Federal Accounting Standards Advisory Board

September 30, 2015

Memorandum

To: Members of the Board

From: Wendy M. Payne, Executive Director
Wendy M. Payne /s/

R. Alan Perry, Financial Auditor, Government Accountability Office
Ricky A. Perry, Jr. /s/

Subj: Tax Expenditures– **Tab E** [1]

MEETING OBJECTIVES

- To obtain member comments on the introduction section of a draft exposure draft on tax expenditures.

BRIEFING MATERIAL

Attachment 1 – Draft Introduction Section

Attachment 2 -- Tax Expenditures Task Force Roster and Meeting Dates

BACKGROUND

At the August meeting, the Board received a briefing regarding the progress of the tax expenditures task force. The task force has made excellent progress on the paper explaining tax expenditures and on recommendations for the government-wide reporting entity. Members also expressed interest in recommendations for the component reporting entity. The task force will address component recommendations in the coming months.

[1] The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

DISCUSSION TOPICS

The task force comprises individuals with extensive experience regarding tax expenditures as well as individuals with extensive financial reporting and auditing experience. Because most of our stakeholders will not be as knowledgeable of tax expenditures, we first asked the task force to develop a paper explaining tax expenditures. The process of developing the paper required the members to share their experiences so that a common understanding of the estimates and audit considerations was formed.

The task force used that common understanding to draft a paper tailored to a general audience. The paper's purpose is to ensure respondents to the exposure draft understand what tax expenditures are, the nature of the estimates, and current financial reporting regarding tax expenditures. This common understanding should enhance the quality of responses.

The paper is intended to be presented in the exposure draft as the introduction. Each exposure draft begins with an executive summary explaining and justifying the Board's proposal. The transmittal letter and specific requests for comment are presented next. Then the introduction section provides any needed context for the detailed proposal that follows.

In developing the draft introduction, the task force attempted to present needed information in a neutral and plain-language manner. During the meeting, we would like first for you to raise any questions you have regarding tax expenditures as a result of reading the draft. This will identify areas in need of clarification. Then, we would like to hear any suggestions you have regarding the content. For example, topics you expected to be covered that were not, areas that you might omit, or alternative wording you would suggest.

Questions for the Members

Do you have questions regarding tax expenditures?

Do you have suggestions regarding the content of the draft introduction?

If you have any questions before the meeting, please contact me at 202.512.7357.

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.[1] 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.

[1] 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.

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.[2]

Estimates are now available annually from both the JCT[3] and the President's Budget.[4] 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.[5]

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.[6] The GPRAMA framework aims at taking a more crosscutting and integrated approach to focusing on results and improving

[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.

[3] 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.

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

[5] 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.)

[6] 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.[7] 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.[8]

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.[9] 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.[10]

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.[11]

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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[7] 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.

[8] OMB, Circular A-11 (2015).

[9] 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).

[10] 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.

[11] "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.[12] 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.

[12] 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[13] 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.[14] 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

[13] 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.

[14] 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.[15] Please note the aforementioned considerations when reviewing these estimates.

[15] 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)

Largest 20 Tax Expenditures by Estimated Revenue Losses, Fiscal Years 2016 and 2015

		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.

Tax Expenditures 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