Tax Expenditures Task Force Meeting
June 11, 2015
9 AM to 11 AM
441 G Street NW, Washington, DC
Room 5047

Agenda

9:00 – 9:15	Introductions
9:15 – 10:00	Identify Objectives to be Met by Including Tax Expenditure Information in Federal Financial Reports - Primary user - Operating performance
10:00 – 10:45	Review draft of “Tax Expenditures Explained” (see Attachment 1) - Discuss member questions about tax expenditures - Identify additions, changes, or deletions needed in proposed content
10:45 – 11:00	Discuss Plan (see Attachment 2) and Next Steps

Attachment 1 – Tax Expenditures Explained (Draft)

Attachment 2 – Tax Expenditures Introduction (Updated Roster of Members)

Tax Expenditures Explained

This

1. Background
    a. Definition
    b. Types of Tax Expenditures
    c. Budget Act Requirements and History
    d. GPRA MA
2. How Estimates Are Prepared
3. Limitations of Estimates
    a. Overall
    b. Is the normal tax system ideal?
    c. Not equivalent to foregone revenue or direct spending

Background

"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 or face special circumstances. The government uses tax expenditures to accomplish public policy goals such as increasing home ownership rates, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production. Tax expenditures can reduce taxes otherwise payable or provide cash in the form of a refundable tax credit.[1] Because tax expenditures reduce tax revenue to the federal government, instead of being a direct or appropriated outlay, they are often referred to as "hidden" spending.

The Board is concerned with ensuring that federal financial reporting assists report users in evaluating the service efforts, costs, and accomplishments of the federal government and understanding how these efforts and accomplishments have been financed. Establishing reporting requirements that assist report users requires an understanding of this complex topic, the methods used to estimate tax expenditures, and limitations on those estimates. This appendix provides an overview of the topic to aid respondents in considering the Board's proposal.

Definition

In its simplest form, a tax is a specific rate applied equally to a specific tax base such as income. Taxes are rarely this simple though. Numerous federal goals are supported through the tax code in a variety of ways; making it a complex matter to identify "tax expenditures." 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)

The first step in identifying tax expenditures is determining what the tax base is so that the provisions considered "special" can be distinguished from those provisions consistent with a "normal" or baseline tax system. Those credits, deductions, special exceptions and allowances that reduce tax liability below the level implied by the baseline tax system are then considered tax expenditures. For the federal income tax, the baseline tax system is a comprehensive income tax with certain practical provisions. It includes personal exemptions, a standard deduction, and deduction of expenses incurred in earning income as well as a progressive rate structure. Attachment 1 provides details regarding baseline tax systems used by the U.S. Congress Joint Committee on Taxation and the Department of Treasury Office of Tax Analysis in preparing annual estimates.

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.

[1] A refundable tax credit is provided 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. So, this type of tax expenditure is included in the budget to the extent payments exceed the taxpayer's tax liability.

Table 1: Examples of Provisions That Are Tax Expenditures When They Are Exceptions to the Normal 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 the same outcome can be achieved in a variety of ways. For example, the same public policy purpose can be achieved through a preferential rate, a deduction, or a credit because each can be structured to provide the same reduction in tax liability. 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 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 Congressional Budget Office (CBO) was created by the Budget Act and directed to provide estimates to Congress. The CBO relies upon the JCT for estimates given the JCT’s role in providing other revenue estimates. The Budget Act further required that the annual President's Budget include tax expenditure estimates.[2]

Estimates are now available annually from both the JCT and the President's Budget. The JCT estimates can be found at https://www.jct.gov/publications.html?func=select&id=5 and the President's Budget at
https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/ap_14_expenditures.pdf

Estimates provided in the President's Budget cover the current fiscal year and the ten years following the current fiscal year. They 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 determining the relative merits of achieving specific public goals through the use of tax expenditures.

Government Performance and Results Act – Modernization Act

The Government Performance and Results Act Modernization Act of 2010 (GPRA MA) (Public Law 111-352) requires OMB to 1) coordinate with agencies to develop a Federal Government performance plan to be updated no less than annually, 2) identify relevant tax expenditures contributing to priority goals within the plan, and 3) periodically assess whether tax expenditures are contributing as planned. Each agency's annual performance plans are also required to identify regulations, such as relevant tax expenditures, that contribute to performance goals. [Update for any information about implementation.]

[The following sections are presented as key points but will be revised to flow as a formal report once key points are agreed upon.]

How Estimates Are Prepared

Key points:

1. Deciding whether a provision of tax law is an exception to the normal tax baseline is a matter of judgment. (May wish to note that identification as a tax expenditure is not intended to as an assessment of the desirability of any special tax provision as a matter of public policy. (See JCS-1-10, page 4)

2. The normal tax baseline 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. The normal tax baseline allows personal exemptions, a standard deduction, and deduction of expenses incurred in earning income. It is not limited to a particular structure of tax rates, or by a specific definition of the taxpaying unit. The normal tax baseline allows several major departures from a pure comprehensive income tax. For example:
    a. Income is taxable only when it is realized in exchange. Thus, the deferral of tax on unrealized capital gains is not regarded as a tax expenditure. Accrued income would be taxed under a comprehensive income tax.
    b. There is a separate corporate income tax.

3. Underlying economic data are based on the Administration's economic forecast.

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

4. Each tax expenditure is measured by the difference between tax liability under present law and the tax liability that would result if the tax expenditure provision were repealed and taxpayers were prohibited from taking advantage of any of the remaining tax expenditure provisions that apply to the income or the expenses associated with the repealed tax expenditure. For example, the tax expenditure provision for the exclusion for employer-paid health insurance is measured by the difference between tax liability under present law and the tax liability that would result if the exclusion were repealed and taxpayers were required to include all of the employer-paid health insurance in income, with no offsetting deductions (i.e., no deductibility on schedule A).

5. Negative tax expenditures are special provisions that increase the tax burden above what the normal tax baseline would impose. This results in the collection of more revenue than does the baseline. Examples include the phaseout of the personal exemption and disallowance of the personal exemption and standard deduction against the alternative minimum tax. (Source: JCT-2-08)

6. The tax expenditure calculations are based on projections of actual claims under the various tax provisions, not the potential tax benefits to which taxpayers are entitled.

7. Key data come from:

    a. Internal Revenue Service ("IRS") statistics from recent tax returns are used to develop projections of the tax credits, deductions, and exclusions that will be claimed (or that will be denied in the case of negative tax expenditures) under the present-law baseline.

    b. Some tax expenditure calculations are based partly on statistics for income, deductions, and expenses for prior years.

8. Year-to-year differences in the calculations for each tax expenditure reflect changes in tax law, including phaseouts of tax expenditure provisions and changes that alter the definition of the normal income tax structure, such as the tax rate schedule, the personal exemption amount, and the standard deduction. For example, the dollar level of tax expenditures tends to increase and decrease as tax rates increase and decrease, respectively, without any other changes in law.

Limitations of Estimates

Overall

1. Tax expenditures can arise in other than income taxes (for example, excise taxes) but these generally are not included in reports on tax expenditures.

2. Tables present total revenue effects that arise under individual and corporate income taxes separately. The reader is cautioned that labeling does not imply that individuals and corporations "benefit from the special tax provisions in proportion to the respective tax expenditure amounts shown. Rather, these breakdowns show the form of tax liability that the various provisions affect. The ultimate beneficiaries of corporate tax expenditures could be shareholders, employees, customers, or other providers of capital, depending on economic forces." (Source: Analytical Perspectives)

3. Estimates are based on tax law enacted as of July 1, 20XX and assume that any provisions scheduled to expire will expire (for example, alternative minimum tax relief). As noted in Key Point 8 above, provisions likely to be extended are ignored for estimation purposes until such legislation is passed. 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.

4. A grand total for the estimated tax expenditures is not provided in Analytical Perspectives because each tax expenditure is estimated assuming other parts of the Tax Code remain unchanged. The estimates would be different if tax expenditures were changed simultaneously because of potential interactions among provisions.

5. Estimates are provided for the cash (current revenue) effect and the present value effect for the period 20XX through 20XX. The present value effects are important because deferrals will reverse in later years. (Note that new deferral provisions may result in expenditures for which later reversals are wholly outside the time period of the estimate.)

Is the "normal tax system" ideal?

1. Selection of the baseline system implies to some that it is "normal" (superior) to other possible systems. Thus, identification of tax expenditures may imply policy preferences rather than a neutral analysis. (Note that there are alternatives approaches. For example, Treasury provides estimates of tax expenditures based on a reference tax law (adhering more closely to the current tax code provisions for the baseline amounts) and this approach results in identification of fewer tax expenditures.)

2. Proposals for redefining the normal tax system for purposes of estimating tax expenditures have included using:

    a. a comprehensive income tax,

    b. a flat tax, or

    c. a consumption tax

Not equivalent to foregone revenue or direct spending

1. Estimates should be regarded as approximations and individual estimates do not necessarily equal the increase in Federal revenues (or the change in the budget balance) 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.

2. Estimates are not equivalent to the amount needed to accomplish the same objectives through direct spending programs.

a. In some cases, direct spending would be taxable income to the recipient so a higher amount would be needed to attain the same net cash result.

b. Administrative expenses that would be incurred in a direct spending program are not included.

ATTACHMENT 1 – Detailed Explanation of Baseline Tax System[3]

A Comparison of Baselines	
JCT Normal Tax Baseline	**Treasury Normal Tax Baseline**

Individual Tax
• One personal exemption for each taxpayer and dependent
• Standard deduction
• Includes all cash transfer payments from the Government
• Deductions for investment and employee business expenses
• Prevailing tax rate schedule and tax brackets
• Capital gains taxed upon realization
• All employee compensation subject to tax currently
    • Employee stock options taxed at regular rate when options exercised (with corresponding deduction for employees). Income is difference between purchase price of stock and the market price on the day the option exercised.
• All other income and transfers subject to tax
    • Social security income excluded only for the portion of retirement benefits that represent a return of payroll taxes paid during working years; Medicare benefits excluded only for the portion of health insurance tax contributions; public assistance benefits (food stamps, Medicaid, public housing) subject to tax; gifts excluded
• Imputed income from owner-occupied homes excluded (but not classified as tax expenditure due to administrative necessity)
• Income tax levied on nominal not real gains in asset values (no indexing)
• Foreign tax credit
	JCT normal tax with the following exceptions:
	• Includes [Alternative Minimum Tax] AMT and passive loss rules as part of the baseline
	• Includes net imputed rental income

Business income taxation • Treatment of capital costs • Cost recovery allowances more favorable than straight-line recovery	**JCT normal tax with the following exceptions** • Includes corporate AMT • Includes cash method of accounting for certain businesses

[3] Adapted from Altshuler, Rosanne and Robert Dietz. “Reconsidering Tax Expenditure Estimation.” *The National Tax Journal*, June 2011, 64 (2, Part 2), 459-490.

• No indexing • Accounting standards • Accrual method of accounting, standard of "economic performance" used to determine whether liabilities are deductible, and general concept of matching income and expenses. Tax provisions that do not satisfy all three are viewed as tax expenditures. • Prevailing carryback and carryforward periods for net operating losses • Top statutory rate on corporate income (no graduated rates) • Special tax rules for pass-through entities and nonprofit corporations exempting them from corporate income tax • Controlled foreign corporations (CFCs) not considered separate entities from controlling U.S. shareholders • Foreign tax credit	• Uses economic depreciation in baseline
Notes: See JCT (2010) and OMB (2010) for further details.	

Tax Expenditure Task Force - Introduction

Objective

Develop guidance for presentation of tax expenditure information in federal financial reports. The primary audiences for the information are citizens and citizen intermediaries (journalists and public policy analysts). The information presented should aid readers in understanding the operating performance of the reporting entity including the efforts associated with the accomplishments of the reporting entity.

Note that the federal government is now identifying tax expenditures for purposes of performance reporting. The Government Performance and Results Act of 1993 (GPRA) as amended by the GPRA Modernization Act of 2010 (GPRAMA) requires identification of tax expenditures that contribute to each crosscutting priority goal. OMB Circular A-11 directs agencies to list tax expenditures among the programs and activities that contribute to the subset of performance goals designated as agency priority goals.

Table 1 - Federal Financial Reporting Objective
Operating Performance—Federal financial reporting should assist report users in evaluating **the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed;** and the management of the entity's assets and liabilities. Federal financial reporting should provide information that helps the reader to determine • the costs of providing specific programs and activities and the composition of, and changes in, these costs; • the efforts and accomplishments associated with federal programs and the changes over time and in relation to costs; and • the efficiency and effectiveness of the government's management of its assets and liabilities.

Financial Reporting Questions

The Board plans to adopt the existing Budget Act[1] definition and work with estimates prepared by the Treasury Office of Tax Analysis (OTA) and/or the Joint Committee on Taxation (JCT).

The task force is asked to consider:

1. What key narrative should be included in the financial report of the US Government regarding tax expenditures?
    a. What are tax expenditures?
    b. How are they used by elected officials (substitute for direct spending, designed to accomplish public policy goals)?

2. What explanatory information is needed to help users understand the estimates and their limitations?
    a. Nature of these estimates – key data sources and methods (major components of a normal/baseline tax system)
    b. Not equivalent to amounts needed if the program were funded as a direct spending program

[1] Congressional Budget and Impoundment Act of 1974 (the Budget Act)

    c. Barriers to summation/categorization
    d. Not revenue foregone because they do not consider behavioral effects of changes in policy and interaction among key tax provisions
    e. Not complete because estimates exclude excise taxes and other revenues

3. Should trends or changes in the estimates be explained?
    a. Sensitivity analysis (key factors, ranges, etc.)
    b. What information should be provided regarding changes in law?
    c. Should information be provided regarding prior projections and why they have changed (methodology, assumptions, behavior)?

4. Should tax expenditure information be related to other information in reports?
    a. For overall context, should tax expenditure information be related to revenue and/or cost information?
    b. Should tax expenditures be discussed in the summary of performance measures (currently required in the management's discussion and analysis (MD&A) section)?
    c. Should tax expenditure projections be incorporated in fiscal sustainability projections?

5. What placement in the financial reports (MD&A, financial statements, notes, or required supplementary information) is needed to meet reporting objectives within the overall constraint of cost-beneficial requirements? (Note: presentation in a variety of places is possible.)

6. Should tax expenditures be reported only at the government-wide level or also at agency level?
    a. Are there challenges in associating tax expenditures with an agency?
    b. Are estimates available to the agencies timely?

Task force discussions will inform the development of financial accounting standards. FASAB staff will assist by drafting requirements based on task force discussions. Also, the task force may wish to develop an illustration of how they would report on tax expenditures.

<u>Attachment 1 – Reference Material</u>

<u>Current federal financial reports:</u> (Hard copies will be available at the first meeting.)

The Citizens Guide to the 2014 Financial Report of the US Government

The FY2014 Financial Report of the US Government

http://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm

Hard copies of the following are available upon request.

<u>Current tax expenditure reports:</u>

Office of Tax Analysis (OTA)
Fiscal Year 2016 Tax Expenditures
http://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2016.pdf

Joint Committee on Taxation
JCX-97-14 (August 08, 2014) https://www.jct.gov/publications.html?func=startdown&id=4664
Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018

<u>1991 Year Federal Financial Reports</u>

In the 1970s, Treasury voluntarily prepared a prototype annual financial report and included information regarding tax expenditures. The following page provides the fiscal year 1991 tax expenditure information from that report.

Estimates for Tax Expenditures in the Income Tax

This table shows revenue losses attributable to tax law provisions allowing special exclusions, exemptions, or deductions from gross income or providing special credits, tax rates, or deferrals.

Revenue loss estimates do not take into account the additional resources, if any, required to provide the same after-tax incentives if the expenditure program were administered as a direct outlay rather than through the tax system.

Revenue loss estimates are not necessarily equivalent to estimates of the increase in Federal receipts that would result from repealing tax expenditure provisions.

For further 1991 information, refer to "Budget of the United States Government, Fiscal Year 1993," Estimates for Tax Expenditures in the Income Tax, table 24-1. For 1990, refer to "Budget of the United States Government, Fiscal Year 1992," Estimates for Tax Expenditures in the Income Tax, table XI-1.

Estimates for Tax Expenditures in the Income Tax for the Years Ended September 30, 1991 and 1990

(In billions of dollars)

	Estimated amount of revenue loss	
Income exclusions	**1991**	**1990**
Capital gains at death	24.4	22.2
Disability and retirement benefits (private)	60.0	58.3
Social Security benefits	21.4	20.2
Education allowances (scholarships and GI benefits)	.7	.7
Foreign earnings and investment incentives (income earned abroad)	5.6	5.0
Interest and dividends (State and local bonds and debt, and life insurance)	27.1	25.8
Medical care and insurance (employer premiums paid)	43.0	32.5
Payroll benefits and allowances (group life, accident, and unemployment)	5.0	4.8
Other (e.g., age 55 or over credit on home sales)	3.2	3.2
Income deferrals		
Interest on U.S. savings bonds	.9	1.0
Real estate (home sales)	12.6	12.6
Other deferrals		
Taxes (shipping companies)	.1	.1
Deductions and credits		
Agriculture related (capital outlays and gains on certain income)	.5	.5
Contributions (charitable and political)	15.7	13.3
Earned income	2.3	1.8
Employee stock ownership plans (funded through investment and tax credits)	2.1	1.9
Excess bad debt reserves (financial institutions)	*	.2
Exemptions (credit unions)	.3	.4
Foreign earnings (corporations doing business in U.S. possessions)	2.2	1.9
Interest (mortgage and consumer)	40.7	39.1
Investments (commercial capital gains, credits, other investment incentives, construction period interest, and expensing developmental costs)	1.6	4.2
Medical	3.0	2.9
Old-age, disability, and other personal exemptions	1.9	1.6
Property damages and losses (casualty losses)	.3	.3
State and local property tax and other taxes	31.7	28.4
Work incentives (employment credits under work programs) and dependent care	2.5	3.9
Accelerated depreciation (rental housing, buildings other than rental housing, and machinery and equipment)	26.0	30.9

* Less than $50 million.

<u>Attachment 2 – Administrative Information</u>

<u>Task Force Roster</u>

R. Scott Bell, US Department of Treasury
Robert Bixby, Concord Coalition
Robert Dietz, National Association of Home Builders
Bert Edwards, Greater Washington Society of CPAs Federal Issues and Standards Committiee (GWSCPA FISC)
Regina Kearney, Office of Management and Budget (plus another OMB – economist)
Andrew Lewis, KPMG (GWSCPA FISC)
John McClelland, US Department of Treasury, Office of Tax Analysis
Dan Murrin, Ernst and Young (GWSCPA FISC)
Alexandra Thornton, Center for American Progress
David Weiner, Congressional Budget Office, Assistant Director, Tax Analysis

<u>Support Staff</u>
R. Alan Perry, Government Accounting Office, Financial Management and Assurance

<u>Meeting Schedule</u>

All meetings will be held at 441 G Street, NW from 9 am to 11 AM.

Thursday, June 11 (Room 5047)
Friday, July 10 (Room 5950B)
Friday, August 14 (Room 5950B)
Friday, September 11 (Room 5950B)

To facilitate meeting minutes, staff records meetings and the recording becomes part of the public record. Minutes documenting key decisions will be on a non-attribution basis.

If you are unable to attend a meeting, your input on draft materials would be most welcome.