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APPENDIX A. TAX EXPENDITURE ESTIMATES FOR  
FISCAL YEARS 1983-1988

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This appendix estimates tax expenditure revenue losses by budget function and subfunction for fiscal years 1983-1988 (see Table A-1). These tax expenditure estimates are identical to those prepared by the Joint Committee on Taxation (JCT) and published in March of this year. They reflect the law as enacted through the 97th Congress. As discussed in Chapter II, there are important differences between these estimates and those prepared by the Administration as part of its budget submission for fiscal year 1984.<sup>1</sup>

The Administration's budget also shows the "outlay equivalents" of all tax expenditures--that is, the amount of budget outlays that would be necessary to provide an equivalent amount of direct subsidies to tax expenditure recipients. The outlay equivalents are often higher than their respective tax expenditures, since, to provide equal benefits, they would have to include the amount of taxes that recipients must pay on many outlay subsidies but not on tax subsidies. The difference between tax expenditure revenue losses and outlay equivalents is discussed in more detail in Chapter II and Appendix D.

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<sup>1</sup> The Budget of the United States Government, Fiscal Year 1984, Special Analysis G, "Tax Expenditures" (February 1983).

TABLE A-1. TAX EXPENDITURE ESTIMATES BY FUNCTION AND SUBFUNCTION, FISCAL YEARS 1983-1988 (in millions of dollars)<sup>a</sup>

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
050 NATIONAL DEFENSE												
051 <u>Department of Defense - Military</u>												
Exclusion of benefits and allowances to Armed Forces personnel	---	---	---	---	---	---	2,205	2,250	2,380	2,520	2,670	2,820
Exclusion of military disability pensions	---	---	---	---	---	---	165	160	165	175	185	195
150 INTERNATIONAL AFFAIRS												
155 <u>International Finance Programs</u>												
Exclusion of income earned abroad by United States citizens	---	---	---	---	---	---	1,285	1,300	1,365	1,435	1,505	1,580
Deferral of income of Domestic International Sales Corporations (DISCs)	1,390	1,185	1,075	1,050	1,075	1,110	---	---	---	---	---	---
Deferral of income of controlled foreign corporations	430	345	375	390	420	455	---	---	---	---	---	---
250 GENERAL SCIENCE, SPACE, AND TECHNOLOGY												
251 <u>General Science and Basic Research</u>												
Expensing of research and development expenditures	2,165	2,370	2,360	2,425	2,485	2,535	105	120	125	125	130	135
Credit for increasing research activities	615	650	660	305	65	25	30	35	40	30	5	b
Suspension of regulations relating to allocation under section 861 of research and experimental expenditures	120	60	b	---	---	---	---	---	---	---	---	---

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
270 ENERGY												
271 <u>Energy Supply</u>												
Expensing of exploration and development costs												
Oil and gas	660	440	590	740	835	895	875	800	815	855	900	950
Other fuels	30	30	35	35	40	40	---	---	---	---	---	---
Excess of percentage over cost depletion												
Oil and gas	375	430	445	465	510	555	1,425	1,275	1,305	1,410	1,505	1,625
Other fuels	325	350	355	380	410	440	15	15	15	15	15	20
Capital gains treatment of royalties from coal	35	40	40	45	50	55	140	145	160	175	190	205
Alternative fuel production credit	5	20	25	40	105	285	---	---	---	---	---	---
Alcohol fuel credit <sup>C</sup>	5	5	5	5	5	5	---	---	---	---	---	---
Exclusion of interest on state and local government industrial development bonds for energy production facilities	15	20	30	40	55	70	5	10	15	20	20	25
Residential energy credits												
Supply incentives	---	---	---	---	---	---	340	450	610	700	70	---
Alternative conservation and new technology credits												
Supply incentives	215	200	175	100	35	20	10	10	5	---	---	---
272 <u>Energy Conservation</u>												
Residential energy credits												
Conservation incentives	---	---	---	---	---	---	330	305	305	260	---	---
Alternative conservation and new technology credits												
Conservation incentives	135	35	15	5	b	---	b	b	b	---	---	---
Energy credit for intercity buses	5	5	5	b	---	---	---	---	---	---	---	---

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
300 NATURAL RESOURCES AND ENVIRONMENT												
302 <u>Conservation and Land Management</u>												
Capital gains treatment of certain timber income	275	390	430	500	575	595	95	125	150	175	205	230
Investment credit and seven-year amortization for reforestation expenditures	b	b	b	b	b	b	10	10	10	10	10	10
303 <u>Recreational Resources</u>												
Tax incentives for preservation of historic structures	65	90	110	140	185	240	130	165	215	275	355	460
304 <u>Pollution Control and Abatement</u>												
Exclusion of interest on state and local government pollution control bonds	900	1,025	1,140	1,255	1,375	1,510	440	505	565	620	680	745
Exclusion of payments in aid of construction of water, sewage, gas and electric utilities	45	75	75	80	75	70	---	---	---	---	---	---
306 <u>Other Natural Resources</u>												
Expensing of exploration and development costs, nonfuel minerals	55	60	65	75	80	85	b	b	b	b	b	b
Excess of percentage over cost depletion, nonfuel minerals	270	295	310	335	355	380	10	10	15	15	15	15
Capital gains treatment of iron ore	5	5	5	5	5	10	5	5	5	5	5	10

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
350 AGRICULTURE												
351 <u>Farm Income Stabilization</u>												
Expensing of certain capital outlays	85	90	95	100	100	105	475	495	510	530	545	565
Capital gains treatment of certain income	30	35	35	40	40	45	455	475	500	530	545	565
Deductibility of patronage dividends and certain other items of cooperatives	950	980	1,010	1,040	1,075	1,110	-390	-400	-410	-425	-435	-450
Exclusion of certain cost-sharing payments	---	---	---	---	---	---	50	45	40	30	25	25
370 COMMERCE AND HOUSING CREDIT												
371 <u>Mortgage Credit and Thrift Insurance</u>												
Excess bad debt reserves of financial institutions	335	575	785	930	1,060	1,030	---	---	---	---	---	---
Deductibility of mortgage interest on owner-occupied homes	---	---	---	---	---	---	25,065	27,945	30,130	32,785	35,305	37,950
Deductibility of property tax on owner-occupied homes	---	---	---	---	---	---	8,765	9,535	10,480	11,710	13,215	14,980
Exclusion of interest on state and local government housing bonds for owner-occupied housing	1,060	1,190	1,190	1,145	1,105	1,070	450	485	475	445	415	385
Exclusion of interest on state and local government housing bonds for rental housing	585	735	880	1,035	1,185	1,345	285	355	430	510	585	665
Deferral of capital gains on home sales	---	---	---	---	---	---	3,770	4,895	5,625	6,000	6,480	7,030
Exclusion of capital gains on home sales for persons age 55 and over	---	---	---	---	---	---	1,255	1,630	1,875	2,000	2,160	2,345

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
376 Other Advancement and Regulation of Commerce												
Exclusion of interest on state and local industrial development bonds	2,355	2,790	3,265	3,875	4,385	4,615	570	675	800	985	1,180	1,310
Exemption of credit union income	170	185	200	220	240	260	---	---	---	---	---	---
Exclusion of interest on life insurance savings	---	---	---	---	---	---	4,805	5,170	5,805	6,640	7,590	8,675
Deductibility of nonmortgage interest in excess of investment income	---	---	---	---	---	---	7,735	8,160	8,815	9,590	10,550	11,645
Expensing of construction period interest and taxes	505	610	735	855	975	1,110	275	320	390	455	515	590
Depreciation on rental housing in excess of straight-line	120	155	165	170	180	185	575	665	720	760	795	820
Depreciation on buildings (other than rental housing) in excess of straight-line	175	200	215	240	265	295	150	165	185	210	230	250
Reinvestment of dividends in stock of public utilities	---	---	---	---	---	---	365	415	450	230	---	---
Net interest exclusion	---	---	---	---	---	---	---	---	1,110	3,095	3,480	3,945
Exclusion of interest on certain savings certificates	---	---	---	---	---	---	2,335	550	---	---	---	---
Accelerated depreciation on equipment other than leased property	9,510	15,865	18,860	17,445	14,110	13,890	1,015	2,460	2,845	2,825	2,255	1,915
Safe-harbor leasing:												
Accelerated depreciation and deferral	1,745	1,885	1,635	1,285	1,040	525	---	---	---	---	---	---
Investment credit	1,625	915	705	710	515	280	---	---	---	---	---	---
Amortization of business start-up costs	15	20	25	30	35	40	105	160	230	285	315	355
Capital gains other than agriculture, timber, iron ore, and coal	1,770	2,075	2,130	2,305	2,475	2,695	14,955	14,320	15,365	16,440	17,590	18,820
Capital gains at death	---	---	---	---	---	---	3,975	3,565	3,665	3,920	4,195	4,490

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
376 <u>Other Advancement and Regulation of Commerce</u> (continued)												
Dividend exclusion	---	---	---	---	---	---	445	435	440	450	460	480
Reduced rates on the first \$100,000 of corporate income	5,690	6,525	7,025	8,060	8,765	9,090	---	---	---	---	---	---
Investment credit, other than for Employee Stock Ownership Plans (ESOPs), rehabilitation of structures, reforestation and leasing	9,965	12,315	16,075	19,870	21,650	22,860	3,220	3,350	3,615	3,945	4,245	4,595
400 TRANSPORTATION												
401 <u>Ground Transportation</u>												
Amortization of motor-carrier operating rights	70	70	50	15	5	b	5	5	5	5	b	---
Exclusion of interest on state and local government mass transit bonds	45	65	75	75	65	75	15	25	20	15	10	20
403 <u>Water Transportation</u>												
Deferral of tax on shipping companies	30	40	40	45	45	45	---	---	---	---	---	---
450 COMMUNITY AND REGIONAL DEVELOPMENT												
451 <u>Community Development</u>												
Five-year amortization for housing rehabilitation	20	25	25	25	25	25	30	35	35	35	35	35
Investment credit for rehabilitation of structures other than historic structures	175	200	185	195	215	235	160	165	160	165	180	200

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
500 EDUCATION, TRAINING, EMPLOYMENT AND SOCIAL SERVICES												
502 <u>Higher Education</u>												
Exclusion of scholarship and fellowship income	---	---	---	---	---	---	415	375	395	410	435	460
Employer educational assistance	---	---	---	---	---	---	40	20	---	---	---	---
Exclusion of interest on state and local government student loan bonds	150	200	260	320	390	460	70	100	125	155	190	225
Parental personal exemption for students age 19 or over	---	---	---	---	---	---	995	950	885	895	905	920
Deductibility of charitable contributions (education)	280	345	360	415	480	525	495	495	580	735	660	615
504 <u>Training and Employment Services</u>												
Credit for child and dependent care expenses	---	---	---	---	---	---	1,520	1,765	2,190	2,465	2,765	3,160
Targeted jobs credit	215	395	355	155	30	5	75	70	30	b	---	---
505 <u>Other Labor Services</u>												
Exclusion of employee meals and lodging (other than military)	---	---	---	---	---	---	680	725	795	870	945	1,030
Tax credit for Employee Stock Ownership Plans (ESOPs)	1,250	1,375	1,875	2,235	2,330	950	---	---	---	---	---	---
Exclusion for employer-provided child care	---	---	---	---	---	---	10	25	55	85	120	155
506 <u>Social Services</u>												
Deductibility of charitable contributions, other than education and health	350	425	445	515	590	645	6,795	6,765	7,930	10,030	9,030	8,370
Exclusion of contributions to prepaid legal services plans	---	---	---	---	---	---	25	25	10	---	---	---
Deduction for two-earner married couples	---	---	---	---	---	---	3,555	5,835	6,350	6,935	7,600	8,460
Deduction for adoption expenses	---	---	---	---	---	---	10	10	10	10	15	15

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals						
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988	
550 HEALTH													
551 <u>Health Care Services</u>													
Exclusion of employer contributions for medical insurance premiums and medical care	---	---	---	---	---	---	18,645	21,300	24,280	27,680	31,555	35,975	
Deductibility of medical expenses	---	---	---	---	---	---	3,105	2,630	3,070	3,370	3,740	4,165	
Exclusion of interest on state and local government hospital bonds	795	960	1,115	1,265	1,420	1,580	385	470	545	625	700	780	
Deductibility of charitable contributions (health)	175	215	225	255	295	325	995	990	1,160	1,470	1,320	1,225	
Tax credit for orphan drug research	10	15	15	10	---	---	---	---	---	---	---	---	
600 INCOME SECURITY													
601 <u>General Retirement and Disability Insurance</u>													
Exclusion of Social Security benefits													
Disability insurance benefits	---	---	---	---	---	---	1,690	1,660	1,695	1,755	1,840	1,930	
OASI benefits for retired workers	---	---	---	---	---	---	15,685	16,680	18,070	19,640	21,275	23,045	
Benefits for dependents and survivors	---	---	---	---	---	---	3,765	3,870	4,095	4,355	4,630	4,920	
Exclusion of railroad retirement system benefits	---	---	---	---	---	---	780	765	765	745	755	775	
Exclusion of workmen's compensation benefits	---	---	---	---	---	---	1,870	2,090	2,395	2,755	3,170	3,645	
Exclusion of special benefits for disabled coal miners	---	---	---	---	---	---	170	165	165	160	160	165	
Exclusion of disability pay	---	---	---	---	---	---	145	135	130	130	130	130	

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
601 <u>General Retirement and Disability Insurance (continued)</u>												
Net exclusion of pension contributions and earnings							49,700	56,560	66,365	78,310	92,405	109,035
Employer plans	---	---	---	---	---	---	1,065	1,050	1,070	1,115	1,165	1,220
Plans for self-employed	---	---	---	---	---	---	2,695	3,180	3,705	4,240	4,745	5,360
Individual retirement plans												
Exclusion of other employee benefits												
Premiums on group term life insurance	---	---	---	---	---	---	2,100	2,250	2,465	2,715	2,985	3,285
Premiums on accident and disability insurance	---	---	---	---	---	---	115	120	125	130	135	140
Additional exemption for the blind	---	---	---	---	---	---	35	35	35	35	35	35
Additional exemption for the elderly	---	---	---	---	---	---	2,365	2,410	2,570	2,720	2,410	3,130
Tax credit for the elderly	---	---	---	---	---	---	135	135	135	135	135	135
603 <u>Unemployment Compensation</u>												
Exclusion of untaxed unemployment insurance benefits	---	---	---	---	---	---	3,260	3,020	2,585	2,405	2,265	2,120
609 <u>Other Income Security</u>												
Exclusion of public assistance benefits	---	---	---	---	---	---	430	430	440	455	470	485
Deductibility of casualty and theft losses	---	---	---	---	---	---	575	380	470	520	590	670
Earned income credit <sup>d</sup>	---	---	---	---	---	---	385	330	290	215	155	210
700 VETERANS' BENEFITS AND SERVICES												
701 <u>Income Security for Veterans</u>												
Exclusion of veterans' disability compensation	---	---	---	---	---	---	1,820	1,830	1,950	1,995	2,070	2,145
Exclusion of veterans' pensions	---	---	---	---	---	---	310	290	280	275	275	275

(Continued)

TABLE A-1. (Continued)

Function and Subfunction	Corporations						Individuals					
	1983	1984	1985	1986	1987	1988	1983	1984	1985	1986	1987	1988
702 <u>Veterans' Education, Training and Rehabilitation</u> Exclusion of GI bill benefits	---	---	---	---	---	---	130	130	115	100	90	65
800 GENERAL GOVERNMENT												
806 <u>Other General Government</u> Credits and deductions for political contributions	---	---	---	---	---	---	190	200	220	220	230	240
850 GENERAL PURPOSE FISCAL ASSISTANCE												
851 <u>General Revenue Sharing</u> Exclusion of interest on general purpose state and local debt	6,985	7,850	8,695	9,530	10,370	11,280	3,435	3,870	4,295	4,715	5,130	5,580
Deductibility of nonbusiness state and local taxes (other than on owner-occupied homes)	---	---	---	---	---	---	20,060	21,770	26,605	29,970	34,125	39,010
852 <u>Other General Purpose Fiscal Assistance</u> Tax credit for corporations receiving income from doing business in United States possessions	1,350	1,075	1,135	1,240	1,375	1,525	---	---	---	---	---	---
900 INTEREST												
901 <u>Interest on the Public Debt</u> Deferral of interest on savings bonds	---	---	---	---	---	---	50	160	225	290	355	410

SOURCE: Congressional Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988 (March 7, 1983), pp. 10-18.

a. All estimates are based on the tax law enacted through the 97th Congress.

b. Less than \$2.5 million.

c. In addition, the exemption from the excise tax for alcohol fuels results in a reduction in excise tax receipts, net of the income tax effect, of approximately \$40 million for 1983, \$60 million for 1984, \$80 million for 1985, \$95 million for 1986, and \$110 million for 1987 and 1988.

d. The figures in the table indicate the effect of the earned income credit on receipts. The increase in outlays is: \$1,197 million in 1983, \$1,119 million in 1984, \$1,032 million in 1985, \$1,004 million in 1986, \$968 million in 1987, and \$910 million in 1988.



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## APPENDIX B. TAX EXPENDITURES WITH EXPIRATION DATES

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It has become increasingly common in recent years for the Congress to provide expiration dates for newly enacted tax expenditures. The usual rationale is that the scheduled expiration date will provide an opportunity to review the provision carefully to determine whether it should be reenacted. Some provisions are allowed to expire without full-scale review, however, while others are extended with little, if any, review. Table B-1 gives the tax expenditures expiration dates in effect as of the date of publication of this report.

TABLE B-1. TAX EXPENDITURES WITH EXPIRATION DATES

Tax Expenditure	Expiration Date
Exclusion for Employer Educational Assistance Programs	December 31, 1983
Exclusion of Interest on State and Local Housing Bonds for Owner-Occupied Housing	December 31, 1983
Exclusion for National Research Service Awards	December 31, 1983
Suspension of Regulations Relating to Allocation Under Section 861 of Research and Experimental Procedures	August 13, 1984
Exclusion of Contributions to Prepaid Legal Services Plans	December 31, 1984
Targeted Jobs Tax Credit	December 31, 1984
Tax-exempt Bonds for Purchase of Mass Transit Equipment	December 31, 1984
Exclusion for Armed Forces Health Professions Scholarship Awards	December 31, 1984
Safe-Harbor Leasing <sup>a</sup>	September 30, 1985
Exclusion for Employer-Provided Transportation	December 31, 1985
Credit for Intercity Buses	December 31, 1985
Geothermal Equipment Credit	December 31, 1985
Solar and Wind Property Credit	December 31, 1985
Credit for Ocean Thermal Energy Conversion Equipment	December 31, 1985
Biomass Property Credit	December 31, 1985

(Continued)

TABLE B-1. (Continued)

Tax Expenditure	Expiration Date
Credit for Small-Scale Hydroelectric Facilities	December 31, 1985
Residential Energy Conservation Credits	December 31, 1985
Residential Renewable Energy Supply Credits	December 31, 1985
Tax-exempt Bonds for Steam Generating or Alcohol-Producing Facilities Using Solid Waste Material	December 31, 1985
Tax-exempt Bonds for Small-Scale Hydroelectric Facilities	December 31, 1985
Public Utility Dividend Reinvestment Plans	December 31, 1985
Tax for Credit for Research and Experimentation	December 31, 1985
Charitable Contribution Deduction for Nonitemizers	December 31, 1986
Tax exemption for Small Issue IDBs	December 31, 1986
Employee Stock Ownership Plan (ESOP) Investment Tax Credit <sup>b</sup>	December 31, 1987
Tax Credit for Orphan Drug Research	December 31, 1987
Alcohol Fuel Tax Credit and Excise Tax Exemption	
Alternative Fuel Production Credit	December 31, 2000

- a. The safe-harbor leasing provision enacted in 1981 and scheduled to expire December 31, 1983 was replaced by a finance leasing provision in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).
- b. Since December 31, 1982, the former ESOP investment tax credit has been replaced by an income tax credit based on aggregate compensa-



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## APPENDIX C. DIFFERENCES BETWEEN THE ADMINISTRATION AND JCT/CBO TAX EXPENDITURE LISTS

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This Appendix discusses the provisions that are included in the JCT/CBO tax expenditure list, but that are excluded from the Administration list (see Table 2 in Chapter II). In general, these differences are the result of judgmental decisions about the definition of the appropriate reference tax structure.

### Reduced Corporate Tax Rates

The corporate rate structure generally consists of a single flat rate of 46 percent and reduced rates on income below \$100,000, which are intended primarily as tax relief for smaller businesses. Since the Administration includes both the progressive rate structure for the individual tax and the rate structure for the corporate tax as part of the reference tax rules, it does not include this provision as a tax expenditure.

In contrast, the JCT/CBO include the reduced corporate rates as a tax expenditure.<sup>1</sup> In general, most corporate income is subject to the flat 46 percent rate, and this is the reference tax rate used by the JCT/CBO. Because the reduced rates on income below \$100,000 are generally referred to as a small business benefit, they are viewed as an exception to the general tax rules and, therefore, as a tax expenditure.

### Exclusion of Scholarship and Fellowship Income and Public Assistance Benefits

The Administration tax expenditure list does not include the income tax exclusions for scholarships and fellowships and public assistance benefits (for example, AFDC and SSI). The Administration omits these items under the theory that they constitute "gifts," rather than income. In general, the income tax does not attempt to tax gifts as income to the recipient, although under a comprehensive definition of income they would

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<sup>1</sup> Canada and France also include reduced corporate rates in their tax expenditure lists.

be taxed.<sup>2</sup> Neither the JCT/CBO nor the Administration count gifts between individuals as income for purposes of the reference tax structure.

Once the income tax standard has been modified to allow for the exclusion of gift income, however, legitimate disagreements can arise as to what constitutes a "gift." Although the Administration views scholarships and fellowship income and public assistance benefits as gifts, the JCT/CBO do not consider these two sources of income as gifts. In the case of these transfers, the benefits are commonly treated as income to the recipient for purposes other than taxation. For example, these benefits are counted as income for purposes of food stamp eligibility or rent subsidies. Indeed, scholarship and fellowship income is taxable if it is in excess of \$300 per month. Accordingly, these items are viewed as income by the CBO and JCT and their exclusion from taxable income is, therefore, considered a tax expenditure.

#### Capital Gains at Death

The JCT/CBO and the Administration differ in their definition of the tax expenditure for capital gains at death. Under current law, when the owner of an appreciated asset dies, the gain is not realized for tax purposes, but is transferred to the heirs. In addition, when the asset is actually sold, no tax is owed on the gain that accrued during the original owner's lifetime. This effect is achieved by the provision that allows the heirs to use the asset's market value as of the date of the decedent's death as the cost for determining capital gains, instead of the original owner's acquisition cost. Thus, gains transferred as a result of the owner's death are never taxed.

In general under current law, any time an asset is exchanged or sold income is realized. The CBO and JCT treat the transfer of the asset to the heirs upon the death of an asset owner as a regular transaction, subject to taxation at full rates. Current law allows taxpayers to exclude 60 percent of the gain on assets held for more than one year; this exclusion is considered a tax expenditure. Thus, under the JCT/CBO reference tax rules, the gain that accrued over the life of the original owner is considered to be realized and subject to full taxation at the time of death. This amount is counted as a tax expenditure.

The Administration also includes capital gains at death as a tax expenditure, but does not recognize the revenue loss until the asset is

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<sup>2</sup> Under the unified estate and gift tax, large gifts are already taxed to the donor, but not as income to the recipient.

actually sold by the heir. In addition, the cost of the tax expenditure is only 40 percent of the amount of revenue that would be realized under full taxation. The other 60 percent is included as part of a tax expenditure for the general exclusion for capital gains.

For example, assume that in 1983 the owner of an asset that originally cost \$1,000 dies and wills the asset, now with a market value of \$3,000 to an heir. Under current law, no income tax is owed on the transaction. In addition, \$3,000 is considered the new cost (or tax basis) by which all future gains and losses accruing to the heir will be measured. The JCT/CBO measure of the associated tax expenditure in 1983 is the product of the full \$2,000 gain and the original owner's marginal tax rate. If that tax rate is 50 percent, the tax expenditure would be estimated at \$1,000 for 1983.

The Administration would calculate the tax expenditure differently. For 1983, none of the gain would be assumed subject to tax--the excluded \$2,000 gain would not be considered taxable until the heir actually sold the property. Suppose the asset is sold in 1986 for \$3,000. At that point, the Administration would recognize a \$1,000 total tax expenditure, but it would allocate \$400 (40 percent) to the provision exempting gains at death and \$600 (60 percent) to the general capital gains exclusion.<sup>3</sup> In 1986, the JCT/CBO method would not record a tax expenditure for this transaction. Over time, the JCT/CBO and Administration approaches should yield a comparable total tax expenditure for each asset transferred, but the timing of the revenue losses will be different. In the example above, the total tax expenditure (both basis carryover and capital gains exclusion) is the same (\$1,000), but it is distributed differently between 1983 and 1986.

#### Deferral of Income of Controlled Foreign Corporations

Under current law, the income of foreign corporations controlled by U.S. firms is generally not subject to U.S. tax until that income is transferred back to the United States. This allows corporations to defer tax payments until they choose to "realize" them. The CBO and JCT recognize this provision as an exception to the standard treatment of income under an income tax, wherein income is subject to taxation on a current basis. In contrast, the Administration excludes this deferred tax from its tax expenditure list because the reference tax rules used by the Treasury do not consider foreign income "earned" until it is repatriated.

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<sup>3</sup> The \$300 is the capital gains exclusion for the higher basis ( $0.5 \times 0.6 \times 2,000 = \$600$ ).

The Treasury considers the earnings of foreign corporations beyond the scope of U.S. taxation unless they are brought into this country.

Suspension of Regulations Relating to Allocation under Section 861 of Research and Experimental Expenditure

In general, research and experimental expenses qualify as deductions in determining a firm's taxable income.<sup>4</sup> For those companies that conduct research and also earn income abroad, the allocation of research expenses is a difficult tax issue. Treasury regulation S. 1.861-8 sets forth the rules that firms must use in distributing these expenses to income from domestic or foreign sources. Corporations are required to "match" their earnings in different countries with the associated research expenditures through the use of allocation formulas. Generally, these rules result in an allocation of a significant amount of domestic research expenditures to foreign source income. While worldwide taxable income is not affected by the apportionment of research and development expenditures to foreign income, the regulation does increase domestic taxes by reducing the amounts that some firms can take as foreign tax credits.<sup>5</sup> (Foreign income taxes are not actually reduced because the foreign countries do not allow the deduction against income as computed under S. 1.861-8.)

In order to measure net income, it is necessary to match expenses against the associated income. The allocation of U.S. domestic research expenses to foreign income is proper to the extent the two are related. As the Treasury has recently explained:

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<sup>4</sup> The Internal Revenue Code section that allows firms to deduct research and development costs instead of amortizing them also results in a tax expenditure that is recognized by the Administration and the JCT and CBO.

<sup>5</sup> The deduction for research and development expenditures and the foreign tax credit are interrelated. The foreign tax credit that a firm can take in a given year is limited to the product of the U.S. tax rate (46 percent) and foreign net income, as determined under U.S. tax law. If the limit is exceeded by the taxes actually levied by foreign countries, firms cannot use the "excess" tax credits, but must carry them over into future years. For those firms for which the limit is effective, any reduction in foreign net income, as prescribed by U.S. tax law, will reduce the amount of foreign tax credits that those firms can utilize currently.