expenses are generally recognized when incurred.
- Nonexchange revenue, including taxes, duties, fines, and penalties, are recognized when collected and adjusted for the change in net measurable and legally collectible amounts receivable. Related refunds and other offsets, including those that are measurable and legally payable, are netted against nonexchange revenue. As such, estimated taxes not collected due to factors such as noncompliance with the tax law (the tax gap) and special provisions identified in the tax laws that reduce tax collections (tax expenditures) are not estimated and reported in the financial statements.
- Exchange (earned) revenue are recognized when the government provides goods and services to the public for a price. Exchange revenue include user charges such as admission to federal parks and premiums for certain federal insurance.

The basis of accounting used for budgetary purposes, which is primarily on a cash and obligation basis and follows budgetary concepts and policies, differs from the basis of accounting used for the financial statements which follow U.S. GAAP. See the Reconciliations of Net Operating Cost and Unified Budget Deficit in the Financial Statements section.

The basis of accounting used and the detail of the basis for the Statement of Social Insurance (SOSI) and the Statement of Changes in Social Insurance Amounts (SCSIA) are covered in Note 24—Social Insurance.

New Standards Issued and Implemented

[Abridged]

[Remainder of Note B thru Note Y: Abridged]

Note 18. Collections and Refunds of Federal Revenue

Collections of Federal Tax Revenue for the Year Ended September 30, 2014					
(In billions of dollars)	Federal Tax Revenue Collections	Tax Year to Which Collections Relate			
		2014	2013	2012	Prior Years
Individual income tax and tax					
withholdings	2,605.0	1,691.1	864.3	24.3	25.3
Corporation income taxes	353.1	252.9	87.9	1.2	11.1
Excise taxes	96.7	74.4	22.1	0.1	0.1
Unemployment taxes	52.7	27.1	15.3	10.2	0.1
Customs duties	34.2	34.2	-	-	-
Estate and gift taxes	20.2	-	7.0	0.9	12.3
Railroad retirement taxes	6.0	4.6	1.4	-	-
Fines, penalties, interest, and other revenue	6.7	6.5	0.1	0.1	-
Subtotal	<u>3,174.6</u>	<u>2,090.8</u>	<u>998.1</u>	<u>36.8</u>	<u>48.9</u>
Less: amounts collected for non-federal entities	(0.3)				
Total	<u>3,174.3</u>				

Treasury is the Government's principal revenue-collecting agency. Collections of individual income and tax withholdings include FICA/SECA and individual income taxes. These taxes are characterized as non-exchange revenue.

Excise taxes, also characterized as non-exchange revenue, consist of taxes collected for various items, such as airline tickets, gasoline products, distilled spirits and imported liquor, tobacco, firearms, and others.

Nonexchange revenue are collected in accordance with laws. Some federal tax law provisions allow special exclusions, exemptions, or deductions from taxpayers' gross income or which provide special credits, preferential tax rates, or deferrals of liabilities. These provisions are referred to as tax expenditures because collections are reduced to support a particular policy goal. Collections are affected by tax expenditures; however, tax expenditures are not directly reported in the financial statements. These and other matters concerning tax expenditures, including tax expenditure estimates, are discussed in greater detail within an annual report published by Treasury's Office of Tax Policy.²⁵

Nonexchange revenue may also be lost due to noncompliance with laws. The amount of loss is referred to as the tax gap. Estimates of the tax gap are not reported in financial statements

[Remainder of Note 18: Abridged]

- END OF APPENDIX II ILLUSTRATION -

²⁵ Department of the Treasury Fiscal Year 2017 Tax Expenditures Report

Appendix III: Illustrations of Recommendation 4 – Options for Board Consideration

Illustration of Recommendation 4 – Option A for Board Consideration

United States Government Other Information (Unaudited) for the Years Ended September 30, 2014, and 2013

Unexpended Balances of Budget Authority

[Abridged]

Tax Burden

[Abridged]

Illustration of Recommendation 4 – Option A continues on the following page

Tax Expenditures

Definition

Generally, tax expenditures are provisions in the tax law available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to stimulate behavior that will accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production. Tax expenditures are “revenue losses” in that the provisions reduce taxes owed and, therefore, revenue collected. Tax expenditures resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, tax expenditures are not treated the same as federal spending for budgetary or financial reporting purposes.²⁶ Tax expenditures are not subject to the annual budget process and can only be removed or changed through tax legislation. Tax expenditure estimates are not explicitly displayed in the Statements of Net Cost or Changes in Net Position. While tax expenditures help determine the government’s net revenue, they are generally not separately disbursed or accounted for in Treasury’s books and records.

Estimates

Tax expenditure estimates are available annually from Treasury’s Office of Tax Policy²⁷. The estimates are for the current fiscal year and the ten years following the current fiscal year. The estimates are intended to support budget analysis and are a measure of the economic benefits that are provided through the tax laws to various groups of taxpayers and sectors of the economy. The estimates also may be useful in assessing the efficiency and effectiveness of achieving specific public goals through the use of tax expenditures. Treasury provides the tax expenditure estimates before the end of each fiscal year and makes them available on the Treasury website before the President’s Budget is issued.

Tax expenditure estimates are developed to aid policymakers. It is important to understand that these are not transaction-based amounts. The estimates are updated annually using the best available data and models. However, data limitations and resource constraints are inherent in the process. For example, some data collected on tax returns are not available in time for the annual estimates; other data are not collected on tax returns at all and must always be estimated.

Major considerations regarding the estimates include the following:

- Significant judgment is required to identify and measure special provisions of the income tax code. For example, preferential rates for capital gains are considered a tax expenditure; however the progressive income tax system is not considered to be a preferential rate or a tax expenditure.
- As with expenses incurred with spending programs, an individual tax expenditure estimate does not necessarily equal the increase in federal revenues (or the change in the deficit) that would result from repealing the special provision. It is assumed that there is no behavioral response to the repeal of the related provision; however, the estimate does account for switching from itemized deductions to standard deductions when repealing a provision would impact the type of deduction claimed by taxpayers.
- Estimates are based on tax law enacted as of July 1 of the reporting year and assume that any provisions scheduled to expire will expire. Provisions likely to be extended are ignored for estimation purposes until such legislation is actually enacted. Extensive knowledge of tax policy may be required in order to understand multi-year tax expenditure projections.
- Treasury relies on economic data and projections to estimate the current utilization of the tax preferences not reflected on tax returns. The use of the preference is then projected into the future using assumptions that are consistent with the Administration’s economic forecast.

²⁶ In certain cases a tax preference may provide cash in the form of a refundable tax credit even if the taxpayer owes no tax. The budget records payments to taxpayers for refundable tax credits (such as earned income tax credits) that exceed the taxpayer’s tax liability as outlays. As such, a portion of this type of tax preference is reported as outlays in the budget to the extent payments exceed the taxpayer’s liability, whereas the portion offsetting the taxpayer’s liability reduces budget revenues but is not explicitly reported in the budget.

²⁷ These estimates are prepared annually by Treasury for inclusion in the President’s Budget and are made available at <http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx>.

Selected major tax expenditures are presented in the table below.

<u>Largest 20 Tax Expenditures, Fiscal Years 2016 and 2015</u>		
	2016 (dollars, in billions)	2015 (dollars, in billions)
I Exclusion of employer contributions for medical insurance premiums and medical care	\$ 211.0	\$ 201.5
I Exclusion of net imputed rental income	101.1	97.9
I Capital gains (except agriculture, timber, iron ore, and coal)	92.8	85.7
C Deferral of income from controlled foreign corporations (normal tax method)	67.8	64.6
I Defined benefit employer plans	66.6	66.6
I Defined contribution employer plans	64.7	62.1
I Deductibility of mortgage interest on owner-occupied homes	62.4	58.9
I Step-up basis of capital gains at death	58.3	54.9
I Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	51.4	48.4
B Deductibility of charitable contributions, other than education and health	44.2	40.9
I Capital gains exclusion on home sales	40.6	37.2
I Deductibility of State and local property tax on owner-occupied homes	33.1	31.1
B Exclusion of interest on public purpose State and local bonds	31.7	29.4
I Self-Employed plans	28.0	25.5
I Social Security benefits for retired workers	26.9	25.8
I Treatment of qualified dividends	25.5	25.7
I Child credit (1)	24.0	24.0
B Exclusion of interest on life insurance savings	18.9	17.5
I Individual Retirement Accounts	16.9	16.4
B Deduction for US production activities	15.7	15.2
Key: I = Individual; C = Corporate; B = Both Corporate and Individual		
FASAB analysis based on U.S. Department of Treasury's Tables of Estimates from the Fiscal Year 2017 Tax Expenditures (September 2015) Source: These estimates are prepared annually by Treasury for inclusion in the President's Budget. There are 169 provisions that are currently classified by Treasury as tax expenditures. Estimates and descriptions of each of the 169 provisions classified as tax expenditures, including the 20 presented here, are made available at http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx .		
(1) The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in billions of dollars) is as follows: 2015 \$27.0 and 2016 \$27.0 All revenue loss estimates have been rounded to the nearest \$100 million.		

The content here was prepared by the FASAB Tax Expenditures Task Force exclusively for purposes of illustrating Task Force proposals and for generating Board discussion.

Tax Gap

[Abridged]

Unmatched Transactions and Balances

[Abridged]

- END OF APPENDIX III – OPTION A ILLUSTRATION -

Illustration of Recommendation 4 – Option B for Board Consideration

United States Government Required Supplementary Information (Unaudited) For the Years Ended September 30, 2014, and 2013

**Fiscal Projections for the U.S.
Government – Fiscal Year 2014**

Social Insurance

[Abridged]

Illustration of Recommendation 4 – Option B continues on the following page

Tax Expenditures

Definition

Generally, tax expenditures are provisions in the tax law available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to stimulate behavior that will accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production. Tax expenditures are “revenue losses” in that the provisions reduce taxes owed and, therefore, revenue collected. Tax expenditures resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, tax expenditures are not treated the same as federal spending for budgetary or financial reporting purposes.²⁸ Tax expenditures are not subject to the annual budget process and can only be removed or changed through tax legislation. Tax expenditure estimates are not explicitly displayed in the Statements of Net Cost or Changes in Net Position. While tax expenditures help determine the government’s net revenue, they are generally not separately disbursed or accounted for in Treasury’s books and records.

Estimates

Tax expenditure estimates are available annually from Treasury’s Office of Tax Policy²⁹. The estimates are for the current fiscal year and the ten years following the current fiscal year. The estimates are intended to support budget analysis and are a measure of the economic benefits that are provided through the tax laws to various groups of taxpayers and sectors of the economy. The estimates also may be useful in assessing the efficiency and effectiveness of achieving specific public goals through the use of tax expenditures. Treasury provides the tax expenditure estimates before the end of each fiscal year and makes them available on the Treasury website before the President’s Budget is issued.

Tax expenditure estimates are developed to aid policymakers. It is important to understand that these are not transaction-based amounts. The estimates are updated annually using the best available data and models. However, data limitations and resource constraints are inherent in the process. For example, some data collected on tax returns are not available in time for the annual estimates; other data are not collected on tax returns at all and must always be estimated.

Major considerations regarding the estimates include the following:

- Significant judgment is required to identify and measure special provisions of the income tax code. For example, preferential rates for capital gains are considered a tax expenditure; however the progressive income tax system is not considered to be a preferential rate or a tax expenditure.
- As with expenses incurred with spending programs, an individual tax expenditure estimate does not necessarily equal the increase in federal revenues (or the change in the deficit) that would result from repealing the special provision. It is assumed that there is no behavioral response to the repeal of the related provision; however, the estimate does account for switching from itemized deductions to standard deductions when repealing a provision would impact the type of deduction claimed by taxpayers.
- Estimates are based on tax law enacted as of July 1 of the reporting year and assume that any provisions scheduled to expire will expire. Provisions likely to be extended are ignored for estimation purposes until such legislation is actually enacted. Extensive knowledge of tax policy may be required in order to understand multi-year tax expenditure projections.
- Treasury relies on economic data and projections to estimate the current utilization of the tax preferences not

²⁸ In certain cases a tax preference may provide cash in the form of a refundable tax credit even if the taxpayer owes no tax. The budget records payments to taxpayers for refundable tax credits (such as earned income tax credits) that exceed the taxpayer’s tax liability as outlays. As such, a portion of this type of tax preference is reported as outlays in the budget to the extent payments exceed the taxpayer’s liability, whereas the portion offsetting the taxpayer’s liability reduces budget revenues but is not explicitly reported in the budget.

²⁹ These estimates are prepared annually by Treasury for inclusion in the President’s Budget and are made available at <http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx>

reflected on tax returns. The use of the preference is then projected into the future using assumptions that are consistent with the Administration’s economic forecast.

Selected major tax expenditures are presented in the table below.

<u>Largest 20 Tax Expenditures, Fiscal Years 2016 and 2015</u>		
	2016 (dollars, in billions)	2015 (dollars, in billions)
I Exclusion of employer contributions for medical insurance premiums and medical care	\$ 211.0	\$ 201.5
I Exclusion of net imputed rental income	101.1	97.9
I Capital gains (except agriculture, timber, iron ore, and coal)	92.8	85.7
C Deferral of income from controlled foreign corporations (normal tax method)	67.8	64.6
I Defined benefit employer plans	66.6	66.6
I Defined contribution employer plans	64.7	62.1
I Deductibility of mortgage interest on owner-occupied homes	62.4	58.9
I Step-up basis of capital gains at death	58.3	54.9
I Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	51.4	48.4
B Deductibility of charitable contributions, other than education and health	44.2	40.9
I Capital gains exclusion on home sales	40.6	37.2
I Deductibility of State and local property tax on owner-occupied homes	33.1	31.1
B Exclusion of interest on public purpose State and local bonds	31.7	29.4
I Self-Employed plans	28.0	25.5
I Social Security benefits for retired workers	26.9	25.8
I Treatment of qualified dividends	25.5	25.7
I Child credit (1)	24.0	24.0
B Exclusion of interest on life insurance savings	18.9	17.5
I Individual Retirement Accounts	16.9	16.4
B Deduction for US production activities	15.7	15.2
Key: I = Individual; C = Corporate; B = Both Corporate and Individual		
FASAB analysis based on U.S. Department of Treasury's Tables of Estimates from the Fiscal Year 2017 Tax Expenditures (September 2015)		
Source:	These estimates are prepared annually by Treasury for inclusion in the President's Budget. There are 169 provisions that are currently classified by Treasury as tax expenditures. Estimates and descriptions of each of the 169 provisions classified as tax expenditures, including the 20 presented here, are made available at http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx .	
(1)	The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in billions of dollars) is as follows: 2015 \$27.0 and 2016 \$27.0	
All revenue loss estimates have been rounded to the nearest \$100 million.		

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Deferred Maintenance and Repairs

[Abridged]

Other Claims for Refunds

[Abridged]

Tax Assessments

[Abridged]

Risk Assumed

[Abridged]

Federal Oil and Gas Resources

[Abridged]

- END OF APPENDIX III – OPTION B ILLUSTRATION -

Appendix IV: Task Force Roster**Task Force Roster**

R. Scott Bell	Department of the Treasury, Senior Accountant
Robert Bixby	The Concord Coalition, Executive Director
Robert Dietz	National Association of Home Builders, Tax and Market Analysis, Vice President
Bert Edwards	GWSCPA, Federal Issues and Standards Committee, Member
Regina Kearney	Office of Management and Budget, Senior Advisor
John McClelland	Department of the Treasury, Office of Tax Analysis, Economist
James McTigue, Jr.	Government Accountability Office, Strategic Issues, Director
Tim Morgan	PricewaterhouseCoopers, Partner (retired)
Dan Murrin	EY, Partner / GWSCPA; Federal Issues and Standards Committee, Member
MaryLynn Sergent	Government Accountability Office, Strategic Issues, Assistant Director
Jamie Taber	Office of Management and Budget, Economist
Alexandra Thornton	Center for American Progress, Tax Policy, Senior Director
Robin Valentine	KPMG LLP, Partner
David Weiner	Congressional Budget Office, Tax Analysis Division, Assistant Director

Support Staff

Ricky A. Perry, Jr.	Government Accountability Office, Auditor, Financial Management and Assurance
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Appendix V: Acknowledgements

This report was the result of strong collaboration among task force members sharing a common objective – improving the information available to citizens. The task force members each made substantial contributions to this report. The able assistance of Ricky A. Perry, Jr. greatly enhanced the report. In addition, Leigha Kiger, FASAB Communications Specialists, assisted in finalizing the report.

If you have questions regarding the report, please contact FASAB Staff at (202) 512-7350 or fasab@fasab.gov.

Errata

Page 7 - **Task Force Member Preferences/Endorsements of Options** – is revised as follows:

Task Force Member Preferences/Endorsements of Options

Option A: Messrs. ~~Bell~~, Bixby, and Edwards; Ms. Kearney; Messrs. Morgan and Murrin; and Mses. Taber and Valentine

Option B: Mr. McTigue, and Mses. Sergent and Thornton

Option C: Messrs. Bell, Dietz, and McClelland

Abstain: Mr. Weiner