

In calculating income subject to tax, individuals may take as itemized non-business deductions State and local personal income, gasoline, sales, property, and other taxes. The deductibility of all these State and local taxes (with the exception of taxes on owner-occupied homes) on nonbusiness returns is classified as support for the finances of State and local governments, rather than listed under any of the functional categories in the current budget.

As a result of the exclusion from tax of State and local bond interest, these governments are able to sell debt obligations at a lower interest cost than would be possible if such interest were subject to tax.

The relative importance of indirect assistance to State and local governments through these provisions as compared with direct aid is not shown because the present budget does not show in a single functional category the aid given to State and local governments. The amounts of direct Federal aid by function, however, are brought together in *Special Analysis O* of the Budget for fiscal year 1970.

TABLE 10.—AID TO STATE AND LOCAL GOVERNMENT FINANCING

Tax expenditures, 1968

[In millions of dollars]

|                                                                                                       |       |
|-------------------------------------------------------------------------------------------------------|-------|
| Exemption of interest on State and local debt obligations.....                                        | 1,800 |
| Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes): <sup>1</sup> |       |
| Individual income tax.....                                                                            | 1,350 |
| General sales taxes.....                                                                              | 775   |
| Gasoline taxes.....                                                                                   | 400   |
| Personal property taxes.....                                                                          | 150   |
| Other taxes.....                                                                                      | 125   |
| Total.....                                                                                            | 2,800 |
| Property taxes on owner-occupied homes (included under community development and housing).....        | 1,800 |
| Total, all State and local nonbusiness taxes.....                                                     | 4,600 |

<sup>1</sup> For businesses owned by individuals, taxes other than income taxes are considered a cost of doing business and thus deductible in arriving at a net income figure.

#### Capital Gains—Individual Income Tax

The tax treatment of capital gains of individuals involves a large amount of tax expenditures. These expenditures would fall under a variety of functions in the Federal budget, including commerce and transportation, agriculture and agricultural resources, natural resources, community development and housing, and health and welfare. Available sources, however, do not provide a basis for accurate distribution among these functions. Thus, to avoid distorting any single category but to identify the importance of this special provision under the individual income tax, a new heading outside the budget classification is included for this item. Omission of this item leads to an understatement of the amounts of tax expenditures for the functional categories affected.

The types of special treatment accorded capital gains and the resulting tax expenditures are as follows:

If the owner of appreciated capital assets dies, the capital gains tax is not applied to appreciation which would have been taxable had he sold the assets just before death. Heirs who receive appreciated property from the decedent and who subsequently sell the property are subject to capital gains tax only on appreciation occurring after they acquired the property. Thus the appreciation on assets held until death is never taxed under the income tax. The revenue cost of this treatment is \$2.5 billion at present capital gains rates. (If taxed at full ordinary rates, the cost is \$4 billion.)

As to realized gains, half of the gains from the sale of capital assets held more than 6 months is excluded from income, and in no case is the tax rate applicable to such capital gains allowed to exceed 25 percent. The revenue cost of this treatment is \$4.5 billion. The revenue cost of this treatment at ordinary rates for both realized gains and gains untaxed at death is \$8.5 billion (including the \$4 billion mentioned above).

The cost of capital gains treatment under present law is complex for a number of reason. It could be contended that:

1. Full taxation of realized capital gains, even with full taxation at death, could result in greater postponement of lifetime gains;