

## **Tax Expenditures Task Force Meeting Minutes**

October 9, 2015

9 AM to 11 AM

441 G Street NW, Washington, D.C.

Room 5N30

- **Attendance**

The following task force members and officials were present at the meeting: Mr. Bell; Ms. Davis; Mr. Edwards; Ms. Kearney; Messrs. McClelland, McTigue, Morgan, and Murrin; Mses. Sergeant, Taber, and Thornton; and Mr. Weiner. The executive director, Ms. Payne, and support staff, Mr. Perry, were present throughout the meeting.

- **Approval of September Meeting Minutes**

Revised minutes for the September 11th task force meeting were provided at the beginning of the meeting. Members described revisions needed to provide context and requested that specific changes be circulated and approved via email following the meeting.

- **Plans for the October FASAB Meeting**

The Board received the draft introduction section (the background paper) and will discuss it at the next meeting. Task force members are encouraged to attend the meeting on October 22<sup>nd</sup> from 9:30 to 10:30. There will be a few seats at the Board table for members and those not seated at the table will be seated in the front row of seats behind the table. An open seat will be available for members to use in responding to questions. Staff encouraged the task force to avoid discussing pending recommendations until the December meeting.

- **Tax Preferences**

Mr. McClelland noted a significant edit to the draft introduction section should be discussed as it may influence recommendations. He explained Treasury's treatment of refundable credits such as the earned income tax credit (EITC). Refundable credits are reported by Treasury as tax expenditures only to the extent that they reduce receipts. Cash payments to taxpayers for refundable credits are not reported as tax expenditures by Treasury but are reported as outlays in the budget and as tax preferences. In contrast, the Joint Committee on Taxation (JCT) treatment does not distinguish between the cash payment and the amount that reduces receipts. The JCT reports the full amount of refundable credits as tax expenditures and discloses the outlay portion in notes to its estimates.

The accrual-basis financial statements included in the Financial Report of the US Government adopt a third treatment. The amount attributable to refundable credits is then included as a cost in the Statement of Net Cost and as revenue. [In response to a follow up question regarding which (all, selected, or only the EITC) refundable credits are treated this way, staff confirmed that all refundable tax credits are treated in this manner.]

The members discussed the confusion that may result from these varying treatments. For example, in some reports the EITC represents the largest credit taking into account its total cost, but in Treasury's report, due to the definition of tax expenditures, it is not. Consequently, the amount reported by Treasury as tax expenditure for the EITC is smaller than the average reader might expect.

The term "tax preference" is a broader term and may be helpful to readers interested in the effectiveness of the tax code in achieving performance goals. However, members noted that the government-wide report is appropriately focused on the fiscal effects of the tax code. For these purposes, Treasury's treatment of refundable tax credits is appropriate because it identifies the reduction in tax receipts that is not otherwise explicitly identified in the budget.

Task force members discussed the merits of providing two tables – one for tax expenditures and one for tax preferences. Tax preferences are an area of great interest. Treasury suggested inquiring of the Board whether there should be separate reporting on tax preferences. Some task force members worried that the financial report may not be suitable for a policy discussion regarding the performance of tax preferences. Given that a separate listing may obscure the fact that tax preferences have already been included as outlays (and costs), the task force decided not to propose separate identification of tax preferences. In addition, adding another term (tax preferences) for readers to understand may confuse readers. For example, a note might explain that there is a related outlay for the refundable portion of the credit.

Some members suggested improvements to the background paper to highlight the explanation of the treatment of refundable tax credits. Options will be developed for the background paper and the illustrations. Members will have a chance to discuss them at a later meeting.

Members noted the importance of ensuring refundable tax credits are treated correctly and consistently in the accrual basis statements.

- **Draft Report to the FASAB**

Members asked how subsequent events would be treated. For example, the estimates are based on tax law as of July of the report year and changes to that law may be enacted late in the calendar year. Typically, the estimates are not updated. One member suggested language regarding the feasibility of providing updated estimates. For example, narrative might reveal that a change had been enacted and, if possible, an estimate of the effect of the change.

Members affirmed their support for the three joint recommendations. Mr. Perry noted that the names of members endorsing each recommendation would be presented following each recommendation. In discussing how the alternative recommendations would be presented, some questioned the role of Appendix D – Alternative Views/Commentary. Generally, two interpretations were suggested. One, that Appendix D is reserved for members not satisfied with the options presented in the body of the paper. Two, that it is an opportunity for members to separately express their views on the topic of tax expenditures. The members agreed that Appendix D should be reserved

for members not satisfied with the options endorsed in the body of the paper. This will allow members to propose and support additional options.

A member noted that the heading of the table refers to largest tax expenditures based on revenue lost. This wording equates to 'forgone revenue' and the paper explains why tax expenditures are not necessarily forgone revenue. The group agreed to shorten the heading to avoid this inconsistency.

A member asked and the group agreed to separate the question of displaying a total tax expenditure amount from the question of placement of the information. Another member noted that the option of not including estimates at all should be presented. Members agreed that the wording of each option should be neutral and not make a case for the option. The question and answer section should present balanced views.

Members were polled regarding their views on the matters embodied in Options 4a (presentation of narrative and estimates in Other Information (OI)) and b (presentation of narrative and amounts in Required Supplementary Information (RSI)) as well as the need for a total. Responses were:

1. A progression toward improving the quality of information so that a detailed note can be provided is desirable. As a first step, OI should include a detailed table but a total on the table is not needed. The total in the context of the table is not meaningful and the magnitude will be apparent from the individual amounts. However, RSI should include information that conveys a sense of the magnitude of tax expenditures. For example, a statement that "estimates such as those prepared by the JCT suggest tax expenditures range from \$X to \$Y (or are in excess of \$Z)" would be helpful and may avoid costly audit consequences.
2. Although abstaining on the placement of estimates, this member advocated presentation of a total for tax expenditures. This was viewed as the single most important piece of information despite the challenges associated with the total. Regarding the cost of audit, the member did not sufficiently understand the ramifications of placement to make a decision.
3. Do not present a total. Provide information on tax expenditures in OI. It would appear along with related information such as tax gap. If there is quantitative information it should be in OI due to the audit costs associated with amounts. (MD&A – which is also RSI – would also provide information.)
4. Present information on individual tax expenditures in OI because we have the option of raising it later if the quality and audit issues are resolved. The totals are not essential.
5. Hopes there will be progression over time toward aggregate information consistent with each financial statement. For example, a deferred tax asset for the balance sheet (for deferrals) and sustainability information. For now, present information on individual tax expenditures in other information. Does not see a need for a total on a table but general information on magnitude expressed in narrative would be helpful.
6. Believes the total is really important and equivalent to outlays. Presenting individual amounts in OI is a good start but the total should be provided in RSI.

7. Present the information as RSI. Prefers to have an indication of the order of magnitude as expressed by other members.
8. Present total and other details in RSI. OI alone does nothing to enhance transparency. Open to an option of progressing toward RSI reporting within a specified timetable if RSI reporting is not adopted. The audit cost issue is difficult to assess without better information on cost and should be weighed against the aggregate magnitude of tax expenditures (>\$1 trillion).
9. Based on recommendations 1, 2, and 3, the report will provide a narrative discussion. Also, supports including something that will highlight the magnitude of tax expenditures but no total or detailed amounts. No additional information in OI or RSI would be needed. Given the current detailed reporting, it is difficult to see the added benefit of audit.
10. Present OI with numbers but no total. There are unresolvable issues. Subjecting the estimates to audit would not add value given these issues.
11. The report is not complete without a discussion of tax expenditures. Recommendations 1, 2, and 3 provide for needed narrative coverage. A display in OI with numbers to highlight important tax expenditures but no total.

One member suggested that implementation of the Government Performance and Results Act Modernization Act at the component reporting entity level has not progressed sufficiently to support component reporting entity recommendations.

- **Next Steps**

1. The September minutes will be revised and circulated for approval.
2. The October minutes will be drafted and circulated for review and approval.
3. Revise the options for recommendation 4 and circulate them for comment. Members will provide edits and indicate which option they expect to endorse.
4. Update the illustrations.

## Tax Expenditures Task Force Meeting – Agenda

October 9, 2015 – 9:00 AM to 11:00 AM

441 G Street NW, Washington, DC Room 5N30

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9:00 – 9:10     1. Approval of September meeting minutes

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### 2. FASAB October meeting

❖ Discussion of task force's October FASAB meeting deliverables

- 9:10 – 9:25                      ○ Plan for addressing the Board's questions about the Introduction Section / background paper (**Attachment 1**)
- Plan for addressing other questions from the Board, given that the task force's Report to the Board is not finalized yet
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### 3. Task force discussion/feedback of the Drafted *Report to the FASAB* (**Attachment 2**)

- 9:25 – 10:25                      ❖ Members – share feedback and comments on the draft report, section by section
- ❖ Plan for addressing component reporting entities and/or providing rationale for focusing on government-wide reporting.
- ❖ Members – share feedback and comments on the Appendices
- ❖ Minor technical comments can be sent directly to Alan and Wendy
- ❖ Appendix D (Alternative Views/Commentary) – plan for completion
- ❖ Appendix F (Acknowledgements) – plan for completion
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### 4. Next Steps:

- 10:25 – 10:45                      ❖ Goal: To approve the *Report to the FASAB* at the December task force meeting. Minor technical comments may be incorporated after the December meeting.
- ❖ December FASAB meeting deliverables
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**Attachment 1** – Introduction Section / Recommendation 1 Illustration

**Attachment 2** – Draft: *Report to the FASAB*



# Tax Expenditure Task Force

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

12/17/2015

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December 17, 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 and have similarities to federal spending in their impact on service efforts, costs, 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 disagreements among experts on how to measure 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 3 joint recommendations to the Board, along with 2 recommended options to the Board. Each recommendation includes a related appendix illustration. Our 2 recommended options to the Board are related to the presentation of tax expenditure estimates within the government-wide financial report. This area required extensive Task Force deliberation, and will likely generate extensive Board deliberations and disagreements among respondents. As such, in order to better inform the Board's deliberation process, we have also included the following information in this report for consideration: 1) the pros and cons of each recommendation, 2) our rationale for each recommendation, 3) Task Force member endorsements of each option, and 4) an appendix of Task Force members' commentary, views, and rationale.

In developing a 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 amongst the Task Force, we are pleased that there was Task Force consensus on 3 of the 4 recommendations to the Board. With respect to the fourth

recommendation, the Task Force believes that sharing our rationale and considerations for each of the 2 recommended 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 financial condition and service efforts of the United States government.

## **Executive Summary**

The objective of the Tax Expenditures Task Force was to assess how best to integrate tax expenditure information into the 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 3 joint recommendations to the Board, along with 2 recommended options to the Board. Each recommendation includes a related appendix illustration. Our 2 recommended options to the Board are related to the presentation of tax expenditure estimates within the government-wide financial report. This area represents an area that required extensive Task Force deliberation, and will likely generate extensive Board deliberations and disagreements among respondents. As such, in order to better inform the Board's deliberation process, we have also included the following information in this report for consideration: 1) the pros and cons of each recommendation, 2) our rationale for each recommendation, 3) Task Force member endorsements of each option, and 4) an appendix of Task Force members' commentary, views, and rationale.

**Recommendation 1** (Joint): To accompany any 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** (Joint): To require the integration of certain narrative disclosures regarding tax expenditures within Notes 1 and 18, 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.

**Recommendation 3** (Joint): To include hyperlinks within the notes of tax expenditures disclosures, 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 tax expenditure estimates published annually by Treasury's Office of Tax Policy.

**Recommendation for Board Consideration (Option 4A):** To encourage the inclusion of information regarding the magnitude of tax expenditures, including tax expenditure estimates, within the *Other Information* section of the government-wide financial report.

**Recommendation for Board Consideration (Option 4B):** To require the inclusion of information regarding the magnitude of tax expenditures, including tax expenditure estimates, within the *Required Supplementary Information* section of the government-wide financial report.

## **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 explore 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 progress, a task force comprising individuals with extensive experience regarding tax expenditures, 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 first asked to develop a paper explaining tax expenditures. See [Appendix A](#) to review this paper, which also serves to provide additional context and background surrounding this project.

## **Recommendations**

**Recommendation 1** (Joint): To accompany any 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 has drafted an illustration of this recommendation, which we endorse for the Board's use (see [Appendix A: Illustration of Recommendation 1](#)).

**Recommendation 2** (Joint): To require the integration of certain narrative disclosures regarding tax expenditures within Notes 1 and 18, 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.

The task force unanimously supports this recommendation, which is illustrated at [Appendix B: 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 of the Financial Report of the U.S. Government – 2014. Such illustrations will enable the Board to visualize the impact of requiring the integration 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 without significant audit implications.

**Recommendation 3** (Joint): To require the use of hyperlinks within the MD&A section and notes to the financial statements, directing users to 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 tax expenditure estimates published annually by Treasury's Office of Tax Policy.

The task force unanimously supports this recommendation, which is illustrated at [Appendix B: Illustration of Recommendations 2 and 3](#). This illustration is provided in tracked changes and based on the MD&A and Notes 1 and 18 of the Financial Report of the U.S. Government - 2014. Such illustrations will enable the Board to visualize the impact of requiring the inclusion of these external references.

While Treasury does not currently include footnotes in its financial statement notes, we have included a footnoted hyperlink to the Office of Tax Policy's annual estimates within Appendix B for illustrative purposes. Treasury may wish to use embedded hyperlinks within the text of its notes 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 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 – Two Options for Board Consideration:** The following recommended options to the Board are related to the presentation of tax expenditure estimates within the government-wide financial report.

**Option 4A:** To encourage the inclusion of information regarding the magnitude of tax expenditures, including tax expenditure estimates, within the *Other Information* section of the government-wide financial report statements.

**Option 4B:** To require the inclusion of information regarding the magnitude of tax expenditures, including tax expenditure estimates, within the *Required Supplementary Information* section of the government-wide statements. This area required extensive Task Force deliberation, and will likely generate extensive Board deliberations and disagreements among respondents. As such, in order to better inform and streamline the Board's deliberation process, we have also included the pros and cons of each option.

**Additional Discussion / Pros and Cons of Options A and B**

The task force is unanimously supportive of providing information that enables readers to understand the magnitude of the financial impact of tax expenditures on the financial position 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, Other Information section, or the MD&A section)?*

**A1)** Task force members supportive of [Option A](#) (the inclusion of tax expenditure estimates within the *Other Information* section of the government-wide financial report) were primarily concerned about the nature and extent of the judgment involved and the subjectivity inherent in identifying and measuring tax expenditures, and the quality, timeliness, and availability of reliable data. These conditions pose unique challenges impeding Treasury's ability to 1) develop estimates generally accepted as reliable and

fair and 2) include estimates within RSI or Basic Information without negative and/or potentially inherently unresolvable audit challenges. There are a host of implications for tallying up all tax expenditures, including fundamental disagreements between Treasury and the Joint Committee on Taxation about estimation methodologies and whether or not certain things in the Internal Revenue Code constitute a tax expenditure or not. Moreover, task force members were concerned that including tax expenditure estimate totals may not ultimately be the primary information that should be conveyed to the reader in the financial report. As such, Option A – as illustrated in [Appendix C: Illustration of Recommendation 4 - Option A for Board Consideration](#) – avoids the costly audit challenges of including tax expenditure estimates in RSI. Moreover, the illustration avoids providing a grand total estimate with little to no predictive or feedback value for users.

Task force members supportive of the inclusion of tax expenditure estimates within the Required Supplementary Information section of the government-wide financial report – as illustrated in [Appendix C: Illustration of Recommendation 4 – Option B for Board Consideration](#) – were primarily concerned with the primary purpose of the government-wide financial report, which is to inform users of matters impacting the government's 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 financial report. Inclusion of such estimates in this section (as opposed to the *Other Information* section) has some audit implications, but may ultimately improve the informational value of tax expenditure estimates and improve the underlying estimation processes and controls behind the numbers. Task force members supportive of Option B believe that disclosure of the overall magnitude with a “grand total” estimate is reasonable, provided disclosures of the limitations and major assumptions underlying the totals are also provided.

**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?*

**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 other external sources of more detailed information available. While the task force did not come to a unanimous agreement on how to do so, the task force unanimously supports providing users with a sense of the magnitude of tax expenditures either in the *Other Information* section or the *Required Supplementary Information* section, as well as 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.

## **Appendices**

### **Appendix A: Illustration of Recommendation 1**

## **Introduction Section of the Exposure Draft**

### **Purpose**

The Board is committed to ensuring that federal financial reporting assists report users in evaluating the service efforts, costs, accomplishments, and fiscal sustainability of the federal government and understanding how these efforts and accomplishments have been financed. Tax expenditures have historically received little focus in general purpose federal financial reporting and have similarities to federal spending in their impact on service efforts, costs, accomplishments, and fiscal sustainability. Establishing reporting requirements that assist report users requires an understanding of the methods used to estimate tax expenditures and considerations in using those estimates.

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

1. provides the definition of 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 Treasury. This ultimately impacts how tax expenditure estimates can be used and interpreted.

### **Background**

“Tax expenditures” are preferences in tax law ensuring more money is 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 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 reduce taxes owed and resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, they are not treated the same as federal spending for budgetary or financial reporting purposes.<sup>1</sup> 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 and Changes in Net Position. While tax expenditures help determine the government's net

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<sup>1</sup> 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.

revenue, they are generally not separately disbursed or accounted for in Treasury's books and records.

### Definition

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)*

### 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.

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.

**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 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.

### 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).

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.<sup>2</sup>

Estimates are now available annually from both the JCT<sup>3</sup> and the President’s Budget.<sup>4</sup> 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 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.<sup>5</sup>

### **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.<sup>6</sup> The GPRAMA framework aims at taking a more crosscutting and integrated approach to focusing on results and improving

<sup>2</sup> 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.

<sup>3</sup> 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.

<sup>4</sup> See [https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/ap\\_14\\_expenditures.pdf](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.)

<sup>5</sup> 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.)

<sup>6</sup> Pub. L. No. 103-62, 107 Stat. 285 (Aug. 3, 1993) and Pub. L. No. 111-352, 124 Stat. 3866 (Jan. 4, 2011).

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.<sup>7</sup> 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.<sup>8</sup>

However, the Government Accountability Office (GAO) has found that the executive branch still has not taken action to assess the outcomes of tax expenditures and their contributions to CAP goals and APGs.<sup>9</sup> OMB's 2013 and 2014 guidance noted that it would work with Treasury and agencies to identify where tax expenditures align with their goals and this information was to be published on Performance.gov and included in relevant agency plans, beginning in February 2014. However, OMB staff did not begin to engage Treasury on this effort until after agency plans were published and the website was updated. In June 2015, OMB removed the guidance language about working with Treasury and agencies to align tax expenditures with agency goals. As of August 2015, OMB has not made progress on this effort and did not provide GAO with any plans or time frames for doing so.

### **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 is adapted from a comprehensive income tax in which income is the sum of consumption and the change in net wealth in a given period of time. This baseline assumes an individual income tax and a separate corporate income tax.<sup>10</sup>

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.<sup>11</sup>

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. It is assumed

<sup>7</sup> 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.

<sup>8</sup> OMB, Circular A-11 (2015).

<sup>9</sup> 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).

<sup>10</sup> 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.

<sup>11</sup> "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.

that there is no behavioral response to the repeal 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 to develop estimates of recent and future utilization of the tax credits, exemptions and deductions that make up each tax expenditure. For tax expenditures not reflected on tax returns—income exclusions, for example—Treasury economists rely on other economic data to estimate the current utilization of the tax preference. The use of the preference is then projected into the future using assumptions that are consistent with the Administration's economic forecast.

The Treasury estimates the current year cash effect of each tax expenditure. Some tax expenditures represent deferrals of taxation. That is, 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.<sup>12</sup> For example, defined contribution employer plans are estimated as the net tax effect of current year contributions excluded from income and of 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, individual tax

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<sup>12</sup> 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.

expenditure estimates do not necessarily equal the change in the deficit<sup>13</sup> 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 remain 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 (CBO) has modeled the interaction of the largest provisions under current tax law and found that interactions that overstate the effect are similar in size to interactions that understate the effect.<sup>14</sup> 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

<sup>13</sup> 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.

<sup>14</sup> Congressional Budget Office. *The Budget and Economic Outlook: 2015 to 2025*. January 26, 2015.

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.<sup>15</sup> Please note the aforementioned considerations when reviewing these estimates.

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<sup>15</sup> See <http://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2017.pdf> for a complete listing of tax expenditures reported and estimated by Treasury in September, 2015.

## Appendix A: Largest Tax Expenditures

### Tax Expenditures – Ranked by Fiscal Year 2016 Revenue Effect

(in billions of dollars, based on assumptions from the Mid-Session Review of the 2016 Budget)

<u>Largest 20 Tax Expenditures by Estimated Revenue Losses, 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 (1)	\$ 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 (2)	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			
Sources: FASAB analysis based on U.S. Department of Treasury's Tables of Estimates from the Fiscal Year 2017 Tax Expenditures (September 2015)			
(1)	The figures in the table indicate the effect on income taxes of the employer contributions for health. In addition, the effect on payroll tax receipts (in billions of dollars) is as follows: 2015 \$127.5 and 2016 \$131.4		
(2)	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 B: 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*.<sup>16</sup>

Table 4: Gross Cost, Revenues, Net Cost, and Net Operating Cost					
Dollars in Billions	2014	2013	Increase / (Decrease)		
			\$		%
<b>Gross Cost</b>	\$ (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%
<b>Net Cost</b>	\$ (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%
<b>Net Operating Cost</b>	\$ (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:

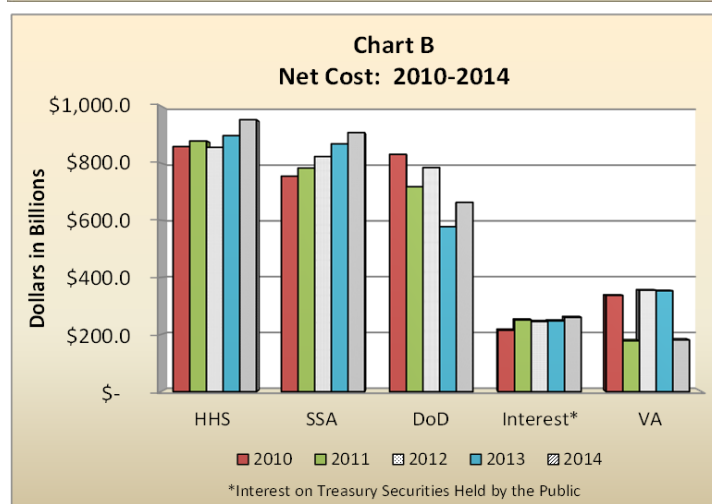
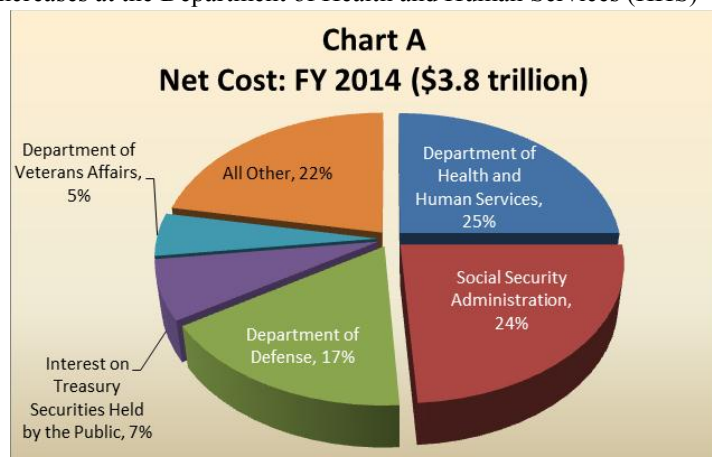
- The loss on changes in assumptions associated with the Government's civilian and military benefits programs amounted to \$3.5 billion in FY 2014 as compared to \$131.2 billion in FY 2013, representing a \$127.7 billion decrease in net cost. Agencies administering these types of programs employ a complex 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

<sup>16</sup> 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 GSEs<sup>17</sup>;
- \$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 rates<sup>18</sup>; 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.<sup>19</sup>

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"

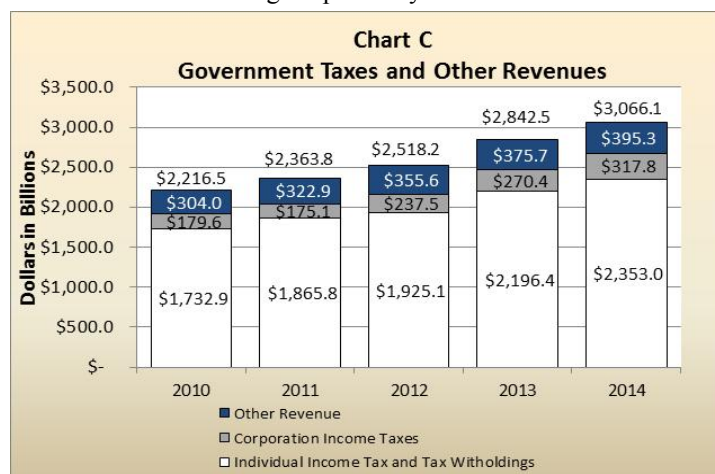
<sup>17</sup> [Department of the Treasury FY 2014 Agency Financial Report](#), p. 22-23. See also Note 9 – Investments in GSEs – of this *Financial Report*.

<sup>18</sup> [Department of Education FY 2014 Agency Financial Report](#), p. 30

<sup>19</sup> [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.<sup>20</sup> 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”

“Tax expenditures” refers to preferences in tax law ensuring more money is 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 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 reduce taxes owed and resemble federal spending in that such provisions impact the federal deficit/surplus by impacting income tax revenue; however, they are not treated the same as federal spending for budgetary or financial reporting purposes.<sup>21</sup> Tax expenditures are not subject to the annual budget process and can only be removed through tax legislation. Tax expenditures estimates are not displayed in the Statements of Net Cost and 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.<sup>22</sup>

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

### **Assets and Liabilities: "What We Own and What We Owe"** **[Abridged]**

<sup>20</sup> Department of the Treasury FY 2014 Agency Financial Report, p. 28

<sup>21</sup> 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 a result, the portion that exceeds liability is not counted as a tax expenditure by the Department of the Treasury.

<sup>22</sup> Department of the Treasury Fiscal Year 2017 Tax Expenditures Report

## **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 .....	3,174.6	2,090.8	998.1	36.8	48.9
Less: amounts collected for non-federal entities .....	(0.3)				
Total .....	3,174.3				

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.<sup>23</sup>

Nonexchange revenue may 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 B ILLUSTRATION -

<sup>23</sup> Department of the Treasury Fiscal Year 2017 Tax Expenditures Report

Appendix C: 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

“Tax expenditures” refers to preferences in tax law ensuring more money is 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 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 reduce taxes owed and resemble federal spending in that such provisions impact the federal deficit/surplus by impacting income tax revenue<sup>24</sup>. Tax expenditures arise from special provisions allowing exclusions, exemptions, or deductions from taxpayers’ gross income, or credits, preferential tax rates, or deferrals of liabilities. They resemble federal spending in that such provisions impact the federal deficit/surplus by affecting income tax revenues; however, they are not treated the same as federal spending in budgetary or financial reporting are not treated the same as federal spending for budgetary or financial reporting purposes. Tax expenditures are not subject to the annual budget process and can only be removed through tax legislation. Tax expenditures estimates are not displayed in the Statements of Net Cost and 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 now available annually from Treasury’s Office of Tax Policy<sup>25</sup>. 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

<sup>24</sup> 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 a result, the portion that exceeds liability is not recorded as a tax expenditure by the Department of the Treasury.

<sup>25</sup> 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/default.aspx>.

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.

Selected major tax expenditures are presented in the table below.

<b><u>Largest 20 Tax Expenditures by Estimated Revenue Losses, Fiscal Years 2016 and 2015</u></b>			
		<b>2016 Dollars (in billions)</b>	<b>2015 Dollars (in billions)</b>
I	Exclusion of employer contributions for medical insurance premiums and medical care (1)	\$ 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 (2)	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			
Sources: FASAB analysis based on U.S. Department of Treasury's Tables of Estimates from the Fiscal Year 2017 Tax Expenditures (September 2015)			
(1)	The figures in the table indicate the effect on income taxes of the employer contributions for health. In addition, the effect on payroll tax receipts (in billions of dollars) is as follows: 2015 \$127.5 and 2016 \$131.4		
(2)	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.			

## Tax Gap

[Abridged]

## Unmatched Transactions and Balances

[Abridged]

- END OF APPENDIX C – 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

“Tax expenditures” refers to preferences in tax law ensuring more money is 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 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 reduce taxes owed and resemble federal spending in that such provisions impact the federal deficit/surplus by impacting income tax revenue<sup>26</sup>. Tax expenditures arise from special provisions allowing exclusions, exemptions, or deductions from taxpayers’ gross income, or credits, preferential tax rates, or deferrals of liabilities. They resemble federal spending in that such provisions impact the federal deficit/surplus by affecting income tax revenues; however, they are not treated the same as federal spending in budgetary or financial reporting are not treated the same as federal spending for budgetary or financial reporting purposes. Tax expenditures are not subject to the annual budget process and can only be removed through tax legislation. Tax expenditures estimates are not displayed in the Statements of Net Cost and 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 now available annually from Treasury’s Office of Tax Policy<sup>27</sup>. 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

<sup>26</sup> 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 a result, the portion that exceeds liability is not recorded as a tax expenditure by the Department of the Treasury.

<sup>27</sup> 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/default.aspx>.

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.

Selected major tax expenditures are presented in the table below.

<b><u>Largest 20 Tax Expenditures by Estimated Revenue Losses, Fiscal Years 2016 and 2015</u></b>		
	<b>2016 Dollars (in billions)</b>	<b>2015 Dollars (in billions)</b>
I Exclusion of employer contributions for medical insurance premiums and medical care (1)	\$ 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 (2)	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
B All others (3)	201.7	203.2
<b>TOTAL (3)</b>	<b>\$ 1,283.3</b>	<b>\$ 1,232.4</b>

Key: I = Individual; C = Corporate; B = Both Corporate and Individual

Sources: FASAB analysis based on U.S. Department of Treasury’s Tables of Estimates from the Fiscal Year 2017 Tax Expenditures (September 2015)

- (1) The figures in the table indicate the effect on income taxes of the employer contributions for health. In addition, the effect on payroll tax receipts (in billions of dollars) is as follows: 2015 \$127.5 and 2016 \$131.4
- (2) 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
- (3) Treasury does not total its own estimates because each tax expenditure estimate is calculated independently, assuming that other parts of the Tax Code remain unchanged. As such, the grand total estimate would be different if multiple tax expenditures were changed simultaneously because of interactions among provisions. Totals presented here should be interpreted as not accounting for such interactions.
- All revenue loss estimates have been rounded to the nearest \$100 million.

## 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 C – OPTION B ILLUSTRATION -

Appendix D: Supplementary Task Force Member Commentary and Rationale for Board Consideration

Appendix E: Task Force Roster**Task Force Roster**

R. Scott Bell	Department of the Treasury, Senior Accountant
Robert Bixby	The Concord Coalition, Executive Director
Curtis Carlson	Department of the Treasury, Office of Tax Analysis, Acting 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, Assistant Director
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**

R. Alan Perry, Jr.	Government Accountability Office, Auditor, Financial Management and Assurance
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Appendix F: Acknowledgements

# Introduction Section of the Exposure Draft

## Purpose

The Board is committed to ensuring that federal financial reporting assists report users in evaluating the service efforts, costs, accomplishments, and fiscal sustainability of the federal government and understanding how these efforts and accomplishments have been financed. Tax expenditures have historically received little focus in general purpose federal financial reporting and have similarities to federal spending in their impact on service efforts, costs, accomplishments, and fiscal sustainability. Establishing reporting requirements that assist report users requires an understanding of the methods used to estimate tax expenditures and considerations in using those estimates.

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

1. provides the definition of 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 Treasury. This ultimately impacts how tax expenditure estimates can be used and interpreted.

## Background

"Tax expenditures" are preferences in tax law ensuring more money is 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 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 reduce taxes owed and resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, they are not treated the same as federal spending for budgetary or financial reporting purposes.<sup>1</sup> 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 and 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.

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<sup>1</sup> 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.

## Definition

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)*

## 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.

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.

<b>Table 1: Examples of Provisions That Are Tax Expenditures When They Are Exceptions to the Normal [Baseline] Tax Structure</b>		
<b>Tax expenditure</b>	<b>Description</b>	<b>Examples</b>
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 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.

### 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).

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.<sup>2</sup>

Estimates are now available annually from both the JCT<sup>3</sup> and the President’s Budget.<sup>4</sup> 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 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.<sup>5</sup>

### **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.<sup>6</sup> The GPRAMA framework aims at taking a more crosscutting and integrated approach to focusing on results and improving

<sup>2</sup> 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.

<sup>3</sup> 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.

<sup>4</sup> See [https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/ap\\_14\\_expenditures.pdf](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.)

<sup>5</sup> 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.)

<sup>6</sup> Pub. L. No. 103-62, 107 Stat. 285 (Aug. 3, 1993) and Pub. L. No. 111-352, 124 Stat. 3866 (Jan. 4, 2011).

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.<sup>7</sup> 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.<sup>8</sup>

However, the Government Accountability Office (GAO) has found that the executive branch still has not taken action to assess the outcomes of tax expenditures and their contributions to CAP goals and APGs.<sup>9</sup> OMB's 2013 and 2014 guidance noted that it would work with Treasury and agencies to identify where tax expenditures align with their goals and this information was to be published on Performance.gov and included in relevant agency plans, beginning in February 2014. However, OMB staff did not begin to engage Treasury on this effort until after agency plans were published and the website was updated. In June 2015, OMB removed the guidance language about working with Treasury and agencies to align tax expenditures with agency goals. As of August 2015, OMB has not made progress on this effort and did not provide GAO with any plans or time frames for doing so.

### **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 is adapted from a comprehensive income tax in which income is the sum of consumption and the change in net wealth in a given period of time. This baseline assumes an individual income tax and a separate corporate income tax.<sup>10</sup>

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.<sup>11</sup>

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. It is assumed

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<sup>7</sup> 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.

<sup>8</sup> OMB, Circular A-11 (2015).

<sup>9</sup> 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).

<sup>10</sup> 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.

<sup>11</sup> "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.

that there is no behavioral response to the repeal 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 to develop estimates of recent and future utilization of the tax credits, exemptions and deductions that make up each tax expenditure. For tax expenditures not reflected on tax returns—income exclusions, for example—Treasury economists rely on other economic data to estimate the current utilization of the tax preference. The use of the preference is then projected into the future using assumptions that are consistent with the Administration's economic forecast.

The Treasury estimates the current year cash effect of each tax expenditure. Some tax expenditures represent deferrals of taxation. That is, 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.<sup>12</sup> For example, defined contribution employer plans are estimated as the net tax effect of current year contributions excluded from income and of 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.

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<sup>12</sup> 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.

**Not Necessarily Equivalent to Forgone Revenue.** Estimates should be regarded as approximations. As with expenses incurred with spending programs, individual tax expenditure estimates do not necessarily equal the change in the deficit<sup>13</sup> 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 remain 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 (CBO) has modeled the interaction of the largest provisions under current tax law and found that interactions that overstate the effect are similar in size to interactions that understate the effect.<sup>14</sup> 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

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<sup>13</sup> 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.

<sup>14</sup> Congressional Budget Office. *The Budget and Economic Outlook: 2015 to 2025*. January 26, 2015.

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.<sup>15</sup> Please note the aforementioned considerations when reviewing these estimates.

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<sup>15</sup> See <http://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2017.pdf> for a complete listing of tax expenditures reported and estimated by Treasury in September, 2015.

## Appendix A: Largest Tax Expenditures

### Tax Expenditures – Ranked by Fiscal Year 2016 Revenue Effect

(in billions of dollars, based on assumptions from the Mid-Session Review of the 2016 Budget)

<u>Largest 20 Tax Expenditures by Estimated Revenue Losses, 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 (1)	\$ 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 (2)	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			
Sources: FASAB analysis based on U.S. Department of Treasury's Tables of Estimates from the Fiscal Year 2017 Tax Expenditures (September 2015)			
(1)	The figures in the table indicate the effect on income taxes of the employer contributions for health. In addition, the effect on payroll tax receipts (in billions of dollars) is as follows: 2015 \$127.5 and 2016 \$131.4		
(2)	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.			