Section 16. Tax Expenditures and Other Tax Provisions Related to Retirement, Health, Poverty, Employment, and Disability

INTRODUCTION

The preceding sections of this publication discuss direct payments to individuals for retirement, health, public assistance, employment, and disability benefits provided through entitlement programs within the jurisdiction of the Committee on Ways and Means. The Federal Government also provides indirect payments to individuals by means of special income tax provisions that yield preferential tax treatment. These provisions, called tax expenditures, are entirely within the jurisdiction of the committee. Those relating to the above-mentioned policy objectives are described in this section.

CONCEPT OF TAX EXPENDITURES

The term ``tax expenditure'' suggests that the goals of these favorable tax provisions in many cases could alternatively be accomplished by direct expenditure programs. They can be viewed as Federal spending through the tax system. Tax expenditures are similar in nature to entitlement programs--they are not subject to the annual appropriations process and are available as entitlements to eligible individuals and corporations. They are administered by the Internal Revenue Service.

Estimates of tax expenditures measure the decreases in individual and corporate income tax receipts that result from the preferential provisions in income tax laws and regulations.\1\ These are intended to provide economic incentives or tax relief for particular activities to particular kinds of taxpayers. As defined in the Congressional Budget Act, the concept of tax expenditures refers to the corporate and individual income taxes. Federal excise, employment, and estate and gift taxes also have preferential provisions, but these are not included in this section.

\1\Estimates of tax expenditures are provided in annual publications of the Joint Committee on Taxation and in the President's budget.

TYPES OF TAX EXPENDITURES

Several different types of income tax provisions can deliver preferential treatment. Exclusions, exemptions, and deductions reduce taxable income. Special, lower tax rates may apply to certain types of income. Tax credits are subtracted, dollar for dollar, from tax liability. Tax deferrals occur when recognition of income is delayed or when deductions more properly allocated to a future year are allowed in the current year.

MEASUREMENT OF TAX EXPENDITURES

Estimates of tax expenditures as revenue losses are subject to important limitations. Each tax expenditure is measured in isolation. The difference between the estimate of tax receipts under present law including a tax preference and the higher level of tax receipts if the provision did not exist is the amount of the tax expenditure. For this computation, it is assumed that nothing else changes. Specifically, the availability of tax expenditures may cause taxpayers to behave differently. These behavioral changes are not taken into account when measuring tax expenditures.

If two or more items were to be eliminated simultaneously, the result of the combined changes might produce a different revenue effect than the sum of the separate amounts for each item. Therefore, adding the amounts of various tax expenditure items can be misleading.

USE OF DISTRIBUTIONAL ANALYSIS

Analyzing the effectiveness of tax provisions at achieving their policy goals often involves examining the distribution of benefits from the provisions, i.e. the forgone revenue allocated by the income class of those who take advantage of the provisions. The income concept used to show the distribution of tax expenditures by income class is adjusted gross income plus (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA taxes, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) corporate income tax liability attributed to shareholders, (8) minimum tax preferences, and (9) excluded income of U.S. citizens living abroad.

This definition of income includes items that clearly increase the ability to pay taxes, but that are not included in the definition of adjusted gross income. However, it omits certain items that clearly affect ability to consume goods and services, including accrual of pension benefits, other fringe benefits (such as military benefits, veterans benefits, and parsonage allowances), means-tested transfer payments (such as Aid to Families with Dependent Children, Supplemental Security Income, food stamps, housing subsidies, and general assistance), and imputed rent on owner-occupied homes.

The tax return is the unit of analysis. Table 16-1 shows the distribution of all tax returns for 1994 by income class.

Unless specifically indicated, all distributional tables exclude returns filed by dependents. All projections of income and deduction items and tax parameters are based on economic assumptions consistent with the January 1994 forecast of the Congressional Budget Office.

TABLE 16-1.--DISTRIBUTION OF TAX RETURNS BY INCOME CLASS, 1994

[Money amounts in millions of dollars, returns in thousands]

		Itemized returns		
		Income class (thousands)		
All returns\1\	Taxable returns	Total	Taxable	Tax liability

Below $10	24,145	2,467	178	16	-$4,469
$10 to $20	25,012	10,308	957	413	756
$20 to $30	20,784	14,456	2,254	1,617	20,671
$30 to $40	16,698	14,578	3,579	3,237	37,145
$40 to $50	11,941	11,465	4,163	3,992	41,337
$50 to $75	18,006	17,848	10,232	10,133	101,078
$75 to $100	7,486	7,446	5,864	5,851	75,339
$100 to $200	5,377	5,351	4,763	4,747	105,129
$200 and over	1,417	1,414	1,309	1,306	164,438
Total	130,866	85,333	33,299	31,312	541,424

\1\Includes filing and nonfiling units. Filing units include all taxable and nontaxable returns. Nonfiling units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.).

Note.--Detail may not add to total due to rounding.

Source: Joint Committee on Taxation.

TAX EXPENDITURE ESTIMATES

Table 16-2 provides estimates of the 25 tax expenditures related to retirement, health, poverty, employment, disability and housing. The largest ones are the exclusion of

employer-
paid pension contributions ($69.5 billion in 1995), the exclusion of employer-paid health insurance premiums ($53.5 billion), and the deduction for interest on home mortgages ($45.8 billion). It is interesting to compare the size of these tax expenditures to the size of spending programs in these areas. The Congressional Budget Office estimates\2\ that the Federal government will directly spend $273 billion in 1995 on the two major health programs (Medicare and Medicaid) and $412 billion on retirement programs (Social Security and federal retirement programs). Direct federal subsidies for housing are of two general types: funds to build and maintain low-cost housing available only to low-income Americans, and below-market mortgage interest rates for certain owner-occupied housing. These are funded through discretionary appropriations, not through entitlements. In total, these are considerably smaller than the mortgage interest tax deduction.

\2\CBO, ``The Economic and Budget Outlook: Fiscal Years 1995-1999'' (January 1994).

TABLE 16-2.--TAX EXPENDITURE ESTIMATES: FISCAL YEARS 1995-99

[Billions of dollars]

Item	1995	1996	1997	1998	1999

Tax expenditures related to retirement:					
Net exclusion of pension contributions and earnings.	69.5	73.5	78.0	82.8	87.9
Keogh plans.................	3.2	3.3	3.5	3.7	4.0
Individual retirement plans.	8.4	8.8	9.3	9.8	10.3
Exclusion of Social Security and railroad retirement benefits\1\................	23.1	24.1	25.1	26.1	27.1
Tax expenditures related to health:					
Exclusions of employer contributions for medical insurance premiums and medical care\2\............	45.8	49.9	53.8	57.9	62.3
Exclusion of Medicare benefits:					
Medicare Part A.........	8.0	9.2	10.8	12.6	14.8
Medicare Part B.........	5.1	6.1	7.3	8.7	10.4
Deductibility of medical expenses...................	4.1	4.5	5.0	5.5	6.0
Tax expenditures related to poverty:					
Earned income tax credit:					
Nonrefundable portion...	3.4	3.7	4.1	4.6	5.1
Refundable portion......	17.7	19.4	21.3	23.3	25.5
Exclusion of public assistance and SSI cash benefits...................	0.5	0.5	0.6	0.6	0.7

Tax expenditures related to employment:					
Dependent care credit.......	2.7	2.8	2.8	2.9	3.0
Exclusion of employer-provided dependent care\3\.	0.6	0.7	0.8	0.9	1.0
Employee stock ownership plans (ESOPs)..............	0.9	1.0	1.1	1.2	1.2
Exclusion for benefits provided under cafeteria plans\4\...................	3.8	4.4	5.0	5.7	6.5
Tax expenditures related to elderly and disabled:					
Exclusion of workers' compensation and special benefits for disabled coal miners:					
Workers' compensation...	3.9	4.0	4.2	4.4	4.6
Special benefits for disabled coal miners...	0.1	0.1	0.1	0.1	0.1
Additional standard deduction for elderly and blind......................	1.9	2.0	2.1	2.2	2.4
Tax credit for elderly and disabled...................	(\5\)	(\5\)	(\5\)	(\5\)	(\5\)
Tax expenditures related to housing:					
Deductibility of mortgage interest..................	53.5	56.8	60.2	63.9	67.8
Deductibility of property tax on owner-occupied housing....................	13.7	14.5	15.3	16.2	17.1

Deferral of capital gain on sale of principal residence	14.8	15.3	15.9	16.4	17.0
Exclusion of capital gain on sale of residence of persons 55 and over........	4.9	5.1	5.3	5.5	5.7
Exclusion of interest on State and local government bonds for owner-occupied housing....................	1.7	1.8	1.8	1.7	1.7
Depreciation of rental housing in excess of alternative depreciation system.....................	1.7	1.6	1.5	1.3	1.2
Exclusion of interest on State and local government bonds for rental housing...	0.9	0.9	0.8	0.8	0.7
Low-income housing tax credit.....................	2.2	2.6	3.0	3.3	3.7

\1\In addition to OASDI benefits for retired workers, these figures also include disability insurance benefits and benefits for dependents and survivors.
\2\Estimate includes employer-provided health insurance purchased through cafeteria plans.
\3\Estimate includes employer-provided child care purchased through dependent care flexible spending accounts.
\4\Estimate includes amounts of employer-provided health insurance purchased through cafeteria plans and employer-provided child care purchased through flexible spending accounts. These amounts are also included in other line items in this table.
\5\Less than $50 million.

Source: Joint Committee on Taxation.

The remainder of this chapter will discuss specific tax expenditures related to retirement, health, poverty, employment, disability, and housing. The discussion includes legislative history, an explanation of current law, and a brief assessment of the effects of each tax expenditure.

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

Legislative history

Prior to 1921, no special tax treatment applied to employee retirement trusts. Retirement payments to employees and contributions to pension trusts were deductible by the employer as an ordinary and necessary business expense. Employees were taxed on amounts actually received as well as on employer contributions to a trust if there was a reasonable expectation of benefits accruing from the trust. The 1921 Code provided an exemption for a trust forming part of a qualified profit-sharing or stock bonus plan.

The rules relating to qualified plans were substantially revised by the Employee Retirement Income Security Act of 1974 (ERISA), which added overall limitations on contributions and benefits and other requirements on minimum participation, coverage, vesting, benefit accrual, and funding. Further revisions of these rules have been made in every major tax bill since then.

Since ERISA, Congress has also acted to broaden the range of qualified plans. In the Revenue Act of 1978, Congress provided special rules for qualified cash or deferred arrangements under section 401(k). Under these arrangements, known popularly as 401(k) plans, employees can elect to receive cash or have their employers contribute a portion of their earnings to a qualified profit sharing, stock bonus, or pre-ERISA money purchase pension plan.

An employee stock ownership plan (ESOP) is a special type of qualified plan that is designed to invest primarily in securities of the employer maintaining the plan. Certain qualification rules and tax benefits apply to ESOPs that do not apply to other types of qualified plans.

Explanation of provision

In general.--Under a plan of deferred compensation that meets the qualification standards of the Internal Revenue Code, an employer is allowed a deduction for contributions to a tax-exempt trust to provide employee benefits. Similar rules apply to plans funded with annuity contracts. An employer that makes contributions to a qualified plan in excess of the deduction limits is subject to a 10-percent excise tax on such excess (sec. 4972).

The qualification rules limit the amount of benefits that can be provided through a qualified plan and require that benefits be provided on a basis that does not discriminate in favor of highly compensated employees. In addition, qualified plans are required to meet minimum standards relating to participation (the restrictions that may be imposed on participation in the plan), coverage (the number of employees participating in the plan), vesting (the time at which an employee's benefit becomes nonforfeitable), and benefit accrual (the rate at which an employee earns a benefit). Also, minimum funding standards apply to the rate at which employer contributions are required to be made to the plan to ensure the solvency of pension plans.

If a defined benefit pension plan is terminated, any assets remaining after satisfaction of the plan's liabilities may revert to the employer. Such reversions are included in the gross income of the employer and are subject to income tax plus an additional excise tax payable by the employer. The excise tax is 20 percent if the employer establishes a qualified replacement plan or provides certain benefit increases. Otherwise, the excise tax is 50 percent.

Minimum participation rules.--A qualified plan generally may not require as a condition of participation that an employee complete more than one year of service or be older than age 21 (sec. 410(a)).

Vesting rules.--A plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules.

Benefit accrual rules.--The protection afforded employees under the minimum vesting rules depends not only on the minimum vesting schedules, but also on the accrued benefits to which these schedules are applied. In the case of a defined contribution plan, the accrued benefit is the participant's account balance. In the case of a defined benefit plan, a participant's accrued benefit is determined under the plan benefit formula, subject to certain restrictions. In general, the accrued benefit is defined in terms of the benefit payable at normal retirement age and does not include certain ancillary nonretirement benefits.

Each defined benefit plan is required to satisfy one of three accrued benefit tests. The primary purpose of these tests is to prevent undue backloading of benefit accruals (i.e., by providing low rates of benefit accrual in the employee's early years of service when the employee is most likely to leave and by concentrating the accrual of benefits in the employee's later years of service when he or she is most likely to remain with the employer until retirement).

Coverage rules.--A plan is not qualified unless the plan satisfies at least one of the following coverage requirements: (1) the plan benefits at least 70 percent of all nonhighly compensated employees, (2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan, or (3) the plan meets an average benefits test. In addition, a plan is not a qualified plan unless it benefits the lesser of (1) 50 employees or (2) 40 percent of the employees of the employer (sec. 401(a)(26)).

General nondiscrimination rule.--In general, a plan is not a qualified plan if the contributions or benefits under the plan discriminate in favor of highly compensated employees.

Limitations on contributions and benefits.--The maximum annual benefit that may be provided by a defined benefit pension plan (payable at the Social Security retirement age) is the lesser of (1) 100 percent of average compensation, or (2) $118,800 for 1994 (sec. 415(b)). The dollar limit is adjusted annually for inflation. The dollar limit is reduced if payments of benefits begin before the Social Security retirement age and increased if benefits begin after the Social Security retirement age.

Funding rules.--Pension plans are required to meet a minimum funding standard for each plan year (sec. 412). In the case of a defined benefit pension plan, an employer must contribute an annual amount sufficient to fund a portion of participants' projected benefits determined in accordance with one of several prescribed funding methods, using reasonable actuarial assumptions. Plans with asset values of less than 100 percent of current liabilities are subject to additional, faster funding rules.

Taxation of distributions.--An employee who participates in a qualified plan is taxed when the employee receives a distribution from the plan to the extent the distribution is not attributable to employee contributions. With certain exceptions, a 10-percent additional income tax is imposed on early distributions from a qualified plan. A 15-percent excise tax is imposed on distributions that exceed a certain amount in any year.

Failure to satisfy qualification requirements.--If a plan fails to satisfy the qualification requirements, the trust that holds the plan's assets is not tax-exempt, an employer's deduction for plan contributions is only allowed when the employee includes the contributions or benefits in income, and benefits generally are includible in an employee's income when they are no longer subject to a substantial risk of forfeiture.

Effect of provision

The tax treatment of pension contributions and earnings has encouraged employers to establish qualified retirement plans and to compensate employees in the form of pension contributions to such plans. The tax advantage of being compensated through pension contributions consists of two parts. One advantage is the ability to earn tax-free returns to savings. When saving is done through a pension plan, the employee earns a higher rate of return than on fully-taxed savings.\3\ The second advantage is that an employee's tax rate may be lower during retirement than during the working years.

\3\This applies to pension contributions made by employers. Employees may also be able to contribute to qualified plans. Employee contributions may be made with after-tax dollars. If so, the tax advantage given to these contributions is smaller than the tax advantage given to employer contributions, and consists of

the deferral
of tax on accumulated earnings.

These tax provisions directly benefit only persons who work for employers with qualified plans and who work for a sufficient period of time before their benefits vest in such plans. The current extent of this coverage and recent trends in coverage are described below.

Coverage

The term covered, as used here, means that an employee is accruing benefits in an employer pension or other retirement plan. The best current comprehensive evidence on pension coverage comes from the 1988 Survey of Employee Benefits, a supplement to the May 1988 Current Population Survey. The data referred to below come from that survey unless otherwise noted.

As of May 1988, 48 percent of full-time wage and salary workers employed in the private sector reported that they were covered by an employer-sponsored pension. Most of these workers were covered by basic defined benefit or defined contribution plans (31 percent), and another 8 percent had both a basic plan and a 401(k) type contributory plan (see table 16-3).\4\ For another 9 percent, the 401(k) type plan was their only retirement plan. Most employers contributed to their 401(k) type plan. While 48 percent of full-time workers in private employment had employer-sponsored plans, 46 percent had employer-financed plans.

\4\Some private-sector employees contribute to 403(b) tax-sheltered annuities instead of 401(k) plans.

TABLE 16-3.--COVERAGE UNDER EMPLOYER-SPONSORED PENSION OR RETIREMENT PLANS: DISTRIBUTION BY TYPE OF FULL-TIME PRIVATE WAGE AND SALARY WORKERS AGED 16 OR OLDER (PERCENT COVERED)

Coverage status	Total	Men	Women
Number of private wage and salary workers aged 16 or older (in thousands)	71,485	43,188	28,296
Employer-sponsored plan	48	51	44
Basic pension only	31	33	29
Basic and 401(k) type	8	9	8
401(k) type only	9	9	8
Employer contributes	7	7	7
Employer does not contribute	1	2	1
Not covered	51	48	55
Don't know	1		

1   1

Source: John R. Woods, ``Pension Coverage Among Private Wage and Salary Workers: Preliminary Findings From the 1988 Survey of Employee Benefits,'' Social Security Bulletin, 52:10 (October 1989), p. 8.

Pension coverage varies substantially among full-time, privately employed workers. Differences depend on the age of the worker, job earnings, the industry of employment, the size of the firm, and whether the worker is represented by a union.

Younger workers are much less likely to be covered by a pension than middle-aged and older workers. Coverage rates rise steadily from 12 percent for those under age 21 to 50-60 percent for those aged 40 or over. This pattern holds for both men and women. However, the jump in coverage for middle-aged men is about 10 percentage points larger than the increase for middle-aged women (see table 16-4).

Higher-paying jobs are more likely to offer pensions. Just 13 percent of workers earning less than $10,000 per year in 1988 were covered compared to 72 percent for those earning $30,000 or more (see table 16-5). Coverage may be higher for higher-paying jobs because of the greater value of the pension tax benefits to workers in higher tax brackets and because of the declining replacement rate of Social Security at higher earnings levels. Lower-paying jobs may also be filled more often by part-time workers who are not covered by their employer's plan. The similarity in coverage between men and women with the same earnings, shown in table 16-5, suggests that the higher overall coverage rate among men is due to their greater representation in higher-paying jobs.

TABLE 16-4.--DISTRIBUTION BY AGE AND GENDER, COVERAGE UNDER EMPLOYER-FINANCED PENSION OR RETIREMENT PLAN, FULL-TIME PRIVATE WAGE AND SALARY WORKERS AGED 16 OR OLDER (PERCENT COVERED)

Age (in years)	Total	Men	Women
Total	46	49	43
Under 21	12	12	11
21 to 25	25	24	26
25 to 29	42	41	42
30 to 34	48	48	48
35 to 39	54	57	49
40 to 44	57	61	51
45 to 49	56	61	49
50 to 54	58	63	49
55 to 59	56	60	49
60 or older	47	51	40

Source: John R. Woods, ``Pension Coverage Among Private Wage and Salary Workers: Preliminary Findings From the 1988 Survey of Employee Benefits,'' Social Security Bulletin, 52:10 (October 1989), p. 10.

TABLE 16-5.--DISTRIBUTION BY WORKERS' EARNINGS, COVERAGE UNDER EMPLOYER-FINANCED PENSION OR RETIREMENT PLAN, FULL-TIME PRIVATE WAGE AND SALARY EMPLOYEES AGE 16 OR OLDER (PERCENT COVERED) \1\

Earnings	Total	Men	Women
Total\2\	46	49	43
Under $10,000	13	12	13
$10,000 to $14,999	33	27	39
$15,000 to $19,999	47	43	51
$20,000 to $24,999	58	57	60
$25,000 to $29,999	66	65	68
$30,000 to $39,999	72	71	73
$40,000 and over	72	72	73

\1\Based on 1988 earnings.
\2\Total includes workers not responding on earnings, not shown separately.

Source: Social Security Administration tabulations from 1988 Survey of Employee Benefits, supplement to May 1988 Current Population Survey.

Industries with high pension coverage include manufacturing, mining, financial services, and transportation and public utilities. Coverage rates are nearly 60 percent in each of these industries.\5\ In contrast, coverage rates are under 30 percent in agriculture, retail trade, and services other than financial and professional. Part of the difference among industries appears to be due to differences in firm size. Coverage is much lower for smaller firms. Smaller firms are less likely to offer comprehensive fringe benefit packages as part of total compensation. Only 11 percent of full-time workers in firms with fewer than 10 employees are covered. The rate rises with employer size but does not reach the 46 percent average rate until firms have 250 or more employees (table 16-6). Workers represented by a union are also more likely to be covered under a pension than are other workers. Seventy-five percent of those represented by a union are covered compared to 43 percent of those without a union. Union representation is particularly important in coverage among small employers.

\5\John R. Woods, ``Pension Coverage Among Private Wage and Salary Workers: Preliminary Findings From the 1988 Survey of Employee Benefits,'' Social Security Bulletin, 52:10 (October 1989), p. 13.

TABLE 16-6.--DISTRIBUTION BY SIZE OF FIRM, COVERAGE UNDER EMPLOYER-FINANCED PENSION OR RETIREMENT PLANS, FULL-TIME PRIVATE WAGE AND SALARY WORKERS AGED 16 AND OLDER (PERCENT COVERED)

Firm size (number of workers)	Total	Men	Women
Total\1\	46	49	43
Fewer than 10	11	12	9
10 to 24	22	22	20
25 to 49	29	33	23
50 to 99	40	43	35
100 to 249	45	49	39
250 or more	67	71	63

\1\Total includes workers for whom firm size is unknown, not shown separately.

Source: John R. Woods, ``Pension Coverage Among Private Wage and Salary Workers: Preliminary Findings From the 1988 Survey of Employee Benefits,'' Social Security Bulletin, 52:10 (October 1989), p. 15.

Significant differences in coverage also are apparent between full-time private wage and salary workers and other wage and salary workers. Coverage is much lower among part-time workers and much higher among public employees.

Trends in coverage

At the outset of World War II, private employer pensions were offered by about 12,000 firms. Pensions spread rapidly during and after the war, encouraged by high marginal tax rates and war-time wage controls that exempted pension benefits. By 1972, when the first comprehensive survey was undertaken, 48 percent of full-time private employees were covered. Subsequent surveys found that coverage reached 50 percent in 1979, but by 1983 had fallen back to 48 percent. The decline continued in the 1980's, reaching 46 percent in 1988.\6\

\6\John R. Woods, ``Pension Coverage Among Private Wage and Salary Workers: Preliminary Findings From the 1988 Survey of

Employee
Benefits,'' Social Security Bulletin, 52:10 (October 1989), p. 17.

The decline in coverage in the 1980s was concentrated among younger men. The coverage rate among older men has fallen less dramatically, and among women it has risen at some ages and fallen at others. Explanations for the decline in coverage among young men include the shifting of employment shares from manufacturing to services and the declining share of employees represented by a union contract. Both factors affect men more than women and new job entrants more than long-tenured workers.

The decline in pension coverage has occurred at the same time that employers have been shifting from defined benefit plans. Defined benefit plans provided basic plan coverage for 87 percent of private wage and salary workers in 1975.\7\ This proportion dropped to 83 percent by 1980 and to 71 percent by 1985. This shifting composition has largely been the result of rapid growth in primary defined contribution plans. Employee stock ownership plans and 401(k) plans have been among the most rapidly growing defined contribution plans.

\7\John A. Turner and Daniel Beller, eds., ``Trends in Pensions,'' Department of Labor, 1989, pp. 65, 357.

INDIVIDUAL RETIREMENT PLANS

Legislative history

The Employee Retirement Income Security Act of 1974 added section 219 of the Internal Revenue Code, providing a tax deduction for certain contributions to individual retirement arrangements (IRAs) and permitting the deferral of tax on amounts held in such arrangements until withdrawal. Active participants in employer plans were not permitted to make deductible IRA contributions.

The Economic Recovery Tax Act of 1981 expanded eligibility to individuals who were active participants and increased the amount of the permitted deduction. The Tax Reform Act of 1986 limited the full IRA deduction to individuals with income below certain levels and to individuals who are not active participants in employer plans. Individuals who are not entitled to the full IRA deduction may make nondeductible contributions to an IRA.

Explanation of provision

An individual who is an active participant in an employer plan may deduct IRA contributions up to the lesser of $2,000 ($2,250 for an individual with a nonworking spouse) or 100 percent of compensation if the individual's adjusted gross income (AGI) does not exceed $25,000 for an unmarried individual, $40,000 for a married couple filing a joint return, and $0 for a married individual filing separately. A couple

is
not treated as married if the spouses file separate returns and
do not live together at any time during the year. The deduction
is phased out over the following AGI ranges: (1) $25,000-$35,000 for unmarried individuals, (2) $40,000-$50,000 for married individuals filing a joint return, and (3) 0-$10,000
for married individuals filing separate returns. An individual
is entitled to make nondeductible contributions to the extent
deductible contributions are disallowed as a result of the phaseout.

An individual who is not an active participant in an employer plan may deduct IRA contributions up to the limits described above without limitation based on income.

The investment income of IRA accounts is not taxed until
withdrawn. Withdrawn amounts attributable to deductible contributions and all earnings are includible in income. A 10-percent additional income tax is levied unless the withdrawal
(1) is made after the IRA owner attains age 59\1/2\ or dies,
(2) is made on account of the disability of the IRA owner, or
(3) is one of a series of substantially equal periodic payments
made not less frequently than annually over the life or life
expectancy of the IRA owner (or the IRA owner and his or her
beneficiary).

Effect of provision

Use of IRAs expanded significantly when eligibility was expanded in 1982 to all persons with earnings and contracted correspondingly in 1987 when deductibility was restricted for higher-income taxpayers who were covered by an employer-provided pension. The number of taxpayers claiming a deductible IRA contribution jumped from 3.4 million in 1981 to 12.0 million in 1982 and to 15.5 million in 1986. In 1987, only 7.3 million taxpayers reported deductible contributions. Since then, the number has continued to fall (see table 16-7).

TABLE 16-7.--USE OF DEDUCTIBLE IRAs FROM 1980 TO 1992

Year	Number of tax returns deducting IRA contributions (millions)	Total IRA deductions (billions)
1980..	2.6	$3.4
1981..	3.4	4.8
1982..	12.0	28.3
1983..	13.6	32.1
1984..	15.2	35.4
1985..	16.2	38.2
1986..	15.5	37.8
1987..	7.3	

		14.1
1988	6.4	11.9
1989	5.8	10.8
1990	5.2	9.9
1991	4.7	9.0
1992p	4.3	8.2

p=Preliminary.

Source: Internal Revenue Service, Statistics of Income, 1981 to 1992.

Upper-income taxpayers facing higher marginal tax rates receive more benefit per dollar of IRA deduction than do lower-income taxpayers facing lower marginal tax rates. When IRAs were available to all workers the percentage of taxpayers contributing to an IRA was substantially higher among taxpayers with higher income. For example, in 1985, 13.6 percent of taxpayers with AGI between $10,000 and $30,000 contributed to an IRA compared with 74.1 percent of taxpayers with AGI between $75,000 and $100,000.

The decline in IRA use between 1985 and 1990 among those with AGI between $10,000 and $30,000 appears to be larger than the reduction required by the change in law, since the restrictions on deductible contributions apply only to a small fraction of taxpayers with AGI below $30,000.

Eligibility percentages and the real value of the IRA contribution limits decrease over time because present law

does
not index the contribution limits or the income eligibility limits for inflation. For example, the real value of a $2,000
contribution has declined more than 30 percent since 1986 because of inflation.

Congress established IRAs to allow workers not covered by
employer pension plans to have tax-advantaged retirement saving. Nonetheless, since 1981 IRA participation rates have
been higher among those covered by an employer-provided pension
plan than those without one, and many of those who are not covered by a pension plan do not contribute to an IRA. For example, in 1987, 10 percent of full-time private-sector earners without pension coverage contributed to an IRA, while
15 percent of those with coverage contributed.\8\

\8\John R. Woods, ``Pension Coverage Among Private Wage and Salary Workers: Preliminary Findings From the 1988 Survey of Employee Benefits,'' Social Security Bulletin, 52:10 (October 1989), p. 9.

EXCLUSION OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Legislative history

Social Security benefits.--The exclusion from gross income
for Social Security benefits was not initially established by
statute. Prior to the Social Security Amendments of 1983, the

exclusion was based on a series of administrative rulings issued by the Internal Revenue Service in 1938 and 1941.\9\

\9\See I.T. 3194, 1938-1 C.B. 114, I.T. 3229, 1938-2 C.B. 136, and I.T. 3447, 1941-1 C.B. 191.

Under the Social Security Amendments of 1983, a portion of the Social Security benefits paid to higher income taxpayers is included in gross income. The Congress stated that Social Security benefits are in the nature of benefits received under other retirement systems, which are subject to taxation to the extent they exceed a worker's nondeductible contributions, and that taxing a portion of Social Security benefits improves tax equity by treating more equally all forms of retirement income and other income that is designed to replace wages. In 1993, the Omnibus Budget Reconciliation Act increased the amount of benefits subject to tax for some benefit recipients but did not increase the number of beneficiaries who pay tax on benefits.

Railroad retirement benefits.--The exclusion from gross income of benefits paid under the railroad retirement system was enacted in the Railroad Retirement Act of 1935. A portion of the benefits payable under the railroad retirement system (generally, tier 1 benefits) is equivalent to Social

Security
benefits. The tax treatment of tier 1 railroad retirement
benefits was modified in the Social Security Amendments of
1983
to conform to the tax treatment of Social Security
benefits.
Other railroad retirement benefits are taxable in the same
manner as employer-provided retirement benefits. The
Consolidated Omnibus Budget Reconciliation Act of 1985
provided
that tier 1 benefits are taxable in the same manner as
Social
Security benefits only to the extent that Social Security
benefits otherwise would be payable. Other tier 1 benefits
are
taxable in the same manner as all other railroad retirement
benefits.

Explanation of provision

For taxpayers whose ``modified adjusted gross income''
exceeds certain limits, a portion of Social Security and
tier 1
railroad retirement benefits is included in taxable income.
``Modified adjusted gross income'' is adjusted gross income
plus interest on tax-exempt bonds plus 50 percent of Social
Security and tier 1 railroad retirement benefits. A two-
tier
structure applies. The base tier is $25,000 for unmarried
individuals and $32,000 for married couples filing joint
returns, and zero for married persons filing separate
returns
who do not live apart at all times during the taxable year.
The
amount of benefits includible in income is the lesser of
(1) 50
percent of the Social Security and tier 1 railroad
retirement
benefits, or (2) 50 percent of the excess of the taxpayer's
combined income over the base amount.

The second tier applies to taxpayers with ``modified

adjusted gross income'' of at least $34,000 (unmarried taxpayers) or $44,000 (married taxpayers filing joint returns).
For these taxpayers, the amount of benefits includible in gross income is the lesser of (1) 85 percent of Social Security benefits, or (2) the sum of 85 percent of the amount by which modified adjusted gross income exceeds the second-tier thresholds, and the smaller of the amount included under prior law or $4,500 (unmarried taxpayers) or $6,000 (married taxpayers filing jointly). The portion of tier 1 railroad retirement benefits potentially includible in taxable income under the above formula is the amount of benefits the taxpayer would have received if covered under Social Security. Pursuant to section 72(r) of the Internal Revenue Code of 1986, all other benefits payable under the railroad retirement system are includible in income when received to the extent they exceed employee contributions.

Effect of provision

About 15 percent of all Social Security recipients pay taxes on their benefits. A large percentage of any current Social Security recipient's benefit does not constitute a return of the recipient's contributions (which were originally made with after-tax dollars).

The tax expenditure per tax return from the exclusion is generally greater for those with incomes above $40,000 than for those with incomes below $40,000. This is related to the likelihood that higher income retirees were generally higher income individuals during their working years who were more likely to be eligible for the maximum benefit. The tendency for the tax expenditure per return to rise with income would be greater in the absence of the partial taxation of Social Security benefits.

EXCLUSION OF EMPLOYER CONTRIBUTION FOR MEDICAL INSURANCE PREMIUMS AND MEDICAL CARE

Legislative history

In 1943, the Internal Revenue Service (IRS) ruled that employer contributions to group health insurance policies were not taxable to the employee. Employer contributions to individual health insurance policies, however, were declared to be taxable income in an IRS revenue ruling in 1953.

Section 106 of the Internal Revenue Code, enacted in 1954, reversed the 1953 IRS ruling. As a result, employer contributions to all accident or health plans generally are excluded from taxable income. Under section 105 of the Internal Revenue Code, benefits received under an employer's accident or health plan generally are not included in the employee's income.

In the Revenue Act of 1978, Congress added section 105(h) to tax the benefits payable to highly compensated employees under a self-insured medical reimbursement plan if the plan discriminated in favor of highly compensated employees.

Explanation of provision

Gross income of an employee generally excludes employer-provided coverage under an accident or health plan. The exclusion applies to coverage provided to former employees, their spouses, or dependents. Amounts excluded include those received by an employee for personal injuries or sickness if the amounts are paid directly or indirectly to reimburse the employee for expenses incurred for medical care. However, this exclusion does not apply in the case of amounts paid to a highly compensated individual under a self-insured medical reimbursement plan if the plan violates the nondiscrimination rules of section 105(h).

Present law permits employers to prefund medical benefits for retirees. Postretirement medical benefits may be prefunded by the employer in two basic ways: (1) through a separate account in a tax-qualified pension plan (sec. 401(h)); or (2) through a welfare benefit fund (secs. 419 and 419A). Generally, the amounts contributed are excluded from the income of the plan or participants. Although amounts held in a section 401(h) account are accorded tax-favored treatment similar to assets held in a pension trust, the benefits provided under a section 401(h) account are required to be incidental to the retirement benefits provided by the plan. Amounts contributed to welfare benefit funds are subject to certain deduction limitations (secs. 419 and 419A). Additionally, the fund is subject to income tax relating to any set-aside to provide postretirement medical benefits.

Effect of provision

The exclusion for employer-provided health coverage provides an incentive for compensation to be furnished to the employee in the form of health coverage, rather than in cash subject to current taxation.

For example, an employer designing a compensation package for an employee would be indifferent between paying the employee one dollar in cash and purchasing one dollar's worth of health insurance for the employee.\10\ Because the employee is likely to pay federal and state income taxes and payroll taxes on cash compensation and no tax on health insurance contributions made on his behalf, the employee would likely prefer that some compensation be in the form of health insurance. Employees subject to tax at the highest marginal tax rates have the greatest incentive to receive compensation in nontaxable forms.

\10\To the extent the employer bears a portion of the payroll tax, the employer may actually prefer to provide compensation through health insurance (which is not subject to payroll tax).

The tax preference that the exclusion provides is substantial and has resulted in widespread access to health care. A majority of the population now receives health insurance as a consequence of their own employment or of a family member's employment. In 1993, for 59 percent of the population employment-based health insurance was the primary source of health coverage, while 6 percent purchased insurance privately, 13 percent received Medicare benefits, and 8 percent received Medicaid benefits. Fifteen percent of the population had no health insurance.\11\

\11\The Congressional Budget Office. The Tax Treatment of Employment-Based Health Insurance. (Washington, D.C.) March 1994. p. 7.

Health coverage through employer-based plans tends to be more prevalent in the manufacturing sector of the economy, among medium and large firms, and for more highly paid workers, especially those over the age of 30. (See Table 16-8).

Despite the widespread use of employer-provided health plans, the problem of access has worsened over the last 1\1/2\ decades. In 1980, 11 percent of the population had no health insurance. This has risen steadily to the 15 percent of the population without insurance in 1993.

TABLE 16-8.--PRIMARY SOURCE OF HEALTH INSURANCE FOR WORKERS UNDER AGE 65, BY DEMOGRAPHIC CATEGORY, 1992

Category	Number of workers (millions)	Percentage distribution by source of insurance				
		Own employer	Other employer	Individual	Public insurance\1\	No insurance

policy

All workers	107.3	60.2	14.8	7.6	2.3	15.2
Industry:						
Agriculture	2.6	24.2	14.2	25.2	3.4	33.0
Construction	6.3	45.5	14.2	9.7	2.4	28.2
Finance	7.3	65.7	15.9	7.9	1.1	9.5
Government	5.3	83.8	8.3	1.9	1.5	4.5
Manufacturing	19.1	76.9	8.0	3.2	1.2	10.7
Mining	0.6	81.1	6.0	3.0	1.1	8.7
Retail trade	16.1	42.4	18.4	10.6	3.8	24.9
Services:						
Professional	26.2	62.1	19.6	7.0	2.3	8.9
Other	11.4	39.0	18.7	12.1	3.9	26.2
Transportation	7.9	77.1	7.5	4.7	1.0	9.6
Wholesale trade	4.5	67.2	13.4	6.3	1.5	11.6
Wage rate\2\:						
Below $5.00	9.0	21.6	18.3	12.0	9.9	38.2
$5.00 to $9.99	36.9	53.7	17.5	6.2	2.8	19.8
$10.00 to $14.99	24.2	76.0	11.5	3.9	0.8	7.7
$15.00 or more	23.7	84.9	8.2	2.9	0.3	3.7
Family income as percentage of poverty level:						

Under 100	6.5	16.4	2.8	12.8	15.7	52.3
100 to 199	15.4	43.4	9.3	9.2	4.9	33.2
200 to 299	19.7	58.2	14.9	7.9	1.5	17.5
300 and over	65.7	69.1	17.2	6.6	0.5	6.6
Firm size (number of employees):						
Fewer than 10	21.2	24.6	24.6	19.9	3.2	27.7
10 to 24	9.3	46.4	18.4	9.5	3.3	22.4
25 to 99	13.7	57.5	14.6	5.9	2.6	19.4
100 to 499	15.2	69.4	12.6	4.1	2.2	11.7
500 to 999	6.0	74.8	11.7	3.6	1.6	8.4
1,000 or more	41.7	76.9	10.2	3.3	1.6	8.0
Age (years):						
Under 30	26.7	51.9	11.4	8.6	3.4	24.6
30 to 39	33.5	61.4	15.9	5.9	2.3	14.5
40 to 49	26.8	64.1	17.2	6.8	1.5	10.3
50 to 64	20.2	64.2	14.1	10.0	1.5	10.2

\1\Public insurance includes Medicaid, Medicare, and coverage provided by the Department of Veterans Affairs.
\2\``Wage'' is the hourly wage for hourly employees and earnings per week divided by hours worked for nonhourly employees. The figures exclude individuals for whom an hourly wage could not be determined.

Note.--These estimates are CBO estimates based on the March 1992 Current Population Survey.

Source: The Congressional Budget Office. ``The Tax Treatment of Employer-Based Health Insurance.'' (Washington, D.C.) March 1994. p. 9.

CAFETERIA PLANS

Legislative history

Under present law, compensation generally is includible in gross income when received. An exception applies if an employee may choose between cash and certain employer-provided nontaxable benefits under a cafeteria plan.

Prior to 1978 the Employee Retirement Income Security Act of 1974 provided that an employer contribution made before January 1, 1977, to a cafeteria plan in existence on June 27, 1974, was required to be included in an employee's gross income only to the extent that the employee actually elected taxable benefits. If a plan did not exist on June 27, 1974, the employer contribution was to be included in income to the extent the employee could have elected taxable benefits. The Revenue Act of 1978 set up permanent rules for plans that offer an election between taxable and nontaxable benefits.

The Deficit Reduction Act of 1984 (P.L. 98-369) clarified the types of employer-provided benefits that could be provided through a cafeteria plan, added a 25-percent concentration test, and required annual reporting to the IRS by employers.

The Tax Reform Act of 1986 also modified the rules relating to cafeteria plans in several respects.

Explanation of provision

A participant in a cafeteria plan (section 125) is not treated as having received taxable income solely because the participant had the opportunity to elect to receive cash or certain nontaxable benefits. In order to meet the requirements of section 125, the plan must be in writing, must include only employees (including former employees) as participants, and must satisfy certain nondiscrimination requirements.

In general, a nontaxable benefit may be provided through a cafeteria plan if the benefit is excludable from the participant's gross income by reason of a specific provision of the Code. These include employer-provided health coverage, group-term life insurance coverage, and benefits under dependent care assistance programs. A cafeteria plan may not provide qualified scholarships or tuition reduction, educational assistance, miscellaneous employer-provided fringe benefits, or deferred compensation except through a qualified cash or deferred arrangement.

If the plan discriminates in favor of highly compensated individuals regarding eligibility to participate, to make contributions or to receive benefits under the plan, then the exclusion does not apply. For purposes of these nondiscrimination requirements, a highly compensated individual is an officer, a shareholder owning more than 5 percent of the employing firm, a highly compensated individual determined under the facts and circumstances of the case, or a spouse

or
dependent of the above individuals.

Effects of provision

The optimal compensation of employees (in a tax planning sense) would require that employers and employees arrive at the compensation package that provides the largest after-tax benefit to the employee at minimum after-tax cost to the employer.\12\ Both the potential taxation of compensation provided to employees and the deductibility of compensation provided by the employer would be considered. If only income taxes were considered, employers would be indifferent between the payment of $1 in salary or wages and the payment of $1 in fringe benefits to an employee, because both types of compensation are fully deductible. When the employer payments for FICA and FUTA taxes are considered, the employer might actually find it less costly to compensate an employee with a dollar's worth of fringe benefit not subject to FICA and FUTA taxes rather a dollar of wage or salary payments that have these taxes assessed on them.

\12\This analysis follows that contained in Myron Scholes and Mark Wolfson, ``Taxes and Business Strategy: A Planning Approach,'' Prentice-Hall, 1992; see especially chapter 10.

The employee, however, would prefer to be compensated in the form that provides the highest after-tax value. An additional dollar of salary or wage paid to the employee will be subject to tax. If a fringe benefit is excludable from the employee's income, the employee pays no tax on receipt of the benefit. Consequently, the employee receives greater compensation via this fringe benefit. This differential treatment of salary or wage payments and excludable fringe benefits implies that compensation packages designed to minimize the joint tax liability of employers and employees could include substantial amounts of excludable fringe benefits.

Employees may have different preferences about the allocation of their compensation. For example, an employee with no dependents may place little value on employer-provided life insurance. Cafeteria plans permit employees some discretion as to the provided benefits, and will tend to be preferred to benefit plans where all employees of the firm receive the identical benefit package.

Cafeteria plans are a growing part of compensation plans, particularly for larger employers. The Bureau of Labor Statistics estimated that in 1991, 36 percent of employees at large and medium sized firms were eligible for flexible benefits and/or reimbursement accounts. This figure has grown from an estimated 5 percent in 1986.\13\ Smaller firms generally do not offer cafeteria plans to their workers. For example, in 1992, only 14 percent of the workers in small, private establishments (non-farm establishments with fewer than 100 employees) were eligible to participate in a cafeteria plan. The lower figure for smaller firms reflects in part the less generous fringe benefit packages provided by smaller firms.

\13\The source for these data is ``Employee Benefits in Medium and Large Firms, 1991'', Bureau of Labor Statistics, Department of Labor, (May, 1993) and ``Employee Benefits in Small Private Establishments, 1992'', Bureau of Labor Statistics, Department of Labor, (forthcoming).

Like any income exclusion, the exclusion from gross income for cafeteria plan benefits can lead to inequities in the tax system. Employees with the same total compensation can have taxable incomes that are substantially different because of the form in which compensation is received. The exclusion for cafeteria plan benefits also may be used in some cases to avoid the 7.5 percent of AGI floor on deductible medical expenses. The use of cafeteria plans reduces the after-tax cost of health care to employees using these plans, which could cause these employees to purchase an unnecessarily large amount of health care services. Overutilization increases health care costs. \14\ On the other hand, cafeteria plans could encourage employers to increase the share of premiums, copayments, and deductibles paid by employees, resulting in increased employee awareness of the costs of their health plans. This incentive could

result in
reduced health care costs.

\14\See, for instance, ``A Study of Cafeteria Plans and Flexible
Spending Accounts,'' U.S. Department of Health and Human Services, July
1985.

HEALTH CARE CONTINUATION RULES

Legislative history

The Consolidated Omnibus Budget Reconciliation Act of 1985
added sections 106(b), 162(i)(2), and 162(k) to the Internal
Revenue Code under which certain group health plans are
required to offer health coverage to certain employees and
former employees, as well as to their spouses and dependents.
Parallel requirements were added to title I of the Employee
Retirement Income Security Act of 1974 and the Public Health
Services Act. If an employer failed to satisfy the health care
continuation rules, the employer was denied a deduction for
contributions to its group health plans and highly compensated
employees were required to include in taxable income the
employer-provided value of the coverage received under such
plans.

The Technical and Miscellaneous Revenue Act of 1988 made
several changes to the health care continuation rules. Sections
106(b), 162(i)(2), and 162(k) were repealed and replaced by
section 4980B. Section 4980B imposes an excise tax on the

employer or other responsible party who fails to satisfy the
rules instead of denying deductions and the exclusion.

Explanation of provision

The health care continuation rules in section 4980B require
that an employer provide qualified beneficiaries with the
opportunity to participate for a specified period in the
employer's health plan after that participation otherwise would
have terminated.

The qualifying events that may trigger rights to
continuation coverage are: (1) the death of the employee, (2)
the voluntary or involuntary termination of the employee's
employment (other than by reason of gross misconduct), (3) a
reduction of the employee's hours, (4) the divorce or legal
separation of the employee, (5) the employee becoming entitled
to benefits under Medicare, and (6) a dependent child of the
employee ceasing to be a dependent under the employer's plan.
The maximum period of continuation coverage is 36 months,
except in the case of termination of employment or reduction of
hours for which the maximum period is 18 months. The 18-month
period is extended to 29 months in certain cases involving the
disability of the qualified beneficiary. Certain events, such
as the failure by the qualified beneficiary to pay the required
premium, may trigger an earlier cessation of the continuation
coverage.

A beneficiary has a prescribed period of time during which to elect continuation coverage after the employee receives notice from the plan administrator of the right to continuation coverage.

EXCLUSION OF MEDICARE BENEFITS

Legislative history

The exclusion from income of Medicare benefits has never been expressly established by statute. A 1970 IRS ruling, Rev. Rul. 70-341, 1970-2 C.B. 31, provided that the benefits under Part A of Medicare are not includible in gross income because they are disbursements made to further the social welfare objectives of the Federal Government. The Internal Revenue Service relied on a similar ruling, Rev. Rul. 70-217, 1970-1 C.B. 13, with respect to the excludability of Social Security disability insurance benefits in reaching this conclusion. (For background on the exclusion of Social Security benefits, see above.) Rev. Rul. 70-341 also held that benefits under Part B of Medicare are excludable as amounts received through accident and health insurance (though the subsidized portion of Part B also may be excluded under the same theory applicable to the exclusion of Part A benefits).

Explanation of provision

Benefits under Part A and Part B of Medicare are excludable from the gross income of the recipient. In general, Part A pays for certain in-patient hospital care, skilled nursing facility care, home health care, and hospice care for eligible individuals (generally the elderly and the disabled). Part B covers certain services of a physician and other medical services for elderly or disabled individuals who elect to pay the required premium.

DEDUCTIBILITY OF MEDICAL EXPENSES

Legislative history

An itemized deduction for unreimbursed medical expenses above a specified floor has been allowed since 1942. From 1954 through 1982, the floor under the medical expense deduction was 3 percent of the taxpayer's adjusted gross income (``AGI''); a separate floor of 1 percent of AGI applied to expenditures for medicine and drugs.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the floor was increased to 5 percent of AGI (effective for 1983 and thereafter) and was applied to the total of all eligible medical expenses, including prescription drugs and insulin. TEFRA made nonprescription drugs ineligible for the deduction and eliminated the separate floor for drug costs.

The Tax Reform Act of 1986 increased the floor under the medical expense deduction to 7.5 percent of AGI, beginning in 1987.

Explanation of provision

Individuals who itemize deductions may deduct amounts they pay during the taxable year, if not reimbursed by insurance or otherwise, for medical care of the taxpayer and of the taxpayer's spouse and dependents, to the extent that the total of such expenses exceeds 7.5 percent of AGI (sec. 213).

Medical care expenses eligible include (1) health insurance (including after-tax employee contributions to employer health plans); (2) diagnosis, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (3) transportation primarily for and essential to medical care; (4) lodging away from home primarily for and essential to medical care, up to $50 per night; and (5) prescription drugs and insulin.

Expenses paid for the general improvement of health, such as fees for exercise programs, are not eligible for the deduction unless prescribed by a physician to treat a specific illness. A deduction is not allowed for cosmetic surgery or similar procedures that do not meaningfully promote the proper function of the body or treat disease. However, such expenses are deductible if the cosmetic procedure is necessary to correct a deformity arising from a congenital abnormality, an injury resulting from an accident, or disfiguring disease.

Medical expenses are not subject to the general

limitation
on itemized deductions applicable to taxpayers with adjusted
gross incomes above a certain limit ($111,800 for 1994 and
adjusted annually for inflation).

Effect of provision

The Code allows taxpayers to claim an itemized deduction if unreimbursed medical expenses absorb a substantial portion of income and thus adversely affect the taxpayer's ability to pay taxes. In order to limit the deduction to extraordinary medical expenses, medical expenses are deductible only to the extent that they exceed 7.5 percent of the taxpayer's AGI.

Table 16-9 shows the effect on medical expense deductions of the increases in the floor on medical deductions. In the absence of those increases, one would have expected the number of taxpayers claiming the deduction and the average deduction claimed to have increased because of inflation of medical costs. However, increasing the floor should reduce the number of taxpayers claiming the deduction and should increase the average deduction claimed because many taxpayers with relatively modest expenses no longer qualify while taxpayers with large expenses continue to qualify. The average deduction claimed has increased substantially, from $769 in 1980 to $4,420 in 1992. Both increases in the floor (to 5 percent in 1983 and to 7.5 percent in 1987) substantially reduced the number of taxpayers claiming deductions.

TABLE 16-9.--TAX RETURNS CLAIMING DEDUCTIBLE MEDICAL AND DENTAL EXPENSES, 1980-92

Year	Total number of returns filed (in millions)	Returns claiming medical and dental expenses: Number of returns (in millions)	Returns claiming medical and dental expenses: Deductible expenses (in billions)
1980..................	93.2	19.5	$15.0
1981..................	95.4	21.4	17.9
1982..................	95.3	22.0	21.7
1983..................	96.3	9.7	18.1
1984..................	99.4	10.7	21.5
1985..................	101.7	10.8	22.9
1986..................	103.0	10.5	25.1
1987..................	107.0	5.4	17.2
1988..................	109.7	4.8	18.0
1989..................	112.1	5.1	20.9
1990..................	113.7	5.1	21.5

1991.................	114.7	5.3	23.7
1992.................	p106.3	p5.0	p22.1

p=Preliminary.

Source: Internal Revenue Service, ``Statistics of Income,'' various years.

Taxpayers in higher tax-rate brackets receive more of a benefit from each dollar of deductible medical expense than do taxpayers in lower tax-rate brackets. However, because the floor automatically rises with a taxpayer's income, higher-income taxpayers are able to deduct a smaller amount (if any) of medical expenses above their floor than are lower-income taxpayers incurring the same aggregate amount of medical expenses.

In 1994, 4,877,000 taxpayers are expected to claim the itemized deduction for medical expenses. Of that number, 60 percent have incomes of $50,000 or less. (See Table 16-10.)

TABLE 16-10.--DISTRIBUTION OF ITEMIZED DEDUCTIONS FOR MEDICAL EXPENSES, 1994

Income class (thousands)	Returns (thousands)	Amount (millions)	Average
0 to $10............................	15	$3	$191
$10 to $20..........................	247	82	333

$20 to $30	742	293	395
$30 to $40	1,021	470	460
$40 to $50	896	502	561
$50 to $75	1,312	1,038	791
$75 to $100	413	638	1,545
$100 to $200	206	502	2,444
$200 and over	26	265	10,173
Total	4,877	3,793	778

Source: Joint Committee on Taxation.

EARNED INCOME TAX CREDIT

Legislative history

The earned income tax credit (Code sec. 32) was enacted in 1975.

Generally, the credit equals a specified percentage of wages up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. The income ranges and percentages have been revised several times since original enactment, expanding the credit. (See Table 16-11.)

In 1987, the credit was indexed for inflation. In 1990 and 1993, the expansions of the credit were quite large. In 1990, auxiliary credits were added for very young children and for health insurance premiums paid on behalf of a qualifying child. These were repealed in 1993. Also in 1993, the group eligible for the credit was expanded to include childless workers.

TABLE 16-11.--EARNED INCOME TAX CREDIT PARAMETERS, 1975-94

Calendar year	Credit rate (percent)	Minimum income for maximum credit \2\	Maximum credit	Phaseout rate (percent)	Phaseout range: Beginning income	Phaseout range: Ending income
1975-78	10	$4,000	$400	10.00	$4,000	$8,000
1979-80	10	5,000	500	12.50	6,000	10,000
1981-84	10	5,000	500	12.50	6,000	10,000
1985-86	11	5,000	550	12.22	6,500	11,000
1987	14	6,080	851	10.00	6,920	15,432
1988	14	6,240	874	10.00	9,840	18,576
1989	14	6,500	910	10.00	10,240	19,340
1990	14	6,810	953	10.00	10,730	20,264

1991:						
One child	16.7	7,140	1,192	11.93	11,250	21,250
Two children	17.3	7,140	1,235	12.36	11,250	21,250
1992:						
One child	17.6	7,520	1,324	12.57	11,840	22,370
Two children	18.4	7,520	1,384	13.14	11,840	22,370
1993:						
One child	18.5	7,750	1,434	13.21	12,200	23,050
Two children	19.5	7,750	1,511	13.93	12,200	23,050
1994:						
One child	26.3	7,750	2,038	15.98	11,000	23,750
Two children	30.0	8,425	2,528	17.86	11,000	25,300
1996:\1\\2\						
One child	34.0	6,160	2,094	15.98	11,290	24,395
Two children	40.0	8,900	3,560	21.06	11,620	28,524

\1\Projection.
\2\Credit rates and phaseout rates remain the same for all years after 1996. Income amounts are indexed for inflation.

Source: Joint Committee on Taxation.

Explanation of provision

Eligibility.--The EITC is available to low-income working taxpayers. Three separate schedules apply.

Taxpayers with one qualifying child may claim a credit in

1994 of 26.3 percent of their earnings up to $7,750, resulting in a maximum credit of $2,038. The maximum credit is available for those with earnings between $7,750 and $11,000. At $11,000 of earnings the credit begins to phase down at a rate of 15.98 percent of the amount of earnings above that amount. The credit is phased down to $0 at $23,753 of earnings. In 1995, the credit rate for a one-child family is 34.0 percent; the maximum credit begins at $6,160 of earnings and applies up to $11,290; the phase down rate continues to be 15.98 percent, resulting in a $0 credit at $24,395.

Taxpayers with more than one qualifying child may claim a credit in 1994 of 30.0 percent of earnings up to $8,425, resulting in a maximum credit of $2,528. The maximum credit is available for those with earnings between $8,425 and $11,000. At $11,000 of earnings the credit begins to phase down at a rate of 17.68 percent of earnings above that amount. The credit is phased down to $0 at $25,300 of earnings. In 1995, the credit rate for a family with more than one qualifying child is 36.0 percent; the maximum credit begins at $8,650; the phase-down rate is 20.22 percent of earnings above $11,290, resulting in a $0 credit at $26,690. In 1996, the credit rate is 40.0 percent; the maximum credit begins at $8,900 and applies up to $11,620; the phase-down rate is 21.06, resulting in a $0 credit at $28,525.

Taxpayers with no qualifying children may claim a credit if they are over age 25 and below age 65. The credit is 7.65 percent of earnings up to $4,000, resulting in a maximum credit of $306. The maximum is available for those with incomes between $4,000 and $5,000. At $5,000 of earnings, the credit begins to phase down at rate of 7.65 percent of earnings above that amount, resulting in a $0 credit at $9,000.

All income thresholds are indexed for inflation annually.

In order to be a qualifying child, an individual must satisfy a relationship test, a residency test, and an age test. The relationship test requires that the individual be a child, stepchild, a descendent of a child, or a foster or adopted child of the taxpayer. The residency test requires that the individual have the same place of abode as the taxpayer for more than half the taxable year. This household must be located in the United States. The age test requires that the individual be under 19 (24 for a full-time student) or be permanently and totally disabled.

Refundability and advance payment.--The EITC is the only refundable tax credit; i.e., if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Under an advance payment system (available since 1979), eligible taxpayers may elect to receive the benefit of the credit in their periodic paychecks, rather than waiting to claim a refund on their return filed by April 15 of the following year. In 1993, Congress required that the IRS begin to notify eligible taxpayers of the advance payment option.

After two years, the Secretary of Treasury is required to report on the effect of notification on participation.

Interaction with means-tested programs.--The treatment of the EITC for purposes of AFDC and food stamp benefit computations has varied since inception of the credit. When enacted in 1975, the credit was not considered income in determining AFDC and food stamp benefits, and the credit could not be received on an advance basis. From January 1979 through September 1981, the credit was treated as earned income when actually received.

From October 1981 to September 1984, the amount of the credit was treated as earned income and was imputed to the family even though it may not have been received as an advance payment. Pursuant to the Deficit Reduction Act of 1984, the credit was treated as earned income only when received, either as an advance payment or as a refund after conclusion of the year.

Under the Family Support Act of 1988, States generally were required to disregard any advance payment or refund of the EITC when calculating AFDC eligibility or benefits. However, the credit was counted against the gross income eligibility standard (185 percent of the State need standard) for both applicants and recipients.

OBRA 1990 specified that, effective January 1, 1991, the EITC was not to be taken into account as income (for the month in which the payment is received or any following month) or as a resource (for the month in which the payment is received or the following month) for determining the eligibility or amount of benefit for AFDC, Medicaid, SSI, food stamps, or low-income housing programs.

Effect of provision

Eighteen million taxpayers are expected to take advantage of the EITC in 1994 (see Table 16-12). Their claims are expected to total $19.6 billion, 84 percent of which will be refunded as direct payments to these families. When the credit is fully phased in in 1996, 18.7 million families are expected to take advantage of the credit. Their claims are expected to total $25.1 billion. As table 16-12 also shows, two-thirds of the tax relief or direct spending from the EITC accrues to single parents who file as heads of households.

Table 16-13 shows the total amount of earned income credit received for each of the calendar years since the inception of the program, the number of recipient families, the amount of the credit received as refunded payments, and the average amount of credit received per family.

TABLE 16-12.--DISTRIBUTION OF TAX EXPENDITURES: EARNED INCOME TAX CREDIT

[Number in thousands; amount in millions]

Joint returns	Head of household	All returns

-------------------- and single returns -------------------
Income class (thousands)

Income class (thousands)	Number	Amount	Number	Amount	Number	Amount
1994						
$0 to $10	1,044	1,029	5,040	4,124	6,084	5,153
$10 to $20	2,003	3,291	4,233	6,473	6,236	9,764
$20 to $30	2,330	2,002	2,620	2,193	4,950	4,194
$30 to $40	443	296	264	182	707	478
$40 to $50	53	32	6	6	59	39
$50 to $75	21	16	2	4	23	20
$75 to $100	(\1\)	(\2\)	(\1\)	(\2\)	(\1\)	(\2\)
$100 to $200	....	....	....	....	....	....
$200 and over	....	....	....	....	....	....
Total	5,893	6,665	12,166	12,982	18,059	19,647
Percent distribution by type of return	32.6	30.8	67.4	69.2	100.0	100.0

1996

$0 to $10	970	1,164	4,480	4,259	5,450	5,423
$10 to $20	1,780	3,796	4,237	7,824	6,017	11,620
$20 to $30	2,438	3,162	2,950	3,398	5,388	6,560
$30 to $40	970	727	700	584	1,670	1,312
$40 to $50	114	92	16	13	129	105
$50 to $75	33	31	3	6	36	37
$75 to $100	3	2	(\1\)	(\2\)	3	2
$100 to $200	(\1\)	(\2\)	....	....	(\1\)	(\2\)
$200 and over	....	....	....	....	....	....
Total	6,305	8,974	12,387	16,084	18,692	25,058
Percent distribution by type of return	33.7	35.8	66.3	64.2	100	100

\1\Less than 500 returns.
\2\Less than $500,000.

Source: Joint Committee on Taxation.

TABLE 16-13.--EARNED INCOME TAX CREDIT 1975-96

Calendar year to which credit applies	Number of families who received credit (thousands)	Total amount of credit (millions)	``Refunded'' portion of credit\1\ (millions)	Average credit per family
1975	6,215	$1,250	$900	$201
1976	6,473	1,295	890	200
1977	5,627	1,127	880	200
1978	5,192	1,048	801	202
1979	7,135	2,052	1,395	288
1980	6,954	1,986	1,370	286
1981	6,717	1,912	1,278	285
1982	6,395	1,775	1,222	278
1983	7,368	1,795	1,289	224
1984	6,376	1,638	1,162	257
1985	7,432	2,088	1,499	281
1986	7,156	2,009	1,479	281
1987				

	8,738	3,931	2,930	450
1988	11,148	5,896	4,257	529
1989	11,696	6,595	4,636	564
1990	12,612	6,928	5,303	549
1991\2\	13,105	10,589	7,849	808
1992\3\	13,433	12,434	9,625	926
1993\3\	14,004	13,239	10,883	945
1994\3\	18,059	19,647	16,549	1,088
1995\3\	18,411	22,806	19,220	1,239
1996\3\	18,692	25,058	21,026	1,341

\1\This is the portion of the credit that exceeds tax liability. It is treated as a budget outlay because it is a direct payment to the beneficiary.
\2\Preliminary.
\3\Projection.

Source: Joint Committee on Taxation.

EXCLUSION OF PUBLIC ASSISTANCE AND SSI BENEFITS

Legislative history

While there is no specific statutory authorization, a number of revenue rulings under Code section 61 have held specific types of public assistance payments are excludable from gross income. Revenue rulings generally exclude Government transfer payments from income because they are considered to be general welfare payments. Taxing benefits provided in kind, rather than in cash, would require valuation of these benefits, which could create administrative difficulties.

Explanation of provision

The Federal Government provides tax-free public assistance benefits to individuals either by cash payments or by provision of certain goods and services at reduced cost or free of charge. Cash payments come mainly from the Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) programs. In-kind payments include food stamps, Medicaid, and housing assistance. None of these payments are subject to income tax.

DEPENDENT CARE TAX CREDIT

Legislative history

Under section 21 of the Internal Revenue Code, taxpayers are allowed an income tax credit for certain employment-related expenses for dependent care. The Internal Revenue Code of 1954 provided a deduction to gainfully employed women, widowers, and legally separated or divorced men for certain employment-related dependent care expenses. The deduction was limited to $600 per year and phased out for families with incomes between $4,500 and $5,100.

The Revenue Act of 1964 made husbands with incapacitated wives eligible for the dependent care deduction and raised the threshold for the income phaseout from $4,500 to $6,000.

The Revenue Act of 1971 (1) made any individual who maintained a household and was gainfully employed eligible for the deduction, (2) modified the definition of a dependent, (3) raised the deduction limit to $4,800 per year, (4) increased from $6,000 to $18,000 the income level at which the deduction began to phase out, (5) allowed the deduction for household services in addition to direct dependent care, and (6) limited the deduction with respect to services outside the taxpayer's household.

The Tax Reduction Act of 1975 increased from $18,000 to $35,000 the income level at which the deduction began to be phased out.

The Tax Reform Act of 1976 replaced the deduction with a nonrefundable credit. This change broadened eligibility to those who do not itemize deductions and provided relatively greater benefit to lower-income taxpayers. In addition, the Act eased the rules related to family status and simplified the computation.

In the Economic Recovery Tax Act of 1981, Congress provided a higher ceiling on creditable expenses, a larger credit for lower-income individuals, and modified rules relating to care provided outside the home.

The Family Support Act of 1988 reduced to 13 the age of a child for whom the dependent care credit may be claimed, reduced the amount of eligible expenses by the amount of expenses excludible from that taxpayer's income under the dependent care exclusion, and disallowed the credit unless the taxpayer reports on his or her tax return the correct name, address, and taxpayer identification number (generally, an employer identification number or a Social Security number) of the dependent care provider.

Explanation of provision

A taxpayer may claim a nonrefundable credit against income tax liability for up to 30 percent of a limited amount of employment-related dependent care expenses. Eligible employment-related expenses are limited to $2,400 if there is one qualifying dependent or $4,800 if there are two or more qualifying dependents. Generally, a qualifying individual is a dependent under the age of 13 or a physically or mentally incapacitated dependent or spouse.

Employment-related dependent care expenses are expenses for the care of a qualifying individual incurred to enable the taxpayer to be gainfully employed, other than expenses incurred for an overnight camp. For example, amounts paid for the services of a housekeeper generally qualify if such services are performed at least partly for the benefit of a qualifying individual; amounts paid for a chauffeur or gardener do not qualify.

Expenses that may be taken into account in computing the credit generally may not exceed an individual's earned income or, in the case of married taxpayers, the earned income of the spouse with the lesser earnings. Thus, if one spouse is not working, no credit generally is allowed. Also, the amount of expenses eligible for the dependent care credit is reduced, dollar for dollar, by the amount of expenses excludible from that taxpayer's income under the dependent care exclusion (discussed below).

The 30-percent credit rate is reduced, but not below 20 percent, by 1 percentage point for each $2,000 (or fraction thereof) of adjusted gross income (AGI) above $10,000. Because married couples are required to file a joint return to claim the credit, a married couple's combined AGI is used for purposes of this computation.

Effect of provision

From 1976 to 1992, the number of families who claimed the dependent care credit increased from 2.7 to 5.5 million, the aggregate amount of credits claimed increased from $0.5 billion to $2.3 billion, and the average amount of credit claimed per family increased from $206 to $423 (see table 16-14). In 1994, 6.1 million families are expected to claim an average credit of $435, for a total of $2.7 billion.

Changes made in the Family Support Act of 1988 generally reduced the attractiveness of the dependent care credit, resulting in the dramatic drop in utilization of the credit that occurred in 1989. The number of families who claimed the credit dropped by about one-third and the amount of credit claimed declined by over $1.373 billion. The average credit claimed, though, remained relatively constant.

Most of the dependent care credit is claimed by families filing joint returns.

Preliminary data for 1992 from the Internal Revenue Service show that about 15 percent of the benefit from the credit accrues to families with AGI of less than $20,000; about 48 percent to families with AGI between $20,000 and $50,000; and about 36 percent to families with AGI above $50,000.\15\

\15\The Internal Revenue Service. SOI Bulletin. Volume 13, number 2. Fall 1993. p. 30.

TABLE 16-14.--DEPENDENT CARE TAX CREDIT, 1976-94

Calendar year	Number of returns claiming dependent credit (thousands)	Aggregate amount of credit claimed (millions)	Average credit claimed per return
1976	2,660	$548	206
1977	2,910	521	179
1978	3,431	654	191
1979	3,833	793	207
1980	4,231		

956   226
1981................................   4,578
1,148   251
1982................................   5,004
1,501   300
1983................................   6,367
2,051   322
1984................................   7,456
2,649   351
1985................................   8,417
3,127   372
1986................................   8,950
3,398   380
1987................................   8,520
3,438   404
1988................................   9,023
3,813   423
1989................................   6,028
2,440   405
1990................................   6,144
2,549   415
1991\1\.............................   5,380
2,285   425
1992\1\.............................   5,498
2,324   423
1993\2\.............................   5,717
2,450   428
1994\2\.............................   6,121
2,662   435

\1\Preliminary.
\2\Projection.

Source: Joint Committee on Taxation.

EXCLUSION FOR EMPLOYER-PROVIDED DEPENDENT CARE

Legislative history

The value of certain employer-provided dependent care

is
excluded from the employee's gross income. The Economic Recovery Tax Act of 1981 added this exclusion (section 129) and amended Code sections 3121(a)(18) and 3306(b)(13) to exclude such employer-provided dependent care from wages for purposes of the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA). The Tax Reform Act of 1986 modified the nondiscrimination rules and limited the exclusion to $5,000 a year ($2,500 in the case of a separate return by a married individual). The Family Support Act of 1988 required the amount of employer-provided dependent care excluded from the taxpayer's income to reduce, dollar for dollar, the amount of expenses eligible for the dependent care credit.

Explanation of provision

Amounts paid or incurred by an employer for dependent care assistance provided to an employee generally are excluded from the employee's gross income if the assistance is furnished under a program meeting certain requirements. These requirements include that the program be described in writing, satisfy certain nondiscrimination rules, and, provide for notification to all eligible employees. The type of dependent care eligible for the exclusion is the same as the type of expenses eligible for the dependent care credit.

The dependent care exclusion is limited to $5,000 per year except that a married taxpayer filing a separate return may exclude only $2,500. Amounts excluded from gross income generally are excludible from wages for employment tax purposes.

Effect of provision

The exclusion provides an incentive to taxpayers with expenses for dependent care to seek compensation in the form of dependent care assistance rather than in cash subject to taxation. This incentive is of greater value to employees in higher tax brackets.

Many employees covered by the exclusion for employer-provided dependent care also are eligible to use the dependent care tax credit. While the limitations on the exclusion and the credit differ, the credit generally is less valuable than the exclusion for taxpayers who are above the 15-percent tax bracket.

According to a survey of private firms with 100 or more workers conducted by the Department of Labor, nearly one-tenth of full-time workers at these firms were eligible for child care benefits provided by the employer in the form of on-site or near-site child care facilities or through direct reimbursement of employee expenses.\16\ A more prevalent form of providing dependent care benefits is through reimbursement accounts, which may cover other nontaxable fringe benefits, such as out-of-pocket health care expenses, in addition to dependent care. Slightly over one-third of full-time employees at large and medium sized firms were eligible for such accounts in 1991.

\16\The source of these data is ``Employee Benefits in Medium and Large Firms, 1991,'' Bureau of Labor Statistics, Department of Labor, May 1993.

TARGETED JOBS TAX CREDIT

Legislative history

Congress enacted the targeted jobs tax credit (Code sec. 51) in the Revenue Act of 1978. A taxpayer is eligible to claim the credit if the taxpayer employs individuals who receive payments under means-tested transfer programs, economically disadvantaged (as measured by family income), or are disabled.

The targeted jobs credit was subsequently extended with certain modifications several times. The credit is scheduled to expire for individuals hired after December 31, 1994.

Explanation of provision

The targeted jobs tax credit is available to employers on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals, (2) economically disadvantaged youths aged 18 through 22, (3) economically disadvantaged Vietnam-era veterans, (4) Supplemental Security Income (SSI) recipients, (5) general assistance recipients, (6) economically disadvantaged cooperative education students aged 16 through 19, (7) economically disadvantaged former convicts, (8) Aid to Families with Dependent Children (AFDC) recipients and Work Incentive (WIN) registrants, and (9) economically disadvantaged summer youth employees aged 16 or 17. Targeted group membership must be certified.

An individual is a member of an economically disadvantaged family if the designated local agency determines that the family had an income during the previous 6-month period that, when annualized, would be 70 percent or less of the Bureau of Labor Statistics lower living standard income level. These income levels vary by geographic region, with the highest levels generally applying to metropolitan areas in the Northeast and the lowest levels generally applying to nonmetropolitan areas in the Southeast.

The credit generally is equal to 40 percent of the first $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200.

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees) or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Also, the employer's deduction for wages must be reduced by the amount of the credit. A taxpayer may not claim the credit for wages paid to a targeted-group individual who performs the same or substantially similar services as an employee participating in or affected by a strike or lockout.

Effect of provision

The targeted jobs tax credit serves as a subsidy to the employer for hiring targeted group members. For example, the targeted jobs credit would provide an effective subsidy of about 18 percent of the first-year wages of a full-time employee hired at the minimum wage ($4.25 per hour) by a corporate employer.\17\ In 1991, almost three-quarters of all certifications were for economically disadvantaged youths age 18 to 22 (52.4 percent) or AFDC recipients and WIN registrants (21.0 percent).

\17\Assume a corporation hired a member of a targeted group full-time at the minimum wage of $4.25 an hour. Wage payments to the employee would be $8,500 and the credit to the employer would be $2,400. The employer's actual subsidy is smaller however, because he must reduce his deduction for wages paid by the amount of the credit. At a 35 percent tax rate, this results in $840 of additional tax. Thus, the net subsidy would be $1,560. This is 18 percent of the $8,500 wage cost.

EXCLUSION OF WORKERS' COMPENSATION AND SPECIAL BENEFITS FOR DISABLED COAL MINERS

Legislative history

Workers' compensation.--Workers' compensation benefits generally are not taxable under section 104(a)(1) of the Internal Revenue Code of 1986. Workers' compensation benefits are treated as Social Security benefits to the extent that they reduce Social Security benefits received (see above). This exclusion from gross income was first codified in the Revenue Act of 1918. The Ways and Means Committee report for that Act suggests that such payments were not subject to tax even prior to the 1918 Act.

Benefits for disabled coal miners.--Payments made to coal miners or their survivors for death or disability resulting from pneumoconiosis (black lung disease) under the Federal Coal Mine Health and Safety Act of 1969 (as amended) are excluded from gross income. Payments made as a result of claims filed before December 31, 1972, originally were excluded from Federal income tax by the Federal Coal Mine Health and Safety Act of 1969. Later payments are excluded from gross income because they are considered to be in the nature of workers' compensation (Rev. Rul. 72-400, 1972-2 C.B. 75).

Explanation of provision

Workers' compensation.--Gross income does not include amounts received as workers' compensation for personal injuries or sickness. This exclusion also applies to benefits paid under a workers' compensation act to a survivor of a deceased employee.

Benefits for disabled coal miners.--Benefits for disabled coal miners (black lung benefits) are not includible in gross income.

There are two types of black lung programs. The first involves Federal payments to coal miners and their survivors due to death or disability, payable for claims filed before July 1, 1973 (December 31, 1973, in the case of survivors). This program provided total annual payments of around $850 million to approximately 200,000 beneficiaries in 1991.\18\

\18\Social Security Bulletin, various issues.

The second program requires coal mine operators to insure payment of black lung benefits for claims filed on or after July 1, 1973 (December 31, 1973, in the case of survivors) in a federally mandated workers' compensation program. Benefits include medical treatment as well as cash payments. These benefits are paid from a trust fund financed by an excise tax on coal production if there is no responsible operator (an operator for whom the miner worked for at least one year) or if the responsible operator is in default. This program provided total annual payments of around $610 million to approximately 156,550 claimants in 1986.\19\

\19\Department of Labor, Employment Standards Administration, ``Annual Report on Administration of Black Lung Benefits Act During Calendar Year 1986,'' January 1989, tables 3 and 6.

ADDITIONAL STANDARD DEDUCTION FOR THE ELDERLY AND BLIND

Legislative history

From 1954 through 1986, an additional personal exemption was allowed for a taxpayer or a spouse who was 65 years or older at the close of the year. An additional personal exemption also was allowed for a taxpayer or a spouse who was blind.

The Tax Reform Act of 1986 repealed the additional personal exemption for the elderly and blind and replaced it with an additional standard deduction amount. These additional standard deduction amounts are adjusted for inflation.

Explanation of provision

The additional standard deduction amount for the elderly or the blind is $750 in 1994 for an elderly or a blind individual who is married (whether filing jointly or separately) or is a surviving spouse, and $1,500 for such an individual who is both elderly and blind. The additional amount is $950 for a head of household who is elderly or blind ($1,900, if both), and for a single individual (i.e., an unmarried individual other than a surviving spouse or head of household) who is elderly or blind.

The definitions of elderly and blind status have not been changed since 1954. An elderly person is an individual who is at least 65 years of age. Blindness is defined in terms of the ability to correct a deficiency in distance vision or the breadth of the area of vision. An individual is blind only if central vision acuity is not better than 20/200 in the better eye with correcting lenses, or if visual acuity is better than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

Effect of provision

The additional standard deduction increases the tax threshold for elderly and blind taxpayers. For example, the additional amount is $1,500 for two elderly individuals filing a joint return, raising the tax threshold in 1994 from $11,250 to $12,750.

In 1994, about 11.9 million taxpayers are expected to claim the extra standard deduction. Of those, 9.4 million are expected to benefit from the additional deductions. (The others are expected to itemize their deductions.) About 70 percent of the 9.4 million beneficiaries have incomes of less than $40,000.

TAX CREDIT FOR THE ELDERLY AND CERTAIN DISABLED INDIVIDUALS

Legislative history

The present tax credit for individuals who are age 65 or over, or who have retired on permanent and total disability, was enacted in the Social Security Amendments of 1983 (Code sec. 22). This credit replaced the previous credit for the elderly, which had been enacted in the Tax Reform Act of 1976. Prior to that provision, the tax law provided a retirement income credit, which initially was enacted in the Internal Revenue Code of 1954.

Explanation of provision

Individuals who are age 65 or older may claim a nonrefundable income tax credit equal to 15 percent of a base amount. The credit also is available to an individual, regardless of age, who is retired on disability and who was permanently and totally disabled at retirement. For this purpose, an individual is considered permanently and totally disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or that has lasted or can be expected to last for a continuous period of not less than 12 months. The individual must furnish proof of disability to the IRS.

The maximum base amount is $5,000 for unmarried elderly or disabled individuals and for married couples filing a joint return if only one spouse is eligible; $7,500 for married couples filing a joint return with both spouses eligible; or $3,750 for married couples filing separate returns. For a nonelderly, disabled individual the initial base amount is the lesser of the applicable specified amount or the individual's disability income for the year. Consequently, the maximum credit available is $750 (15 percent of $5,000), $1,125 (15 percent of $7,500), or $562.50 (15 percent of $3,750).

The maximum base amount is reduced by the amount of certain nontaxable income of the taxpayer, such as nontaxable pension and annuity income or nontaxable Social Security, railroad retirement, or veterans' nonservice-related disability benefits. In addition, the base amount is reduced by one-half of the taxpayer's AGI in excess of certain limits: $7,500 for a single individual, $10,000 for married taxpayers filing a joint return, or $5,000 for married taxpayers filing separate returns. These computational rules reflect that the credit is designed to provide tax benefits to individuals who receive only taxable retirement or disability income, or who receive a combination of taxable retirement or disability income plus Social Security benefits that generally are comparable to the tax benefits provided to individuals who receive only Social Security benefits (including Social Security disability benefits).

Effect of provision

In 1991, $57 million in elderly and disabled credit was claimed. The utilization rate and average credit granted has been relatively stable since the credit was modified by the Social Security Amendments of 1983, as shown in table 16-15.

TABLE 16-15.--CREDIT FOR THE ELDERLY AND DISABLED, 1976-94\1\

	Number of families who received credit (thousands)	Total amount of credit (millions)	Average credit per return
Calendar year:			
1976	1,011	$206	$204
1977	569	93	163
1978	689	145	210
1979	607	132	217
1980	562	135	240
1981	474	124	262
1982	483	131	271
1983	423	116	275
1984	475	107	225
1985	460	106	230

1986	430	86	200
1987	354	67	189
1988	357	69	193
1989	320	65	202
1990	342	63	183
1991\1\	280	54	193
1992\1\	281	67	238
1993\2\	208	\2\62	298
1994\2\	158	\2\32	203

\1\Preliminary.
\2\Projection.

Source: Joint Committee on Taxation.

TAX EXPENDITURES RELATED TO HOUSING

OWNER-OCCUPIED HOUSING

Legislative history

Deductibility of mortgage interest.--Prior to the Tax Reform Act of 1986, all interest payments on indebtedness incurred for personal use (e.g., to purchase consumption goods) were deductible in computing taxable income. The 1986 Act amended section 163(h) of the Internal Revenue Code to disallow deductions for all personal interest except for interest on indebtedness secured by a first or second home.

In the Omnibus Budget Reconciliation Act of 1987, Congress further restricted the deductibility of mortgage interest. Only two classes of interest were distinguished as deductible: interest on acquisition indebtedness and interest on home equity indebtedness. Acquisition indebtedness, defined as indebtedness secured by a residence and used to acquire or improve the residence by which it is secured, was limited to $1,000,000 ($500,000 in the case of a married individual filing a separate return). Home equity indebtedness, defined as any nonacquisition indebtedness secured by a residence (for example, a home equity loan), was limited to the lesser of (1) $100,000 ($50,000 for married taxpayers filing separately) or (2) the excess of the fair market value of the residence over the acquisition indebtedness.

Deferral of capital gains from sale of principal residence.--Prior to 1951, capital gains on housing were taxed when realized. This treatment was consistent with the tax treatment of other capital assets. In 1951, Congress added section 112(n) to the Internal Revenue Code of 1939, permitting capital gains from the sale of a principal residence to be deferred (rolled over) as long as a new principal residence was purchased within the 24-month period beginning 12 months before the date of sale of the old residence and ending 12 months after the sale of the old residence. When capital gains are rolled over, the basis of the newly purchased house must be reduced by the amount of deferred gains. This rollover period had been extended twice and now is 24 months before and 24 months after the sale of the old residence.

Exclusion of capital gains for certain taxpayers.--In the Revenue Act of 1964, Congress introduced section 121 of the Internal Revenue Code of 1954, which permitted a one-time exclusion of all or part of the gain on the sale of a principal residence by older individuals. This exclusion was limited to homeowners who had lived in the property as a principal residence for 5 out of the last 8 years before the property's sale or exchange. Furthermore, full exclusion was permitted only for houses that sold for $20,000 or less.

The parameters of this exclusion have been modified and expanded a number of times. Currently, the one-time exclusion is allowed to taxpayers 55 or older for capital gain up to $125,000 if they have lived in the property as a principal residence for 3 of the past 5 years.

Explanation of provisions

Homeowners may deduct a number of expenses related to housing as itemized deductions in computing taxable income. These include payments of interest on qualified residence debt, certain interest on home equity loans, certain payments of points (i.e., up-front interest payments) on the purchase of a house, and payments of real property taxes. Interest on acquisition debt of $1,000,000 or less is fully deductible, as is any interest on debt secured by a residence that was incurred on or before October 13, 1987. Interest on home equity indebtedness of $100,000 is fully deductible for regular tax purposes, as long as the total amount of debt (acquisition plus home equity indebtedness) does not exceed the fair market value of the house. Interest on home equity indebtedness exceeding $100,000 (and incurred after October 13, 1987) or exceeding the difference between the fair market value of the home and the acquisition indebtedness is not deductible. Interest paid on home equity loans is generally not deductible in computing the alternative minimum tax.

Capital gains from the sale of residences generally are subject to tax when realized, unless one of two conditions is met. First, capital gains are not taxed if a new residence of equal or greater value is purchased or constructed within a period 24 months before to 24 months after the first residence is sold. If the price of the new residence is less than the selling price of the old residence (less any selling expenses) then the difference between the two prices must be recognized as a gain. The basis of the new residence must be reduced by the amount of the excluded gain.

Second, taxpayers age 55 or older may exclude once in their lifetime up to $125,000 ($62,500 for married taxpayers filing separately) of capital gain on the sale of a principal residence.

Effects of provision

The Tax Code has provided favorable treatment for housing consumption in a number of ways. Two of the largest subsidies are that the imputed rental value of owner-occupied housing is not taxed and that capital gains generated by investment in housing are given favorable tax treatment. The annual economic net return to an investment in owner-occupied housing consists of the rental value of the home plus any capital gains (or losses) on the house (whether realized or not), less the interest paid on mortgage debt outstanding and costs of repairs and maintenance. Because the tax system does not include the imputed value of homeowners' rent in gross income, this part of the return is untaxed.

However, because the rental value of homes is difficult to measure, the tax expenditures estimated are only for deductibility of mortgage interest and property taxes, the deferral of capital gains, and the exclusion of capital gains for taxpayers older than 55.

In the President's budget submission for fiscal year 1995, the Administration estimates forgone revenue from tax expenditures.\20\ The fiscal year 1995 revenue loss from the deductibility of mortgage interest on owner-occupied housing is projected to be $54.8 billion; from the deferral of capital gains on homes sales, $14.6 billion; and the one-time exclusion of capital gains on home sales for people age 55 and older, $5.0 billion. Preliminary tax return information for 1992 indicates that 27 million taxpayers claimed the deduction for mortgage interest. Data are not yet available on how many claimed the one-time exclusion. (It is not possible to identify how many taxpayers deferred tax on home sales because homeowners do not have to report gain to the IRS until it is realized.)

\20\Analytical Perspectives, Budget of the United States Government, Fiscal Year 1995. p. 77.

This favorable treatment of owner-occupied housing may affect both the home ownership rate and the share of total investment in housing in the United States.

Homeownership.--The traditional view has been that the tax system encourages homeownership. Consider an investor who buys a house for $100,000 that could be rented for $10,000 per year. Excluding tax considerations, that investor would be equally well off purchasing a $100,000 bond that paid $10,000 per year in interest, and renting a similar house for $10,000. However, the investor who purchases the house pays no tax on the return to the investment (the $10,000 per year in imputed rent), whereas the investor who rents and purchases a bond pays tax on the $10,000 of interest.

Such preferential treatment may benefit neighborhoods because it encourages homeownership and home improvement. The United States has maintained a high rate of homeownership--64 percent of all American households own the homes they live in. Some feel that the tax preferences may be larger than necessary to maintain high rates of home ownership.

Investment in housing.--The tax advantages for owner-occupied housing encourage people to invest in homes instead of taxable business investments. This shift may lead to a relatively low rate of investment in business assets in the United States. One study suggested that housing capital is 25 percent higher and other capital is 12 percent lower than it would be if tax policy provided equal treatment for all forms of capital.\21\ Currently, about one-third of net private investment goes into owner-occupied housing, so even a modest shift of investment to other assets could have sizable effects.

\21\See Edwin S. Mills, ``Dividing up the Investment Pie: Have We Overinvested in Housing?'', Philadelphia Business Review, March-April 1987, 13-23.

LOW-INCOME HOUSING CREDIT

Legislative history

The low-income rental housing tax credit was first enacted in the Tax Reform Act of 1986. The Omnibus Budget Reconciliation Act of 1989 substantially modified the credit. The Omnibus Budget Reconciliation Act of 1993 modified the credit and made it permanent.

Explanation of provision

A tax credit may be claimed by owners of residential rental property used for low-income rental housing. The credit is claimed annually, generally for a period of 10 years. New construction and rehabilitation expenditures for low-income housing projects are eligible for a maximum 70 percent present value credit, claimed annually for 10 years. The acquisition cost of existing projects that meet the substantial rehabilitation requirements and the cost of newly constructed projects receiving other Federal subsidies are eligible for a maximum 30 percent present value credit, also claimed annually for 10 years. These credit percentages are adjusted monthly based on an Applicable Federal Rate.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. A residential rental project will qualify for the credit only if (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with 50 percent or less of area median income, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with 60 percent or less of area median income. These income figures are adjusted for family size. Maximum rents that may be charged families in units on which a credit is claimed depend on the number of bedrooms in the unit. The rent limitation is 30 percent of the qualifying income of a family deemed to have a size of 1.5 persons per bedroom (e.g., a two-bedroom unit has a rent limitation based on the qualifying income for a family of three).

Credit eligibility also depends on the existence of a 30-

year extended low-income use agreement for the property. If property on which a low-income housing credit is claimed ceases to qualify as low-income rental housing or is disposed of before the end of a 15-year credit compliance period, a portion of the credit may be recaptured. The 30-year extended use agreement creates a State law right to enforce low-income use for an additional 15 years after the initial 15-year recapture period.

In order for a building to be a qualified low-income building, the building owner generally must receive a credit allocation from the appropriate credit authority. An exception is provided for property that is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. The low-income housing credit is allocated by State or local government authorities subject to an annual limitation for each State based on State population. The annual credit allocation per State is $1.25 per resident.

Effect of provision

Comprehensive data from tax returns concerning the low income housing tax credit currently are unavailable. However, table 16-16 presents data from a survey of State credit allocating agencies. These data indicate that allocation of the available credit rose from approximately 20 percent in 1987, the initial year of credit availability, to nearly complete allocation in 1989, but allocation subsequently fell to 65 percent in 1990. There are several reasons why the 1990 experience may not be indicative of the long-term use of the credit. First, 1990 was the first year following substantial modification to the credit, including the requirement of an additional low-income commitment beyond the credit compliance period. The substantial modification may be expected to delay some use of the credit. Moreover, the initial allocative authority for 1990 was limited to $0.9375 per capita per State rather than the $1.25 per capita per State for 1987-89. While the Omnibus Budget Reconciliation Act of 1990 restored 1990 credit authority to $1.25 per capita per State, the restoration occurred late in the calendar year and the reaction of allocation agencies and investors may have been delayed. In addition, 1990 was marked by a general economic slowdown in the real estate industry. On the other hand, the 1991 and 1992 data on credit authority reflect credits unallocated or returned from prior years carried over to 1991 and 1992.

TABLE 16-16.--ALLOCATION OF THE LOW INCOME HOUSING CREDIT, 1987-92

Years	Authority (millions)	Allocated (millions)	Percentage allocated (percent)
1987	$313.1		

	$62.9	20.1	
1988	311.5	209.8	67.4
1989	314.2	307.2	97.8
1990	317.7	213.1	67.0
1991\1\	497.3	400.6	80.6
1992\1\	476.8	332.7	70.0

\1\Increased authority includes credits unallocated from prior years carried over to the current year.

Source: Survey of State allocating agencies.

THE EFFECT OF TAX EXPENDITURES ON THE INCOME AND TAXES OF THE ELDERLY AND THE POOR

Table 16-17 presents values of the personal exemptions, standard deductions, additional standard deductions for the elderly and the blind, and taxable income brackets for 1990 to 2000. The figures for 1995 to 2000 are based on Congressional Budget Office projections.

TABLE 16-17.--PERSONAL EXEMPTIONS, STANDARD DEDUCTIONS, AND TAXABLE INCOME BRACKETS

Projected

1990	1991	1992	1993	1994

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-----------------------------------------------------------
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1995       1996       1997       1998       1999       2000
-----------------------------------------------------------
-----------------------------------------------------------
----------------------------------
Personal exemptions............    $2,050     $2,150
$2,300     $2,350      2,450      2,500      2,550
2,650      2,750      2,800      2,900
Standard deductions:
    Joint......................     5,450      5,700
6,000      6,200      6,350      6,550      6,750
6,950      7,150      7,350      7,600
    Single.....................     3,250      3,400
3,600      3,700      3,800      3,900      4,050
4,150      4,300      4,400      4,550
    Head of household..........     4,750      5,000
5,250      5,450      5,600      5,750      5,900
6,100      6,300      6,500      6,700
Additional standard deductions
 for elderly/blind:
    Joint (each individual)....       650        650
700        700        750        750        800        800
850        850        900
    Single/head of household...       800        850
900        900        950        950      1,000      1,000
1,050      1,100      1,100

    Taxable Income Brackets
Joint returns:
    15 percent rate ends at....    32,450     34,000
35,800     36,900     38,000     39,000     40,150
41,350     42,650     44,000     45,350
    28 percent rate ends at....    78,400     82,150
86,500     89,150     91,850     94,300     97,050
100,000    103,100    106,300    109,600
    31 percent rate ends
at....  .........  .........  .........    140,000
140,000    143,700    147,900    152,350    157,100
161,950    167,000
```

36 percent rate ends
at.... 250,000
250,000 256,600 264,100 272,100 280,550
289,250 298,200
Single returns:
15 percent rate ends at.... 19,450 20,350
21,450 22,100 22,750 23,350 24,050
24,750 25,550 26,350 27,150
28 percent rate ends at.... 47,050 49,300
51,900 53,500 55,100 56,550 58,250
60,000 61,850 63,750 67,750
31 percent rate ends
at.... 115,000
115,000 118,000 121,500 125,150 129,050
133,050 137,150
36 percent rate ends
at.... 250,000
250,000 256,600 264,100 272,100 280,550
289,250 298,200
Heads of households:
15 percent rate ends at.... 26,050 27,300
28,750 29,600 30,500 31,300 32,200
33,200 34,200 35,250 36,350
28 percent rate ends at.... 67,200 70,450
74,150 76,400 78,700 80,800 83,150
85,700 88,350 91,100 93,900
31 percent rate ends
at... 127,500
127,500 130,850 134,700 138,750 143,050
147,500 152,050
36 percent rate ends
at.... 250,000
250,000 256,600 264,100 272,100 280,550
289,250 298,200

Note.--The 39.6 percent rate begins at $250,000 (for 1993 and 1994), regardless of filing status. This income threshold is indexed for inflation
beginning in 1995. The amounts shown in the table as the

end points for the 36 percent bracket are also the beginning points for the 39.6 percent bracket.

Source: Congressional Budget Office.

HYPOTHETICAL TAX CALCULATIONS FOR SELECTED FAMILIES

Table 16-18 presents examples of tax liabilities for hypothetical taxpayers. The table presents 1994 Federal income and payroll tax burdens. The worker is assumed to bear both the employer and employee shares of FICA tax (7.65 percent for each). Taxpayers claim the earned income tax credit, if eligible, and they claim the standard deduction. They do not itemize. Income sources are listed in the table's footnotes for each example.

TABLE 16-18.--EXAMPLES OF FEDERAL INCOME AND PAYROLL TAX LIABILITIES OF HYPOTHETICAL TAXPAYERS, 1994

Income	Income tax liability	FICA tax liability	Total tax liability	Overall average tax rate\1\ (percent)	Overall marginal tax rate\1\ (percent)
Joint filer--3 exemptions:\2\					
$10,000	-$2,038	$1,530	-$508	-4.7	14.2

$30,000	2,445	4,590	7,035	21.8	28.1
$50,000\12\	4,898	7,650	12,548	23.3	40.2
$100,000\13\	15,402	10,042	25,444	24.2	30.5
Head of household--2 personal exemptions:\2\					
$10,000	-2,038	1,530	-508	-4.7	14.2
$30,000	2,865	4,590	7,455	23.1	28.1
$50,000\12\	5,863	7,650	13,513	25.1	40.2
$100,000\13\	17,063	10,042	27,105	25.8	33.4
Elderly couple filing joint return:					
$10,000\3\	0	0	0	0.0	\6\0.0
$30,000\4\	788	0	788	2.6	\7\15.0
$50,000\5\	4,688	1,530	6,218	12.2	40.0
Elderly single filer:					
$10,000\8\	0	0	0	0.0	\6\0.0
$30,000\9\	2,389	0	2,389	8.0	\11\22.5
$50,000\10\	8,712	3,060	11,772	22.8	40.2

\1\The average tax rate is total tax liability divided by income plus the employer share of FICA. The marginal rate computations also count the employer share of FICA tax as income to the employee (for both payroll and income tax purposes). Unless otherwise noted, all calculations assume the taxpayer takes the standard deduction rather than itemized deductions.

\2\Assumes one child, one earner, and all income is wage income.

\3\All income is Social Security.

\4\$12,000 is Social Security, $12,000 is a taxable pension and $6,000 is taxable interest.
\5\Same as above plus additional $10,000 of taxable interest and $10,000 of wages.
\6\If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 14.2 percent. This represents the FICA tax liability on this income.
\7\If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 28.1 percent, representing both the income tax liability and the FICA tax liability on this income.
\8\$7,500 is Social Security, $2,500 is taxable pension.
\9\$7,500 is Social Security, $7,500 is taxable pension, $15,000 is taxable interest.
\10\Same as above plus $20,000 of wages.
\11\If the marginal dollar of income is assumed to consist of wage income, the marginal tax rate would be 35.1 percent, representing both the income tax liability (22.5 percent marginal rate reflects the inclusion of 50 cents of Social Security benefits as taxable for each additional dollar of AGI) and the FICA tax liability on this income.
\12\Assumes taxpayer claims itemized deductions of $10,000.
\13\Assumes taxpayer claims itemized deductions of $20,000.

Source: Joint Committee on Taxation.

TAX TREATMENT OF THE ELDERLY

Present law contains several provisions that reduce, or in some cases eliminate, the burden of Federal income tax on senior citizens. These provisions are: the exemption from income taxation of some or all of an individual's Social Security benefits; a tax credit for certain taxpayers who do not receive substantial Social Security income; and an additional standard deduction for taxpayers age 65 and older.
These are described in detail in preceding portions of this

section.

As a result of these favorable tax provisions, the tax threshold (the level of income, excluding Social Security, at which tax liability is incurred) for elderly taxpayers is well above the poverty level. For example, in 1994, a single elderly individual with $5,000 in Social Security benefits can have up to $7,200 in other income without incurring tax liability (or total income of $12,200). An elderly married couple filing jointly with $5,000 in excluded Social Security benefits has a tax threshold of $13,500 (or total income of $18,500). Table 16-19 displays similar information for other years and for varying amounts of Social Security benefits.

The combination of these tax provisions ensures that an estimated 43 percent of elderly individuals will have no tax liability for 1994 (see table 16-20).

TABLE 16-19.--INCOME TAX THRESHOLDS FOR ELDERLY INDIVIDUALS,\1\
SELECTED YEARS, 1988-2000

Year and filing status	Amount of Social Security income			
	Zero	$2,500	$5,000	$7,500
1988:				
Single..........	9,633	7,967	5,700	5,700
Joint...........	15,067	13,400	11,733	

				10,100
1990:				
Single..........	9,900	8,233	6,100	6,100
Joint...........	15,567	13,900	12,233	10,850
1991:				
Single..........	10,100	8,433	6,400	6,400
Joint...........	15,867	14,200	12,533	11,300
1992:				
Single..........	10,367	8,700	6,800	6,800
Joint...........	16,333	14,667	13,000	12,000
1993:				
Single..........	10,467	8,800	6,950	6,950
Joint...........	16,533	14,867	13,200	12,300
1994:\2\				
Single..........	10,633	8,967	7,200	7,200
Joint...........	16,833	15,167	13,500	12,750
1995:\2\				
Single..........	10,733	9,067	7,350	7,350
Joint...........	17,033	15,367	13,700	13,050
1996:\2\				
Single..........	10,900	9,233	7,600	7,600
Joint...........	17,300	15,633	13,967	13,450
1997\2\:				
Single..........	11,033	9,367	7,800	7,800
Joint...........	17,587	15,900	14,233	13,850

1998\2\:				
Single..........	11,233	9,567	8,100	8,100
Joint...........	17,900	16,233	14,567	14,350
1999\2\:				
Single..........	11,367	9,700	8,300	8,300
Joint...........	18,100	16,433	14,767	14,650
2000\2\:				
Single..........	11,533	9,867	8,550	8,550
Joint...........	18,467	16,800	15,133	15,200

\1\The tax threshold is the amount of adjusted gross income (excluding Social Security) at which tax liability begins. Table assumes taxpayers are 65 or older, are not blind, and receive no tax-exempt disability benefit, annuity, or pension income other than Social Security income.

\2\Estimated.

Source: Congressional Budget Office.

DISTRIBUTION OF FAMILY INCOME AND TAXES

Table 16-20 presents estimates of the distribution of families and individuals by the Federal individual income tax rate brackets for calendar year 1995. This allows for comparison of data about the elderly to data about other types of families and about the total population. As shown in the bottom panel, slightly over 28 million families pay no Federal income taxes. There are slightly over 54 million families with 134 million individuals who are in the 15 percent bracket. These families on average had income of approximately $35,000 and paid Federal taxes of $2,315 per family. There are approximately 4 million families who face marginal income tax rates of 31 percent or above.

Table 16-21 is a more complicated version of table 6. It illustrates for various types of wage-earners the additional (marginal) Federal tax these wage-earners will pay if they earn one more dollar of wages. For purposes of this table, marginal tax rates include both Federal income and payroll taxes. The majority of single wage earners have income between $20,000 and $30,000 per year and face marginal tax rates of 20.0 to 24.9 percent.

TABLE 16-20.--DISTRIBUTION OF FAMILIES AND PERSONS BY MARGINAL FEDERAL INCOME TAX RATE, 1995

[Number of families and persons in thousands]

Families Persons Families

Average Average

Marginal tax rate (percent)

pre-tax Federal

Number

		Percent	Number	Percent	income	income
		($)\1\	tax ($)			
Families with children:						
0	8,944	24.0	34,161	23.4	9,830	-1,152
15	20,023	53.6	78,719	53.9	41,785	2,445
28	7,214	19.3	28,405	19.5	89,984	9,979
31	639	1.7	2,551	1.8	165,775	26,437
36	262	0.7	1,018	0.7	238,058	44,553
39.6	265	0.7	1,099	0.8	703,165	198,206
Total	37,346	100.0	145,952	100.0	51,626	5,132
Families with aged head:						
0	10,831	48.6	15,564	43.4	14,099	-1
15	8,193	36.7	14,273	39.8	35,260	1,757
28	2,564	11.5	4,786	13.3	77,171	9,814
31	421	1.9	709	2.0	138,572	22,574
36	184	0.8	359	1.0	245,045	50,011
39.6	106	0.5	203	0.6	975,682	221,219

Total	22,298	100.0	35,895	100.0	37,932	3,659
Other families:						
0	8,248	16.4	10,871	13.4	5,937	-88
15	25,593	51.0	41,371	51.1	30,261	2,391
28	14,163	28.2	24,789	30.6	69,274	8,690
31	1,403	2.8	2,388	3.0	130,708	21,393
36	470	0.9	977	1.2	241,126	52,271
39.6	295	0.60	631	0.8	861,466	212,503
Total	50,173	100.0	81,026	100.0	46,952	5,997
All families:						
0	28,023	25.5	60,595	23.1	10,334	-394
15	53,809	49.0	134,363	51.1	35,310	2,315
28	23,941	21.8	57,980	22.1	76,360	9,199
31	2,463	2.2	5,648	2.2	141,150	22,903
36	916	0.8	2,354	0.9	241,034	49,609
39.6	665	0.6	1,933	0.7	816,659	208,203

Total	109,817	100.0	262,873	100.0	46,710	5,228

\1\Excluding corporate income taxes and employer paid Social Security and U.I. taxes.

Source: Congressional Budget Office.

TABLE 16-21.--DISTRIBUTION OF EARNERS BY INCOME AND MARGINAL TAX RATES ON WAGES,\1\ 1995

[In thousands of earners, tax rates in percent]

Income in thousands of 1995 dollars	Marginal tax rate									All incomes
	<10	10-20	20-30	30-40	40-50	50-75	75-100	100-200	200+	
All earners ages 21-64 without Social Security benefits										
Less than 0	2,842	341	43	6	3	0	0	0	0	3,236
0 to 4.9										

	1,414	46	14	0	0	0	0	0	0	1,474
5.0 to 9.9	4,822	1,155	184	31	8	4	2	0	0	6,206
10.0 to 14.9	0	0	0	0	0	0	0	0	0	0
15.0 to 19.9	755	102	13	2	12	135	2	0	0	1,022
20.0 to 24.9	2,705	12,079	14,124	12,001	10,825	8,097	46	0	0	59,877
25.0 to 29.9	0	1,844	354	7	38	1,103	1,686	819	0	5,850
30.0 to 34.9	1,600	55	7	129	152	146	317	1,767	9	4,183
35.0 to 39.9	0	2,081	1,603	3,720	2,463	13,404	7,176	3,316	255	34,018
40.0 to 44.9	0	1,209	2,683	49	6	8	0	177	882	5,014
45.0 to 49.9	0	0	1	0	0	10	0	94	508	613
Total	14,139	18,912	19,026	15,947	13,507	22,907	9,229	6,173	1,654	121,493
Mean marginal tax rate	5.6	24.4	26.6	25.8	25.1	30.6	34.4	34.9	43.3	25.6
Mean marginal income tax rate	-2.0	16.8	19.0	18.1	17.5	23.4	28.0	30.2	39.9	18.3

Mean marginal Social Security tax rate..............
7.6 7.6 7.6 7.6 7.6 7.3
6.3 4.8 3.4 7.3

Single earners

Less than 0..	2,005	129	10	4	1	0	0	0	0	2,150
0 to 4.9..	1,235	19	6	0	0	0	0	0	0	1,260
5.0 to 9.9..	3,723	380	1	2	0	0	0	0	0	4,107
10.0 to 14.9..	0	0	0	0	0	0	0	0	0	0
15.0 to 19.9..	563	15	4	1	1	1	0	0	0	583
20.0 to 24.9..	2,705	10,466	8,399	1,712	312	42	4	0	0	23,639
25.0 to 29.9..	0	328	4	5	27	464	78	14	0	921
30.0 to 34.9..	1,600	42	4	0	2	131	314	206	0	2,299
35.0 to 39.9..	0	1,291	797	3,689	2,437	1,927	76	80	54	10,351
40.0 to 44.9..										

0   742   629   3   2   0
0   9   94   1,478
45.0 to 49.9..
0   0   0   0   0   0
0   2   0   2

      Total...
11,831   13,411   9,854   5,415   2,784   2,565
471   311   147   46,789
Mean marginal tax rate..............................
7.8   24.5   25.1   31.5   34.1   34.2
32.8   34.9   41.1   22.5
Mean marginal income tax rate.......................
0.1   16.9   17.5   23.8   26.5   28.0
30.3   32.8   39.6   15.1
Mean marginal Social Security rate..................
7.6   7.6   7.6   7.6   7.6   6.2
2.5   2.1   1.4   7.5

Married earners

Less than 0...
837   212   33   3   1   0
0   0   0   1,086
0 to 4.9..
180   27   8   0   0   0
0   0   0   214
5.0 to 9.9..
1,099   775   183   29   8   4
2   0   0   2,100
10.0 to 14.9..
0   0   0   0   0   0

							0	0	0	0
15.0 to 19.9....................................	192	87	10	2	11	135	2	0	0	438
20.0 to 24.9....................................	0	1,613	5,725	10,290	10,512	8,055	42	0	0	36,237
25.0 to 29.9....................................	0	1,516	350	2	11	639	1,608	805	0	4,930
30.0 to 34.9....................................	0	14	3	129	150	15	3	1,561	9	1,884
35.0 to 39.9....................................	0	790	806	31	26	11,477	7,100	3,236	201	23,667
40.0 to 44.9....................................	0	468	2,054	46	4	8	0	169	788	3,537
45.0 to 49.9....................................	0	0	1	0	0	10	0	92	508	611
Total..	2,308	5,500	9,172	10,532	10,724	20,342	8,757	5,862	1,506	74,705
Mean marginal tax rate..............................	-5.2	24.1	28.3	22.8	22.8	30.2	34.4	34.9	43.5	27.5
Mean marginal income tax rate.......................	-12.9	16.5	20.6	15.2	15.1	22.8	27.9	30.0	39.9	20.3
Mean marginal Social Security rate..................	7.6	7.6	7.6	7.6	7.6	7.4	6.5	4.9	3.6	7.2

Earners with children

Less than 0	2,591	321	35	6	3	0	0	0	0	2,956
0 to 4.9	0	3	2	0	0	0	0	0	0	5
5.0 to 9.9	1,165	738	97	26	1	0	0	0	0	2,026
10.0 to 14.9	0	0	0	0	0	0	0	0	0	0
15.0 to 19.9	0	0	0	2	3	133	2	0	0	141
20.0 to 24.9	0	394	3,020	6,914	6,653	6,099	21	0	0	23,101
25.0 to 29.9	0	1,813	351	2	11	487	1,055	474	0	4,193
30.0 to 34.9	0	0	0	24	21	4	4	734	0	788
35.0 to 39.9	0	1,690	1,104	32	141	5,095	3,541	1,480	21	13,104
40.0 to 44.9	0	1,096	2,569	47	6	6	0	102	455	4,282
45.0 to 49.9	0	0	0	0	0	0	0	50	211	260

Total	3,756	6,055	7,178	7,053	6,839	11,825	4,623	2,839	688	50,856
Mean marginal tax rate	-16.8	28.1	32.2	22.8	22.9	28.5	34.2	34.7	43.7	25.1
Mean marginal income tax rate	-24.4	20.4	24.5	15.1	15.3	21.1	27.9	30.0	40.2	17.9
Mean marginal Social Security rate	7.6	7.6	7.6	7.6	7.6	7.3	6.2	4.7	3.4	7.2

\1\Marginal tax rates are the combined tax rates on an additional dollar of earnings of the Federal individual income tax and the employee share of the Social Security payroll tax (FICA).

Source: Congressional Budget Office tax simulation model.

FEDERAL TAX TREATMENT OF FAMILIES IN POVERTY

During the 1970s and early 1980s, inflation gradually increased the tax burdens of the poor and lowered the real income level at which a poor family became liable for income tax. Legislation passed by Congress reversed or slowed this trend, but in the absence of indexing, inflation during this period gradually offset these legislative efforts. This trend can be measured in two ways. One measure is the degree to which the income at which a poor family begins to pay income taxes (termed the tax threshold, or alternatively, the tax entry point) exceeds or falls below the poverty threshold. A second measure is the actual amount of tax liability incurred by a family with income at the poverty line.

Table 16-22 shows the income tax threshold, the poverty level, and the tax threshold as a percent of the poverty level for a married couple with two children in selected years since 1959. These figures demonstrate that before 1975 a family of four was generally liable for Federal income tax if the family's income was significantly below the poverty line. In 1975, following the enactment of the earned income tax credit (EITC), a family of four incurred no tax liability until its income exceeded the poverty threshold by 22 percent. Over the next decade this margin eroded; by 1984, a poor family of four incurred income tax liability when its income was 17 percent below the poverty line.

Table 16-23 shows the income tax burden and payroll tax burden of households with incomes at the poverty line for families of different sizes. This table shows that a family of four in 1978 had an income tax refund (through the earned income tax credit) of $134; the refund offset 33 percent of the family's payroll tax burden of $403. By 1986, a family in the same situation incurred a positive tax liability of $363. Combined income and payroll taxes represented 4 percent of income for a family with income equal to the poverty level in 1978; by 1986, combined income and payroll taxes consumed 10.4 percent of family income.

The Tax Reform Act of 1986 significantly increased the income tax entry point for poor families with children from

$9,575 in 1986 to $15,110 in 1988. Because the system was indexed for inflation, future increases in the Consumer Price Index will not increase the tax burden for poor families.

TABLE 16-22.--RELATIONSHIP BETWEEN INCOME TAX THRESHOLD AND POVERTY LEVEL FOR A FAMILY OF FOUR, ASSUMING FULL USE OF THE EARNED INCOME TAX CREDIT, 1959-2000

Year	Income tax threshold	Poverty level	Tax threshold as a percent of poverty level
1959.............................	$2,667	$2,973	89.7
1960.............................	2,667	3,022	88.3
1965.............................	3,000	3,223	93.1
1969.............................	3,000	3,743	80.2
1970.............................	3,600	3,968	90.7
1971.............................	3,750	4,137	90.6
1972.............................	4,300	4,275	100.6
1974.............................	4,300	5,038	

			85.4
1975..............................	6,692	5,500	121.7
1976..............................	6,892	5,815	118.5
1977..............................	7,520	6,191	121.7
1978..............................	7,533	6,662	113.1
1979..............................	8,626	7,412	116.4
1980..............................	8,626	8,414	102.5
1981..............................	8,634	9,287	93.0
1982..............................	8,727	9,862	88.5
1983..............................	8,783	10,178	86.3
1984\2\...........................	8,783	10,610	82.8
1986..............................	9,575	11,203	85.5
1987..............................	13,288	11,611	114.4
1988..............................	15,110	12,092	125.0
1989..............................	15,656	12,675	123.5
1990..............................	16,296	13,359	122.0
1991..............................	17,437	13,924	125.2
1992..............................	18,548	14,335	129.4
1993..............................	19,187	14,774	129.9
1994\1\...........................	21,098	15,173	139.1
1995\1\...........................	22,372	15,612	143.3

1996\1\	23,710	16,092	147.3
1997\1\	24,463	16,593	147.4
1998\1\	25,239	17,104	147.6
1999\1\	25,966	17,635	147.2
2000\1\	26,797	18,187	147.3

\1\Estimated.

\2\Effective payroll tax calculated as 6.7 percent for 1984 because in this year employees were allowed a payroll tax credit equal to 0.3 percent of taxable wages.

Note.--Poverty levels used are the Bureau of the Census poverty thresholds. These differ from the poverty guidelines used by the Office of Management and Budget to determine eligibility for many government transfer programs. The poverty levels are for all families, not just those with heads under age 65. Tax thresholds represent the income level at which a family of 4 making full use of the earned income tax credit owes positive income tax. They are based on the schedule for a married nonelderly couple filing jointly.

Source: Congressional Budget Office.

TABLE 16-23.--TAX THRESHOLDS, POVERTY LEVELS, AND FEDERAL TAX AMOUNTS FOR DIFFERENT FAMILY SIZES WITH EARNINGS EQUAL TO THE POVERTY LEVEL, ASSUMING FULL USE

OF THE EARNED INCOME TAX CREDIT, 1978-2000\1\

	Family size					
	1	2	3	4	5	6
Poverty levels:						
1978	$3,311	$4,249	$5,201	$6,662	$7,880	$8,891
1982	4,900	6,280	7,690	9,862	11,680	13,210
1984	5,277	6,759	8,276	10,610	12,562	14,211
1986	5,572	7,138	8,737	11,203	13,259	14,986
1988	6,024	7,704	9,435	12,092	14,305	16,149
1990	6,652	8,509	10,419	13,359	15,792	17,839
1991	6,932	8,865	10,860	13,924	16,456	18,587
1992	7,143	9,137	11,186	14,335	16,592	19,137
1993\3\	7,362	9,417	11,529	14,774	17,101	19,724
1994\4\	7,560	9,671	11,840	15,173	17,562	20,255
1995\4\	7,779	9,951	12,183	15,612	18,070	20,842
1996\4\	8,019	10,257	12,557	16,092	18,626	21,483
1997\4\	8,268	10,576	12,948	16,593	19,206	22,151
1998\4\	8,523	10,902	13,347	17,104	19,797	22,833
1999\4\						

	8,787	11,241	13,761	17,635	20,412	23,543
2000\4\..	9,062	11,592	14,192	18,187	21,050	24,279
Income tax threshold:\1\						
1978..	3,200	5,200	6,930	7,520	8,183	9,167
1982..	3,300	5,400	8,237	8,727	9,216	9,706
1984..	3,300	5,400	8,315	8,783	9,251	9,719
1986..	3,560	5,830	9,063	9,575	10,086	10,598
1988..	4,950	8,900	13,940	15,110	16,280	17,450
1990..	5,300	9,550	15,066	16,296	17,526	18,756
1991..	5,550	10,000	16,179	17,437	18,616	19,794
1992..	5,900	10,600	17,217	18,548	19,774	21,000
1993..	6,050	10,900	17,841	19,187	20,405	21,624
1994..	7,179	11,250	18,887	21,098	22,222	23,347
1995\4\..	7,359	11,550	19,387	22,372	23,437	24,501
1996\4\..	7,583	11,850	19,924	23,710	24,770	25,831
1997\4\..	7,810	12,250	20,555	24,463	25,565	26,668
1998\4\..	8,080	12,650	21,208	25,239	26,383	27,527
1999\4\..	8,288	12,950	21,809	25,966	27,131	28,296
2000\4\..	8,558	13,400	22,518	26,797	28,004	29,210
Income tax at poverty level:\1\						
1978..	16	0	-280	-134	-12	0
1982..	202	106	-134	285	417	491

1984	226	149	-9	364	478	569
1986	230	144	-76	363	480	564
1988	161	0	-874	-648	-427	-243
1990	203	0	-953	-691	-433	-229
1991	207	0	-1,192	-905	-591	-328
1992	187	0	-1,324	-1,053	-711	-422
1993\3\	197	0	-1,434	-1,153	-829	-463
1994\4\	86	0	-1,904	-1,790	-1,367	-891
1995\4\	95	0	-1,952	-2.240	-1,743	-1,183
1996\4\	99	0	-2,006	-2,618	-2,085	-1,483
1997\4\	104	0	-2,064	-2,694	-2,144	-1,524
1998\4\	100	0	-2,127	-2,777	-2,210	-1,570
1999\4\	113	0	-2,195	-2,867	-2,282	-1,623
2000\4\	114	0	-2,263	-2,953	-2,350	-1,670
Payroll tax at poverty level:						
1978	200	257	315	403	477	538
1982	328	421	515	661	783	885
1984\2\	354	453	555	711	842	953
1986	398	510	625	801	948	1,071
1988	452	579	709	908	1,074	1,213
1990	509	651	797	1,022	1,208	1,365

1991	530	678	831	1,065	1,259	1,422
1992	547	699	856	1,098	1,298	1,466
1993\3\	563	720	882	1,130	1,308	1,509
1994\4\	578	740	906	1,161	1,343	1,550
1995\4\	595	761	932	1,194	1,382	1,594
1996\4\	613	785	961	1,231	1,425	1,643
1997\4\	633	809	991	1,269	1,469	1,695
1998\4\	652	834	1,021	1,308	1,514	1,747
1999\4\	672	860	1,053	1,349	1,562	1.801
2000\4\	693	887	1,086	1,391	1,610	1,857
Combined income and payroll tax at poverty level:						
1978	216	257	35	269	465	538
1982	530	527	381	946	1,200	1,376
1984	580	602	546	1,075	1,320	1,521
1986	628	654	549	1,164	1,428	1,635
1988	614	579	-165	256	647	970
1990	712	651	-156	331	775	1,136
1991	738	678	-362	160	668	1,094
1992	734	699	-467	45	587	1,044
1993\3\	760	720	-552	-22	480	1,046
1994\4\	665	740	-998	-629	-24	658

1995\4\	690	761	-1,020	-1,046	-361	412
1996\4\	712	785	-1,045	-1,387	-660	161
1997\4\	736	809	-1,073	-1,425	-675	171
1998\4\	752	834	-1,106	-1,468	-695	177
1999\4\	785	860	-1,142	-1,518	-721	178
2000\4\	808	887	-1,177	-1,562	-739	188
Combined tax as percent of income at poverty level:						
1978	6.5	6.1	0.7	4.0	5.9	6.1
1982	10.8	8.4	5.0	9.6	10.3	10.4
1984	11.0	8.9	6.5	10.1	10.5	10.7
1986	11.3	9.2	6.3	10.4	10.8	10.9
1988	10.2	7.5	-1.7	2.1	4.5	6.0
1990	10.7	7.6	-1.5	2.5	4.9	6.4
1991	10.6	7.6	-3.3	1.1	4.1	5.9
1992	10.3	7.7	-4.2	0.3	3.5	5.5
1993\3\	10.3	7.7	-4.8	-0.2	2.8	5.3
1994\4\	8.8	7.7	-8.4	-4.1	-0.1	3.3
1995\4\	8.9	7.7	-8.4	-6.7	-2.0	2.0
1996\4\	8.9	7.7	-8.3	-8.6	-3.5	0.7
1997\4\	8.9	7.7	-8.3	-8.6	-3.5	0.8
1998\4\	8.8	7.7	-8.3	-8.6	-3.5	-0.8

1999\4\	8.9	7.7	-8.3	-8.6	-3.5	0.8
2000\4\	8.9	7.7	-8.3	-8.6	-3.5	0.8

\1\The table reflects assumptions that all family income consists of wages or salaries, that families of two or more include a married couple (rather than an unmarried head of household with one or more dependents), that all family members are under age 65, and that families of three or more persons are eligible for the earned income tax credit. For families of three or more, the effect of the earned income tax credit is included. Negative figures in the table reflect refundability of the earned income tax credit. The poverty level figures are for all families, not just those with heads under age 65.

\2\Effective payroll tax is calculated as 6.7 percent for 1984 because in this year employees were allowed a payroll tax credit equal to 0.3 percent of taxable wages.

\3\Estimated.

\4\Projected.

Source: Congressional Budget Office.