Federal Accounting Standards Advisory Board

February 5, 2016

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 A** [1]

MEETING OBJECTIVES

To review proposed standards based on decisions at the December 2015 meeting.

BRIEFING MATERIAL

Attachment 1 – Draft Exposure Draft

Attachment 2 – Example Revisions to the Illustrations

NOTE: The final report of the task force is available for reference at http://www.fasab.gov/pdffiles/tab_a_tax_expeditures_dec2015.pdf

BACKGROUND

At the December meeting, the Board received the final report of the task force. Several task force members attended to respond to member questions and suggestions. The members made the following decisions.

1. Include the introduction developed by the task force as an appendix.
2. Require narrative disclosures regarding tax expenditures in appropriate notes and the management's discussion and analysis (MD&A) section. These disclosures should include:

    a. the definition of tax expenditures,

[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.

441 G Street NW, Mailstop 6H19, Washington, DC 20548 ♦(202) 512-7350 ♦fax (202) 512-7366

   b. their general purpose,
   c. their impact on and treatment within the Federal Budget process, and
   d. their impact on the government's financial position and fiscal sustainability.
3. Require information regarding the availability of more detailed reports including estimates and explanations of each tax expenditure. The inclusion of hyperlinks to the report was approved contingent upon avoiding unintended audit implications.
4. Encourage the inclusion of tax expenditure estimates published annually by Treasury's Office of Tax Policy within the Other Information section of the government-wide financial report.

Draft proposed standards were developed and shared with the task force. Task force input was helpful in ensuring the attached draft is consistent with their recommendations and clear.

DISCUSSION TOPICS

We have identified three topics for discussion—other accompanying information (OAI) or other information (OI), hyperlinks, and context. However, member comments on any aspect of the draft are welcome.

Other Accompanying Information

Statement of Federal Financial Accounting Concepts 2, *Entity and Display* (as amended), describes categories of information including OAI. At that time, the auditing standards also used this term for information that accompanies basic information and RSI, but is not required by a body that establishes generally accepted accounting principles (GAAP).

The American Institute of CPAs no longer uses the term OAI. It now defines OI as "Financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information ." They further exclude from OI:

- A press release or similar memorandum or cover letter accompanying the document containing audited financial statements and the auditor's report thereon
- Information contained in analyst briefings
- Information contained on the entity's website

GASB Concept Statement 3, paragraph 46, provides for a similar category.

> "Supplementary information (SI) is supporting information that is useful for placing basic financial statements and notes to basic financial statements in an appropriate operational, economic, or historical context. SI is presented with the

basic financial statements, notes to basic financial statements, and RSI in a government's general purpose external financial report. Although the GASB does not require SI to be presented, preparers of governmental financial reports who elect to present SI (or are otherwise required by law or regulations to present SI) with their basic financial statements, notes to basic financial statements, and RSI should follow any applicable GASB-issued or GASB-cleared guidance regarding the format and content of that information."

Some have questioned whether OAI is the same as OI. We intend that it be the same. The task force recommended adopting the term OI but including a footnote confirming that OAI has the same status as OI. Because OAI is the term included in existing federal accounting concepts and standards, board input would be helpful.

Question 1: Which of the following approaches is preferred?

a) Adopt the term OI and include an explanatory footnote (Footnote text - "The term Other Information (OI) used in this Statement and the term Other Accompanying Information (OAI), as defined by SFFAC 6 paragraph 6, are synonymous.")
b) Adopt approach a) for purposes of this exposure draft and make conforming amendments to existing concepts and standards
c) Continue to use the term OAI

<u>Hyperlinks</u>

Because members raised concern regarding requirements for hyperlinks, staff contacted one of the firms and found that their audit opinions now routinely include this text:

Management has elected to reference to information on websites or other forms of interactive data outside the Agency Financial Report to provide additional information for the users of its financial statements. Such information is not a required part of the basic financial statements or supplementary information required by the Federal Accounting Standards Advisory Board. The information on these websites or the other interactive data has not been subjected to any of our auditing procedures, and accordingly we do not express an opinion or provide any assurance on it.

In addition, we contacted the American Institute of CPAs Audit Standards Board staff regarding a new Audit Issues Task Force project related to such practices. Ross Simms, FASAB Assistant Director, will be the liaison with the AICPA's project team and share lessons learned from the audit perspective.

The related text of the proposed standards is presented below.

17. The Management's Discussion and Analysis should include:

(items a., b., and c. omitted)

d. a statement regarding the availability of the Treasury Office of Tax Policy's unaudited annual report on tax expenditures and how that information can be obtained by the reader.

18. Regarding 17.d above, Treasury may—at its discretion—embed a hyperlink to its most recent annual report on tax expenditures or the webpage containing a catalog of such reports released to-date.

One concern raised in our discussions was management's use of the term "unaudited" within RSI text when referring to another source of information. Because the RSI section is an "unaudited" section labeling an item mentioned within RSI as "unaudited" may imply the rest of the RSI is audited. We believe this is a matter that the preparer should address and that we do not need to provide boiler plate wording for the statement regarding the availability of the report on tax expenditures. (Note that use of the term "unaudited" in paragraph 17.d is intended to clarify that the Board does not intend to require audit coverage of the report.)

Question 2: Do members approve the proposed wording regarding the reference to the Treasury Office of Tax Policy's report?

<u>Context</u>

During the December meeting, Mr. Dacey indicated that many policy decisions influence the final tax collections and many reduce tax collections. Some of the policies reducing tax collections are tax expenditures while others are not. Alerting the reader to this fact may provide important context regarding tax expenditures.

The draft exposure draft provides these definitions.

> 12. Tax expenditures - Tax expenditures refer to revenue losses attributable to provisions of the Federal tax laws which allow a **special** exclusion, exemption, or deduction from gross income or which provide a **special** credit, a **preferential** rate of tax, or a deferral of tax liability. These exceptions are often viewed as alternatives to other policy instruments, such as spending or regulatory programs. (emphasis added)
>
> 13. Baseline provisions - Baseline provisions are the starting points used to measure the impact of tax expenditures on tax revenues as compared to revenues that would be collected otherwise, absent the special exclusion, exemption, deduction, credit, preferential rate, or deferral. **Certain practical allowances are incorporated**—such as progressive tax rates, personal exemptions, standard deductions, deductions of expenses incurred in order to earn income, and deferrals of unrealized income. (emphasis added)

The definitions provide that tax expenditures are “special” and that there are practical allowances included in the baseline. The information proposed by the task force does not extend to a discussion of the baseline but the required plain language definition may result in the needed context. (See the illustrations included in the draft exposure draft.)

If members prefer more specific provisions intended to address context, additional requirements and illustrations could be developed. Mr. Dacey offered suggestions to staff that we used to develop a revised MD&A illustration (see attachment 2) addressing his points. If the added context is helpful then a requirement to discuss the baseline provisions could lead to needed context. Further contextual information might be provided by requiring discussion of how the following factors affect tax collections:

1. The general state of the economy

2. The timing of collections

3. The tax gap

Question 3: Do members wish to add requirements related to context?

As always, it is helpful to hear from members before the meeting. Please contact me at 202.512.7357 or paynew@fasab.gov.

Federal Accounting Standards Advisory Board

TAX EXPENDITURES

Statement of Federal Financial Accounting Standards

Exposure Draft

Written comments are requested by [date 90 days after issuance]

Month day, year

Working Draft – Comments Are Not Requested on This Draft

THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General, established the Federal Accounting Standards Advisory Board (FASAB or "the Board") in October 1990. FASAB is responsible for promulgating accounting standards for the United States Government. These standards are recognized as generally accepted accounting principles (GAAP) for the federal government.

An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, federal executives, federal program managers, and other users of federal financial information. The proposed standards are published in an Exposure Draft for public comment. In some cases, a discussion memorandum, invitation for comment, or preliminary views document may be published before an exposure draft is published on a specific topic. A public hearing is sometimes held to receive oral comments in addition to written comments. The Board considers comments and decides whether to adopt the proposed standard with or without modification. After review by the three officials who sponsor FASAB, the Board publishes adopted standards in a Statement of Federal Financial Accounting Standards. The Board follows a similar process for Statements of Federal Financial Accounting Concepts, which guide the Board in developing accounting standards and formulating the framework for federal accounting and reporting.

Additional background information is available from the FASAB or its website:

- "Memorandum of Understanding among the Government Accountability Office, the Department of the Treasury, and the Office of Management and Budget, on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board."
- "Mission Statement: Federal Accounting Standards Advisory Board", exposure drafts, Statements of Federal Financial Accounting Standards and Concepts, FASAB newsletters, and other items of interest are posted on FASAB's website at: www.fasab.gov.

Contact us:

Federal Accounting Standards Advisory Board
441 G Street, NW, Suite 6814
Mailstop 6H19
Washington, DC 20548
Telephone 202-512-7350
Fax – 202-512-7366
www.fasab.gov

Federal Accounting Standards Advisory Board

ISSUE DATE

TO: ALL WHO USE, PREPARE, AND AUDIT FEDERAL FINANCIAL INFORMATION

Your comments on the exposure draft of a proposed Statement of Federal Financial Accounting Standards, entitled *Tax Expenditures*, are requested. Specific questions for your consideration appear on page 7 but you are welcome to comment on any aspect of this proposal. If you do not agree with the proposed approach, your response would be more helpful to the Board if you explain the reasons for your position and any alternative you propose. Responses are requested by DUE DATE.

All comments received by the FASAB are considered public information. Those comments may be posted to the FASAB's website and will be included in the project's public record.

Mail delivery is delayed by screening procedures. Therefore, please provide your comments in electronic form by e-mail to fasab@fasab.gov. If you are unable to e-mail your responses, we encourage you to fax the comments to (202) 512-7366. Alternatively, you may mail your comments to:

Wendy M. Payne, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6H19
441 G Street, NW, Suite 6814
Washington, DC 20548

We will confirm receipt of your comments. If you do not receive confirmation, please contact our office at 202.512.7350 to determine if your comments were received.

The Board's rules of procedure provide that it may hold one or more public hearings on any exposure draft. No hearing has yet been scheduled for this exposure draft.

Notice of the date and location of any public hearing on this document will be published in the Federal Register and in the FASAB's newsletter.

Sincerely,

D. Scott Showalter

Chairman

EXECUTIVE SUMMARY

WHAT IS THE BOARD PROPOSING?

The Board is proposing to require that the consolidated financial report of the United States Government (CFR) include certain narrative information on tax expenditures to assist users in understanding their existence, purpose, and impact on the financial position and fiscal sustainability of the United States government.

Tax expenditures resemble federal spending in that they affect the federal deficit or surplus. However, unlike federal spending, tax expenditures impact federal tax revenues. Tax expenditures are not treated the same as federal spending for budgetary or financial reporting purposes. Tax expenditures are not subject to the annual appropriations process and can only be removed or changed through tax legislation. Tax expenditure estimates are not explicitly displayed in the Statements of Net Cost or Changes in Net Position. While tax expenditures help determine the government's net revenue, they are generally not separately disbursed or accounted for in the Department of the Treasury's (Treasury) books and records.

The proposed standards would require the Treasury to:

1. Include narrative disclosures and information regarding tax expenditures that inform the reader regarding:
    a. the definition of tax expenditures,
    b. their general purpose,
    c. their impact on and treatment within the Federal Budget process, and
    d. their impact on the government's financial position and fiscal sustainability.
2. Alert readers regarding the location of more detailed reports on tax expenditure estimates and explanation, including estimates published annually by Treasury's Office of Tax Policy.

The proposed standards would also encourage Treasury to include tax expenditure estimates as Other Information (OI)[1] within the CFR.

HOW WOULD THIS PROPOSAL IMPROVE FEDERAL FINANCIAL REPORTING AND CONTRIBUTE TO MEETING THE FEDERAL FINANCIAL REPORTING OBJECTIVES?

Tax expenditures have historically received little focus in general purpose federal financial reporting, yet have similarities to federal spending in their impact on service efforts, costs, fiscal sustainability, and the financial position of the United States government. Given the significance and increased use of tax expenditures, the Board identified a need to improve users' awareness and understanding of tax expenditures. By requiring disclosures as a first step, the Board will provide a mechanism and framework for Treasury to achieve this objective. The Board is

[1] The term *Other Information* (OI) used in this Statement and the term *Other Accompanying Information* (OAI), as defined by SFFAC 6 par. 6, are synonymous.

mindful of the need to avoid extensive, voluminous disclosures. The Board believes that disclosures of the definition, purpose, and impact of tax expenditures can be integrated into the CFR in a succinct manner.

Given the unique and significant challenges inherent in defining, estimating, reporting, and auditing tax expenditures, the Board believes that it is not appropriate to require the presentation of estimates at this time; however, the Board may elect to evaluate the costs, limitations, benefits, and other implications of developing additional measurement, recognition, and disclosure guidance in the future. Before such efforts are potentially undertaken, there is a great deal that needs to be learned regarding (1) how best to define, identify, and measure tax expenditures for financial reporting purposes; (2) whether it is feasible to develop tax expenditure estimates that are considered to be representationally faithful and auditable; and (3) if auditability can be achieved, what considerations would enable the preparer and auditor to achieve their respective responsibilities in a reasonably cost-effective manner.

Of the four federal financial reporting objectives outlined in Statement of Federal Financial Accounting Concepts (SFFAC) 1, *Objectives of Federal Financial Reporting*, the Board believes this proposal is a useful and cost-effective means of improving the extent to which the operating performance and budgetary integrity objectives are achieved. Tax expenditure disclosures are important to meeting these objectives because they will help the reader to evaluate: (1) the service efforts, costs, and accomplishments of the reporting entity, and the manner in which these service efforts have been financed, and (2) how budgetary resources have been obtained and used.

Operating Performance Objective

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:

2A. the costs of providing specific programs and activities and the composition of, and changes in, these costs;

2B. the efforts and accomplishments associated with federal programs and the changes over time and in relation to costs; and

2C. the efficiency and effectiveness of the government's management of its assets and liabilities.

Budgetary Integrity Objective

Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations. Federal financial reporting should provide information that helps readers to determine:

1A. how budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization,

1B. the status of budgetary resources, and

1C. how information on the use of budgetary resources relates to information on the costs of program operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.

Source: SFFAC 1

TABLE OF CONTENTS

QUESTIONS FOR RESPONDENTS

The Board encourages you to become familiar with all proposals in the Statement before responding to the questions in this section. In addition to the questions below, the Board also would welcome your comments on other aspects of the proposed Statement. Because the proposals may be modified before a final Statement is issued, it is important that you comment on proposals that you favor as well as any that you do not favor. Comments that include the reasons for your views will be especially appreciated.

The Board believes that this proposal would improve federal financial reporting and contribute to meeting the Federal financial reporting objectives. The Board has considered the perceived costs associated with this proposal. In responding, please consider the expected benefits and perceived costs and communicate any concerns that you may have in regard to implementing this proposal.

The questions in this section are available in a Word file for your use at www.fasab.gov/exposure.html. Your responses should be sent by e-mail to fasab@fasab.gov. If you are unable to respond by e-mail, please fax your responses to (202) 512-7366. Alternatively, you may mail your responses to:

Wendy M. Payne, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6H19
441 G Street, NW, Suite 6814
Washington, DC 20548

All responses are requested by [insert date].

Q1. A summary of the issue (one paragraph) should be presented followed by a question. If multiple questions follow one issue summary, use letters to distinguish them.

Q2. New Question

Comment [RAP1]: Questions for Respondents to be updated after February Board meeting.

INTRODUCTION

PURPOSE

1. In Statement of Federal Financial Accounting Concepts (SFFAC) 1, the Board established four objectives of federal financial reporting. These objectives provide a framework for assessing the existing accountability and financial reporting systems of the federal government and for considering new accounting standards.[2] The objectives address (1) Budgetary Integrity, (2) Operating Performance, (3) Stewardship, and (4) Systems and Controls.

2. Objectives 2 and 1, in order of relevance, are areas of focus in this Statement.

   a. Objective 2, Operating Performance, states that:

      Federal financial reporting should assist report users in evaluating the service efforts, costs, and accomplishments of the reporting entity, and the manner in which these service efforts have been financed; and the management of the entity's assets and liabilities.

   b. Objective 1, Budgetary Integrity, states that:

      Federal financial reporting should assist in fulfilling the government's duty to be publicly accountable for monies raised through taxes and other means and for their expenditure in accordance with the appropriations laws that establish the government's budget for a particular fiscal year and related laws and regulations.

      i. Sub-objective 1A states that:

         Federal financial reporting should provide information that helps readers to determine how budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization.

      ii. Sub-objective 1C states that:

         Federal financial reporting should provide information that helps readers to determine how information on the use of budgetary resources relates to information on the costs of program operations and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.

3. Tax expenditures are used as a means to accomplish objectives. Although tax expenditures are not direct outlays of federal funds, they are often viewed as alternatives to other policy instruments, such as spending or regulatory programs. The Board believes that the service efforts, costs, and accomplishments of the reporting entity—the U.S. Government—include those service efforts undertaken, costs incurred through, and accomplishments resulting

[2] SFFAC 1, par. 109.

from the use of tax expenditures. Accordingly, the Board believes that this Statement will contribute to meeting Objective 2.

4. Tax expenditures reduce federal revenues, thereby reducing budgetary resources available for spending. Because tax provisions are not subject to the annual appropriations process and spending controls, forgoing budgetary resources through the use of tax expenditures can be a method of achieving policy objectives outside of the appropriations process and without direct outlays of funds to federal agencies and programs. As such, the Board believes that the disclosure requirements in this Statement will contribute to meeting Objective 1 and especially sub-objectives 1A and 1C because these disclosures provide readers with an understanding of how tax expenditures impact the availability of budgetary resources and resulting tax collections, and how certain objectives can be achieved through the mechanism of forgoing tax revenues.

5. The Board believes that this Statement will improve users' awareness and understanding of tax expenditures, their use, and their relationship to and impact on federal revenues and the overall financial position of the U.S. government.

6. Appendix B: Tax Expenditures Explained provides additional background which will aid respondents' understanding of tax expenditures, their "plain language" definition, why they are important, how estimates are prepared by Treasury, and considerations for understanding how Treasury's estimates can be used.

MATERIALITY

7. The provisions of this Statement need not be applied to immaterial items. The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.

EFFECTIVE DATE

8. This proposal provides for presenting required disclosures in the CFR effective beginning in fiscal year 2018. Earlier implementation is encouraged.

PROPOSED STANDARDS

SCOPE

9. This Statement provides a general definition of tax expenditures and related disclosure requirements, but does not alter the definition of tax expenditures, as defined by the Congressional Budget and Impoundment Act of 1974. This Statement does not alter the Department of the Treasury's (Treasury) Office of Tax Policy interpretation of the statutory definition.

10. The reporting requirements in this Statement apply to the consolidated financial report of the U.S. Government (CFR). They do not apply to the financial statements of component reporting entities. They also do not affect the reporting in the *Budget of the U.S. Government* or any other special purpose report.

11. The Statement encourages the inclusion of financial information reported annually by Treasury's Office of Tax Policy within the Other Accompanying Information (OAI) section of the CFR. This Statement does not alter the policies and practices of Treasury's Office of Tax Policy with respect to the definition of tax expenditures, identification and recognition of tax expenditures, and measurement of tax expenditures.

DEFINITIONS

12. Tax expenditures

    Tax expenditures refer to revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.

13. Baseline provisions

    Baseline provisions are the starting points used to measure the impact of tax expenditures on tax revenues as compared to revenues that would be collected otherwise, absent the special exclusion, exemption, deduction, credit, preferential rate, or deferral. Certain practical allowances are incorporated—such as progressive tax rates, personal exemptions, standard deductions, deductions of expenses incurred in order to earn income, and deferrals of unrealized income.

DISCLOSURE REQUIREMENTS

FINANCIAL REPORT OF THE US GOVERNMENT DISCLOSURES

14. Disclosures about tax expenditures should help provide readers with a general understanding of how tax expenditures impact the government's tax collections and financial position, and how budgetary objectives can be achieved through the mechanism of forgoing tax revenues.

15. Disclosures within the notes to the financial statements should include:

    a. a "plain language" definition of the term tax expenditures;

    b. examples of types of tax expenditures such as special deductions, credits, deferrals, preferential rates, exemptions, and exclusions; and

    c. a description of how tax expenditures impact nonexchange revenue, tax collections, and refunds, as well as whether tax expenditure amounts are presented in financial statements.

16. An example of how these financial statement note disclosures might be presented is presented in Appendix C: Illustrations for illustrative purposes only.

Required Supplementary Information

17. The Management's Discussion and Analysis should include:

    a. a "plain language" definition of the term tax expenditures,

    b. the general purpose of tax expenditures,

    c. a description of how tax expenditures are treated for budgetary and financial reporting purposes, including:

        i. their impact on and treatment within the Federal Budget process,

        ii. how they impact on the government's financial position, and

        iii. their relationship to the government's fiscal sustainability.

    d. a statement regarding the availability of the Treasury Office of Tax Policy's unaudited annual report on tax expenditures and how that information can be obtained by the reader.

18. Regarding 17.d above, Treasury may—at its discretion—embed a hyperlink to its most recent annual report on tax expenditures or the webpage containing a catalog of such reports released to-date.

19. An example of how this information might be presented within Management's Discussion and Analysis is presented in Appendix C: Illustrations for illustrative purposes only.

OTHER ACCOMPANYING INFORMATION ENCOURAGED BY THE BOARD

20. Treasury is encouraged to present a selection of the major tax expenditure estimates published annually by Treasury's Office of Tax Policy within the Other Accompanying Information (OAI) section of the CFR.

21. Treasury is encouraged to present tax expenditure estimates in a manner that informs readers of:

    a. the general magnitude of tax expenditures and their impact on federal revenues (revenue effect) during the fiscal year,

    b. the source of the estimates, and

    c. the availability of the complete unaudited annual report on tax expenditures from Treasury Office of Tax Policy's, including explanatory definitions of each tax expenditure presented and a complete population of the tax expenditure estimates identified and estimated by Treasury, and how that information can be obtained by the reader.

22. Regarding 21.c above, Treasury may—at its discretion—embed a hyperlink to its most recent unaudited annual report on tax expenditures or the webpage containing a catalog of such reports released to-date.

23. An example of how tax expenditure estimates might be presented within OAI is presented in Appendix C: Illustrations for illustrative purposes only.

EFFECTIVE DATE

24. This proposal provides for presenting required disclosures in the CFR effective beginning in fiscal year 2018. Earlier implementation is encouraged.

The provisions of this Statement need not be applied to immaterial items.

APPENDIX A: BASIS FOR CONCLUSIONS

Comment [RAP2]: Note: this section is currently in rough outline format. To be updated after the February Board meeting.

This appendix discusses some factors considered significant by Board members in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others. The standards enunciated in this Statement—not the material in this appendix—should govern the accounting for specific transactions, events, or conditions.

PROJECT HISTORY

A1. In 2013, the Board identified tax expenditures as a high-priority project.

A2. In 2015, the Board approved this project in order to determine what information regarding tax expenditures should be included in general purpose federal financial reports. The decision followed an October 2013 educational briefing to the Board made by Dr. Donald Marron.

a. Why the project is important (reference reporting objectives)

b. Maybe mention the GPRA MA emphasis on TE performance reporting

A3. Decision to rely on existing definitions and estimates (I put this here because it is part of the history and framed the TF effort but it could be the next section instead)

A4. TF efforts –

a. Need for education regarding TE - The process of writing the appendix and direct readers to it

b. Education regarding the audit of RSI vs OI? (maybe not needed in the ED)

c. Final report with recommendations (include a hyper link)

REQUIREMENT FOR INFORMATION IN MD&A AND NOTES

A5. Briefly describe the proposal

A6. Chief reasons the MD&A requirement is important

a. Role of MD&A

b. Existing requirement for summary of financial statement information

c. Need to have complete coverage of efforts (operating performance objective)

A7. Chief reasons the note is important

a. To understand that the tax system is used to accomplish goals as well as to collect revenue

b. To understand that some “efforts” and related costs are not transparent

c. Context

A8. Describe desire for hyperlink and audit issues (here or as a separate section)

PRESENTATION OF ESTIMATES

A9. Briefly describe the proposal

A10. Repeat the reasons for OI rather than RSI

A11. Suggest that the Board will revisit this in the future

APPENDIX B: TAX EXPENDITURES EXPLAINED

Purpose

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

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

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

Background

The Congressional Budget and Impoundment Act of 1974 (the Budget Act) defines tax expenditures as

> *"…revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." (Section 3(3) of Public Law 93-344)*

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

Tax expenditures are "revenue losses" in that the provisions reduce income taxes owed and, therefore, revenue collected. Tax expenditures resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, tax expenditures are not treated the same as federal spending for budgetary or financial reporting purposes.[3] Tax expenditures are not subject to the annual appropriations process and can only be removed or changed through tax legislation. Tax expenditure estimates are not explicitly displayed in the Statements of Net Cost or Changes in Net Position. While tax expenditures help determine the

[3] 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.

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

<u>How Tax Expenditures Are Identified</u>

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

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

After determining the baseline tax system, the credits, deductions, special exceptions and allowances that reduce tax liability below the level implied by the baseline tax system are then considered to be tax expenditures. See Figure 1 Illustration in Appendix C for a list of the largest income tax expenditures, ranked by fiscal year 2016 revenue effect.

<u>Types of Tax Expenditures</u>

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

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

Budget Act Requirements and History

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

In 1974, the Budget Act charged the House and Senate Budget Committees with the duty "to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies" to Congress on a recurring basis. The Budget Act further required that the annual President's Budget include tax expenditure estimates.[4]

[4] 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.

Estimates are now available annually from both the JCT[5] and the President's Budget.[6] 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.[7]

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.[8] The GPRAMA framework aims at taking a more crosscutting and integrated approach to focusing on results and improving government performance. The Office of Management and Budget (OMB) is required to coordinate with agencies to establish federal government priority goals—otherwise referred to as cross-agency priority (CAP) goals.[9] 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.[10]

However, the executive branch still has not completed actions necessary to assess the outcomes of tax expenditures and their contributions to CAP goals and APGs.[11]

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

As noted in the definition above, tax expenditures arise from special provisions allowing an exclusion, exemption, or deduction from gross income, a credit, a preferential rate of tax, or a deferral of liability. Deciding whether a provision of tax law is a special exception to the baseline income tax system is a matter of judgment. The baseline used by the Treasury to identify these

[5] 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.

[6] 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.)

[7] 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.)

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

[9] 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.

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

[11] 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).

special exceptions is adapted from a comprehensive income tax approach in which income is the sum of consumption and the change in net wealth in a given period of time with certain departures.[12] This baseline assumes an individual income tax and a separate corporate income tax.[13]

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.[14]

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

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

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

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

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

[13] 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.

[14] "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.

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

The Treasury estimates the cash effect of each tax expenditure. Some tax expenditures represent deferrals of taxation (a tax not paid in the current tax year will be paid in a future tax year when the deferral reverses). Estimates for such deferrals are based on the net tax effect of current year deductions or exclusions and reversals of prior year deferrals included in current year taxable income.[15] For example, defined contribution employer plans are estimated as the net tax effect of current year contributions excluded from income and income reported upon withdrawals from plans.

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

Understanding Estimates

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

The major considerations regarding the estimates are identified below.

Not Necessarily Equivalent to Forgone Revenue. Estimates should be regarded as approximations. As with expenses incurred with spending programs, tax expenditure estimates do not necessarily equal the change in the deficit[16] that would result from repealing these special provisions because:

a. eliminating a tax expenditure may have incentive effects that alter economic behavior, and

b. tax expenditures are interdependent even without incentive effects.

Difficulty in Calculating Totals. A total for the estimated tax expenditures is not provided in the President's Budget because each tax expenditure is estimated independently assuming other parts of the Tax Code remains unchanged. The estimates might be different if two or more tax expenditures were changed simultaneously because of potential interactions among provisions. Nonetheless, other experts do present a total summing the separate estimates. The Congressional Budget Office has modeled the interaction of the ten largest tax expenditures in the individual income tax law and found that interactions that overstate the effect are similar in size to interactions that understate the effect.[17] As a result, they conclude that the total is a meaningful estimate for the general magnitude of tax

[15] 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.

[16] 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.

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

expenditures under current tax law. If the law changes in significant ways the interactions may not result in offsetting over- and understatements of the effect to the same extent.

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

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

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

See Figure 1 Illustration in Appendix C for a list of the largest income tax expenditures and the related Treasury estimates, ranked by fiscal year 2016 revenue effect.[18] Please note the aforementioned considerations when reviewing these estimates.

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

APPENDIX C: ILLUSTRATIONS

This appendix illustrates the application of the provisions of this Statement to assist in clarifying their meaning. The facts assumed in these examples are illustrative only and are not intended to modify or limit the requirements of this Statement or to indicate the Board's endorsement of the situations or methods illustrated. Additionally, these illustrations are not intended to provide guidance on determining the application of materiality. Application of the provisions of this Statement may require assessing facts and circumstances other than those illustrated here and require reference to other applicable Standards.

The examples in this Appendix are illustrative only and do not represent authoritative guidance.

[Begin illustration]

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]

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*. [19]

Table 4: Gross Cost, Revenues, Net Cost, and Net Operating Cost

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

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

Gross Cost and Net Cost

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

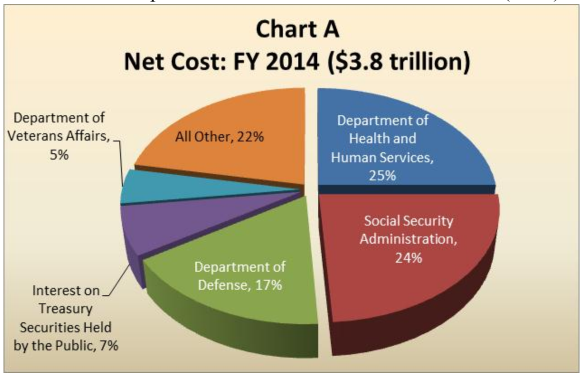
Typically, the Government's net cost is impacted by a variety of offsetting increases and decreases. The more significant drivers affecting the change in net cost during FY 2014 were:

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

[19] 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[20];
- $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[21]; 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.[22]



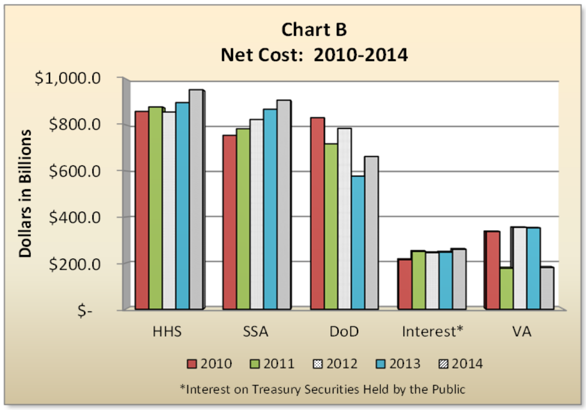
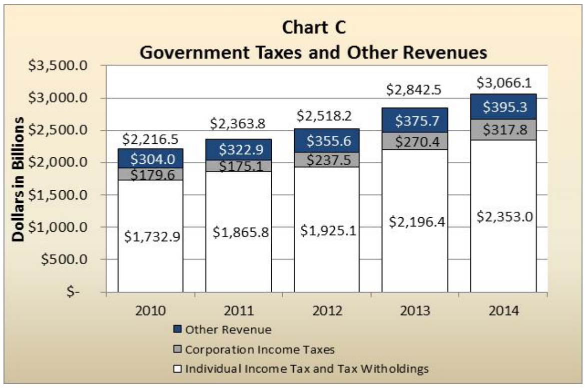


Chart A shows the composition of the Government's net cost. In FY 2014, two-thirds of total net cost came from DOD, the Social Security Administration (SSA), and the Department of Health and Human Services (HHS). These three agencies have consistently incurred the largest agency shares of the Government's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

[20] Department of the Treasury FY 2014 Agency Financial Report, p. 22-23. See also Note 9 – Investments in GSEs – of this *Financial Report*.
[21] Department of Education FY 2014 Agency Financial Report, p. 30
[22] Department of Labor FY 2014 Agency Financial Report, p. 27

Taxes and Other Revenues - Getting to the "Bottom Line"

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.[23] As noted in the earlier discussion of budget receipts, these increases largely stem from a stronger economy and growth in wages and salaries, as well as and the expiration of certain tax provisions. Earned revenues from Table 4 are not considered "taxes and other revenue" and, thus, are not shown in Chart C. Individual income tax and tax withholdings and corporation income taxes accounted for about 77 percent and 10 percent of total revenue, respectively in FY 2014; other revenues from Chart C include excise taxes, unemployment taxes, and customs duties.



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

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

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

Tax expenditures are "revenue losses" in that the provisions reduce taxes owed and, therefore, revenue collected. Tax expenditures resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, tax expenditures are not treated the same as federal spending for budgetary or financial reporting purposes.[24] Tax expenditures are not subject to the annual budget process and can only be removed or changed through tax legislation. Tax expenditure estimates are not explicitly displayed in the Statements of Net Cost or Changes in Net Position. While tax expenditures help determine the government's net revenue, they are generally not separately disbursed or accounted for in Treasury's books and records. Hence, tax expenditure estimates do not appear in the net operating cost calculation in Table 4 above.

These and other issues concerning tax expenditures, including tax expenditure estimates, are discussed in greater detail within an annual report published by Treasury's Office of Tax Policy.[25]

[Also refer readers to additional discussion in OI.]

Assets and Liabilities: "What We Own and What We Owe"

[Abridged]

[23] Department of the Treasury FY 2014 Agency Financial Report, p. 28

[24] 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.

[25] 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]

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.[26]

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

[Remainder of Note 18: Abridged]

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

Unexpended Balances of Budget Authority

[Abridged]

Tax Burden

[Abridged]

Tax Expenditures

Definition

Generally, tax expenditures are provisions in the tax law available to certain subsets of taxpayers who engage in certain kinds of activities, face special circumstances, or otherwise meet certain criteria. The government uses tax expenditures to stimulate behavior that will accomplish public policy goals such as facilitating homeownership, reducing the cost of borrowing for state and local governments, encouraging higher education, or promoting domestic energy production. Tax expenditures are "revenue losses" in that the provisions reduce taxes owed and, therefore, revenue collected. Tax expenditures resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, tax expenditures are not treated the same as federal spending for budgetary or financial reporting purposes.[27] Tax expenditures are not subject to the annual budget process and can only be removed or changed through tax legislation. Tax expenditure estimates are not explicitly displayed in the Statements of Net Cost or Changes in Net Position. While tax expenditures help determine the government's net revenue, they are generally not separately disbursed or accounted for in Treasury's books and records.

[26] Department of the Treasury Fiscal Year 2017 Tax Expenditures Report

[27] 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.

Estimates

Tax expenditure estimates are available annually from Treasury's Office of Tax Policy[28]. The estimates are for the current fiscal year and the ten years following the current fiscal year. The estimates are intended to support budget analysis and are a measure of the economic benefits that are provided through the tax laws to various groups of taxpayers and sectors of the economy. The estimates also may be useful in assessing the efficiency and effectiveness of achieving specific public goals through the use of tax expenditures. Treasury provides the tax expenditure estimates before the end of each fiscal year and makes them available on the Treasury website before the President's Budget is issued.

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

Major considerations regarding the estimates include the following:

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

Selected major tax expenditures are presented in the figure below.

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

Figure 1

Largest 20 Tax Expenditures, 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	$ 211.0	$ 201.5
I	Exclusion of net imputed rental income	101.1	97.9
I	Capital gains (except agriculture, timber, iron ore, and coal)	92.8	85.7
C	Deferral of income from controlled foreign corporations (normal tax method)	67.8	64.6
I	Defined benefit employer plans	66.6	66.6
I	Defined contribution employer plans	64.7	62.1
I	Deductibility of mortgage interest on owner-occupied homes	62.4	58.9
I	Step-up basis of capital gains at death	58.3	54.9
I	Deductibility of nonbusiness State and local taxes other than on owner-occupied homes	51.4	48.4
B	Deductibility of charitable contributions, other than education and health	44.2	40.9
I	Capital gains exclusion on home sales	40.6	37.2
I	Deductibility of State and local property tax on owner-occupied homes	33.1	31.1
B	Exclusion of interest on public purpose State and local bonds	31.7	29.4
I	Self-Employed plans	28.0	25.5
I	Social Security benefits for retired workers	26.9	25.8
I	Treatment of qualified dividends	25.5	25.7
I	Child credit *(1)*	24.0	24.0
B	Exclusion of interest on life insurance savings	18.9	17.5
I	Individual Retirement Accounts	16.9	16.4
B	Deduction for US production activities	15.7	15.2

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

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

These estimates are prepared annually by Treasury for inclusion in the President's Budget. There are 169 provisions that are currently classified by Treasury as tax expenditures. Estimates and descriptions of each of the 169 provisions classified as tax expenditures, including the 20 presented here, are made available at http://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Expenditures.aspx.

(1) The figures in the table indicate the effect of the child tax credit on receipts. The effect of the credit on outlays (in billions of dollars) is as follows: 2015 $27.0 and 2016 $27.0

All revenue loss estimates have been rounded to the nearest $100 million.

The examples in this Appendix are illustrative only and do not represent authoritative guidance.

[End of illustration]

APPENDIX D: ABBREVIATIONS

CFR	Consolidated financial report of the U.S. government
ED	Exposure draft
FASAB	Federal Accounting Standards Advisory Board
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office
GASB	Governmental Accounting Standards Board
IPSASB	International Public Sector Accounting Standards Board
OI	Other Information
OMB	Office of Management and Budget
SFAS	Statement of Financial Accounting Standards (FASB)
SFFAC	Statement of Federal Financial Accounting Concepts
SFFAS	Statement of Federal Financial Accounting Standards

APPENDIX E: TASK FORCE MEMBERS

R. Scott Bell	Department of the Treasury, Senior Accountant
Robert Bixby	The Concord Coalition, Executive Director
Robert Dietz	National Association of Home Builders, Tax and Market Analysis, Vice President
Bert Edwards	GWSCPA Federal Issues and Standards Committee (FISC) Member
Regina Kearney	Office of Management and Budget, Senior Advisor
John McClelland	Department of the Treasury, Office of Tax Analysis, Economist
James McTigue, Jr.	Government Accountability Office, Strategic Issues, Director
Tim Morgan	PricewaterhouseCoopers, Partner (retired)
Dan Murrin	EY, Partner; GWSCPA FISC 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

APPENDIX F: GLOSSARY

Tax expenditures

Tax expenditures refer to revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.

Baseline provisions

Baseline provisions are the starting points used to measure the impact of tax expenditures on tax revenues as compared to revenues that would be collected otherwise, absent the special exclusion, exemption, deduction, credit, preferential rate, or deferral. Certain practical allowances are incorporated—such as progressive tax rates, personal exemptions, standard deductions, deductions of expenses incurred in order to earn income, and deferrals of unrealized income.

Behavioral assumptions

Behavioral assumptions address taxpayer decisions and responses to the hypothetical removal of one or more tax expenditures. Such decisions and responses are unknown and must be estimated when measuring tax expenditures. Certain hypothetical behaviors can be estimated with greater confidence than others, depending on numerous factors such as the number of interactions with other provisions in the tax code and the significance of those interactions.

Economic assumptions

Economic assumptions address the unknown variables related to past, current, and/or future economic situation that are unknown and must be estimated when measuring tax expenditures.

Comment [RAP3]: To be included in the event that the Basis for Conclusions mentions these types of assumptions. Otherwise, delete.

FASAB Board Members

D. Scott Showalter, Chair

Gila J. Bronner

Robert F. Dacey

George A. Scott

Michael H. Granof

Christina Ho

Sam M. McCall

Mark Reger

Graylin E. Smith

FASAB Staff

Wendy M. Payne, Executive Director

Ricky A. Perry, Jr.; Government Accountability Office, Auditor

Federal Accounting Standards Advisory Board

441 G Street NW, Suite 6814
Mailstop 6H19
Washington, DC 20548
Telephone 202-512-7350
Fax 202-512-7366
www.fasab.gov

Illustrative MD&A Text

The text below is from the task force's illustration of MD&A and includes marked changes to address the contextual matters raised by Mr. Dacey.

[The following section heading and text were published in the FY2014 FR text with the exception of marked changes.]

Taxes and Other Revenues - Getting to the "Bottom Line"

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.

Nonexchange revenue from taxes are recognized when collected and adjusted for the change in net measurable and legally collectible taxes receivable. There are a number of factors that affect the amount of taxes collected, including:

- The general state of the economy, which may affect incomes subject to tax.
- The timing of collections, which affect the fiscal year in which the taxes are collected (see Note X to the financial statements).
- The tax gap, which is the difference between what taxpayers should pay and what they actually pay due to not filing tax returns, not paying their reported tax liability on time, or failing to report their correct tax liability.
- Tax expenditures, which represent provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability. Certain policy decisions, such as progressive tax rates, personal exemptions, standard deductions, deductions of expenses incurred in order to earn income, and deferrals of unrealized income, which also affect taxes collected, are excluded from tax expenditures.

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. 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 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.

[The following section heading and text were developed by the task force with the exception of marked changes.]

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

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

Tax expenditures are "revenue losses" in that the provisions reduce taxes owed and, therefore, revenue collected. Tax expenditures resemble federal spending in that such provisions affect the federal deficit/surplus by impacting income tax revenue; however, tax expenditures are not treated the same as federal spending for budgetary or financial reporting purposes.[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 or Changes in Net Position. While tax expenditures help determine the government's net revenue, they are generally not separately disbursed or accounted for in Treasury's books and records. Hence, tax expenditure estimates do not appear in the net operating cost calculation in Table 4 above.

[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.

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.[2]

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

[2] Department of the Treasury Fiscal Year 2017 Tax Expenditures Report