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PRESIDENT'S TAX RELIEF PROPOSALS: TAX PROPOSALS AFFECTING INDIVIDUALS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

MARCH 21, 2001

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PRESIDENT'S TAX RELIEF PROPOSALS: TAX PROPOSALS AFFECTING INDIVIDUALS

WEDNESDAY, MARCH 21, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:05 a.m., in room 1100 Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
March 14, 2001
No. FC–6

CONTACT: (202) 225–1721

Thomas Announces Hearing on President's Tax Relief Proposals

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold an additional hearing on President Bush's proposed tax relief provisions that affect individuals. **The hearing will take place on Wednesday, March 21, 2001, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10 a.m.**

Oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

On February 8, 2001, President Bush released his "Agenda for Tax Relief" that includes doubling the child credit, relief of the marriage tax penalty, and repeal of the death tax.

On February 13, 2001, the Committee held a hearing on President Bush's tax relief proposals. On March 1, the Committee on Ways and Means ordered favorably reported H.R. 3, the "Economic Growth and Tax Relief Act of 2001," a bill reducing individual income tax rates, with a new 12 percent rate taking effect on January 1, 2001. On March 8, 2001, H.R. 3 passed the House by a vote of 230 to 198.

In announcing the hearing, Chairman Thomas stated: "Now that the House has passed the heart of President Bush's tax relief plan—the permanent reduction in individual income tax rates—we will now turn to fixing other problems in the Tax Code. Married couples shouldn't pay more in taxes just because they're married. People shouldn't pay more taxes when they die. And more families could benefit by doubling the $500 per child tax credit. In summary, we are just beginning to provide real and lasting tax relief to the American people who pay the bills, and I look forward to hearing from the witnesses about the need for further tax relief."

FOCUS OF THE HEARING:

The focus of this hearing will be the President's tax relief proposals, other than permanent marginal rate reduction, with particular emphasis on marriage penalty relief, death tax repeal, and doubling the child credit.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, with their name, address, and hearing date noted on a label, by the *close of business*, Thursday, March 22, 2001, to Allison Giles, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may de-

liver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, typed in single space and may not exceed a total of 10 pages including attachments. **Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.**

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone, and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman THOMAS. Good morning. Today, the Committee proceeds with its second hearing on President Bush's tax relief plan, and today we are going to look more closely at the President's proposals addressing the marriage tax penalty problem in the Tax Code, the question of the estate or the death tax, the child credit, and other provisions in the President's tax relief plan. Obviously, there are Members who were advocating positions in these areas prior to the President's plan being presented, in fact for a number of years laboring in the vineyards, and we are going to hear their suggestions, as well.

According to the Congressional Budget Office, almost 25 million married couples pay an average of about $1,400 in higher taxes just because they are married. That is not fair. Last year, President Clinton vetoed a strong bipartisan bill written in large part by our colleague from Illinois on the Committee, Mr. Weller. In fact, 48 Democrats in the House of Representatives voted for our balanced approach, and we believe, working together in a bipartisan way, we will see a similar support in fixing the marriage tax

penalty once again. The difference, of course, is that if it does arrive at the President's desk in a bipartisan way, this President will sign that legislation.

Likewise, the House passed strong bipartisan legislation written by the team on this Committee of the gentlewoman from Washington, Jennifer Dunn, and the gentleman from Tennessee, Mr. Tanner, that repealed the estate or death tax. Sixty-five Democrats in the House voted for that approach in the last Congress. Our goal, obviously, is to make sure that something similar to that is placed on this President's desk. We believe if we are able to do that, that, too, will be signed.

In 1997, Congress passed with overwhelming support the $500 per child tax credit to help those families with children help make ends meet. The President has proposed doubling that $500 credit, phasing it in to the $1,000 limit. We think we need to look at that portion of the President's tax proposals, as well.

There are other portions of the President's plan, including the education saving incentives, the charitable giving, the permanent extension of the research and development tax credit, and other areas where Americans can increase savings and investment.

Finally, let me say that notwithstanding all of the suggestions of additional changes in the Tax Code, I do find it rather remarkable that the initial statement was that no plan should be offered until the budget resolution is passed and we now find, especially in the other body, a number of our colleagues on the other side of the aisle rushing to the microphone with the latest plan to make changes in the Tax Code, notwithstanding the fact that a budget resolution has not passed the Budget Committee and it has not passed the floor. I fully intend to have any provisions that we have pass on the floor of the House after a budget resolution passes the floor of the House.

I do welcome, and I think all of us welcome, our colleagues in looking at new and additional ways in which we can reduce the tax burden on hard-working American income taxpayers, those who are married and those who are not, those who have children and those who do not. The key here is to come together, move product, place it on the President's desk, and let the American people know that we understand we need to change the burden of taxation on income tax-paying Americans and then continue with the fine work in this Committee in the other areas of jurisdiction of this Committee.

With that, I would recognize the gentleman from New York, the Ranking Member, Mr. Rangel.

[The opening statements of Chairman Thomas and Mr. Ramstad follow:]

Opening Statement of the Hon. Bill Thomas, M.C., California, and Chairman, Committee on Ways and Means

Good morning. Today the Committee proceeds with its second hearing on President Bush's tax relief plan.

Today, we will be looking more closely at the President's proposals to fix the marriage tax penalty, repeal the death tax, double the child credit and other provisions in the President's tax relief plan.

According to the Congressional Budget Office, almost twenty-five million married couples pay an average of $1,400 in higher taxes just because they're married. That's not fair. Last year, President Clinton vetoed a strong bipartisan bill written by Mr. Weller to fix the marriage tax penalty. In fact, forty-eight Democrats in the

House of Representatives voted for our balanced approach, and we hope to have similar bipartisan support for fixing the marriage tax penalty again. This year, however, we have a President who will sign the bill.

Likewise, Congress passed the strong bipartisan bill written by our colleagues Mrs. Dunn and Mr. Tanner to completely repeal the death tax. Sixty-five Democrats in the House voted for that approach. They understand that the death tax should be repealed for one reason, which is simply that Americans should not be taxed when they die. That is wrong. I'm glad that President Bush's plan buries the death tax once and for all, and I look forward to discussing the options available to us as we move forward to eliminate the death tax.

In 1997, Congress passed with overwhelming support the $500 per child tax credit, which has helped millions of families with children make ends meet. President Bush has proposed to double that credit up to $1,000 per child, and I would suspect that there would be strong bipartisan support for this proposal as well.

There are other important components in the President's plan B including education savings incentives, charitable giving, and the permanent extension of the R&D tax credit. The Committee will be looking at all these and other proposals to expand savings and investments opportunities as we work together to provide real and lasting tax relief to the American people.

Opening Statement of the Hon. Jim Ramstad, M.C., Minnesota

Mr. Chairman, thank you for your leadership in examining and acting on the President's tax relief agenda for Americans.

We have now seen the responsible framework of this year's budget resolution. Our budget will allow us to pay down an unprecedented amount of debt, preserve Social Security and improve Medicare, fund important education, medical research and defense priorities, *and* provide meaningful tax relief.

The House recently sent the Senate the first installment of the President's tax relief plan—a reduction in marginal tax rates for all taxpayers. These rate reductions are urgently needed to stimulate our sputtering economy. It is time now to turn to the next critical elements of the President's plan.

The President's plan is pro-family and pro-fairness. It recognizes the sacrifices families make to raise children. It defends married couples against higher taxes simply because they are married. It rewards charitable giving to help Americans in need. And it buries the unfair death tax, which prevents families from passing farms and businesses to the next generation.

I look forward to hearing from our distinguished witnesses about these crucial tax relief proposals.

Thank you, Mr. Chairman.

Mr. RANGEL. Thank you, Mr. Chairman. Mr. Chairman, yesterday, you indicated that there may be a markup on certain legislation either on Thursday or Friday. Could you share with us whether or not these hearings today would have any relationship at all with legislation that you intend to mark up, and if so, what would the connection be? Are we to assume that whatever testimony we hear today may be the subject of a bill to be marked up this week?

Chairman THOMAS. I would tell the gentleman that as we are looking at the other portions of the President's tax plan, having moved the permanent marginal rate reduction, to other areas that this Congress had involved itself with prior to the election of President Bush, the marriage penalty and the death tax aspect are represented in large part by, for example, some of the Members in front of us.

We believe that between now and when we have our next markup, we can incorporate a number of ideas of the President's, but also our colleagues' ideas, and I look forward to working with the

gentleman from New York. As he knows, we have already supplied him with significant information in terms of the direction that we believe we are going to take.

I am never, however, surprised of the valuableness of hearings and information provided to us by witnesses which, of course, can be incorporated in any markup as long as we have about 24 hours prior to the markup. So I look forward to hearing the witnesses, listening carefully to what they have to say, digesting it, and then if, in fact, we do find information that is very useful that we had not anticipated, including it in a markup.

Mr. RANGEL. Mr. Chairman, I am embarrassed not to fully understand what you said.

Chairman THOMAS. What I said was we ought to listen to the witnesses carefully, see what they have to say, and if we agree they have something worthwhile to say and we have not anticipated it in legislation, to include it.

Mr. RANGEL. But I was only talking, Mr. Chairman, about whether or not their gems of wisdom would be of assistance to us with a bill since we have yet to know what is in the bill that we may mark up tomorrow or Friday. I guess that was my partisan way of requesting, do we have the slightest clue as to what the language would be in a bill that we may mark up on Thursday or Friday, and what the cost would be, so that we could more intelligently ask questions of these witnesses?

You mentioned the death tax. I assume you mean the estate tax repeal. If that is going to be something that we are marking up this week, then, of course, we would want to ask questions about this when having these expert witnesses here. And, of course, if you have no intention of marking up bills that relate to their expert testimony then we would listen and absorb it, but we would not waste a lot of time asking questions on a bill that we are not marking up tomorrow or the next day. But, of course, if you feel more comfortable not answering any questions, then I will just not inquire any further.

Chairman THOMAS. Great. And with that, we will——

Mr. RANGEL. That is the end of my opening statement, Mr. Chairman.

Chairman THOMAS. And with that, we will turn to the panel.

Mr. CAMP. Mr. Chairman, if I might just have a minute.

Chairman THOMAS. The gentleman from Michigan.

Mr. CAMP. I just wanted to briefly welcome the panel, including my colleague and friend from Michigan, Congressman Barcia. We have adjoining districts. I look forward to your testimony. Thank you, Mr. Chairman.

Mr. CRANE. Mr. Chairman.

Chairman THOMAS. I thank the gentleman. The gentleman from Illinois.

Mr. CRANE. May I welcome my distinguished colleague from Illinois, Mr. Weller.

Mr. RANGEL. Mr. Chairman, I would like to welcome the Senator and my colleagues for whatever wisdom they can share with us from now and to the end of this session, because we will never know when we will have a chance to use their advice. We thank you for sharing your views with us now.

[Laughter.]

Chairman THOMAS. The chair is constrained to say, though, it is much more difficult in picking up the pearls of wisdom from our witnesses if the Members are not here, so I anticipate full attendance through the entire hearing.

Now, it is my pleasure to turn to the gentleman from Illinois and the gentleman from Michigan on the House side and the Senator from Texas, who has been a champion for a long time on examining the Tax Code in which there ought not to be punishment for the act of marriage. And with that, I will turn first to the Senator from Texas and indicate that if you have any written testimony, we will make it a part of the record and you can address us in any way you see fit.

I will also tell you that you have to turn the mike on and it is very uni-directional in terms of its sound. You have to speak into it.

STATEMENT OF THE HON. KAY BAILEY HUTCHISON, A UNITED STATES SENATOR FROM THE STATE OF TEXAS

Mrs. HUTCHISON. Thank you very much, Mr. Chairman. I do appreciate your holding this hearing and I do hope there will be a markup soon on marriage penalty relief.

I want to start by saying that I have introduced every iteration of marriage penalty relief in the last 4 years in Congress, and I want to acknowledge that Congressman Weller has done the same thing on the House side. He has really been a leader. We have worked together and, of course, have passed marriage penalty relief twice, only to see it vetoed. But this time, I believe we can work on a bill that will be signed by the President and will give measurable tax relief to married couples who now suffer a penalty. And I want to welcome Congressman Barcia, also, to help us in this effort so that we can have a bipartisan effort.

Of course, 21 million American couples do suffer a marriage penalty tax in this country and there should be zero tax to being married. Let me give you an example from Texas.

Heather Diederich and Willie Simmons live in Tyler, Texas. They are engaged to be married May 26, so when the distinguished Ranking Member says, why are we talking about this today, are we really going to do something, I hope we are going to do something before May 26 for this couple. They both work for a local grocery store chain. Heather is a single mother of a 3-year-old boy. She makes $20,000 a year. Willie makes $19,000 a year. When they get married, they will be hit with a marriage penalty of $1,600. Mr. Chairman, this is wrong and we could do something about it to help this couple before the end of the year, after they have gotten married.

I think we need to talk about what is possible within the range of the President's plan of $1.6 trillion. Based on my experience and on what we have been able to pass through Congress before, I think it is important that we do something simple and fair, not something that is going to add layers in the reporting requirements, layers in forms or any more complicated responsibility for filing.

I believe increasing the standard deduction for a married couple filing jointly so that it is twice that of a single person and widening the 15 percent tax bracket so that we can at least alleviate the pain at that lowest level and it will give some relief to every couple that either does not itemize and takes the standard deduction or anyone who is paying taxes would get some relief from the 15 percent bracket.

Now, this has been tested. We have passed it through Congress twice before. I think it is very important—and, in fact, Chairman Grassley on the Senate side is trying very hard to stay within the President's allocations. Based on the most recent allocation of the OMB, the President's proposal would reinstate the 10 percent second earner deduction and it would cost $112 billion. If we do both the 15 percent bracket doubling and the standard deduction doubling, it would cost about $183 billion. But if we phase it in slower, it would come about within the President's cost. So we would not be having to take away from any of the other tax cut proposals that you have already passed and are in the President's plan.

Now, I think it is important that we do this, but I want to just regress for a moment here and say, after what we have seen in the stock market and in the economy in general in the last 2 months, I think we need to do something more bold, Mr. Chairman. I think we need to look at actually front end loading all of our tax cuts more. I think we need to send real relief to our taxpayers so that we can spur this economy which is sinking every day and which, I think if we take a bold move, we can do.

The income tax withholding surpluses, not even looking at Social Security are increasing even for this year. So I think we could increase both the marriage penalty relief and the tax bracket relief even more this year, and I would encourage us to do that. I think the failure to do so is unfair, and I thank you for taking this as a priority and I hope very much that it will be in the next one or two bills that will be passed by the House and I hope that we can act expeditiously in the Senate. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you very much, Senator.

[The prepared statement of Mrs. Hutchison follows:]

Statement of the Hon. Kay Bailey Hutchison, U.S.S., Texas

Thank you, Mr. Chairman, Ranking Member Rangel and members of the committee for inviting me to speak at this hearing on individual tax relief. I am pleased to talk about ending one of the most egregious aspects of our tax code—the marriage penalty. As a Senator, relieving the marriage penalty has been one of my highest priorities.

Right now, married couples all over America—21 million or so—are being penalized by our tax code for no apparent reason other than because they are married. The Treasury Department estimates that 48% of married couples pay a marriage penalty. According to a study by the Congressional Budget Office, the average penalty paid is roughly $1,400.

Let me give you an example: Heather Diederich and Willie Simmons live in Tyler, Texas, and are engaged to be married on May 26. Both work at Brookshires, a local grocery store chain. Heather is the single mother of a 3-year-old boy and makes $20,000 a year. Willie makes $19,000 a year. When they get married, they will be hit with a marriage penalty of $1,600.

Other than love, what incentive do these two young people have to get married? Indeed, they are faced with an unbelievable disincentive. It would save them $1,600 a year if they simply lived together. $1,600 is equal to half a year's rent.

It doesn't have to be this way. According to the Congressional Budget Office's latest projections, we will achieve a $5.6 trillion surplus over the next 10 years. This

surplus is affording us an unprecedented opportunity to relieve the marriage penalty in a meaningful way. With this in mind, Mr. Chairman, I would like to suggest that there be certain standards for how Congress addresses the marriage penalty.

First, marriage penalty relief should not add another layer of complication for taxpayers. Our tax code is already enormously complex. Every year, America's taxpayers are forced to spend billions of dollars in tax preparation fees and millions of hours filling out complicated tax forms. Marriage penalty relief should not contribute to this already significant burden.

Second, marriage penalty relief should ensure that all married couples are treated equally. We should strive to bring relief to as many couples as possible, and we should not create a tax system in which we discriminate against certain couples solely on the basis of the division of income. Under current law, couples earning the same amount of combined income pay the same amount in taxes, regardless of whether one spouse chooses to work within the home. We need to make sure this remains the case.

On this point, some have argued that single-earner couples should pay more in tax than two-earner couples with the same combined income. This is because single-earner couples currently benefit from what they call a marriage "bonus."

For the most part, so-called marriage "bonuses" arise in single-earner families. For example, let's say a man who earns $40,000 a year is engaged to a single mom who earns no income. Once they get married, he will pay less income tax than he did as a single person and, therefore, would be receiving a marriage "bonus."

But let's keep in mind that his $40,000 income will now have to support three people instead of just one. His expenses have increased, not decreased. By getting married, he is hardly getting a "bonus"—at least in the monetary sense of the word.

Would it be fair for this couple to pay more in tax than a similar family in which both spouses work outside the home and earn the same total income? The answer is no.

Over the last four years, I have introduced every iteration of marriage penalty relief in the Senate. In the final analysis, I believe that the simplest and fairest way to address this issue is to do two things:

- Increase the standard deduction for married filing jointly so that it is twice that of an individual; and
- Widen the 15% tax bracket.

By taking this approach, we will not be adding a single ounce of complexity for taxpayers, and we won't be choosing which married couples should get relief. In effect, everyone who is married will benefit, and no couple will be discriminated against based on the division of income.

Of course, this approach does not address the marriage penalties found in the upper income brackets. However, expanding the 15% bracket and increasing the standard deduction for joint filers is a reasonable and responsible first step—one that will fit within the $1.6 trillion the President has set aside in his budget for tax relief.

Based on the Joint Tax Committee's estimates of the marriage penalty relief bill that Congress approved last year, doubling the standard deduction and expanding the 15% bracket would cost $183 billion over 10 years. According to the Office of Management and Budget, the President's proposal—which would reinstate the 10% second-earner deduction—would cost $112 billion. These two revenue estimates are not that far apart, and I believe we can close the gap between them by phasing in the 15% bracket expansion at a slightly slower pace than we did in last year's bill, thereby achieving savings over the 10-year period.

I would support expanding the other brackets if surpluses continue to grow. Doubling the standard deduction and widening the 15% bracket now, however, would be a significant down payment.

Again, Mr. Chairman, I would like to emphasize the importance of enacting meaningful marriage penalty relief this year. I believe our failure to do so—especially at a time when the federal government is receiving record income tax surpluses—would send the wrong message to couples like Heather and Willie in Tyler. Let's give them marriage penalty relief this year, and let's do so in a way that is simple and fair.

Thank you, Mr. Chairman.

Chairman THOMAS. Now I will turn to our colleagues. Any written testimony you have will be made a part of the record and you

can take the time and share it to talk about your bill or your desires in terms of marriage penalty reform in any way you see fit.

Mr. Weller.

STATEMENT OF THE HON. JERRY WELLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. WELLER. Thank you, Mr. Chairman, Mr. Rangel, members of the Committee. Thank you for your warm welcome this morning and the opportunity to work with all of you as we work to bring fairness to the Tax Code.

I also want to acknowledge my friend, Senator Hutchison, and my friend, Congressman Barcia, for their good work on working to eliminate the marriage tax penalty. Clearly, this is an issue that should be addressed in a bipartisan way and I am proud to bring before this Committee a bipartisan bill that we will discuss today.

I also want to acknowledge that President Bush has recognized the need to address the marriage tax penalty and included a provision in his package. We like his provision. However, many of us believe we should do more than the President proposes in addressing the marriage tax penalty.

I believe that the whole issue of the marriage tax penalty is best framed by asking some basic questions of fairness, and that is, is it right, is it fair that under our Tax Code, 25 million married working couples, on average, pay higher taxes than they would if they stayed single? Is it right, is it fair that 25 million married working couples, on average, pay $1,400 more in higher taxes just because they are married?

And if you think about it, I represent the south side of Chicago and the south suburbs. Fourteen-hundred-dollars is real money back home in Illinois. It is a year's tuition at a community college, several months' worth of car payments. It is three months' worth of day care at a local child care center in Joliet, Illinois.

Working to address the issue of the marriage tax penalty, I joined with my colleagues, Representatives Barcia, Capito, Kerns, and almost 230 other bipartisan Members in this House and introduced H.R. 6, legislation designed to address the marriage tax penalty. We offer a solution. We offer a solution in H.R. 6 which provides broad marriage tax relief, wiping out the marriage tax penalty for the vast majority of those who suffer it. We do it in several ways.

First, we double the standard deduction for joint filers to twice that of singles. That helps those that do not itemize their taxes.

Second, we widen the 15 percent bracket so that joint filers can earn twice as much in the 15 percent bracket as a single filer. That helps those who itemize their taxes, such as average middle class married couples who happen to own a home and, of course, itemize their taxes.

In H.R. 6, we help the working poor by addressing the marriage tax penalty under earned income credit, helping the working poor, and we also recognize the need to address the AMT, the alternative minimum tax consequences through our solution and we work to make our proposal, of course, holding those harmless and ensuring that no one suffers higher consequences because of our solution.

The bottom line is, we want to eliminate the marriage tax penalty. It is an issue of fairness. I was proud when this House and the Senate this last year sent twice to the President a solution which wiped out the marriage tax penalty. Unfortunately, the previous President chose to veto those bills. I was also very proud that our legislation was bipartisan. Fifty-one Democrats joined every Republican House Member in voting to eliminate the marriage tax penalty this past year when we sent that legislation to the President. Building on that, I believe we have a real opportunity.

I am joined today by Jim Barcia, a friend of mine from across the aisle, a Democrat from Michigan, a great guy, someone who has been working as my partner in the House on working to eliminate the marriage tax penalty, and Mr. Chairman, with your permission, I would like to yield the remainder of my time to Mr. Barcia to present the merits of our legislation.

[The prepared statement of Mr. Weller follows:]

Statement of the Hon. Jerry Weller, M.C., Illinois

Mr. Chairman, I want to thank you for granting me the opportunity to testify on this historic effort to bring about tax fairness. I appreciate the Committee allowing me to testify on an issue that is really an issue of fairness for working couples, eliminating the marriage tax penalty imposed on married working couples by our tax code.

On March 16, 2001, Representatives Barcia, Capito, Kerns and I introduced H.R. 6 with the goal of significantly reducing the marriage tax penalty for the majority of American families who suffer it. H.R. 6 now enjoys broad bipartisan support with 225 cosponsors. The bill we introduced last week is exactly the same as the bill the House and Senate sent to President Clinton last year. Unfortunately, President Clinton chose to veto this bill, in spite of the fact that 51 Democrats voted in favor of the Conference Report. I am proud that H.R. 4810 has obtained such strong bipartisan support and I look forward to working with Representative Barcia, the lead Democrat cosponsor of H.R. 6, to continue to increase the bipartisan support for H.R. 6 this year.

As it was introduced on March 16th, H.R. 6 significantly reduces the marriage penalty for 25 million American working couples by doubling the standard deduction to twice that of singles and widening the 15% income tax bracket to relieve the marriage tax penalty on those who itemize their taxes as homeowners. The bill also provides marriage tax relief for the working poor who benefit from the Earned Income Credit and ensures that no one sees their taxes rise because of this proposal and its relationship to AMT.

Since 1969, our tax laws have punished married couples. For no other reason than the decision to be joined in holy matrimony, more than 25 million couples a year are penalized an average $1,400 per year. They pay more in taxes than they would if they were single. Not only is the marriage penalty unfair, it's immoral that our tax code punishes society's most basic institution. The marriage tax penalty exacts a disproportionate toll on working women and lower income couples with children.

Let me give you an example of how the marriage tax penalty unfairly affect a middle class, married working couple in my district.

By now, many of you are familiar with two school teachers that live in my district in Joliet, Illinois. Shad and Michelle Hallihan make a combined income of $61,500 a year in salary. Let's assume that they each make about the same salary—Shad at $31,500, Michelle at $31,000. In addition, they have one child. If they both filed their taxes as singles, as individuals, they would pay taxes in the 15 percent bracket.

But when they made the choice to live their lives in holy matrimony, and now file jointly, their combined income of $61,500 pushed part of their income into a higher tax bracket of 28 percent, producing a tax penalty of $828 in higher taxes.

On average, America's married working couples pay $1,400 more a year in taxes than individuals with the same incomes. That's serious money. $1,400 is a year's tuition at Joliet Junior College. Over ten years, average couples pay $14,000 more in taxes than singles! This can represent the cost of a new car or a year of college tuition at almost any university in America.

I believe that in an era of federal budget surpluses which do not include Social Security revenues, American families deserve a fairer tax code. We should focus on tax code fairness and simplification beginning with eliminating the unfairness of the marriage tax penalty.

I think the issue of the marriage penalty can best be framed by asking these questions: Do Americans feel its fair that our tax code imposes a higher tax penalty on marriage? Do Americans feel its fair that the average married working couple pays almost $1,400 more in taxes than a couple with almost identical income living together outside of marriage—is it right that our tax code provides an incentive to get divorced?

Eliminating the marriage tax penalty addresses an important issue of fairness—I am excited by the prospect that we can work together to eliminate it. Mr. Chairman, I would again like to thank you for giving me the opportunity to address the Committee on this important issue affecting 25 million American families. I would be happy to answer any questions.

STATEMENT OF THE HON. JAMES A. BARCIA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. BARCIA. Thank you, Mr. Chairman and distinguished Committee Members. It is a privilege for me to join with my good friend, Congressman Weller, and the distinguished Senator Kay Bailey Hutchison, in presenting testimony in favor of H.R. 6 this morning. I want to thank you for granting me this opportunity to testify before you on this issue that is of such critical importance to our Nation's married couples. My comments will be brief, although I see I have about a minute left, I will try to stay in that range.

Chairman THOMAS. In the bipartisan way, we will give you a full five minutes.

Mr. BARCIA. Thank you, Mr. Chairman. As the lead Democratic cosponsor of the Marriage Tax Elimination Act, I first would like to recognize the leadership of Congressman Weller and I want to thank him for giving me the opportunity to do my part to ensure that, one day, the marriage penalty is taken out of the Federal Tax Code. It has truly been an honor and a pleasure to work with him. Without his leadership, vision, and perseverance, as well as that of Senator Hutchison on the other side of the Capitol, frankly, we would not be here this morning.

Let me begin by saying that, fundamentally, the marriage penalty is an issue of tax fairness. Congressman Weller once said that the only form someone can file to avoid the marriage tax penalty is the paperwork for a divorce. That is not the message that this Congress, nor any Congress, should send to working families across our Nation. Marriage is a sacred institution and our Tax Code should not discourage it by making married couples pay more.

As you know, the marriage penalty occurs when a couple filing a joint return experience a greater tax liability than would occur if each of the two people were to file as single taxpayers. The Congressional Budget Office estimates that more than 25 million married couples suffer under this financial burden. The penalty harms the pocketbooks of working families, with an average couple losing about $1,400 under the current system.

The bill that we recently introduced will fix the grave injustice of our current Tax Code that results in married couples paying higher taxes than they would if they had remained single. For me,

this bill strikes to the heart of middle-income tax relief. These are the people who are the backbone of our communities. These are the people who need tax relief the most.

With a record budget surplus, the time is long overdue for Congress to remove the marriage penalty from the Tax Code. This bipartisan bill achieves that goal, and I know that all of us present here today who support the measure will not stop working until this legislation is signed into law.

I will not be redundant in terms of the two distinguished colleagues who have articulated the framework of the legislation, but wanted to add my support for the good work this Committee is doing in helping to correct this injustice in our Federal Tax Code and want to thank you, Mr. Chairman, for the attention and time that you are devoting to this issue and your leadership, as well as the Members of the Committee, on this very important issue that, hopefully, Congress will pass expeditiously. Thank you for the time.

[The prepared statement of Mr. Barcia follows:]

Statement of the Hon. James A. Barcia, M.C., Michigan

• I want to thank you for granting me this opportunity to testify before you on this issue that is of such critical importance to our nation's married couples. My comments will be brief.

• As the lead Democratic cosponsor of the Marriage Penalty Elimination Act, I would like to recognize the leadership of Congressman Weller, and I want to thank him for giving me the opportunity to do my part to ensure that one day the Marriage Penalty is taken out of the tax code. It has truly been an honor to work with him.

• Without his leadership, vision and perseverance we frankly would not be here this morning.

• Let me begin by saying that—fundamentally—the Marriage Penalty is an issue of tax fairness. Congressman Weller once said that the only form someone can file to avoid the marriage tax penalty is the paperwork for divorce.

• That's not the message that Congress should send to working families across our nation.

• Marriage is a sacred institution and our tax code should not discourage it by making married couples pay more.

• As most of you know, the Marriage Penalty occurs when a couple filing a joint return experiences a greater tax liability than would occur if each of the two people were to file as single individuals.

• The Congressional Budget Office estimates that more than 25 million married couples suffer under this burden.

• The penalty harms the pocketbooks of working families—with an average couple losing about $1,400 under the current system.

• The bill that we recently introduced will fix the grave injustice of our current tax code that results in married couples paying higher taxes than they would if they had remained single.

• For me, this bill strikes to the heart of middle income tax relief. These are the people who are the backbone of our communities, these are the people who need tax relief the most.

• With a record budget surplus, the time is long overdue for Congress to remove the marriage penalty from the tax code.

• This bipartisan bill achieves that goal—and I know that all of us present here today who support the measure will not stop working until this legislation is signed into law.

• Thank you.

Mr. WELLER. Mr. Chairman, may I reclaim 30 seconds of the time that I yielded to Mr. Barcia, if I could just briefly? I do want

to acknowledge Shad and Michelle Hallihan, two public schoolteachers who are an example——

Chairman THOMAS. The gentleman's time has expired.

[Laughter.]

Mr. WELLER. Two public schoolteachers who suffer the marriage tax penalty and they are looking to us to solve that problem today. Thank you, Mr. Chairman.

Chairman THOMAS. I actually would tell the gentleman, I believe I know them——

[Laughter.]

And the gentleman has done an excellent job.

Does the gentleman from Florida wish to inquire?

Mr. SHAW. No, Mr. Chairman. I just want to congratulate each one of the witnesses on the good work that they have done and their persistence in seeing that this does become law. Having four kids who are struggling to raise a family, all of whom, I am pleased to say, are happily married, I am very hopeful we will be able to do it, and I hope we can do it before this couple has grandchildren. I yield back, Mr. Chairman.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from California, Mr. Stark, wish to inquire?

Mr. STARK. I just wonder if any of the witnesses know what we can anticipate we will be looking at. What is going to be in the bill? Do you know, Jerry? What is going to be in the bill? What are we going to mark up? Do you know?

Mr. WELLER. Mr. Stark, we have made suggestions to Chairman Thomas, who has been very inclusive in this process, and, of course, when he is prepared to release the mark, we will take a look at it. But we have suggested in H.R. 6——

Mr. STARK. Are you going to vote for it, whatever it is?

Mr. WELLER. Chairman Thomas has been very receptive to many of the ideas we have been suggesting to him.

Mr. STARK. That was not what I asked. You will vote for whatever it is?

Mr. WELLER. I certainly expect and hope to vote for the proposal we vote on later this week.

Mr. STARK. Senator, you would support it without knowing what it is going to be?

Chairman THOMAS. Would the gentleman yield?

Mr. STARK. Happily.

Chairman THOMAS. The bill that has been introduced in the House by the two gentlemen who are in front of us will be the base text.

Mr. STARK. Aha.

Chairman THOMAS. However, as is usually the case in this Committee for as long as I have been on this Committee, there is a chairman's substitute which will be offered. So if the gentleman is concerned about what the base bill is going to be, the gentleman only needs to consult H.R. 6, introduced at the beginning of the——

Mr. STARK. What is going to be the chairman's substitute?

Chairman THOMAS. The gentleman will see the chairman's substitute, as has been the case, when the majority, who were the Democrats, the day before the markup.

Mr. STARK. So we call that a pig in a poke, I think, but you may call it a substitute.

Senator, will you vote for whatever form of marriage penalty the Chairman decides will finally be in his substitute? Are you willing to say that today?

Mrs. HUTCHISON. Mr. Stark, I do not know that you have ever heard a Senator agree to vote for a bill just as it came out of the House, so that would be sort of a different kind of a question.

Mr. STARK. So you are not sure, either.

Mrs. HUTCHISON. Let me say, I know what you are doing. I think we all do. I am working very hard with the chairman and ranking member of the Finance Committee and trying to make some very simple points, and those are that we should try to affect as many married couples as we possibly can.

Mr. STARK. What limits us from being completely fair? You do not change the upper brackets in any of your bills. Is it perhaps that you do not think we have enough money to do this completely?

Mrs. HUTCHISON. I think we have competing priorities and that is why we have the opportunity——

Mr. STARK. Would you rather have a drug benefit for seniors or would you rather have a bigger marriage tax penalty relief?

Mrs. HUTCHISON. They are not mutually exclusive, Mr. Stark.

Mr. STARK. Oh, they are both money. You cannot have them both.

Mrs. HUTCHISON. I disagree with you totally. I think tax relief should be a first priority, because——

Mr. STARK. Before drug benefit for seniors?

Mrs. HUTCHISON. No, Mr. Stark. I do not think they are mutually exclusive, and as soon as you are able to, in an orderly way, take up each issue as it comes, we have a budget, we have tax relief, we have——

Mr. STARK. I beg to differ with the——

Mrs. HUTCHISON. We have Medicare reform, and I do think Medicare reform——

Mr. STARK. I beg to differ with you, Senator. We do not have a budget.

Mrs. HUTCHISON. Mr. Stark, I do think Medicare reform——

Mr. STARK. We do not have a budget, Senator.

Mrs. HUTCHISON. Needs to be done as a whole and not piecemeal.

Mr. STARK. Senator, we do not have a budget. Do you?

Mrs. HUTCHISON. We are working on a budget, yes.

Mr. STARK. But you do not have one, do you?

Mrs. HUTCHISON. Mr. Stark——

Mr. STARK. So, in effect, you do not know what you are talking about when you talk about a budget.

Mrs. HUTCHISON. Mr. Stark, I would just say that we have very good estimates on what our surplus is going to be——

Chairman THOMAS. Senator——

Mrs. HUTCHISON. And, in fact, those surpluses are going up.

Chairman THOMAS. Senator, if you would refrain for just a minute, I understand the gentleman's exuberance and frustration at being in the minority, but that should not replace common courtesy in terms of responding to a fellow colleague who is a Senator. Would the Senator——

Mr. STARK. I would repeat my question, Senator. Do you know what you are talking about when you talk about a budget?

Mrs. HUTCHISON. I assure you that I do.

Mr. STARK. You do? What is your budget, then?

Mrs. HUTCHISON. And I do know that——

Mr. STARK. How much is budgeted?

Mrs. HUTCHISON. The estimates are, on our surplus and what we are going to have in the way of——

Mr. STARK. How much is your tax bill going to be, Senator?

Mrs. HUTCHISON. Our tax bill is going to be $1.6 trillion——

Mr. STARK. All right.

Mrs. HUTCHISON. And we are going to have $1 trillion in added capacity for spending that we plan to encourage spending in Medicare, in public education, and national defense.

Mr. STARK. And how much is your drug benefit going to be for the seniors?

Mrs. HUTCHISON. Mr. Stark, I know what you are trying to do and I think $1 trillion set aside for added spending needs and priorities is quite responsible.

Mr. STARK. That is not what I asked you. You may think that, but I asked you if you have any idea what you are going to spend on a drug benefit for seniors, and I think the answer is you do not.

Mrs. HUTCHISON. Mr. Stark, I think it is very important that we——

Mr. STARK. Senator, do you or do you not know what you are going to spend on a drug benefit?

Mrs. HUTCHISON. We are able to address any issues——

Mr. STARK. I am asking for a yes or no response. I do not need any help from pipsqueaks on this side of the aisle, Mr. Chairman. You can ask a question on your time, son.

Chairman THOMAS. The gentleman's time has expired.

Does the gentleman from New York wish to inquire?

Mr. HOUGHTON. I would like to ask Mr. Stark whether he intends to vote against the bill without having seen it.

Mr. STARK. Unlike Mr. Houghton, not being a Republican, I am unable to make statements about things that I may or may not do.

Chairman THOMAS. I think the gentleman wants a yes or a no. [Laughter.]

Mr. STARK. Mr. Houghton, I do not intend to vote for any bill until there is a budget and I know what the priorities are and what the effects will be on the American people and whether the seniors will have a drug benefit or not, or is it just a few thousand wealthy Republicans who will get huge tax breaks under the chairman's bill. So that is where I am. If your children and my children are just waiting there panting to get their hands on estates, that may be one thing. I do not intend to do that, discrediting the people who need a drug benefit.

Mr. HOUGHTON. You know, Mr. Stark, you tend to pull in my children with your children on almost every opportunity. Thank you very much.

Chairman THOMAS. Does the gentleman from California, Mr. Matsui, wish to inquire?

Mr. MATSUI. I would just like to thank Mr. Weller for the photo because I miss that couple. I have not seen them in a while.

[Laughter.]

Actually, I have no questions at this time, Mr. Chairman.

Chairman THOMAS. Thank you. Does the gentleman from Louisiana wish to inquire?

Mr. MCCRERY. No questions.

Chairman THOMAS. The gentleman from Pennsylvania? Does the gentleman from Michigan wish to inquire? The other gentleman from Michigan?

Mr. LEVIN. I do not think so, except the question has been raised about when we will see the details of a proposal, and maybe you can let us know, Mr. Chairman, when we are going to see the legislation, your mark, that is proposed to be handled either tomorrow or Friday. Really, I think this legislation is much too important for us to go in without being fully aware of the details. So maybe you could let us know. We have not seen it. I do not think some of your colleagues on the Republican side have seen it. At least we on the Democratic side have not seen it. So when do you intend to give us your mark?

Chairman THOMAS. I will tell the gentleman that he apparently is chafing under the rules that this Committee has operated under for a number of years.

Mr. LEVIN. I am not chafing. Mr. Chairman——

Chairman THOMAS. We are following exactly the rules that the gentleman's party followed when they were in the majority, and that is you have been supplied with the base text 2 days before the markup. The chairman's mark or the substitute is to be supplied one day before the markup with revenue tables. This is the day before the markup. You will receive the substitute and the revenue tables today. The gentleman is complaining that I am not meeting his time table, but rather I am meeting the rules of this Committee. That is the gentleman's problem.

Mr. LEVIN. Mr. Chairman, I am not chafing and I do not think anybody else should. It is suggested that we mark up a bill involving hundreds of billions of dollars and you say—I am not sure what rules you are talking about. I think there is a 48-hour rule, is there not?

Chairman THOMAS. I will tell the gentleman he received it 48 hours before the markup if the markup is to occur on Thursday. If, in fact, we decide to have the markup on Friday, he will then have an additional 24 hours in which to consider the base text under the rules. The base text is H.R. 6. Not only is it not unfamiliar to us, but it passed the House just a year ago by a very large bipartisan majority. We are focusing primarily on the marriage penalty structure in H.R. 6. There may be some revisions to bring it current and to make other adjustments that have come to us since the bipartisan passage of that marriage penalty legislation.

Mr. LEVIN. All right. And also, there is a child credit proposal that is going to be in the mark?

Chairman THOMAS. We are going to try to put a child credit provision, which is the President's doubling of that child credit phased in with, again, modifications, in part, as the gentleman well knows, from the marginal rate reduction bill. There is a problem with the alternative minimum tax exacerbated by the gentleman's tax bill of 1993 which has not been dealt with, but we are dealing with it so

that no income tax payer who gets a tax cut inadvertently gets an increase in their taxes because of the alternative minimum tax.

Mr. LEVIN. Right.

Chairman THOMAS. That will be part of the adjustment in dealing with the child credit.

Mr. LEVIN. And the estate tax, will that——

Chairman THOMAS. That will not be marked up this week.

Mr. LEVIN. And so you are saying that sometime today—it could be as late as five or six or seven o'clock—we are going to receive your mark?

Chairman THOMAS. The gentleman will receive the day before the markup the chairman's substitute or the mark, as has been done traditionally in this Committee for years.

Mr. LEVIN. Well, Okay. I——

Chairman THOMAS. I understand the gentleman's frustration with——

Mr. LEVIN. I am not frustrated——

Chairman THOMAS. With not getting the information as soon as he would like to release to the press and others. But we are going to follow the rules of this Committee.

Mr. LEVIN. Mr. Chairman, I think it is still my time, so let me just say——

Chairman THOMAS. I thank the gentleman for yielding.

Mr. LEVIN. It is not a question of yielding. I am glad to yield to you at any point. It is not a question of giving information to the media. This Committee has a responsibility. We are talking about a $1.6 trillion, I think, plus, tax proposal, and now the second chunk is supposed to be marked up. We are talking about hundreds of billions of dollars and I think we should not worry so much about the past but argue about or discuss what is an intelligent way to proceed in the present.

And all I am saying is for us to receive a mark, which is the precise proposal we would be considering and perhaps amending, less than 24 hours before you want us to mark up, I think is not reflective of due consideration of major tax policy.

Chairman THOMAS. I will tell the gentleman if he will examine in his packet a description of the Marriage Penalty and Family Tax Relief Act of 2001, which was provided to the gentleman's staff yesterday, he might become familiar with——

Mr. LEVIN. I have read it.

Chairman THOMAS. Oh, Okay. You have read it. Fine.

Mr. LEVIN. That is not the bill that will be before us tomorrow.

Chairman THOMAS. Does the gentlewoman from Washington wish to inquire?

Ms. DUNN. Thank you very much, Mr. Chairman. I have no questions but I simply want to congratulate Congressman Weller and Senator Hutchison for taking leadership on this very important issue of marriage penalty tax relief. I appreciate the chairman's comments that we will have the budget on the floor of the House before we act on this particular bill on the floor of the House, and I think that is important in terms of priorities.

So I just want to thank you both very much for doing something, and Congressman Barcia, for doing a lot of work on an issue that my constituents are very, very interested in seeing done. This is

the year to do it. We have the dollars in the surplus. We have budgeted the dollars for marriage penalty tax relief and I congratulate you both for being successful.

Chairman THOMAS. Does the gentleman from Washington wish to inquire?

Mr. MCDERMOTT. Thank you, Mr. Chairman. I am sorry I am a little bit late because I was over at the Budget Committee, where I was walking through the budget for the first time. What I am having trouble understanding is how do you know which figures to use, because we just got the budget last night at ten o'clock, and how do you know that there is money in here to do the tax cuts that you are asking for? Where are you getting your figures from, or are you just deciding how much money you want to give and——

Mrs. HUTCHISON. Mr. McDermott, I would just answer by saying that we get the figures from OMB and the Congressional offices, the Congressional Budget Office, and we know how much surplus we are going to have over the next 10 years. Our proposal is to spend $1.6 trillion of that proposed $5.6 trillion surplus in giving money back to the people who earned it. That is a decision that we have made and I think that there is no question that the budget is going to go through in a timely manner and so are the tax relief bills that are going through both houses of Congress and I am very pleased that they will be.

Mr. MCDERMOTT. Does it trouble you at all that you are using the Medicare surplus as a part of this tax cut?

Mrs. HUTCHISON. I do not think we are going to not address the Medicare issue. We have been trying to address that issue, quite frankly, for the last few years, and not only has Congress not been able to agree on the right approach, but we have not had support from the President. So I think all of us would like to address the issue and I hope we can do it in a bipartisan way on an expedited basis and that we will use some of the $1 trillion surplus that we are setting aside for spending priorities.

Mr. MCDERMOTT. Five-hundred-and-sixty-five billion of which is from Medicare. If we demonstrate in the process of this budget hearing that you are using the Medicare trust fund for funding of the tax cut, would you vote against that?

Mrs. HUTCHISON. I do not think that you will be able to make that case. I think——

Mr. MCDERMOTT. I understand that, but if I can, if we do, will you vote against it?

Mrs. HUTCHISON. Well, let me just say that you used the term $565 billion and we know we are going to have $1 trillion left over if we stick with the $1.6 trillion tax cut, so there will be plenty of money if that is our priority to address the issue.

Mr. MCDERMOTT. I know you can construct a $1 billion. We have got charts and all kinds of stuff in here. But the fact is, you have to use the Medicare trust fund to create that contingency fund, as the President calls it, or as it appears in the budget document. I think that that is going to become clear. I think that a lot of people are going to get into a position where they have committed themselves to tax cuts, and then they are going to stand up and say, well, I voted for H.R. 2, because everybody in here voted for H.R. 2. We said, we are putting this in a lockbox and we are not going

to take any of that hospital trust money and use it for anything else except for Medicare.

Mr. MCCRERY. Will the gentleman yield?

Mr. MCDERMOTT. Just a moment. We are going to now change that definition of what Medicare is from hospitals to everything in the whole of the Medicare program. We are changing the concept of the tax that the people in America are paying into Medicare or the Part A hospital trust fund. And in using that money for other things, you are simply spending Part A money on other things in the budget. There is no way to avoid it, given the numbers that are here.

Mr. MCCRERY. Will the gentleman yield?

Mr. MCDERMOTT. Yes, I yield to the gentleman.

Mr. MCCRERY. I understand what the gentleman is trying to say, and I know that he does not want to mislead anybody, so I want to make it clear that nobody is proposing that the Medicare trust fund be violated. In other words, the gentleman knows that the trust fund is composed of government securities—not cash, government securities—and I believe what the gentleman is referring to is the cash——

Mr. MCDERMOTT. You are saying that it is not fungible? Come on, Jim.

Mr. MCCRERY. I believe what the gentleman is referring to is the cash surplus that is used to buy those government securities and place the government securities in the trust fund. Nobody is going to take those government securities out and spend them. That would be spending the trust fund. Now, if the gentleman is referring to the cash surplus that the trustees use to buy those securities, that is a different matter. But I know the gentleman does not mean to imply that we are going to violate the Medicare trust fund. Nobody is proposing that and I know the gentleman knows that.

Mr. MCDERMOTT. I guess my time has expired, so I will not answer that any more than to say you can do all the monkeying you want with the budget figures, but the fact is that the money is being used for the tax breaks.

Chairman THOMAS. Does the gentleman from Pennsylvania, Mr. English, wish to inquire?

Mr. ENGLISH. No questions.

Chairman THOMAS. Does the gentleman from Wisconsin, Mr. Kleczka, wish to inquire?

Mr. KLECZKA. Dare I? Mr. Weller, how does your marriage penalty relief differ from the President's proposal, and could you also give me the 5- and 10-year cost?

Mr. WELLER. The proposal the President puts forward, and first, I want to acknowledge that I am pleased with——

Mr. KLECZKA. Do not acknowledge. I only have 5 minutes.

Mr. WELLER. I recognize that, and I am giving you the abbreviated answer. Let me first acknowledge we have a President who wants to address the marriage tax penalty and he, in his proposal, provides roughly $100 billion in marriage tax relief over 10 years, and the way he does it is he provides for a second earner deduction of 10 percent of up to $30,000 of the second earner's income, which means a $3,000 deduction. That would provide about $700 in marriage tax relief for those who are able to use that.

The average marriage tax penalty is about $1,400. Shad and Michelle Hallihan suffer the average marriage tax penalty, and what we propose doing is to ensure that those who——

Mr. KLECZKA. Mr. Weller, what is the cost of your H.R. 6?

Mr. WELLER. The proposal that we offer is roughly $180 billion over ten. We, of course, solve the marriage tax penalty and essentially eliminate the marriage tax penalty for the vast majority of those who suffer it in several ways.

Mr. KLECZKA. And the further question is, when can a married couple anticipate receiving the full $1,400 relief, because I believe your bill is phased in, also.

Mr. WELLER. Our legislation is phased in. The standard deduction, we double the standard deduction for joint filers. That would be immediately available in the 2001 tax year. Actually, our proposal is retroactive, so it would be available this year.

Mr. KLECZKA. When can a married couple expect the $1,400?

Mr. WELLER. Well, those who use the standard deduction would see benefit this year under our proposal because we do make it retroactive.

Mr. KLECZKA. Okay.

Mr. WELLER. Those who itemize their taxes, it is phased in over five years, so the widening of the 15 percent bracket. Those who benefit from the EIC would see benefit in the first year.

Mr. KLECZKA. So a couple would see the $1,400 possibly in 2006, is that accurate?

Mr. WELLER. Once fully phased in, that is correct.

Mr. KLECZKA. Thank you very much. My colleague, Mr. McDermott, talked about this contingency fund, and I know Senator Hutchison also indicated that we are going to have $1 trillion available even after the tax cuts for star wars, for a drug benefit, for education, for all sorts of other programs which a lot of members are looking forward to supporting.

However, I think in discussions we had in this Committee and discussions we had yesterday with the trustee for the Social Security and Medicare trust fund, what we found out, Senator, is that over one-half of that $1 trillion you talk about being a contingency fund is the Medicare HI trust fund. Well, here we go again, and I guess we can debate it, but the figures and facts that we have indicate that $526 billion of this $1 trillion or whatever the amount is is counting that surplus from the Medicare HI trust fund. So I think we can keep talking about $1 trillion being available, but in essence, that is not really accurate. Let me thank the chair.

Chairman THOMAS. Does the gentleman from Arizona wish to inquire?

Mr. HAYWORTH. I thank the Chairman for the time and I thank my colleagues from the House and our friend from the Senate, the lady from Texas, for coming down to visit with us this morning.

Mr. Chairman and my colleagues, listening to some of the comments here today reminds us of a road we have been down before, and we heard it yesterday with the interesting questions going to the Secretary of the Treasury. Though Halloween is some months away, it appears that we are getting the sequel to so many cheap horror films today with perhaps a misunderstanding of the budgetary process and perhaps an honest difference of opinion.

Senator Hutchison, I think we all can appreciate passion and differences of opinion, and goodness knows I have had my share of passionate exchanges with people where we have profound disagreements. I will lament the fact that there are those here who perhaps did not want to hear your answers and so I feel compelled to apologize on their behalf, because I know they seek civility in what we do here.

I also thank my colleague from Michigan for pointing out the fact that this is a bipartisan bill, and I would address my inquiry to Mr. Barcia. Jim, what are you hearing from your constituents? What are they telling you about the marriage penalty and why did you feel compelled to join with Congressman Weller and Senator Hutchison in offering this piece of legislation?

Mr. BARCIA. Thank you, Congressman Hayworth. When this legislation was introduced, we, of course, sent out a news release in our district. It was carried extensively by our electronic and print media throughout our region of the State and I received a lot of positive comments about people who, as Congressman Weller mentioned, could use that additional $1,400 to $1,600 of annual tax relief to apply to the cost of tuition for their children, or themselves if they are being retrained if they have recently lost their employment.

We are seeing the signs of the economy slowing down in Michigan, and for the first time in quite a while now, we are seeing layoffs in my district. So a lot of people certainly would appreciate having that additional tax relief to either pay down perhaps some credit card debt, to perhaps address the increased energy costs which we anticipate in this next winter season, both Michigan being a major tourism State and relying on tourism for the economic health of many of our shoreline communities in my district. The cost of gasoline is expected to rise again, as well as home heating costs may be a serious issue for many families throughout Michigan and the frost belt States.

So I think a lot of people, when they read that we have a surplus at the Federal level, that they feel that this would be one way to target tax relief to working families, especially those where both spouses work to sustain the family economically. So I am very pleased and honored to be able to join Congressman Weller and the other Democrats and Republicans on this legislation to—what we hope to achieve is to have a fairer Federal tax code. Yes, it will provide tax relief, but there is simply no rationale why a couple should be punished for being married if a couple that lives together without the benefit of marriage is not susceptible to that same tax burden.

So I guess that is why I joined with Congressman Weller, and I want to thank my Democratic colleagues who serve on the Committee also for giving me a pass on some of these difficult questions today. I am here because I think the issue is one of tax fairness and I am honored to lend my support. We do have a lot of Democratic cosponsors and we have reached out to many in my caucus to join in this effort.

Mr. HAYWORTH. I thank my colleague from Michigan and I do believe that despite some of the rather provocative protestations of some of my friends on the other side, we are seeing a bipartisan

consensus on this issue, because after all, Mr. Chairman and my colleagues, I believe in all 50 of our States when people apply for marriage licenses, they are not asked their party registration in the intent for that civil union.

So I look forward to moving forward and I thank the chairman also for operating under the time-honored regular order and rules of this Committee, despite, again, some of the rather passionate protests we are hearing today. It is as if institutional history failed to exist, and I would also acknowledge that we are not being uncivil when we follow the rules. I thank the chair.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Georgia, Mr. Lewis, wish to inquire?

Mr. LEWIS of Georgia. Thank you very much, Mr. Chairman. Thank you so much. Let me thank my colleagues from the House and friend from the Senate for being here today, and let me say to my colleague from the great State of Arizona, civility and peace is not the absence of tension and conflict. It is the presence of justice and fairness.

Mr. Chairman, I want to say to you, sir, this member is not frustrated. I am not frustrated, not at all. But I do not understand, I do not understand for the life of me, how do we plan to do all these things with such a massive tax cut, pay down the national debt, save Social Security, take care of Medicare, educate all of our children, and look out for the basic human needs of our people? I do not understand how we are going to do it. I wish you could tell me.

But as a member who believes in the philosophy of non-violence and passive resistance, I do not have any questions. I yield back the time, Mr. Chairman.

[Laughter.]

Chairman THOMAS. I thank the gentleman. I can assure him, he just needs to vote "yes" as these measures come up.

Does the gentleman from Colorado wish to inquire?

Mr. MCINNIS. Thank you, Mr. Chairman. I do. First of all, Senator and colleagues up there, it is interesting that when the cameras are in the room, the Committee sometimes takes on an atmosphere of a little more courtroom drama, including some of the examination that took place. I would assure our guest from the other side of the Capitol that rudeness is not routine on the Committee and I think it is unfortunate that we saw a display of it this morning.

We all have a lot of interest in what to do with our economy as we go through here. I am reading Newsweek, and I get to page, about 36, before they quit talking about the economy. We have got a serious problem out there.

And I would say to my colleague, my respected colleague from the State of Georgia, this is not a massive tax cut. We have a massive problem on our hands that is taking place as we now speak. We have got to get some money out there to the people that are going to bring this consumer confidence back up, and $1.6 trillion over a 10-year period of time is not what could be classified as a massive tax cut.

We are going to be able to take care of more needs than we have ever taken care of in the history of this country. But at the same time, I think we have fiscal responsibility that we need to exercise

and I think that the bill that is in front of us, the proposals that are being discussed in front of us which will later accumulate into a bill, are a step in that right direction.

I would also say to my colleagues that I have heard some discussion about, well, maybe sometime this afternoon they are going to get a copy of a bill and they do not have time to read it or things like that. I think that is a little unfair description of what is occurring. The content, the Chairman has said repeatedly during this meeting, that you can pick up a good portion of the content, so you can get kind of a head start on your reading this evening by looking at the content of the previous bill last year, which was vastly supported, and I would venture to say that the bipartisanship demonstrated today in the support of this bill will also be demonstrated on the House floor when the final vote comes down, although it may not be demonstrated here in this Committee. But once it leaves the Committee, it will be.

The fact is, all of us can get a start on what the substance of this bill is by simply reading it. I mean, there is a lot of material here that will prepare you. So I do not think anybody is going to get caught off guard. I think we all have a good idea of what is coming forth and I would hope that we move forward in a little more bipartisan fashion and with a little more teamwork.

And again, I commend members of both parties sitting up there that are sponsors of this bill and thank the Senator for coming over. Mr. Chairman, I yield back my time.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from New York, Mr. McNulty, wish to inquire?

Mr. MCNULTY. I do. Thank you, Mr. Chairman. I thank the chairman and the ranking member. I thank our witnesses this morning.

I will not ask a question, Mr. Chairman, just want to take a moment to express the same concern that was expressed by my colleague, John Lewis, with regard to the overall amount of the tax cut, and I continue to make this simple point. The numbers do not add up. If you assume a $5.6 trillion surplus over the next ten years and you do what the President said in his address to the joint session of Congress by subtracting $2 trillion for debt reduction, which is something I support, and then if we keep our word on the lockbox, $2.5 trillion in Social Security trust fund and $400 billion in the Medicare trust fund, you are down to $700 billion. And then if you have a $1.6 trillion tax cut, you are back into a deficit situation. We did that before. I do not want to go back to the days of deficit spending, but I do want to work with the Chairman, the ranking member, and the other members of the Committee in having some reasonable tax cut proposal. Thank you, Mr. Chairman.

Mrs. HUTCHISON. Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Yes, the gentlewoman.

Mrs. HUTCHISON. Could I just say one point on the numbers. I think you are doubling up on the debt reduction and the Social Security lockbox and that is where you get the deficit.

Mr. MCNULTY. And I want to respond to that, because I still have time, then. That is the same rhetoric we keep hearing, and my good friend from Louisiana makes that point, too. But when I talk about the Social Security trust fund, I am talking about the cash. The President of the United States said in a meeting directly with me that he wants to take care of these funds and he said that it is a crisis that we are facing in the years ahead, especially when the baby boom generation retires.

Now, we cannot solve that problem, Senator, by putting a bunch of IOUs in that lockbox. In that lockbox to me means money, and if we stop stealing the Social Security trust fund money, which we have been doing for 30 years—and listen, Senator, I am an equal opportunity critic on that, because during most of those years, we had Republican Presidents. During most of those years, we had Democratic Congresses. If we want to point the finger, there is enough blame to go around for everybody.

That is not what I am about. I am talking about the future. I am talking about avoiding this crisis that we are talking about in the future with regard to Social Security, and the best way to do that, Senator, is to stop stealing the money.

Mrs. HUTCHISON. Mr. McNulty, I would just say that you have to use accurate math, and part of paying down the debt is in the Social Security side and you just cannot double count it.

Mr. MCNULTY. We have another whole $1 trillion, Senator, that we owe to the Social Security trust fund from before. This is the projected surplus in the fund we ought to leave there to take care of this impending crisis. And on top of that, we still owe $1 trillion to the fund in IOUs. Let us not put more IOUs in the box. Let us leave the cash in the box.

Mrs. HUTCHISON. I would just say, if you are looking toward the future, paying down the debt and strengthening Social Security is an important part of this whole package.

Mr. MCNULTY. Senator, somebody is using the money twice, but it is not me.

Chairman THOMAS. Does the gentleman yield back the balance of his time?

Mr. MCNULTY. I do, Mr. Chairman.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Florida wish to inquire?

Mr. FOLEY. Thank you very, very much, Mr. Chairman. I am indeed sorry I missed the bipartisan retreat. I wonder if the moderator was Jerry Springer.

Mr. Weller, you sound like you are interested in obviously eliminating the marriage penalty, but you also sound like you are willing to compromise with the President. Is that what I hear you say today?

Mr. WELLER. We, of course, not only want to work with the President to eliminate the marriage tax penalty, but we also want to make it a bipartisan effort, and that is why I appreciate the good work of Mr. Barcia and his colleagues on his side of the aisle, our colleagues on his side of the aisle who are working with us.

The bottom line is, the President has a plan. It eliminates about half the marriage tax penalty. Many of us believe we can and should do more. We believe it will fit in the framework of the $1.6

trillion in tax relief over 10 years, and we have got a $5.6 trillion surplus of extra tax revenue. The President proposes taking a portion of that, essentially less than one-fourth, to provide tax relief, and a key part of his tax relief proposal not only is helping our economy, but also bringing fairness to the tax code.

I, for one, and I know many in this House agree that the most unfair consequence of our complicated tax code is the marriage tax penalty. It is just wrong that 25 million couples pay $1,400 more in higher taxes just because they are married. My hope is that we will continue to have bipartisan support. I would note that 51 Democrats voted for the proposal that every House Republican voted for this past year, and unfortunately, the previous President vetoed it.

But we have a new President who, at the time that President Clinton vetoed our effort to eliminate the marriage tax penalty, said had the same bill reached his desk and he was sitting in the Oval Office, he would sign it into law. Of course, H.R. 6, the base bill that we have before you today, is legislation that President Bush said he would have signed had he received it had he been President last August.

Mr. FOLEY. Mr. Barcia, we have heard a lot this morning about failure to have a budget before we consider tax relief. Can you tell me what was in the thinking of the Democratic Caucus when they offered a substitute proposal last week, because it would seem to me if the budget is the hold up and they are accusing us of constructing this fictitious document of tax relief without a budget, how did your side come to the floor with an alternative proposal?

Mr. BARCIA. I think the feeling was that the expenditures would be less, but I understand your point, and perhaps some Members of the Committee might——

Mr. POMEROY. Will the gentleman yield?

Mr. BARCIA. Sure.

Mr. POMEROY. We constructed our alternative within a framework that allowed one-third of the projected surplus for progress on eliminating the debt, one-third for tax relief for the American people, one-third held in contingency in case these 10-year projections do not all come in, as well as for the critical investments that we made. So we recognized it was out of order, but we felt that at least trying to get it back into a framework that allowed a balance was the appropriate way to proceed.

Mr. FOLEY. Reclaiming my time, so it was a political response. Nobody wanted to be outside the box. No one wants to go home on Sunday to tell your Members of the congregation you voted against marriage penalty.

Senator, during the debate on capital gains reduction, I remember Mr. Rubin and Mr. Clinton and others roundly criticizing us, saying if we cut capital gains, it would have a huge effect on the economy. We would blow up the deficits. We would cause irreparable damage to the economy. Was not the response of the reduction of capital gains the opposite? Was it not stimulative? Did we not see income to the Treasury that was dramatic and increasing revenues to the Treasury?

Mrs. HUTCHISON. That is correct, Mr. Foley. It was the opposite. There was not only no loss, there was actually a gain in revenue

when capital gains were lowered and many people are talking about adding that to a tax cut package because we do need a response, as Mr. McInnis pointed out, to the real crisis we are facing in our economy. It has been shown that lowering capital gains taxes is a positive factor and I think it would give a lot of people more incentive to invest and save.

Mr. FOLEY. And we have studied, obviously, the economic projections. We have looked very carefully. We have used CBO, OMB in order to determine the scope of our initiative today, have we not?

Mrs. HUTCHISON. Well, of course. We would not be talking about tax relief if we had not had growing surpluses being put forward. In fact, when we first started talking about tax cuts, the surplus was $3 trillion. Now it is $5.6 trillion, and the surplus for this year is also being now looked at and revised upward toward $90 to $100 billion this year. I hope we can front end load some of these tax cuts.

Mr. FOLEY. Thank you, Senator. How many Democratic cosponsors are there of this initiative on marriage penalty? Are you——

Mr. BARCIA. We lost two recently. We have, I think, close to 40–50—excuse me, 15. We expect more to join when we see the actual language that is reported from the Committee.

Mr. FOLEY. So there is bipartisan support, no question?

Mr. BARCIA. There will be, and as I think Congressman Weller pointed out, 51 Democrats last year on the floor voted for it. I think as more discussion occurs on the issue of the fairness of the marriage penalty, or the unfairness of the marriage penalty, perhaps we will be joined by more Democrats. We have some new Members that may be lending their support, as well.

Mr. FOLEY. I want to thank you all for your courtesy today and for your complete answers and for your testimony.

Chairman THOMAS. Does the gentleman from Louisiana wish to inquire, Mr. Jefferson?

Mr. JEFFERSON. Yes, briefly, Mr. Chairman. Thank you for the allowance.

Mr. Weller, let me ask you, I suppose you have looked at President Bush's proposal in this area compared to your own. What do you think are the major shortcomings, if there is one, or the major shortcoming, if there is only one, of President Bush's plan as opposed to yours with respect to attacking this question?

Mr. WELLER. Thank you, Mr. Jefferson. I think to begin with, number one, I think it is important to acknowledge we have a President who wants to address the marriage tax penalty and that is progress. The President's proposal, which provides a second earner deduction, essentially would eliminate about half the marriage tax penalty for the average couple who is able to use the second earner deduction.

Many of us feel we need to do more, and the proposal, the bipartisan proposal in H.R. 6 that we are presenting today would essentially wipe out the marriage tax penalty for the vast majority of those who suffer it. I would point out, it is phased in. It will not happen immediately. But under our proposal, we, of course, provide for a doubling of the standard deduction, which will help those who do not itemize. That would be available immediately. We propose phasing in a widening of the 15 percent bracket so that joint filers

could earn twice as much in the 15 percent bracket as single filers, and those who benefit from this, and this is why it is so important that we widen the 15 percent bracket, are those who itemize, who are homeowners. You give to your church or your synagogue or own a home, you itemize your taxes.

Mr. JEFFERSON. Before my time is gone on this, I am satisfied with your answer so far. Which half of the taxpayers are left out from the President's proposal? Is it not the tax that is on the lower end of the income scale and is it not the half, really, that needs this relief the most?

Mr. WELLER. The President's proposal would benefit all those where you have two-earner households. So if you have a lower moderate income family with two earners in the household, they would benefit from the President's proposal. But I would point out that in the proposal that we offer, we not only double the standard deduction and widen the 15 percent bracket, but we also help those who utilize the earned income tax credit because there is a marriage tax penalty under the EIC and we adjust the eligibility threshold for joint filers, eliminating the marriage tax penalty for them, and that will help those who suffer the EIC.

And last, if I could, just to complete the description of the bill, we also address any AMT consequences that would occur from the adjustments we make in the tax code.

Mr. JEFFERSON. Do you not think if we are going to provide relief here and if the President is only going to let us take care of half of the married couples that we ought to take care of the half that needs this help the most? Your bill does do, as you just pointed out, some things through EITC, which, of course, is going to be helpful to that lower end of the income scale. We are going to end up with this bill being slanted, as we did with the rate adjustments, geared more to people who are the upper income and that is not where we should be going with this, I do not believe, Mr. Weller. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Texas wish to inquire?

Mr. BRADY. Thank you, Mr. Chairman. I want to thank Congressmen Weller and Barcia for your leadership in this effort and I want to also welcome my Senator, Kay Bailey Hutchison, to the Committee. I also, Senator, want to apologize for the conduct and behavior of my colleague specifically from California. As you know, sometimes when your argument lacks substance and intellect, you resort to rudeness and interruption and badgering a witness.

Now, you are a Senator from a major State. You have been involved in eliminating the marriage penalty long before some of our born-again repealers have gotten involved. You know how people act. But what bothers me is the thought that there may be young people in this Committee room, or because our hearings are so often televised, watching on TV, who think that some of the leaders of our Nation with such big responsibility can be so small in stature. So let me apologize again to you.

I am somewhat astonished at the point that keeps being raised and demanded of you, where is the money, stop stealing our money. I know that there is quite a bit of dollars in this budget.

I cannot tell you exactly where it is, but I can tell you where it has gone.

I know that we went on a $50 billion spending spree the final weeks of Congress up here, not that we do not need another Lawrence Welk museum, not that the "big dig" should not soon approach the cost of the international space station, not that we should not—and this is what we did—we actually funded a program to give lifelong housing and health care to chimpanzees who have been used in research. Lifelong health care and homes for chimpanzees, but not a dime for the long-term reform of Medicare. How dare we demand from you where the money is. I think the taxpayers ought to be demanding from us, where is our money? Where are your priorities?

It seems to me we finally have a President who has said, we cannot go on a spending spree. If we say no to a program, Washington, D.C. will not slide off into the Potomac, and we have got a President who understands first things first and that he has put his priorities together.

So I appreciate the fact that you are trying to restore fairness to our Tax Code. It is wrong to tax people more for being married. And yes, we do have the money to restore fairness. Thank you, Senator.

Mr. HERGER. Would the gentleman yield?

Mr. BRADY. Yes.

Mr. HERGER. Thank you. I want to thank the gentleman from Texas for pointing out how we have not managed many of our tax dollars in the past, and I would also like to point out another distinction and that is we have heard from some of our good friends on the other side of the aisle that they think perhaps this tax reduction, allowing people, couples like we see over here that are married, that are paying a penalty of $1,400 a year more than they should, that somehow we are allowing them to keep too much. One-point-six trillion is too much, we hear argued, and I would argue that it is not nearly enough. If we put it into perspective of what other tax reductions have been over the years, and as the gentleman knows, in 1963, the Kennedy tax reduction, this is only half of what it was equivalent to that time, or in 1983, the Reagan tax reduction is one-third of what it was equivalent at that time. And so if anything, during this time of turmoil in our economy, if anything, the taxpayers, this couple and every other couple that is married that is being penalized——

Mr. MCNULTY. Would the gentleman yield?

Mr. HERGER. We should allow them more. It is not my time to yield, but I appreciate your bringing it out and I yield back my time to the gentleman from Texas, who controls the time.

Chairman THOMAS. Does the gentleman from Tennessee, Mr. Tanner, wish to inquire?

Mr. TANNER. Thank you very much, Mr. Chairman. I would just like to make the observation that we are being asked to vote on a tax plan that is phased in over 5 or 6 years based on 10-year projected numbers. However one puts the pieces together, that is what we are being asked to do.

Now, the uncertainty of this 10-year projection is unassailable, in my view, by any reasonably sane human being. Nobody knows

what the next 10 years hold for this country. People are surprised when you tell them that only 29 percent of this 10-year projection is supposed to even show up here in the next 5 years. Last year, we spent $205 billion in interest checks we wrote. All of the corporate income taxes in the country amounted to $207 billion. Said another way, all of the corporate income taxes that corporations in this country pay go to pay nothing but interest. Over 20 percent of every dime that we send in personally, in our personal income tax returns next month, will go, 20 percent or a little better, to pay nothing but interest on the national debt.

Now, when we are talking about why we need a budget first, if we do not have a budget, everything fits. Now, the Secretary of the Treasury was over here 2, 3 weeks ago. He said $1.6 trillion is the number for the tax cut, and if I cannot hold it to that, I ought to leave town. Those are his words, not mine. The Chairman of the Budget Committee a couple of days ago said $1.6 trillion is merely the floor. The Majority Leader a couple of days ago said the $1.6 trillion figure is irrelevant. Without a budget, everything fits.

Now, in the President's plan, we do not have, for example, the alternative minimum tax provisions that many of us think ought to be included. We added over here to his plan a retroactive feature to the marginal rate reductions that cost $150 billion to as much as $300 billion, depending on who you talked to and how quickly it is phased in. We do not have in the President's plan Portman-Cardin, which I think will do more for this country in terms of aligning people to put aside $5,000 into an IRA account and make a tax deduction on their tax return for that. I think that is much more valuable to working people than a marginal rate reduction for some guy that makes $50 million playing basketball or baseball, but that is another question we could talk about.

I believe that a 100 percent self-employment deduction for health care insurance premiums is a great boon to this country, just as the saving rate would be increased by Portman-Cardin, but this would allow people to deduct for health insurance premiums. We desperately need more money in the health system. People are talking about a capital gains reduction. That is not in the President's $1.6 trillion.

So my point is, all of this discussion is terrific. All of us want a tax cut of some kind, but without a budget, all of this stuff fits and all of us know that it cannot. So when people say, well, we need a budget passed in the House, we do need a budget passed in the House, but that is like taking a dollar bill and tearing it in half. You have got to have the other half, and that is the Senate budget resolution, before you have a dollar to spend. That is not going to occur for another couple of months.

So what some of us have asked, and begged for, really, in many respects, is we are interested in marginal rate. We are interested in everything the President has got. We are interested in marriage penalty. We are interested in AMT. We are interested in R&D extenders. They are not in the President's plan. Everybody knows we have done it forever. It is good for business in this country. It keeps business and laboratories in this country. It ought to be done.

But without a budget, again, to sound like Johnny one-note, everything fits and we all know that it cannot and we all know that we have this cloud of debt hanging over the country. I have argued that as long as we are paying 14 cents out of every dollar in interest on this country, people in this country, including our children, are going to be overtaxed. They have to be because they are dragging around this mortgage on their backs.

Now, I do not know that we can do anything about it today. I commend you fellows and Senator Hutchison for being here this morning. I would hope that you would see the wisdom of what some of us are trying to say as it relates to a universe, a business plan, a budget, so that we can make the tradeoffs between the marriage penalty, between R&D, between capital gains, between Portman-Cardin, between whatever you want to put in it. But until we reach that point, we are being asked to vote on tax measures that are based on 10-year projections phased in over 5 or 6 years, and that is a very, very difficult position to be in. Thank you.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Wisconsin wish to inquire?

Mr. RYAN. Yes, Mr. Chairman. I just wanted to commend my colleagues for coming here today. Hopefully, this can continue to be a bipartisan issue. I was blessed with the ability to be married 3 months and 19 days ago, so I would like to just voice my support for a chairman's mark that eliminates the marriage tax penalty retroactive to December 2, 2000. If that is possible, I would be for that.

But in all seriousness, I am learning how this Committee works. This is a good lesson today. I am concerned about some of the rhetoric I hear in this Committee. Hopefully, we can still work together to pass things that I think we all basically believe in, and Mr. Barcia, seeing you here today is a great thing because it tells me that in the United States Congress, in our conferences, there is broad and deep bipartisan support. It is not a Republican issue. It is not a Democratic issue. It is an issue of fairness to repeal the marriage penalty. So I hope that when this bill gets to the floor of the Congress, those principles and that support will be reflected, and thank you for your participation today.

Chairman THOMAS. Does the gentlewoman from Florida wish to inquire?

Mrs. THURMAN. Thank you, Mr. Chairman. Mr. Weller, I want to go back a little bit and let us talk about what happened last year, because I think it is important because I think we are losing or leaving out some very important steps that took place.

Last year, if I remember correctly, the total of your bill was somewhere around $283 billion. Is that about right, by the time it got to the floor?

Mr. WELLER. The conference report.

Mrs. THURMAN. Okay, and then there was a substitute that was offered on the floor for marriage tax penalty, is that right?

Mr. WELLER. You are talking about the Democratic substitute?

Mrs. THURMAN. Correct.

Mr. WELLER. Yes. The Democratic substitute only addressed marriage tax penalty for those who do not itemize. So if you are a homeowner, they would have been left out under the substitute.

Mrs. THURMAN. But some believe that it was fixing the penalty and not going beyond the penalty.

Mr. WELLER. Well, if you actually analyze that proposal, the alternative failed to help millions of middle class married couples who are homeowners, and because they are homeowners, they itemize their taxes, and the only way to help those who itemize their taxes is actually to broaden the bracket itself, and that is why we proposed broadening the 15 percent bracket so that joint filers could earn twice as much as a single filer and stay in the 15 percent bracket. That will help those who give money to church and charity. That will help those who itemize their taxes because they own a home.

Mrs. THURMAN. And point well taken, but on the other side of it, it did help us with a marriage tax penalty. I mean, you cannot deny that there was. And that was about $90 billion, if I remember correctly. This year, you have the President who has put in one for about $100 billion.

What I am concerned about is the way this debate is characterized. We could have had a marriage tax penalty bill passed and signed into law, maybe not everything you wanted, certainly not everything that everybody wanted, but one that would have done something for married couples. Mr. Barcia, would you agree with that?

Mr. BARCIA. Well, I think there is sentiment in our caucus to address some of the inequities in the marriage context.

Mrs. THURMAN. But the fact of the matter is, we got the signal from the President that, in fact, he would accept some compromise on this piece of legislation that many of us—all of the Democrats on this Committee—voted for, both in this Committee and on the floor. In fact, 198 Democrats voted for this bill on the floor to try to take care of a marriage tax penalty.

So in the spirit of bipartisanship and in the spirit of moving ahead, we could have had a bipartisan bill if we would have had some Republicans come over to the other side and help support a bill that would have gone to the President that would have been passed——

Mr. WELLER. Could I respond?

Mrs. THURMAN. And we could have been back up here this year, maybe extending it with the other tax bills, because we are all talking about brackets again. We are doing an awful lot of the same kind of thing that might have been accomplished in the bill last year.

But let me just suggest to all of us that while neither one of those bills passed, neither one of them were signed into law, the fact of the matter is, the American public still became the beneficiary of these bills not passing because we took those dollars of tax cuts that were not spent and we put them in paying down the debt. So we helped every American family in some ways.

But I just did not want it to be characterized that the marriage tax penalty was and could not be passed. This is an art of compromise. There is not a constituent in this country that does not understand that. The difference is, in bipartisanship, there becomes compromise. Bipartisanship is not just taking one side and not having another being able to participate. Thank you.

Mr. WELLER. May I respond?

Chairman THOMAS. Sure.

Mr. WELLER. Your point is well taken. I am very proud that this Congress has paid off $600 billion in national debt and we are on track to eliminate the available national debt by the end of the decade. I am proud of that and that was a great accomplishment we can all be proud of.

And as you pointed out, there was an alternative which was supported only by one party, and I would note that the proposal we have brought before the Committee today in H.R. 6 is the proposal which received bipartisan support. H.R. 6 received the votes of 51 Democrats as well as all Republicans, so you had support from both sides of the aisle under this bill. It went through the House and Senate. There were a half a dozen or so Democrats in the Senate that voted for this proposal.

So we have kind of vetted it through the process, and when it comes to marriage tax penalty, there are about 63 different consequences in the code and that consequence suffered by joint filers is the biggest marriage tax penalty and that is what we addressed, as well as the earned income credit marriage penalty, in our proposal.

So I believe that the proposal we have before you today in H.R. 6 is the bipartisan proposal, and the fact that we have 15 Democrats under the leadership of Mr. Barcia that have joined as original cosponsors of this bill, we have almost 230 members of the House cosponsoring this legislation, I think we have a tremendous opportunity with a President who said he would have signed it into law now, that he would sign H.R. 6 once we put it on his desk. So I appreciate the opportunity to discuss this. Thank you.

Chairman THOMAS. The gentlewoman's time has expired.

Does the gentleman from Texas wish to inquire?

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

Chairman THOMAS. I would tell the Committee that it appears as though we have a four-vote sequence. The gentleman from Texas will probably be the last inquirer on this panel. I will make sure that the other gentleman from Texas and the gentleman from North Dakota will be the first inquirers on the next panel, and I apologize because somebody else controls the time. The fact that we have multiple Members from States indicates that I was referring to the Republican following the Democrat, the gentleman from Texas, Mr. Sam Johnson.

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

Mr. Brady, that is my Senator. She is yours, too, and yours too, Doug, and she is a great one and a great representative for the State.

Listen, I just want to tell you guys, we are arguing about peanuts here. What we have got is tax relief for married couples and it applies across the board. We are not trying to reduce taxes for those people who do not pay any taxes. We are trying to reduce taxes for people who pay taxes—families, people with children, husbands and wives, whether they work or not. And I think that it is something we have to do for America.

They talk about Portman-Cardin. We are going to do Portman-Cardin. It is just not in the tax bill that we are talking about

today. It is not in the President's proposal that we are talking about today. We need to work with this administration, we need to work with the United States Senate, people like Senator Hutchison who can get the job done, and pass marriage penalty relief. I do not think it makes a tinker's dam whether we have a budget or not. You guys are focusing on the wrong thing. The emphasis ought to be on tax relief for the American people because we have a tax surplus out there and the people of America need their money back. Would you agree, Ms. Hutchison?

[Laughter.]

Mrs. HUTCHISON. Since you are my Congressman, I agree wholeheartedly.

[Laughter.]

Mrs. HUTCHISON. Certainly, I do appreciate so much the comments of everyone. I think that it is very clear that if there is a priority for tax relief, the inequity in the tax code should be addressed, and that is the marriage penalty tax. We are not even talking about lowering taxes. We are talking about bringing equity back into the tax code for people who get married. And I think it should be marriage penalty relief for people who are two working people getting married or for two people who are married and one spouse is staying at home raising children. We are paying too much in taxes and people deserve to have the relief, and I thank you for the support and I know this Committee is going to do what is right.

Mr. JOHNSON OF TEXAS. Thank you, Senator, and thank you, Mr. Chairman. I yield back the balance of my time.

Chairman THOMAS. I thank the gentleman.

I do want to thank this panel, especially for their perseverance. The chair will indicate that we will now go to a series of votes and the chair intends to reconvene the hearing about 5 minutes after the last vote has ended. The Committee stands in recess.

[Recess.]

Chairman THOMAS. The Committee will reconvene. Our guests will find their seats, and if we can find Mr. Donovan. Dr. Primus, our biorhythms are much more in tune with the Committee based on the years you spent with us. Thank you very much, Mr. Donovan.

Our next panel consists of Charles Donovan, Executive Vice President of the Family Research Council, and Wendell Primus, Director of Income Security, Center on Budget and Policy Priorities, a longtime staff member, someone who should be familiar with most of us.

With that, I would indicate to each of you that any written statements you may have will be made a part of the record and you can address us in the time that you have in any way you see fit. We will start with Mr. Donovan and then go to Dr. Primus.

Mr. Donovan.

STATEMENT OF CHARLES A. DONOVAN, EXECUTIVE VICE PRESIDENT, FAMILY RESEARCH COUNCIL

Mr. DONOVAN. Thank you, Mr. Chairman. I want to thank you and the Members of the Committee for holding this hearing on marriage penalty relief. This time of year, we watch the National Collegiate Athletic Association tournament with some wonder, and

one of the phrases we will undoubtedly hear is about teams that do not make it all the way to the championship game or make it and do not win the game. And the cliche that is applied to them is they are always a bridesmaid and never a bride.

I think there is some feeling with respect to marriage penalty relief that the proposals that have been advanced over the last 5 years qualify as bridesmaids. We have had several proposals, as Senator Hutchison outlined this morning, that have made it through the Congress and all the way to the President's desk. We believe that there is really no more urgent cause in the tax code, no more urgent need than to provide relief from this penalty for married couples.

The bill last year fits, we think, very nicely with the ambition of finding this relief for married couples, regardless of the work arrangements they may make in order to earn the income their families require. Last year during the political campaign, now-President Bush indicated that if he had been in the Oval Office when the legislation that passed Congress last year had reached his desk, that he would have signed it. He asked the rhetorical question, what kind of tax code imposes a penalty on a couple for deciding to get married, and his answer was, a bad tax code does that.

Vice President Cheney on another occasion in debate about marriage penalty relief indicated his concern that the tax code not do too much to require certain behaviors on the part of couples or individuals in order to earn a tax benefit. It is for that reason, that specific reason, that we believe that marriage penalty relief should make no distinction between and among the multifarious work arrangements that couples make in order to earn the income they need to support their household and raise their children.

There was in the middle of the 1990s a pretty considerable debate about the "mommy track," about whether or not it was better for a mother to be in the home, at what ages for the children this was best, and so forth. We believe that there ought to be a truce called in that debate, and maybe in some ways there has been. The real issue is marriage and whether or not our tax code—and it does, in fact, now—continues to provide a disincentive to marriage.

The urgency is apparent in the birth data that we continue to see. There are some 30 percent of all children who are born without benefit of a father married to the mother. When you throw in family disintegration, something like four out of ten children will face a period in their lives when they will not have a father in the home. The costs exacted on society in the well-being of children, in economic costs, in educational deficits, and there is considerable evidence with respect to delinquent behavior among adolescents, all of these things suggest that there are considerable cost impositions on the failure to deal with the need to encourage marriages to occur and to stay together. Tax policy obviously cannot do all of this, but it can do something, and the marriage penalty is the prime thing that it does.

The other reason we have to get away, in my opinion, from debates about how much and where work is performed by couples in a marriage is that in most cases, in most marriages, couples themselves go through cycles. When married, typically both husband and wife are working. Through the years in which children are

born, even the data now show that the vast majority of women raise children up until age five. And the work patterns after that may vary tremendously, from part-time work to tag-team parenting, where the couple makes sure that one parent is with the child at all times. All of these things are just evidence that there is no single family model out there for work relationships and, therefore, tax relief, in our view, the elimination of the marriage penalty ought to help all couples regardless of how they make their work and family arrangements.

We would urge that there be a generous effort to relieve the marriage tax penalty, that now, in these times of budget surpluses, is the time to take this step, and that it should begin with a decisive down payment on reclamation of the two-parent married household. We believe the time to act on these measures is now and we want to express our appreciation to the Committee for its interest in debating this subject and moving it forward. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you very much.

[The prepared statement of Mr. Donovan follows:]

Statement of Charles A. Donovan, Executive Vice President, Family Research Council

Good Morning, I am Chuck Donovan, the Executive Vice President of the Family Research Council, an organization representing some 450,000 families across the United States. Thank you for taking the time to consider my statement today regarding the position of Family Research Council on the need for marriage tax penalty relief.

The heart of family, the foundation of civilization, is marriage. As the institution ordained by the Creator for the begetting and raising of children, marriage has had special protection within the law and the culture; it is indispensable to civilized life. American society cannot survive if marriage ceases to be the normative way to raise children. When families collapse, communities collapse. The wreckage is all around us. The institution of marriage deserves the highest protection under the law. There are many ways government can help. One way is to treat marriage and married childbearing properly and favorably in the tax code.

As a matter of family policy, structuring taxes and other incentives so that they are available only for dual-earner couples contributes to the undermining of marital arrangements that most couples prefer. By discriminating against single-earner families, our tax code effectively dismisses the sacrifice the stay-at-home spouse makes on behalf of the family and society. In choosing to have one spouse stay at home families are penalized by the government, and the labor of love that this arrangement represents is subjected to a punitive tax.

The tax proposal put forward by the White House is replete with admirable pro-family and pro-charitable provisions, which we wholeheartedly embrace. Nonetheless, the proposal moves in the wrong direction on marriage penalty relief, and marriage is the key to perfecting the other pro-family provisions in the plan. Those who want to help strengthen marriages and families must abide by the rule of non-discrimination: they cannot make family benefits contingent upon both parents' participation in the workforce. While the proposed tax package, overall, provides many benefits to working class American families, the fact remains that it will have a negative effect on marriage as an institution. The marriage penalty provision picks and chooses which families get relief and which families do not. From our perspective, it would be better to do nothing about the marriage penalty than to do this.

We have this on good authority, Vice President Cheney made the same case during the Vice Presidential debate last fall, when he defended stay-at-home moms against his opponent's tax plan, "They discriminate between stay-at-home moms with children that they take care of themselves, and those who go to work who have their kids taken care of outside the home. You, in effect, as a stay-at-home mom get no tax advantage under the Gore plan." And again: "If you live your life the way they want you to live your life, if you do, in fact, behave in a certain way, then you qualify for a tax credit and at that point you get some relief." (10/5/2000, Centre

College, Danville, KY. www.c-span.org/campaign2000/transcript/debate__100500.asp, p. 7.)

I would argue that the proposal before your committee does the same thing that Vice President Cheney criticized his opponent for, that is, it provides incentives for certain behaviors. "It is a classic example of wanting to have a program, in this case a tax program, that will in fact direct people to live their lives in certain ways rather than empower them to make decisions for themselves." (10/5/2000, Centre College, Danville, KY. www.c-span.org/campaign2000/transcript/debate__100500.asp, p. 8.)

Is the purpose of fixing the marriage tax to accord long overdue socioeconomic respect for marriage as an institution fundamental to our society and to the raising of children? Or is the purpose to enable government to engage in national economic planning by using tax policy to influence human behavior?

Giving a tax cut only to two-earner couples would send the message that the government sees no value in a homemaker's work at home, that the role of a "nonworking" wife and mother is less socially beneficial (or less worthy) than paid employment. In fact, these spouses, primarily women, have sacrificed all of their income during this period in their lives and in their children's lives. They have foregone a second income and all the material advantages they might have conferred on their offspring. It makes no sense to increase their taxes merely because they stay home with their children.

This debate is not about money. It is a matter of right and wrong. Marriage is good for this country, and it's wrong that our tax code penalizes it. This is not so much a tax cut as it is a tax correction and correcting the problem is not complex.

There are several ways to eliminate the marriage penalty properly, without undermining marriage as an institution. The essential idea is to treat married couples as a single economic unit, just like other legally recognized economic partnerships, permitting them to share their income for purposes of taxation. The bill passed by Congress last year espoused this idea; a pro-marriage solution is available. The *Marriage Penalty Relief Act of 2000* incorporated the very important policy change of treating *all* married couples equitably, whether they earn one income or two.

This committee now has the same—indeed an even better—opportunity to provide substantial relief to millions of American families, while recognizing and supporting the vital contribution marriage makes to the betterment of society. Will your proposal treat all married couples and their multitude of work and family arrangements alike? It should. It is unfair to reject marriage tax relief for families who decide to have one spouse stay at home because they have decided to care for their children themselves, or because one spouse is unable to work, or because one spouse is pursuing higher education.

The current proposal for reducing the marriage penalty is modest, in purely economic terms. But in terms of family tax policy, it reinforces a policy denigrates some of the most important benefits marriage confers on society and the economy. More broadly, by moving toward an individual basis for taxation, instead of a family basis, the policy discourages the economic and personal interdependence that lie at the heart of marriage.

While there are 66 provisions in the tax code that produce marriage penalties, according to the American Institute of Certified Public Accountants, the standard deduction and the graduated rate structure combined cause 55.6 percent of extra marriage taxes. Because the standard deduction amount for joint filers is not twice that for those claiming single or head of household status, a married couple can deduct less money from their income than can an unmarried couple with the same combined income. The income thresholds that push taxpayers into higher brackets for joint filers are less than twice what they are for those claiming single or head of household status. This means that a married couple can be forced into a higher tax bracket than an unmarried couple earning the same combined income.

Since the marriage penalty is largely the result of inequities in the rate structure, the marriage tax penalty would be substantially reduced for all married couples by placing each bracket breakpoint for married couples at precisely twice the level for single filers. Expanding the standard deduction for married couples to twice the amount for singles would eliminate the marriage penalty for lower income couples and provide at least some tax relief for one-income families. This approach was taken last year and, according to the Congressional Budget Office (CBO), doubling the standard deduction alone would affect approximately 21 million married couples. Implementing these proposals would help to ensure that "no married couple is left behind."

Family Research Council strongly believes that a policy of tax fairness is no less important than the dollar figure attached to it. Any marriage penalty relief should apply equally to all married couples and all work arrangements. This principle of

equity was tested in 1995 when Senators Kay Bailey Hutchison and Barbara Mikulski advocated legislation allowing homemakers to contribute the same amount to an IRA as working spouses, thus treating working and "non-working" spouses equally. At that time, the limit had been $2,000 for a working spouse and $250 for a homemaker. Relying upon that same principle of equity, Congress should provide equal marriage penalty relief to single- and dual-earner couples. Tax fairness requires that relief from the marriage penalty apply equally to *all* married couples.

Most of you already know the history of the battle to eliminate the marriage tax penalty, but let me state for the record the work and the commitment of Congress on this issue.

In 1995, the House and Senate both passed measures to relieve the marriage penalty. The final version, doubling the standard deduction for joint filers to twice the amount single filers enjoyed, was included in a tax package which was vetoed by President Clinton.

In 1998, the House of Representatives passed reductions in the marriage penalty but the measure died in the Senate.

In 1999, Congress voted to reduce the "marriage penalty" by increasing the standard deduction for married couples to twice that for singles, and doubling the 15% bracket breakpoint for married couples to twice that of singles, this too was vetoed by President Clinton as part of a larger tax reduction package.

Last year, the House and the Senate passed, by overwhelming margins, marriage penalty relief, which included a doubling of the standard deduction and bracket adjustments to ensure that all married couples received marriage penalty relief. President Clinton vetoed this legislation. The bill passed by Congress last year, H.R. 6, serves as a good starting point for meaningful reform of the unfair marriage tax penalty. This approach has the support of the Family Research Council.

I urge the Ways and Means Committee to seize the opportunity before it. This is not the time for debate and competition among married couples who arrange their work and family time in an astonishing variety of ways. Congress passed the right marriage penalty relief in the recent past when the President's veto pen was at the ready. A new era is upon us, the revenue to do justice is at hand, and the ink in that pen has now run dry. It is time to act on behalf of marriage and to turn the tax code toward home.

Chairman THOMAS. Dr. Primus.

STATEMENT OF WENDELL PRIMUS, DIRECTOR, INCOME SECURITY, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. PRIMUS. Thank you, Mr. Chairman and Members of the Committee, for the opportunity to come back and testify today on two aspects of President Bush's tax plan, the expansion of the child tax credit and marriage penalty relief.

As you know, the President's proposal doubles the current child tax credit, but it provides no benefit to families who currently owe no income tax. It also makes eligible for the first time families with two children who have incomes between $130,000 and $300,000. Approximately 24 million children, 33.5 percent of all children in this country, would not benefit from this expansion of the child tax credit. Two-thirds of the children excluded from the expansion, almost 16 million children, live in families where earnings exceed $5,150, the amount equivalent to working half-time for the entire year at the minimum wage.

Fifty-five percent of African American children and 56 percent of Hispanic children would receive nothing from this expansion. And if you look at this by State, there are numerous States where over 40 percent of the children would not benefit, including Arizona, California, Georgia, Louisiana, New York, North Dakota, Tennessee, and Texas, for example.

A married family of $25,000 with two children gets nothing from this expansion, while such a family with $150,000 will get $2,000 from the child credit provision. This is because the President's proposal extends the child tax credit to many families with high incomes that currently receive no credit. The percentage of children left out under the Democratic proposal is significantly less, 14 percent versus 33.5 percent under the President's.

There are four reasons, Mr. Chairman, why working families that do not pay Federal income taxes should benefit from the tax legislation. The first is that in the context of a strong economy and the "make work pay" policies of EITC and child care, many single-mother families have responded to your welfare reform bill by working harder. Yet, their overall income gains have been small. They deserve an income boost.

For example, mothers in the second quintile of female-headed families, the second-to-lowest fifth, who have income between 86 and 127 percent of poverty, on average, increased their earnings by $4,600. Yet, their income only increased by $1,555. Female-headed families in the middle of that distribution, with incomes between 127 and 173 percent of poverty, also average earned about $4,550 more, yet their disposable income increased by less than 40 percent.

The second reason is that this approach fails to reduce high marginal tax rates that many of these low-income families face—and I know all the Members of this Committee are concerned about high implicit marginal tax rates. A large number of low-income families that confront some of the highest marginal tax rates of any families in the nation would not have their marginal tax rates reduced as a result of this proposal. It is one of the reasons that these families are working harder but their income gains have not gone up. I have an example in the testimony from Maryland where a mother who has child care expenses and increases her earnings from $10,000 to $15,000, her marginal tax rate is 70 percent. As her earnings increase from $15,000 to $20,000, she faces a 60 percent marginal tax rate.

The third reason is that these families owe other income taxes. They also owe State income taxes, gasoline, property taxes, and sales taxes. You can fix this by making the child tax partially refundable, let us say 5 to 10 to 15 percent of earnings up to the maximum credit allowed, or you could do this by changing the EITC. Phasing the EITC out at a lower rate would alleviate some of these marginal tax problems.

Finally, Mr. Chairman, as my colleague here at the table indicated, about a third of the births in this country are to unmarried women. Half of these children now come home to a two-parent unmarried family, but most of those families have very low incomes and would not benefit from the marriage penalty relief that is in the President's proposal.

So in conclusion, what I would like to say is our analysis finds that a third of these children do not benefit, yet these families pay taxes and face high marginal tax rates. Similarly, the proposal provides no marriage penalty relief to the families that face the highest marriage penalties as a percent of income and does nothing to equalize the tax treatment of marriage and cohabitation for a fam-

ily with children in the part of the income range where cohabitation rates are the highest. I would respectively urge the Committee to design alternatives that address those shortcomings.

Chairman THOMAS. Thank you very much.

[The prepared statement of Mr. Primus follows:]

Statement of Wendell Primus, Director of Income Security, Center on Budget and Policy Priorities

Mr. Chairman and Members of the Committee on Ways and Means: Thank you for the opportunity to testify today on two aspects of President Bush's tax plan—the expansion of the child tax credit and marriage penalty relief.[1] My name is Wendell Primus, and I am Director of Income Security at the Center on Budget and Policy Priorities. The Center is a nonpartisan, nonprofit policy organization that conducts research and analysis on a wide range of issues affecting low- and moderate-income families. We are primarily funded by foundations and receive no federal funding.

My testimony is divided into four sections. The first part of my testimony discusses the design of the Administration's expansion of the child tax credit. The second section addresses the question of whether a tax bill should benefit families raising children that do not currently pay federal income taxes. The third section examines other options for improving the tax code and assisting the working poor that are not reflected in the Administration proposal. The final section assesses the issue of marriage penalties.

I. Child Tax Credit Expansion is Inappropriately Designed

Under the Bush tax plan, the current child tax credit of $500 per child is doubled to $1,000 by 2006. Nearly all families that owe no federal income tax will fail to benefit from this expansion.[2] For a family with two children, eligibility for the child tax credit under current law ends at $130,000 of income for a married family with two children. The Bush plan would extend this limit to $300,000 for such a family.

Many Children Would Not Benefit from Expansion of the Credit

As a result of this design, an estimated 12.2 million low- and moderate-income families with children—31.5 percent of all families with children—would not receive any tax reduction from the Bush proposal.[3] Approximately 24.1 million children—33.5 percent of all children—live in these families. The vast majority of left-out families include workers.

Approximately two-thirds of the children excluded from the expansion—a total of almost 16 million children—live in families where earnings exceed $5,150, an amount equivalent to working 20 hours per week throughout the year at the minimum wage rate.

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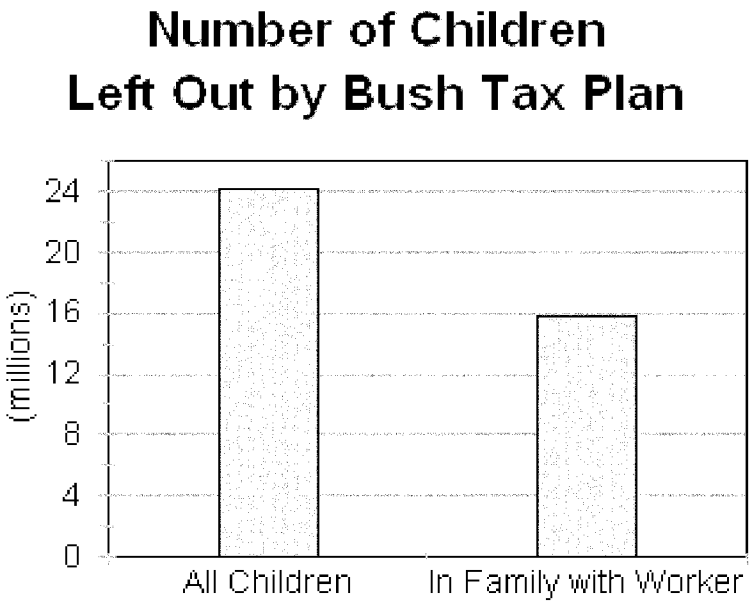
[1] This testimony draws heavily upon the work of colleagues at the Center, including Isaac Shapiro, Iris Lav, Nicholas Johnson, Allen Dupree, and James Sly. The analysis in the following Center papers contributed significantly to this testimony: *In Many States, One-Third to One-Half of Families Would Not Benefit from Bush Tax Plan*, *More Than Half of Black and Hispanic Families Would Not Benefit from Bush Tax Plan*, and *Alleviating Marriage Penalties in the EITC*. All papers are available online at www.cbpp.org.

[2] The exception is a limited number of cases including working families with three or more children that may claim some or all of the child credit as a refund. In such cases, the credit is limited to the amount by which the employee share of a family's payroll tax liability exceeds its EITC. IRS data show that only about 750,000 families benefitted from this provision in 1998.

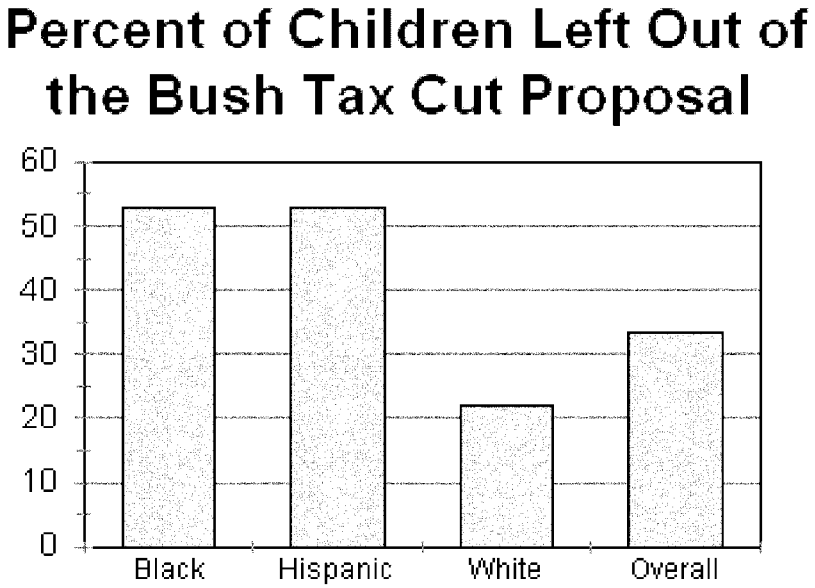
[3] The national estimates were prepared using the latest data (1999) from the Census Bureau. For the state estimates cited later, we used Census data from 1997, 1998, and 1999. The data for 1997 and 1998 were adjusted to simulate the current $500-per-child tax credit, and the combined data at the state level were slightly scaled to match nationwide estimates of the numbers of left-out families and children for 1999, the latest year for which CPS data are available. The resulting state-level figures may be considered accurate to within about 2 to 5 percent, depending on the state. For comparison, these figures are approximately as accurate as the U.S. Census Bureau's annual estimate of poverty rates by state, which also are based on three-year pooling of data.



Over One-Half of Minority Children Left Out of Bush Tax Plan

Among African-Americans and Hispanics, the figures are especially striking. While one-third of all children would not benefit from the Bush tax credit expansion, more than half of black and Hispanic children would not receive any assistance.

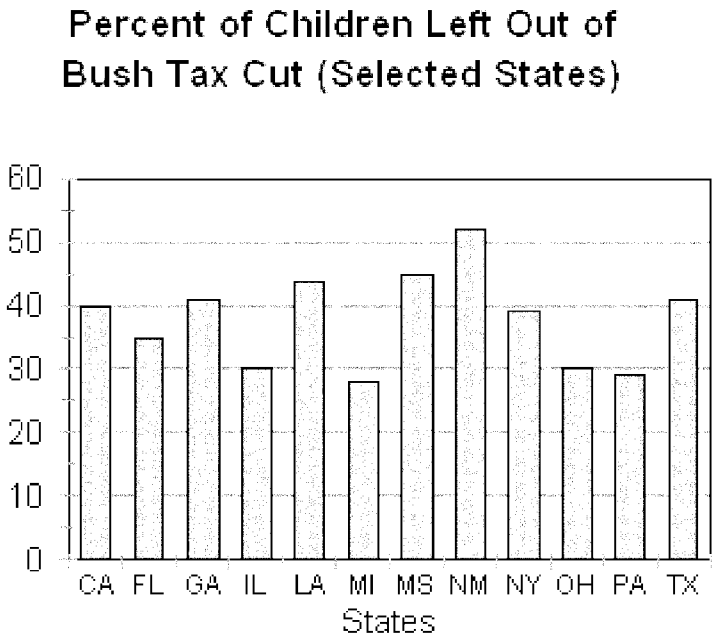
- An estimated 55 percent of African-American children and 56 percent of Hispanic children live in families that would receive nothing from the tax cut.
- Of the 24.1 million children living in families that would receive no benefit from the tax cuts, an estimated 10.1 million are non-Hispanic whites, 6.1 million are black, and 6.5 million are Hispanic.



In Many States, Families of One-Third to One-Half of Children Do Not Benefit

We have also estimated the number of families and children who would receive no assistance from the Bush tax plan on a state-by-state basis. As Appendix Table 1 shows, the figures indicate that throughout the country there would be substantial numbers of children left out of the plan. In some states, very high numbers of children and families would receive no benefit.

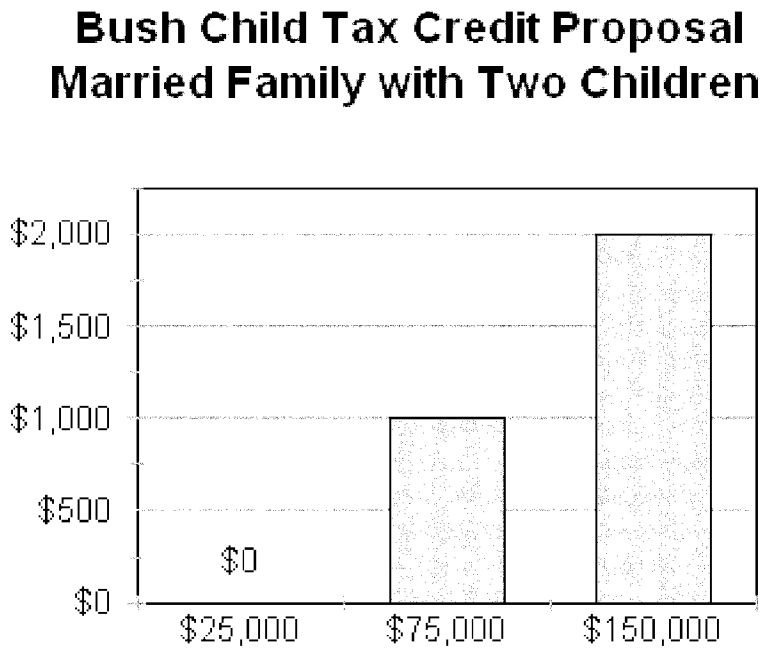
- An estimated 3.7 million children in California, 2.3 million children in Texas, 1.9 million children in New York, and 1.2 million children in Florida, along with their families, would receive no benefit from the tax proposal. In each of another eight states—Arizona, Georgia, Illinois, Michigan, North Carolina, Ohio, Pennsylvania, and Tennessee—the families of half a million children, or more, would fail to gain from the tax cut plan.
- Approximately 52 percent of children in New Mexico live in families that would not benefit under the tax proposal. Other states in which approximately 40 percent to 50 percent of children live in families that would not benefit include Alabama, Arizona, Arkansas, California, Georgia, Idaho, Louisiana, Mississippi, Montana, New York, North Dakota, Tennessee, Texas, and West Virginia, plus the District of Columbia. Not surprisingly, because the families that would be left out of the Bush plan are those with incomes below the poverty line or modestly above it, these states tend to have relatively high levels of child poverty.



The Bush Child Tax Expansion Particularly Benefits Higher-Income Families

While the proposal to double the child tax credit would be of little or no help to millions of children in low-income working families, it would provide the largest tax reductions to families with incomes above $110,000 and confer a much larger share of its benefits on upper-income families than on low- and middle-income families. The chart below illustrates this. A married family of $25,000 with two children gets nothing under the Bush child tax credit proposal, while such a family with $150,000 will receive $2,000 just from the child credit provision.

- Married families with two children in the $110,000 to $250,000 range would receive an increase in the child tax credit of *more than $500* per child. For many of these taxpayers, the child credit would rise from zero under current law to $1,000 per child under the Administration's plan.



This is because the Bush proposal extends the child tax credit to many families with high incomes that currently receive no credit, an outcome reflecting two aspects of the Bush plan. The plan both increases the point at which the child credit begins to phase out and slows the rate at which it phases out.

Under current law, the credit for a married family with two children phases out between $110,000 and $130,000. Under the Bush plan, when fully in effect starting in 2006, the credit for such a family would phase out between $200,000 and $300,000. This means that for a married family with two children:

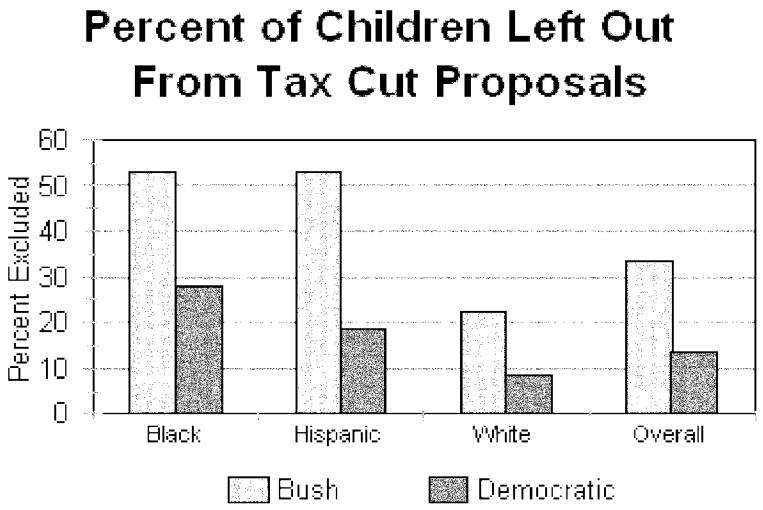
- All such families with incomes between $110,000 and $300,000 would get a larger credit than under current law.
- All such families with incomes between $130,000 and $300,000 would be made eligible for the credit for the first time.
- All such families with incomes between $130,000 and $200,000 would receive a gain of $1,000 per child under the Administration's proposal, for a total of $2,000; under current law they do not receive a credit.

The precise point at which the credit would drop back to zero would vary by the number of children in the family. The more children in the family, the longer it would take for the credit to phase out. If, for example, a high-income family has three children, the family's new child tax credit of $3,000 would phase out between $200,000 and $350,000. There are approximately three million children in higher income families who would benefit from the proposed increase in the income eligibility limit for the child tax credit.

In crafting its proposal to expand the child tax credit, the Administration faced a choice. It could propose increasing the size of the credit without explicitly changing which families are covered by it; it could propose extending the credit to more low- and moderate-income families; it could propose extending the credit to more low- and moderate-income families *and* to high-income families; or it could extend the credit only to high-income families. The Administration selected the fourth option. As a consequence, Center calculations based on data from the Institution on Taxation and Economic Policy data indicate that when the increase in the child credit is fully in effect, the 20 percent of families with children with the highest incomes would receive about 35 percent of the new tax cuts. The bottom 40 percent of families with children would receive less than 10 percent of the tax cuts.

Democratic Proposal Excludes Many Fewer Children

By expanding the Earned Income Tax Credit, the Democratic alternative tax cut proposal would extend assistance to many of the working families that will be left out of the Administration's proposal. Because the EITC is refundable, this approach would reach a greater share of children.



As the figure shows, the percent of children left out under the Democratic proposal is less than half the number left out under the Bush option. Some 14 percent of children live in families that would benefit under the Democratic alternative, as compared to 34 percent under the Administration's plan. Appendix Table 1 shows the differences in coverage by state. In almost every state, the Democratic alternative leaves out less than half as many children as the Bush plan.

II. Should Families with Children That Do Not Pay Federal Income Taxes Benefit from Tax Reduction Legislation?

The estimated cost of the child tax credit expansion over the next 10 years is $193 billion. The President has indicated that the rationale for expanding the child tax credit is not simply tax relief but "to help families rear and support their children." He also has placed a special emphasis on reducing marginal tax rates. This section will discuss why working families that do not pay federal income taxes should benefit from the tax legislation.

Many single mother families have responded to welfare reform by working harder. Yet their overall income gains have been small. They deserve an income boost.

A major theme of welfare reform has been to prod, assist, and enable families to work their way out of poverty. There is considerable evidence that welfare reform—in combination with a strong economy (low unemployment rates, increasing real wages) and "make work pay" policies (an expanded EITC and increased child care expenditures)—has significantly increased employment rates among single mothers and expanded their earnings. An analysis of Census data[4] shows that female-headed families in the second-poorest fifth of female-headed families (the 1.8 million families with incomes between 86 percent and 127 percent of the poverty line in 1999) increased their earnings on average by $4,574 between 1995 and 1999, after adjusting for inflation, an increase of more than 70 percent. Yet their disposable income increased only $1,555. Only one-third of their earnings gains were reflected in disposable income gains.

Female-headed families in the middle fifth (the 1.8 million families with incomes between 127 percent and 173 percent of the poverty line) had a similar experience.

[4] For a complete description of how the analysis was performed, see Appendix Table 2.

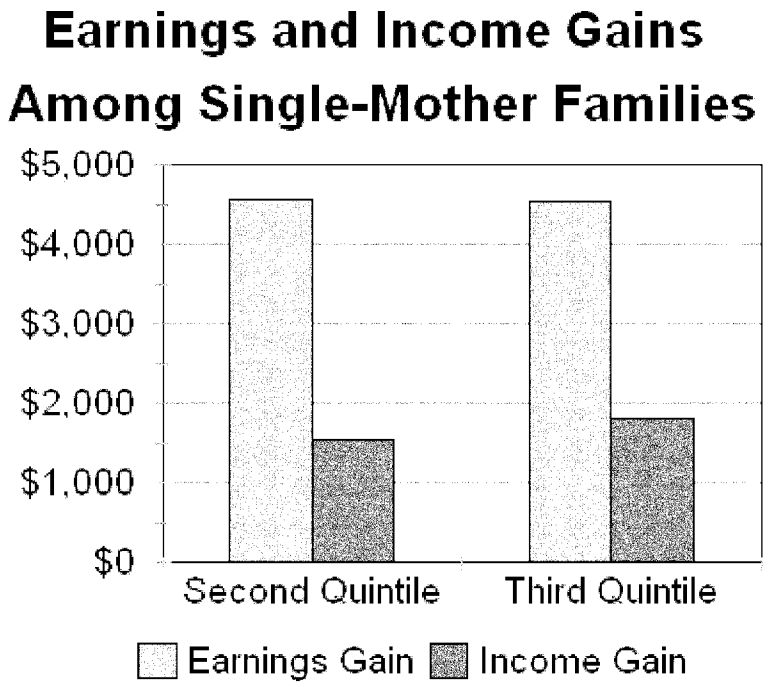
In the context of a strong economy, they responded to welfare reform and the "make work pay" policies by working more and earning an additional $4,550. Yet their disposable income increased by less than 40 percent of their earnings increase. It seems appropriate that these families receive an income boost.

Most of these families, however, will receive no income gain from the child credit expansion. No additional children will be removed from poverty as a result of the Bush tax plan. In contrast, approximately 200,000 additional children would be removed from poverty by the Democratic plan.

A study by the Manpower Demonstration Research Corporation finds that improving income—and not just employment—is important if the lives of children in poor families are to improve.[5] The MDRC report examined five studies covering 11 different welfare reform programs. The report's central finding was that increased employment among the parents in a family did not by itself significantly improve their children's lives. It was only in programs where the parents experienced increased employment *and* increased income that there were positive effects—such as higher school achievement—for their elementary school-aged children.

The Bush approach fails to reduce the high marginal tax rates that many low-income families face.

Throughout the presidential campaign and early into the new Presidency, President Bush and his advisors have cited the need to reduce the high marginal tax rates that many low-income working families face as one of their tax plan's principal goals. They have observed that a significant fraction of each additional dollar these families earn is lost as a result of increased income and payroll taxes and the phasing out of the EITC.[6] Yet a large number of low-income families that confront some of the highest marginal tax rates of any families in the nation would not have their marginal rates reduced at all by the Bush plan.



[5] Pamela A. Morris, et al., *How Welfare and Work Policies Affect Children: A Synthesis of Research*, January 2001.

[6] For example, for a family with two children, the size of the Earned Income Tax Credit is reduced by 21 cents for each dollar of income between $13,090 and $32,121.

Analysts across the ideological spectrum, including the Joint Tax Committee on Taxation[7] and the Congressional Budget Office, have long recognized that the working families who gain the least from each additional dollar earned are those with incomes between about $13,000 and $20,000. For each additional dollar these families earn, they lose up to 21 cents in the EITC, 15.3 cents in payroll taxes (including the employer share), 24 cents to 36 cents in food stamp benefits, and additional amounts if they receive housing assistance or a child care subsidy on a sliding fee scale, are subject to state income taxes, or have to pay income-related premiums for health insurance. Their marginal tax rates are well above 50 percent. Yet the Bush plan provides no marginal tax rate relief to them.

To a large extent, these high marginal tax rates are one of the reasons the income gains between 1995 and 1999 shown previously are so small relative to the earnings increases. (Another part of the reason is that in many instances, these families no longer receive food stamp and cash benefits to which they remain entitled.)

Gains in Disposable Income as Earnings Increase for a Mother with Two Children in Maryland				
Annual Earnings	$10,000	$15,000	$20,000	$25,000
Disposable Income	$17,903	$19,423	$21,414	$24,145
% of Earnings Gain Reflected in Disposable Income	NA	30%	40%	55%
Marginal Tax Rate	NA	70%	60%	45%

The table above is illustrative. It shows the income gains as earnings increase by $5,000 for a single mother with two children in Maryland. These examples (which are similar in other states) show that the implicit tax rates faced by these families are very high. If the purpose of the major provisions in the Bush tax cut is to decrease marginal tax rates for low-income working families, why don't the families facing the highest marginal tax rates in the nation receive any marginal rate reductions?

Many of these families owe federal taxes other than federal income taxes, often paying significant amounts

Since the reason that millions of families and their children would not benefit from the Bush plan is that they do not owe federal income taxes, some have argued it is appropriate that they not benefit. "Tax relief should go to those who pay taxes" is the short-hand version of this argument. This line of reasoning is not persuasive for several reasons.

First, for most families, the biggest federal tax burden by far is the payroll tax, not the income tax. Data from the Congressional Budget Office show that in 1999, three-fourths of all U.S. families paid more in payroll taxes than in federal income taxes. (This comparison includes both the employee and employer shares of the payroll tax; most economists concur that the employer's share of the payroll tax is passed along to workers in the form of lower wages. This is also the approach used by CBO and the Joint Committee on Taxation.) Among the bottom fifth of households, 99 percent pay more in payroll than income taxes. Low-income families also pay federal excise taxes and state and local taxes, which are discussed further on the next page. While the Earned Income Tax Credit offsets these taxes for working poor families, many families with incomes close to or modestly above the poverty line who would not benefit from the Bush plan are net taxpayers.

For example, a married family with two children and income of $25,000 would pay $3,825 in payroll taxes (again, counting both the employee and employer share) and lesser amounts in gasoline and other excise taxes. The family pays various state taxes as well. The family would receive an Earned Income Tax Credit of $1,500, well under half of its payroll taxes. As a result, even if just payroll taxes and the EITC

[7] Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to Marginal Tax Rates and the President's Individual Income Tax Rate Proposals*, JCX–6–01, March 6, 2001.

are considered, the family's net federal tax bill would be $2,325. Nonetheless, this family would receive no tax cut under the Bush plan.

Low- and moderate-income families in every state pay state and local taxes, often paying a larger percentage of income in such taxes than higher-income families.

Families with incomes below or near the poverty line bear substantial state and local tax burdens. These taxes commonly include sales taxes, excise taxes on such items as gasoline, property taxes (passed on by landlords to tenants in the form of increased rent), various tax-like fees, and sometimes state- or locality-specific taxes such as local taxes on wages. In addition, many states have income taxes that tax families at lower income levels than the federal income tax does. The Institute on Taxation and Economic Policy estimates that state and local taxes equal anywhere from eight percent to 17 percent of the income of an average low-income married couple, depending on the state. Furthermore, these burdens are inequitably distributed; in almost every state, lower-income families pay a larger share of their incomes in state and local taxes than higher-income families do.[8]

Although some states have taken steps to reduce the burden of taxes on low-income families in recent years, they are limited in their ability to do so. States that for many years have levied the sales, excise and property taxes that are most burdensome on the poor cannot simply eliminate those taxes without dramatic effects on state budgets. In addition, it can be cumbersome for states to target relief to poor families that are burdened by these taxes. For example, the sales tax is collected by merchants from consumers without regard to their income level, and property taxes are passed through from property owners to renters as part of a rent payment.[9] Moreover, states with higher levels of poverty often have the least fiscal resources with which to pay for tax relief for low-income families.

These state and local taxes that poor families pay often help finance federally required services or joint federal-state programs. For instance, state contributions to Medicaid typically are financed in whole or in part by general fund taxes such as state sales taxes and excise taxes. Similarly, state contributions to federal highway construction often are financed by gasoline and other motor vehicle taxes. In part because these and other federal programs rely on state and local taxes, it can be appropriate for the federal government to administer tax relief that helps offset the burden of those taxes.

III. Assisting Low- and Moderate-Income Families with Children

If a large tax cut is enacted, it should include, rather than leave out, low- and moderate-income families with children. The Committee could benefit low- and moderate-income working families in the following ways.

Make the child tax credit partially refundable

This could be done in a variety of ways. For example, a family with children might receive a tax credit of five percent to 15 percent of earnings up to the maximum credit per child. This would insure that low-income families with earnings receive assistance in raising their children. If a partially refundable child tax credit equal to 10 percent of earnings were enacted up to a maximum of $1,000 per child, only seven percent of children would be excluded from receiving any benefit. Some 1.1 million more children would be removed from poverty if the credit were designed in this fashion. In addition, this approach would lower implicit marginal tax rates significantly and give those mothers who responded to welfare reform an important income boost.

An alternative approach is one suggested by Belle Sawhill and Adam Thomas of the Brookings Institution.[10] This would provide a credit of 15 percent of earnings above $8,000. Such a structure encourages full-time employment and offsets some

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[8] Institute on Taxation and Economic Policy, *Who Pays?*, 1996.

[9] States that have income taxes do have the ability to enact refundable income tax credits that would help offset other taxes for poor families. Even the most generous such credits, however, offset only a portion of families' overall state and local tax burdens. In Minnesota, for instance, one of the two or three states that have made the most use of refundable tax credits and sales tax rebates, the Department of Revenue calculates that the overall state and local tax burden on low-income taxpayers exceeds 10 percent of income even after the credits and rebates are taken into account.

[10] Isabel Sawhill and Adam Thomas, *A Tax Proposal for Working Families with Children*, Policy Brief No. 3, The Brookings Institution, January 2001.

of the marginal taxes incurred by low-income working parents as they become ineligible for means-tested benefits.

Expansion of Earned Income Tax Credit

One important proposal is to provide a larger EITC benefit for families with three or more children. Congressman Cardin and others introduced this approach last year in the House. Senators Hatch, Jeffords, Breaux, and Rockefeller have advanced such proposals in the Senate. This idea is not a new one; in Wisconsin, a bipartisan group of state legislators designed and secured passage of a substantially larger EITC for families with three or more children a decade ago. Then-governor Tommy Thompson signed that legislation into law and has championed the Wisconsin EITC.

Recent research indicates the EITC has a powerful effect in increasing employment among single female parents and also that the EITC lifts more children out of poverty than any other program or category of programs. Nevertheless, the official poverty rate remains 24 percent for children in families with three or more children and 19 percent when the EITC and various non-cash benefits are counted. In both cases, this is more than double the poverty rate among children in smaller families.

Another useful proposal is to lower the EITC phase-out rate. As I pointed out earlier, families with two or more children earning between $13,000 and $20,000 face especially high marginal tax rates. The Administration's plan fails to reduce the marginal tax rates of these families because it does not expand refundable tax credits.

One approach the Administration could have taken in assisting these working poor families with high marginal tax rates would have been to reduce the rate at which the EITC phases down for families in this income range.[11] For families with two or more children that earn between $13,000 and $22,000, the phase-out rate could, for example, be reduced from 21 percent to 16 percent. For families with two or more children who have earnings above $22,000, the phase-out rate would remain at its current level. If this approach is coupled with EITC marriage penalty relief (described below), these EITC improvements would reduce marginal tax rates for a large share of low-income working families that face high marginal tax rates today and would get no relief from the high rates under the Administration's plan.

An alternative approach to reducing implicit marginal tax rates would be to link the phase-out of the EITC to the point where food stamp eligibility ends.

Other Important Steps to Help the Working Poor

Additional steps would help states in the next stage of welfare reform and support recipients as they make the transition from welfare to work. Funds to reduce the vast disparities in TANF resources available to states through supplemental grants are needed. Another important step that would benefit low-income working families would be to enact H.R. 4678, the Child Support Distribution Act of 2000, which passed the House last year by a vote of 405–18. H.R. 4678 would greatly improve and simplify the child support distribution system and ensure that children benefit more when their non-custodial parents pay child support.

Expanding health care coverage is another important way to support the working poor. Research has shown that expanding state Medicaid programs to cover parents also increases the number of low-income children protected by health insurance. Congress should consider expanding funding for the State Children's Health Insurance Program (SCHIP) and allow states to use SCHIP funds to extend coverage (either through Medicaid or through separate state programs) to low-income working parents (including noncustodial parents who pay child support), along with their children. This approach is preferable to a modest refundable tax credit for the purchase of health insurance.

IV. Marriage Penalties

The rise in the number of unwed mothers receiving low-income assistance over the last several decades and the increase in cohabitation has motivated policy-makers to question whether welfare and tax policies influence a range of decisions about family formation, including decisions to marry, have children, or cohabit. Conservatives (and liberals) have been troubled by these trends for many years.

About one-third of births in this country are to unmarried women. New research indicates that in approximately 40 percent to 50 percent of cases, those out-of-wed-

[11] Congressman Cardin and others proposed this change last year.

lock babies come home to a two-parent but unmarried family.[12] Based upon data from the Urban Institute, about half of these children live in families below 150 percent of the poverty level. The question is whether the tax and transfer system is creating incentives to form single-parent, cohabiting, or married families. The issue is not solely whether the families become married but also their choice of living together or living separately.

In a recent paper that I co-authored with Jennifer Beeson, we examined carefully the economic incentives in the entire tax and transfer system between those three choices for couples with children. Contrary to popular wisdom, the transfer system does not treat two-parent married families differently from two-parent unmarried families that have a child in common.

When economies of scale and the child support system are taken into account, this research shows that family income is maximized when the parents live together—either married or unmarried. If the economic incentives favor living together, what about marriage? Among these lower-income families, our research indicates that the transfer system treats married families and cohabiting families with children about the same, but the tax code does not. It favors cohabitation over marriage in many instances because of the marriage penalty in the EITC.

Research suggests that marriage penalties and bonuses in the tax code have little effect on marriage rates at any income level. To the extent that studies find any effect of tax considerations on the decision to marry, the effect on marriage decisions for every tax dollar foregone has been found to be very small. In some of the latest research, Ellwood finds that the combination of the Earned Income Tax Credit and welfare reform has encouraged single parents to work but has had no discernible effect on marriage or cohabitation.[13] Rosenbaum found that tax incentives *may* have an influence on decision to enter into marriage, but the magnitude of the effect is hard to measure. He also finds that it is unlikely that tax incentives influence a decision to end a marriage.[14] Nevertheless, there is much we do not know in this area, and public policy needs to signal strongly what it believes is best for couples (and their children).

The chart below indicates that couples with lower earnings (the income range where cohabitation is most frequent) face the highest marriage penalties. Under current law, a couple where each adult earns $10,000 faces a marriage penalty of 4.2 percent of income; this increases to 4.5 percent of the couple's income when each adult earns $20,000. The couple where each adult makes $30,000 faces a marriage penalty of less than one percent of income.

President Bush's proposal to reduce marriage penalties by providing an additional deduction for two earner married couples does not affect low- and moderate-income working families that have no income tax liability. The Administration does not make any changes to the Earned Income Tax Credit, which is the primary source of marriage penalties for families in lower income ranges. If as a society we want to signal that marriage is the best solution for raising children, why would we ignore the cases where the marriage penalties are the greatest, and where cohabitation is the most prevalent?

In the last session of Congress, virtually every major tax bill providing marriage penalty relief—including the bills that Congress passed and former President Clinton vetoed in 1999 and 2000—included a provision that reduced the marriage penalty for low- and moderate-income families receiving the EITC. Though the specifics were different, each bill reduced the marriage penalty in the EITC by increasing the income level where the EITC begins to phase-out for married couples, which is set under current law at $13,090 regardless of marital status. By raising this income level for married couples, the effect is to increase the amount of EITC a married couple can receive when its income falls in the phase-out range of the EITC schedule under current law.

- In 2000, the House increased the beginning of the EITC phase-out by $2,000 in H.R. 4810, while the Senate version of the same bill increased the beginning of the phase-out by $2,500. The conference report that passed both houses of Congress used the $2,000 increase from the House bill.
- In 1999, Congress increased the beginning of the EITC phase-out by $2,000 in its reconciliation tax bill (H.R. 2488).

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[12] McLanahan, Sara, Irwin Garfinkel, and Marcia Carlson, *The Fragile Families and Child WellBeing Study Baseline Report: Baltimore, Maryland*, 2000.

[13] Ellwood, David T., *The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements*, unpublished manuscript, 1999.

[14] Rosenbaum, Dan, *Taxes, the Earned Income Tax Credit, and Marital Status*, presented at the ASPE/Census Bureau Small Grants Sponsored Research Conference, Washington, D.C., May 18–19, 2000.

- Democratic alternatives to these Republican tax bills also included increases in the EITC for married couples, as does the current Democratic alternative.
- The Heritage Foundation, in a recently published book, calls for a larger effort to shrink EITC marriage penalties and has called on policymakers to devote $5 billion a year for this purpose. Isabel Sawhill of the Brookings Institution and David Ellwood of Harvard also have called for larger efforts to reduce EITC marriage penalties than last year's bills would have made.

The Administration's plan departs from the bipartisan consensus formed in Congress over the past two years to reduce marriage tax penalties for low-wage working families, not just for middle- and upper-income families. This is a serious deficiency that is difficult to understand.

V. Conclusion

This analysis finds that one-third of children would not benefit from the expansion of the child tax credit. Yet these families pay taxes, and face high marginal tax rates in many instances. Similarly, the tax proposal provides no marriage penalty relief to many families that face the highest marriage penalties and does nothing to equalize the tax treatment of marriage and cohabitation (i.e., to stop favoring cohabitation over marriage) for families with children in the part of the income range where cohabitation rates are the highest. I would respectfully urge the Committee to design alternatives that address these shortcomings.

Appendix Table 1. Non-Beneficiaries of Tax Cut Proposals: Children

	Administration Proposal		Democratic Proposal		Additional Children Assisted by Democratic Alternative	
State	# Children	% Children	# Children	% Children	# Children	% Children
Alabama	436,000	38%	195,000	17%	241,000	21%
Alaska	50,000	25%	20,000	10%	30,000	15%
Arizona	565,000	41%	185,000	13%	380,000	27%
Arkansas	276,000	40%	104,000	15%	172,000	25%
California	3,744,000	40%	1,421,000	15%	2,323,000	25%
Colorado	233,000	20%	95,000	8%	138,000	12%
Connecticut	191,000	21%	70,000	8%	121,000	13%
Delaware	70,000	34%	25,000	13%	45,000	22%
Florida	1,213,000	35%	462,000	13%	751,000	21%
Georgia	859,000	41%	362,000	17%	497,000	24%
Hawaii	108,000	33%	42,000	13%	66,000	20%
Idaho	138,000	40%	35,000	10%	103,000	30%
Illinois	985,000	30%	420,000	13%	565,000	17%
Indiana	390,000	26%	137,000	9%	253,000	17%
Iowa	201,000	28%	63,000	9%	138,000	19%
Kansas	201,000	30%	78,000	12%	123,000	18%
Kentucky	326,000	35%	159,000	17%	167,000	18%
Louisiana	496,000	44%	219,000	19%	277,000	24%
Maine	90,000	29%	47,000	15%	43,000	14%
Maryland	255,000	21%	107,000	9%	148,000	12%
Massachusetts	471,000	31%	244,000	16%	227,000	15%
Michigan	807,000	28%	356,000	12%	451,000	16%
Minnesota	297,000	22%	138,000	10%	159,000	12%
Mississippi	339,000	45%	119,000	16%	220,000	29%
Missouri	435,000	30%	187,000	13%	248,000	17%
Montana	98,000	41%	35,000	14%	63,000	27%
Nebraska	132,000	29%	42,000	9%	90,000	20%
Nevada	172,000	29%	46,000	8%	126,000	21%
New Hampshire	83,000	23%	38,000	11%	45,000	13%
New Jersey	486,000	24%	219,000	11%	267,000	13%
New Mexico	278,000	52%	98,000	18%	180,000	33%
New York	1,865,000	39%	939,000	20%	926,000	19%
North Carolina	644,000	34%	261,000	14%	383,000	20%
North Dakota	61,000	40%	21,000	13%	40,000	27%
Ohio	887,000	30%	440,000	15%	447,000	15%
Oklahoma	282,000	35%	120,000	15%	162,000	20%
Oregon	291,000	33%	124,000	14%	167,000	19%
Pennsylvania	835,000	29%	358,000	12%	477,000	17%
Rhode Island	68,000	26%	35,000	13%	33,000	13%

Appendix Table 1. Non-Beneficiaries of Tax Cut Proposals: Children—Continued

State	Administration Proposal		Democratic Proposal		Additional Children Assisted by Democratic Alternative	
	# Children	% Children	# Children	% Children	# Children	% Children
South Carolina	338,000	37%	122,000	13%	216,000	24%
South Dakota	50,000	27%	22,000	12%	28,000	15%
Tennessee	528,000	38%	190,000	14%	338,000	25%
Texas	2,256,000	41%	839,000	15%	1,417,000	26%
Utah	171,000	24%	49,000	7%	122,000	17%
Vermont	43,000	28%	22,000	14%	21,000	14%
Virginia	439,000	26%	164,000	10%	275,000	16%
Washington	391,000	28%	190,000	13%	201,000	14%
Washington, DC	54,000	48%	34,000	30%	20,000	18%
West Virginia	161,000	45%	69,000	19%	92,000	26%
Wisconsin	316,000	20%	114,000	7%	202,000	13%
Wyoming	43,000	33%	16,000	12%	27,000	21%
US Total	24,148,000	34%	9,894,000	14%	14,254,000	20%

Appendix Table 2. Income Changes Among Single Mother Families: 1995–1999

(Includes Incomes of Related Adults and Unrelated Males)

	1995	1999	Change	Percent of Earnings Change Reflected in Disposable Income Change
Quintile 1				
Earnings	2,473	3,465	992	
AFDC/TANF, SSI, and Food Stamps	4,647	2,932	(1,715)	−27.2%
Disposable Income	9,551	9,281	(270)	
Quintile 2				
Earnings	6,427	11,001	4,574	
AFDC/TANF, SSI, and Food Stamps	6,126	3,158	(2,968)	34.0%
Disposable Income	16,331	17,886	1,555	
Quintile 3				
Earnings	15,661	20,211	4,550	
AFDC/TANF, SSI, and Food Stamps	3,696	1,556	(2,140)	39.7%
Disposable Income	22,672	24,480	1,808	
Quintile 4				
Earnings	26,920	32,423	5,503	
AFDC/TANF, SSI, and Food Stamps	1,653	921	(732)	75.6%
Disposable Income	31,009	35,170	4,161	
Quintile 5				
Earnings	57,423	71,891	14,468	
AFDC/TANF, SSI, and Food Stamps	698	251	(447)	94.7%
Disposable Income	59,165	72,865	13,700	

Source: CBPP tabulations of the Current Population Survey.

Values are in 1999 dollars.

Disposable income income includes the value of means-tested in-kind benefits and the EITC, and deducts federal income and payroll taxes and work expenses.

Quintiles are formed by dividing the family's disposable income by the poverty threshold for a family of that size.

Each quintile contains approximately an equal number of individuals, 5.5 million in 1995 and 5.3 million in 1999.

The number of families gradually increase from approximately 1.7 million in the bottom quintile to 2 million in the top quintile.

The maximum incomes used as quintile cut-points, as a percent of the families poverty threshold, are 86%, 127%, 173% and 252% in 1999. They were somewhat lower in 1995.

Chairman THOMAS. I thank both of you for your testimony.

Mr. Donovan, I understand how you feel with your analogy, always a bridesmaid and never a bride, although I would believe that the appropriate phrase in the 106th Congress was that you were left at the altar. You were, in fact, ready to go to the wedding ceremony and were not allowed. It is my strong belief that following the November elections, we will move marriage penalty reform out of the House, out of the Senate, and present it to the President and the President will sign it.

Dr. Primus, you indicated that the President's plan is deficient in a number of areas and I want to focus in on, if you will help me, in terms of, if you will, a prioritization of where, if the Committee were to focus on adjustments or a better understanding of where the inequities are the greatest. If you looked at, for example, the marriage penalty, are you familiar with H.R. 6 in terms of the adjustment on the earned income marriage penalty aspect of H.R. 6?

Mr. PRIMUS. Yes.

Chairman THOMAS. Would that be a step in the right direction vis-a-vis the rate adjustment program of the President?

Mr. PRIMUS. My understanding, Mr. Chairman, is that particular proposal would only affect families who pay income taxes and, therefore, would not affect families who are hit by the highest marriage tax penalties because of the EITC design.

Chairman THOMAS. All right. So you are still looking for, and obviously the President has indicated that we are going to address the payroll tax question when we look at Social Security and other areas.

Let us turn to the child credit, then. If you were to pick the aspect of the President's plan that probably needs to be focused on most, what would you put as the number one concern?

Mr. PRIMUS. I would probably put as number one reducing the marginal tax rates for mothers at the beginning of the EITC phase-out, the mothers from $13,000 to about $20,000 of earnings, because they have an EITC phase-out of 21 percent. They can have their food stamps being phased out. In the case of Maryland, child care copays in the State were going up.

Chairman THOMAS. OK. We have in current law, under the current child credit, a provision which partially adjusts on the basis of the child credit. Are there flaws with the current law adjustment?

Mr. PRIMUS. Yes, Mr. Chairman. I think it is very complicated. For one, it only applies to families, as you know, with three or more children.

Chairman THOMAS. You have been behind the scene on a lot of activities. I know this was after your time. Why was it structured to apply to families with three or more rather than families with one or two?

Mr. PRIMUS. I do not know. There was some attempt to increase the refundability of the child tax credit in 1997, but this was a very, very narrow approach to increasing that refundability. Also, it only takes into account, Mr. Chairman, the employee portion of the payroll tax, and I think all economists agree that low-income families pay both the employer's and the employee's share of those payroll taxes.

Chairman THOMAS. I think most economists would say every employee, whether they are low income or not, pay all of those costs, notwithstanding the pay stub saying that is divided.

Mr. PRIMUS. OK. We agree.

Chairman THOMAS. So would a step toward making it fairer be to move it to any number of children rather than just above three?

Mr. PRIMUS. That would be a very small step in the right direction.

Chairman THOMAS. I understand. What other aspects of the President's proposal would you change if you could on the child credit?

Mr. PRIMUS. Well, as I indicated in my testimony, I would like to make the child tax credit partially refundable against earnings, so that, for example, if you picked a simple 10 percent rate, then a mother who earned $10,000 would get 10 percent of $10,000 or $1,000. If she had two children, she would not get the full credit of $2,000. But that is what I would do first with respect to the child tax credit.

Chairman THOMAS. And what would you do next?

Mr. PRIMUS. What I would do next is try to do something on the EITC. But in terms of the child tax credit, making it partially refundable, I think, is the right thing to do.

Chairman THOMAS. And then what would you do next?

Mr. PRIMUS. Then I would do some of the marriage——

Chairman THOMAS. No, on the child credit.

Mr. PRIMUS. Do something to reduce——

Chairman THOMAS. We are still on the child credit.

Mr. PRIMUS. OK. Some have advocated full refundability. My sense is that proposal probably is not going to get the vote of a majority of this Committee. But I talked about the families that face the highest marginal tax rates, those families that have, again, responded to your welfare reform bill and are working harder. I think they need an income boost and that is for families in the $10,000 to $20,000 range. You can do that by lowering and do a kink like Mr. Cardin and others have——

Chairman THOMAS. Yes, but those are all permutations of your earlier points and I understand that, so we have exhausted the suggested changes to the President's plan as far as you are concerned?

Mr. PRIMUS. Yes.

Chairman THOMAS. Otherwise——

Mr. PRIMUS. Oh, I also——

Chairman THOMAS. We will keep it in place as he proposed it.

Mr. PRIMUS. I would not extend it to families of very high income levels. Since you have provided lots of tax relief in the rate reduction bill that has already passed the House, I am not convinced that families above $130,000 need more tax relief.

Chairman THOMAS. But that is current law, is it not?

Mr. PRIMUS. Yes. It ends at $130,000.

Chairman THOMAS. So you would not extend it beyond current law?

Mr. PRIMUS. That is correct.

Chairman THOMAS. OK. Obviously, I want to get the input, because if we are looking at changing the President's proposal, I want

to make sure, given your background knowledge and involvement, that I get an exhaustive list of changes from you so that if, in fact, we make those changes, my colleagues on the other side of the aisle will be able to readily recognize where those suggestions came from in terms of trying to fashion a package that is fairer and more equitable, and I appreciate your comments.

The gentleman from California.

Mr. STARK. Is it in order for me, Mr. Chairman, as long as we are dealing with a bill we have not seen, for me to ask unanimous consent to incorporate Dr. Primus' ideas in the bill that we will see soon?

Chairman THOMAS. The gentleman can certainly try. First of all, the chair wants to apologize to the other gentleman from Texas, because I had told him that he would be first off, and frankly, four votes and lunch blurred my memory.

Mr. STARK. Let me, then, by all means, yield to my colleague from Texas, if I may, Mr. Chairman.

Chairman THOMAS. I appreciate the gentleman allowing me to honor the commitment that I made to him and to his colleague, but since his colleague is not here, we only have to allow the gentleman from Texas.

Mr. STARK. I yield to him.

Mr. DOGGETT. Let me just ask, as a preface to my questions, Mr. Chairman, I understand what you said this morning about this description of the Marriage Penalty and Family Tax Relief Act, that while you would be perfecting it further through the benefit of witnesses like this, you anticipate that the subjects that will be included in the bill we will mark up in a few hours would be limited to the five that are included in the description?

Chairman THOMAS. I will tell the gentleman, a few hours means tomorrow——

Mr. DOGGETT. Yes, sir.

Chairman THOMAS. And my characterization of tomorrow is one I prefer rather than a few hours.

Mr. DOGGETT. Tomorrow, then.

Chairman THOMAS. Yes. I will tell the gentleman that he is substantially correct, with the exceptions of testimony that may allow us to make some adjustments that would make the package more relevant.

Mr. DOGGETT. On the same subjects?

Chairman THOMAS. Exactly.

Mr. DOGGETT. We are not getting into——

Chairman THOMAS. That is correct.

Mr. DOGGETT. Retirement or estate tax or capital gains tomorrow?

Chairman THOMAS. No, that is correct.

Mr. DOGGETT. Just these? OK.

Chairman THOMAS. The base text will be H.R. 6, as adjusted with a child credit, subject to modification based upon the excellent testimony of the witnesses.

Mr. DOGGETT. I understand and thank you for your clarification.

Mr. Donovan, our colleague, Mr. Weller, made clear earlier this morning that he found the proposal by President Bush on the marriage penalty to be deficient, but as I read your written testimony,

it is much stronger than your testimony you just gave us. In no uncertain terms, you condemn President Bush's proposal on marriage tax penalty and, in your words, say that it is so bad that "it would be better to do nothing about the marriage penalty than to do this." Does that written testimony still reflect your position, sir?

Mr. DONOVAN. That is my written testimony. Let me state our views on the bill overall.

Mr. DOGGETT. Well, does that reflect your views, since my time is limited? You stick by your written testimony that his proposal is so bad that it would be better to do nothing than to adopt the Bush proposal, is that correct?

Mr. DONOVAN. The deficiency in the proposal is that——

Mr. DOGGETT. Well, let me just ask you if it is correct or not, your written testimony.

Mr. DONOVAN. I have stated that that is my testimony and——

Mr. DOGGETT. I appreciate it.

Mr. DONOVAN. I need to give to the Committee the words around it, if I may.

Mr. DOGGETT. I want to ask you one further question to clarify that, then. Is it your feeling, coming as someone who has been married myself now for 32 years and has an appreciation for the institution of marriage, that the institution of marriage is so important that we should, in writing our tax laws, seek to discriminate against those who are not married?

Mr. DONOVAN. I think that we should provide tax relief to the American people.

Mr. DOGGETT. Do you believe that our—just tell me. I understand you may want to elaborate to other members, but do you or do you not believe that we should discriminate as we write our tax laws against those people that do not have the good fortune, such as myself, to have been married, in my case, 32 years?

Mr. DONOVAN. Congressman, I think that married people and the children they raise, if they raise them successfully, they provide a wealth of benefits to single people, including paying for the Social Security benefits of that rising generation to whom a non-married person with no children does not.

Mr. DOGGETT. I could not agree with you more.

Mr. DONOVAN. I think that there is no discrimination——

Mr. DOGGETT. I could not agree with you more that families who——

Mr. DONOVAN. As a result of policies that favor families with children.

Mr. DOGGETT. Yes, sir. Reclaiming my time, I could not agree with you more that married families contribute greatly to our society, and I take your answer, then, to be that you do think that it is appropriate in designing our tax laws that we should discriminate against those people who are not married.

Mr. DONOVAN. I believe that we should provide preferences for families with children to raise their children, yes.

Mr. DOGGETT. A preference to me as a married person means that someone who does not enjoy my good fortune is taxed at a higher rate, and as you know, there are many single individuals who are taxed at a higher rate, and if we adopt the proposal that you advance, we will discriminate against them even more. And my

feeling, Mr. Donovan, is that a widower, an abused and abandoned spouse, someone who is single by choice, might well contribute as much as someone who is married, that a single mom who is out there who is trying to make ends meet and who is single through no fault of her own and has kids to support and is working and trying to get them through school and do the job of two parents, does not deserve to have to pay higher taxes and be discriminated against just because of your belief and my belief in the value of the institution of marriage and all that it contributes to our society.

But that is one of the problems that I have had with the bills that have been introduced, is that they are not written on a neutral basis because groups such as yours are so committed to the institution of marriage that they are willing to have our tax laws written deliberately to be discriminatory against single individuals in our society and, in fact, at the conclusion——

Chairman THOMAS. The gentleman's time has expired, but go ahead and finish your sentence.

Mr. DOGGETT. It was a mighty fast 5 minutes. In my district, in Travis County, Austin, Texas——

Chairman THOMAS. Time goes fast when you are having fun.

Mr. DOGGETT. It does.

In Austin, Texas, I actually have more individuals who stand to not gain and be potential beneficiaries from this proposal, who are either divorced, separated, widowed, or live as single individuals, than those who do not. And it seems to me that the goal ought to be to treat everyone equitably and fairly without regard to their choice of being married or not being married. Thank you.

Chairman THOMAS. The gentleman's time has completely expired.

Does the gentleman from Florida wish to inquire?

Mr. SHAW. Thank you, Mr. Chairman. Wendell, it is good to welcome you back to the Committee where you spent so many years, both on the majority and the minority side as the winds of change went about changing much of that. I have always valued your opinion on many things. I count you as a friend and perhaps would characterize you as an honest liberal, and that is not an oxymoron. I think you sincerely believe what you say and you are a good advocate for it, and I think you make a lot of sense a lot of times and I enjoy your testimony. I particularly enjoy the dialog back and forth with the Chairman.

As you recall, we worked together, and I think there was good bipartisan support for the earned income credit. It was EITC back then. We have changed the name of it. But I want to be sure that the record is complete in many areas. Right now, the EIC payment, someone earning, a family with two kids earning, say, $10,000 a year, they would receive back, I think under EIC, $4,000, which is more than the payroll tax that they would pay in.

I also think the record should be clear that low-income people, because of the progressivity of the Social Security payment schedule, that they get a better deal than the high-income people when it comes to retirement and Social Security.

You are nodding yes, and I assume that I can put a "yes" in the record, that you do agree with what we are saying.

Mr. PRIMUS. Yes. They ultimately will benefit from some of those payroll tax payments.

Mr. SHAW. Now, also, is it your opinion—and this is getting a little bit out of your scope of direct testimony, but I think you are certainly qualified to answer the question—is it your opinion that if we pass these bills and put money back into the paycheck or refund, as the case may be with the EIC, that this would go a long way toward helping to stimulate the economy by putting money back into the economy? Is that your opinion, particularly at the lower income level?

Mr. PRIMUS. Yes. I appreciate all those kind words, Mr. Chairman. I am getting a little nervous about where this conversation is going.

Mr. SHAW. Oh, I think——

Mr. PRIMUS. I firmly believe, yes, that increasing the EITC—I mean, the purpose of the EITC was, as you know, to refund or rebate some of the payroll taxes at the bottom end of the income distribution, but it was also——

Mr. SHAW. It was also to reward work.

Mr. PRIMUS. To give an earnings supplement. Rather than increasing the minimum wage, the Congress made decisions that said—because sometimes an increase has adverse employment effects—the right way to help low-income wage earners was through the EITC, which then became an earnings supplement and an alternative way of rewarding their wages, if you will.

And just because that says they should not be paying Federal income taxes does not necessarily mean that these families should not get some benefit from the expansion of the child tax credit.

Mr. SHAW. In other words, then, if you go back to the minutes of the meetings that we had and the hearings that we had, the purpose, I believe, as it was framed, was to reward work. And I think that the Human Resources Subcommittee did an awful lot of work back then in seeing that that happened.

I do have one simple question that I would like a yes or no from you. I just want to get it on the record. Is welfare reform a success, yes or no?

Mr. PRIMUS. For some mothers, yes; for others, no.

Mr. SHAW. That is a yes or no, I guess.

Mr. PRIMUS. I also think that is pretty close to the truth.

Mr. SHAW. Well, I think all of us know that overall it has been a tremendous success in getting people off the welfare rolls, getting them to take control of their life and getting them on the track toward a better life. Even though it may be a struggle for some at the beginning, at least it is a beginning for all. And I think that you would agree with that.

Mr. PRIMUS. Yes. And as I said in my testimony, I mean quite amazingly, these mothers are earning a lot more money. More of them have gone into the labor force. But the other effect is they are not getting as much of increased earnings reflected in their income gains as I think you and I would like to see. I mean, if you earn an additional $4,500 but only get $1,500 more in income, that is not a very good return for all that extra earnings.

Mr. SHAW. Well, at least it is earnings and it is productivity, and it has really tremendously done a lot for the self-esteem of particu-

larly these single moms out there that were really at the bottom rung of the economic ladder as well as the ladder of self-esteem.

Thank you, Mr. Chairman. I yield back.

Chairman THOMAS. I thank the gentleman.

The gentleman from California, Mr. Stark. Thank you for your courtesy.

Mr. STARK. Certainly. I have been taking a back seat to some Texans here. I would like to talk to my colleague from Texas, Mr. Doggett. I refuse to take a back seat any longer. I presume that if he is going to get credit from Mr. Donovan's organization for being married, I then would get three or four times the credit that he is getting. And if this is a linear sort of thing, I probably then should get three or four times the tax credit. I like that idea.

Wendell, your appendix suggests that, if I read it correctly, you talk about non-beneficiaries of the tax cut proposals, which I presume are those before us. Do you include in that table a combination of both the earned income tax credit and the marriage penalty? Is this a compendium or is it only one of those two?

Mr. PRIMUS. It reflects the President's proposal of the child expansion, the marriage penalty, et cetera. It reflects all of the President's proposals.

Mr. STARK. OK. So what you are telling me is that under the President's proposal, there would be 24,148,000 children who would not benefit from this proposal. How many children are there?

Mr. PRIMUS. About 71 million.

Mr. STARK. So more than a third of the children in the United States would receive no benefit from either of these or the combination of these proposals.

Now, to be bipartisan, under our Democratic proposal there would be almost 10 million who would not also, so that this is not—but it remains that more than two and a half times more children would be left out of this.

Now, can you characterize for me, if it isn't a random selection, who are those 71 million children that this bill would discriminate against?

Mr. PRIMUS. Well, most of those, I think about 80 percent of the children excluded, have an earner. Two-thirds have an earner who is earning at least half-time.

Mr. STARK. Excuse me. Have an earner? You mean one——

Mr. PRIMUS. Have some earnings in that family where the child resides.

Mr. STARK. OK.

Mr. PRIMUS. Two-thirds of those children excluded, again, 16 million, reside in families that earn more than half time, full year, at minimum wage. So these families have earners and have substantial amounts of earnings.

Mr. STARK. Could you bracket that? I mean, 20, 30, 40? How much earnings? I am trying to get a picture of——

Mr. PRIMUS. Well, they clearly have earnings between $5,150 and—where they start to pay Federal income taxes. That range of income, if you will, is where two-thirds of the children excluded reside.

Mr. STARK. So under 25,000 bucks.

Mr. PRIMUS. Yes.

Mr. STARK. I guess that is what I am getting at.

Mr. PRIMUS. That is the right number for a family of—a married family with two children, approximately.

Mr. STARK. So basically we are leaving out of our—in this bill, and would the suggestions that you made to the Chairman alter that? I know this is a rough cut, but if we are leaving out 24 million children in the lowest-income group of Americans, just to save them the embarrassment of giving all this money to the richest couple of thousand if we got rid of the death tax, how could we save the Republicans from themselves and allow them to do something for the lower income children? Would your suggestions to the chairman take care of that?

Mr. PRIMUS. Well, obviously, the suggestion that says make the credit partially refundable against earnings would only leave out then the children where the household doesn't earn a thing. And that is a very small percentage; probably 20 percent of the children now left out would be left out if you made the credit partially refunded against earings. Obviously, then, if you start the credit at higher income levels or make it partially refundable at higher income levels, that percentage, as you can see from the Democratic alternative, which really targeted families at about $8,000 and higher, roughly, left out 14 million children.

Mr. STARK. Mr. Donovan, do you think Mr. Primus' idea is good?

Mr. DONOVAN. To be honest with you, I haven't studied that proposal. I would like to read his testimony and have a chance to respond in writing.

Chairman THOMAS. The gentleman's mike is not on. It is hard to hear the response.

Mr. STARK. He is not familiar with it.

Thank you, Mr. Chairman.

Chairman THOMAS. Thank you.

Does the gentleman from Louisiana wish to inquire?

Mr. MCCRERY. Yes. Thank you, Mr. Chairman.

I will put this question to both of you. What do you think the purpose of the child tax credit is? Why do we have a child tax credit? Mr. Donovan.

Mr. DONOVAN. I believe the child tax credit is appropriate recognition of the important investment that society and parents make in their children. It is a recognition of the extreme costs of raising a child in the world today, from providing food and shelter, the traditional things, and also the expectations these days that children will have the best of education, and parents are responsible, first and foremost, for providing that. Five hundred dollars is not a huge step in that direction for most parents.

Mr. MCCRERY. Do you agree with that, Dr. Primus?

Mr. PRIMUS. Yes, I think the rationale, as the President has said, it is not just simply tax relief, but to help families rear and support their children. I think it is an important public function to help families raise their children.

Mr. MCCRERY. I agree, and I also agree with your statement, Mr. Donovan and Dr. Primus, of the rationale for the public policy of the child tax credit. And if that is the rationale, then it seems to me, Mr. Chairman, that this Committee ought to try to give that advantage in the tax code to everybody that has children that pays

taxes, whether it is income tax or payroll tax. And so I think that our friends on the other side of the aisle and Dr. Primus make some good points. And I would hope that this Committee could maybe look at the President's proposal and massage it a little bit to make sure that that sound public policy of helping people to rear their kids is extended to all parents with children who pay taxes.

Thank you.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Pennsylvania, Mr. Coyne, wish to inquire?

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Primus, you may have given this statistic, but I guess it would be worth repeating. How many more low- and moderate-income families would receive benefits in earned income tax credit under the Democratic alternative than under President Bush's plan? Do you have those figures?

Mr. PRIMUS. Because you do all of your additional tax relief at the bottom through the EITC, that difference is approximately 10 million children.

Mr. COYNE. Ten million more children would receive the benefit——

Mr. PRIMUS. No, no. Fourteen million more children.

Mr. COYNE. Would receive the benefit than under President Bush's plan. Thank you.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Michigan, Mr. Camp, wish to inquire?

Mr. CAMP. Thank you, Mr. Chairman.

Either Mr. Donovan or Mr. Primus, can you talk a little bit, if you are able to, about the ability of the IRS to administer a refundable child tax credit? And have you done any research or do you have any information on the ability to keep that program with integrity and to make sure that it does really get to the people who need it and deserve it?

Mr. PRIMUS. I think the IRS is capable of administrating a refundable child tax credit. Most of those families do get some benefit from the EITC. We can always try to do a better job, but there is no doubt in my mind that the IRS could administer a refundable, as Congressman McCrery indicated, credit that gave some relief to all families who paid income or payroll taxes.

Mr. CAMP. Have you done any research or any studying on that area? I realize your supposition, you think they can do it. Is there anything you have examined that would support that, or have you——

Mr. PRIMUS. Well, they do administer the refundable credit of the EITC, which——

Mr. CAMP. And there are problems with that in administering it, would you agree?

Mr. PRIMUS. And there are some problems with that.

Mr. CAMP. So why would this not be any different?

Mr. PRIMUS. I think the major problem in the earned income tax credit is which family should receive tax relief because of a child. There are some very complicated provisions of the EITC.

For example, in a household with three generations, let's say a grandmother makes $25,000, but the mother makes $15,000, and

they would file separate returns today. The EITC doesn't go to the mother. She is ineligible for the EITC because it is supposed to go to the grandmother in that household. So that is one example.

So I think there are ways that some of the very complex rules surrounding the EITC—the Treasury has put forward some proposals that—for example, lots of time noncustodial parents are taking advantage, of the EITC when they are eligible. We could make sure that doesn't happen by matching IRS information against the child support registry data and immediately calling it a math error and adjusting the return. I think those are some of the provisions that would reduce the EITC error rate considerably.

Mr. CAMP. That would assume any parent paying support doesn't have custody, which isn't always the case. The registry doesn't distinguish in terms of where the child is physically living. But I understand your point and——

Mr. PRIMUS. In most cases, I wouldn't expect a parent who has custodial status—you know, where the kid is residing with that parent, shouldn't be paying child support. I mean, either there is something wrong with the child support system then where the dad is paying child support to himself because the kid is residing with him. That doesn't make sense.

Mr. CAMP. Well, in a lot of the joint custodial relationships now, that is different. Anyway, I know my time—Mr. Donovan, any comment on the refundability of the child tax credit and its——

Mr. DONOVAN. No, I have no data on the difficulty in applying it. I know that there has been some error. We do support refundability against Social Security taxes, both employer and employee.

Mr. CAMP. All right. Thank you.

Thank you, Mr. Chairman.

Chairman THOMAS. I would just interject briefly. It seems to me that—and I agree with the gentleman from Michigan that there has been an error rate problem with the earned income credit. But I think that is largely to the extent of the fact that a number of these people have multiple employers and that it is the flow of income and that, as a matter of fact, in any system that says you get more relief if you claim more income, whether you actually make it or not, there is a perverse incentive there.

But in dealing with the child credit, I think everyone would have to agree that the determination of whether or not there is a child is an easier determination in which to verify, much the same as indicating that you are filing married jointly. No one would do that now because of the penalty. But, in fact, they may want to file separately, notwithstanding the fact that they may, in fact, be married.

Both of those, I think, are far easier to detect if someone is trying to commit fraud on a tax form. It is a question of degree, but I believe we are pushing the argument quite a ways if we are dealing with the child credit or marriage penalty, as opposed to falsifying income for the purpose of actually getting more back, claiming that you made more than you actually did. That to me is the real perversity of the earned income credit in terms of the way in which you can defraud the system.

Does the gentleman from Massachusetts wish to inquire? Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Dr. Primus, I had an opportunity to talk with President Bush about a month ago about the AMT issue, and he described it as "a huge problem." Based upon the Chairman's bill here, do you think that there is any legitimacy to the argument that the same benefit that is being promised in the bill will actually be denied based upon implementation?

Mr. PRIMUS. I think the issue of the AMT is a huge problem. My understanding from the Joint Tax Committee is that about 1.5 million taxpayers are hit this year, and under current law that goes up to 21 million by the year 2011, and that the President's proposal increases that an additional 15 million or so.

I know that in the bill that passed the Committee and was taken up by the full House, there were some provisions to address that. But my understanding is those provisions made very small differences in the number of families who would be affected by the AMT.

Mr. NEAL. Let me follow up on that. As I understand it, and perhaps as you understand it, the bill that passed the Committee here continues the current law waiver of AMT limitations for the child credit but not for other non-refundable credits such as the education credits.

Is it possible that a family with children in college would actually find their taxes going up next year compared to their taxes in 2001?

Mr. PRIMUS. Yes. Again, many families in this situation currently can use the full amount of the education credits, the HOPE and the lifetime learning credit, if they have two children in college. But if you don't continue this waiver, their taxes will go up.

Mr. NEAL. My interest here, once again, is not in trying to draw any partisan fire on this issue as much as it is to acknowledge that the President is right that it represents a huge problem. And as much as we have discussed it here, I don't think any of us really like the solution offered to date.

Mr. PRIMUS. Right. I think you know all this very well. The alternative minimum tax was set up to make sure that some very high income families wouldn't take undue advantage of tax preferences. It was supposed to affect a very narrow band of high-income families.

I don't believe the majority or the minority on this Committee is going to let the AMT affect millions and millions of families, which means they have to do two calculations.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman THOMAS. Not only new calculations but to spend money to make sure that people do not fall into the trap of the AMT, which was exacerbated in the 1993 tax bill and which we have not addressed, and now discovering in giving people tax relief, in fact, on the back side, they will not be getting that relief. And I can assure you as we move these different pieces of legislation, we will do our best to include provisions beyond the one mentioned to hold those individuals harmless until we can sit down and fundamentally address the problem of the alternative minimum tax.

But no one, no new individuals, if we can help it, should fall into the alternative minimum tax by virtue of the tax relief packages that we will be moving through, whether it is the marriage penalty, child credit, or any other area of tax relief.

Does the gentleman from Minnesota wish to inquire?

Mr. RAMSTAD. Thank you, Mr. Chairman. Just very briefly.

Good to see you again, Dr. Primus and Mr. Donovan. I liked Mr. Shaw's characterization of the honest liberal, and I think it is healthy when a honest liberal and an honest conservative are showing such a concurrence of views on some very important elements of our tax relief that we are trying to get to the American people. And I think that reflects the bipartisan nature of this tax relief. Certainly that was reflected in the vote last year on the bill to eliminated the marriage penalty, to phase it out, a large number of people from the other side, Members from the other side of the aisle.

I wanted to thank you particularly, Mr. Donovan, for the work that you and your organization have done. It will benefit 80,000 couples in my 3rd Congressional District of Minnesota, 80,000 married couples right now paying an average of $1,400 more in taxes. So I appreciate Mr. Weller's leadership on the panel and certainly your organization's efforts as well.

I just want to take a minute to respond to the colloquy, Dr. Primus, that you had with Mr. Shaw on welfare reform, just one minute.

That question, I think, was best answered, for me at least, not in the statistic that, in fact, 49 percent fewer people are on the welfare rolls nationally—in Minnesota, it is a little less, 40 percent fewer welfare recipients than before welfare reform. But that was answered for me up close, anecdotally, by a former welfare mother who became a friend of mine through a group I go to every week to stay sober, a group of recovering people. And she was a very diehard opponent of welfare reform: What are you doing? I have two children and you can't take this welfare away.

At Christmas and Hanukkah season, I was back home at this meeting, and she came up to me and was very, very warm and jubilant. And I said, What has gotten into you? And she said, I just want to thank you for welfare reform; because of it, I have a job now, I am not on welfare. I was able to learn computer skills, and for the first time since my kids started school, they didn't wear hand-me-downs the first day of classes in September. I went to Target and got them clothes, and I am making more money than I ever thought possible.

You could just see the dignity, I could just see the dignity and self-worth, self-respect. So, for me, that is a resounding yes, and I am glad to see at least partially, Dr. Primus—and I have always appreciated your views even though they diverge with mine on some of the issues. But I respect you and appreciate your honest answer to that question of Mr. Shaw's. I just couldn't let the opportunity go by without addressing that.

Thank you again, both of you, for your input here today, and I appreciate, as I said, the concurrence of your views, surprisingly, on some of the very important issues that this bipartisan tax relief package addresses.

Thank you. I yield back, Mr. Chairman.

Chairman THOMAS. I thank the gentleman.

Does the gentlewoman from Washington wish to inquire?

Ms. DUNN. Thank you very much, Mr. Chairman. And I, too, want to applaud Mr. Weller for the good work he has done on keeping the importance of the marriage penalty before us in what has turned out to be a very positive era where we have the dollars that we can do this thing, this right thing, and we can do it in the right way.

A point on welfare reform. Having served on that Committee, having helped to write that legislation, I am absolutely delighted in the results it has had over the last few years. We took great care as we were writing welfare reform to make sure that we considered how we could be helpful in moving women from welfare into work. And now as we consider the reauthorization of that bill, we have a chance to observe, as I have done over the years in meeting with welfare moms and dads, to find out what is going right and what may not be going right with this legislation. We have a chance now to make sure that nobody falls through the cracks on welfare reform.

But I guess I am most grateful to Mr. Weller because he has been persistent on this issue, and at many points he could have phased out his support. It will be because of him—Mr. Weller—that we will have been successful at the time that we pass this off the floor of the House. I think myself personally that it is time we honor marriage, not tax it.

I yield back.

Chairman THOMAS. I thank the gentlewoman.

Does the gentlewoman from Florida wish to inquire?

Mrs. THURMAN. Thank you, Mr. Chairman.

I am sorry to both of you that I missed the opening statements and obviously some exchanges that happened here. But, Dr. Primus, I just have one question. We are a political body, and we all have to go back home, and we have to explain to our constituents why we did or did not vote for something. And I found your Table 1 very interesting, particularly as it relates to each State, and particularly the amount of children that would or would not be in it.

And you may have gone over this in your testimony, and I hope that my colleagues will just let me ask you to kind of walk us through here and give us an idea of, as we put a bill together, what is—how do we make the largest impact on children with families so generally all children would be covered?

Mr. PRIMUS. Well, Congresswoman, as that table shows, in the State of Florida 1.2 million children, or thereabouts, would not benefit from the expansion of the child tax credit or even the lowering of the income tax rate because those children live in families that don't pay income taxes. And most of those children would have an earner. Obviously, under a proposal that started to give those families something as they started to earn money, that number would shrink. And under the Democratic proposals in Florida, it shrunk to 462,000; or thereabouts, from 35 percent of kids to 13 percent of kids.

Mrs. THURMAN. Is this proposal on all of the tax issues or any one in particular? Is this the marriage tax? Is this the bracket

change or the marginal—I mean, does this include everything that has been talked about or——

Mr. PRIMUS. It includes everything that has been talked about as it affects children or families with children. So it is not looking at couples without children, et cetera. It is saying 1.2 million children in Florida don't get any help from the way the President's tax proposals are designed.

Mrs. THURMAN. OK.

Mr. PRIMUS. And you can do something about that, and as I have indicated in the colloquy with Mr. Shaw, a lot of these mothers are working harder. And even though their earnings have gone up $4,500 on average, their income only went up $1,500. I think, they deserve an income boost. They deserve help in raising their children. They have done what you wanted them to do, in essence, but they didn't get much of an increase in income.

Mrs. THURMAN. And these would be some of the same children that have lost some of their medical benefits, other areas that we would be very concerned about.

I just might let the Committee know that I was actually in Tallahassee on Monday. We have a Federal-State summit, and I found something very interesting, that they have asked for a waiver from Medicaid, and that was to allow the State employees of that State to participate in the CHIP program because they actually would meet the financial criteria that we have set for children for medical services. So, you know, here is an idea that if some of this was given back, they would have an opportunity to buy some of that insurance, do some of the things that we are asking them to do that we have actually taken away from them in the past.

So, Dr. Primus, thank you very much.

Chairman THOMAS. I would tell the gentlelady, perhaps she wasn't here when the Chair invited Dr. Primus to indicate where he thought changes could be made. He indicated that he thought the current law upper-income level was more appropriate than the President's proposal. Obviously, as has been discussed a number of times, that child credit shouldn't apply just to income but it should apply to other taxes, such as payroll tax offset. And I inquired about the current law in terms of low income, which sets it at three or more children, and that I asked him why it was not one or two. We didn't really have a good answer and that it seems to me we will be looking at the question of why not have it apply to the first child, second child, and so on.

So he has provided a number of options for us to examine any child credit program, to perfect a program to address the concerns the gentlewoman has indicated, and a number of other colleagues on your side.

Mrs. THURMAN. Mr. Chairman, would that also include some of the issues—I know that it has been stated that even in the earned income tax credit, the marriage penalty was also included, I think, even in Mr. Weller's and all of the others. So as we put this bill together tomorrow, those would be considerations?

Chairman THOMAS. We would be looking for adjustments in that area as well, always mindful that we are going to have to, as the gentlewoman well knows, pay down the AMT cost so that people

would not find the insidious aspect of getting a tax reduction but, in fact, on the alternative minimum tax winding up paying more.

Mrs. THURMAN. Well, Mr. Chairman, I believe we have moved a long way, then.

Chairman THOMAS. I believe that is one of the reasons we have hearings, notwithstanding the reaction of my colleagues earlier, to hear testimony which may, in fact, produce the product that will be before us shortly.

The gentleman from Illinois I know wants to inquire.

Mr. WELLER. Thank you, Mr. Chairman, and thank you for conducting this hearing today as we talk about discrimination in the Tax Code, particularly as it affects married couples. I note with some interest some of the comments by some of my colleagues to talk about if we pass legislation to eliminate the marriage tax penalty, somehow that discriminates against single people. Well, today under our Tax Code, if two single people choose to get married, they are going to pay higher taxes as joint filers; whereas, if they stay single, they pay less in taxes. So, clearly, our Tax Code today discriminates against married couples, and we, of course, are looking today for solutions to eliminate that penalty on families who work and suffer the marriage tax penalty.

I have a couple of questions I would like to ask, Mr. Chairman. First, I would like to direct my first question to Dr. Primus.

Dr. Primus, you noted in your testimony that legislation that we sent to the President last year that President Clinton vetoed addressed the marriage penalty that earned income tax credit participants participate in. Are you familiar with H.R. 6, the legislation that we reintroduced this year, which is modeled after that legislation?

Mr. PRIMUS. Yes, somewhat.

Mr. WELLER. OK. Well, we adjust for joint filers for the EIC, we adjust the income threshold by $2,000, which eliminates that marriage tax penalty.

Based on your expertise, for those who suffer the marriage tax penalty under the EIC, what would that mean in change in their income, making that adjustment in the income threshold?

Mr. PRIMUS. Well, it doesn't eliminate the marriage tax penalty. It lowers it. When you expand the phase-out by about $2,000, you are lowering that marriage tax penalty by about $400, which is $2,000 times the phase-out rate of 21 percent.

Mr. WELLER. It would mean an additional $400 a year.

Mr. PRIMUS. That is right.

Mr. WELLER. In income for that married couple.

Mr. PRIMUS. That is right.

Mr. WELLER. Thank you.

Mr. Donovan, some have said why not just double the standard deduction for joint filers to twice that for singles as a solution to the marriage tax penalty and forget about the other things. You know, if we were solely to double the standard deduction which is used by those who do not itemize, it would not affect those who itemize their taxes.

From your perspective and your organization, what are the benefits of widening the 15 percent bracket as we propose in H.R. 6 to

married couples who suffer the marriage tax penalty? Who would benefit directly, and what would be the benefit?

Mr. DONOVAN. Well, it would certainly benefit a large number of families who may have just acquired a home, which is probably the first significant step they have taken financially since getting married. They work hard to get to that place in life. The expansion of that bracket is not going to help upper-income families in any way, shape, or form.

I was asked earlier about discrimination between single people and married couples. The most dramatic difference between being single and being married is the number of people you have to care for. The typical family earning the median income or up to $50,000 or $60,000 a year is caring for three or four people, not one person. If you look at in terms of the tax relief they would get by expanding that 15 percent tax bracket, on a per capita basis they are probably still paying more taxes than a single person.

So we believe it is essential to reach a large swath of married couples who need the relief and also the growing group of individuals who are living together without benefit of marriage and need an incentive to marry. We would favor that. We think that tax policy ought to encourage that, not discourage it.

Mr. WELLER. What would you consider to be a typical married couple? Do you have an example that you could use which would be a typical married couple suffering the marriage tax penalty?

Mr. DONOVAN. Well, we have talked in terms of averages. The average is about a $1,400 penalty for a married couple. The median family income I believe is in the upper $30,000 range. That family has one or two children, typically. And if they were not to be assisted by this tax relief, they would incur that penalty.

Mr. WELLER. I know some have said that many of those who suffer the marriage tax penalty are rich people. I find that the average couple that usually brings the marriage penalty to my attention when I am back home are a construction worker and a schoolteacher making about $65,000. They have a child. They own a home. Their average marriage tax penalty is $1,400, and that is real money. Where I come from, that is a year's college tuition; $1,400 is several months' worth of car payments for many families; it is 2 to 3 months of child care at a day-care center. If both mom and dad work, many times they need day-care, and that would pay for 2 to 3 months' worth of day-care per child.

Mr. Chairman, I see my time has expired, and I do want to thank you again for conducting this hearing.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Texas, Mr. Brady, wish to inquire?

Mr. BRADY. Mr. Chairman, we have had a very thorough discussion today, and I appreciate the panelists here. But in the sake of time and the other two panels we still have to go, I would yield the balance of my time.

Chairman THOMAS. The Chair thanks the gentleman, and I do want to thank the panel. We appreciate your testimony, especially in providing very specific assistance to the Committee in suggesting some changes that would make a better package. I want to thank you very much.

At this time the Chair would ask the next panel to please come forward: Maria Coakley David, chief financial officer of the C.J. Coakley Company; Bob Stallman, president of the American Farm Bureau Federation; Frank A. Blethen, publisher of *Seattle Times*; Lauren Y. Detzel, who is an attorney; and I believe Margo Thorning will be with us because, unfortunately, Dr. Allen Sinai could not get out of Logan Airport because of the weather. But I would call to my colleagues' attention the materials submitted by Dr. Sinai that perhaps will be commented on.

Before I turn to the panel, however, though, I would like to recognize the gentlewoman from Washington for the introduction, a special introduction, of one of the Members of the panel. The gentlewoman from Washington.

Ms. DUNN. Thank you very much, Mr. Chairman, and I welcome the panel.

Today we are going to hear from a panel of people regarding the repeal of the estate tax, better known as the death tax. Some of the members of this panel are going to tell you the story of how the death tax has begun to impact middle-income people. I think that is a story that is not often told, and the reason that I and my cosponsor, Mr. Tanner, have not chosen to take time away from this panel is because these folks can tell the story a lot better than we can. They are on the frontlines. So you will be hearing something about that today.

You will hear about the death tax impact on businesses, family held businesses, family farms, small businesses that are owned by families, and probably you will hear how current law almost totally ignores the health of these operations.

You will also hear how the compliance cost to provide for paying the death tax after the head of a household dies extracts huge amounts of money through compliance out of our economy, some say almost as much money as the death tax brings into the government itself.

So I am very grateful that we have this panel here so that you can listen with objectivity, as our Committee always does, but so you can also question these folks.

It is a particular pleasure that I introduce to you Frank Blethen who is the publisher and one of the owners of our major daily newspaper in Washington State, the *Seattle Times*. He has worked on this issue for a number of years. He knows the ins and outs from personal experience. He speaks on behalf of four other owners of this newspaper and on behalf of five generations of folks who have been in the same family that owns the *Seattle Times*.

I yield back my time, Mr. Chairman. Thank you for that opportunity.

Chairman THOMAS. I thank the gentlewoman.

I would tell each of the panel Members, any written testimony that you may have will be made part of the record, and during the time that you have available to you, you can address us in any fashion you see fit.

I will start with Ms. David, and then we will simply move across the panel. And you need to turn the microphone on.

STATEMENT OF MARIA COAKLEY DAVID, CHIEF FINANCIAL OFFICER, C.J. COAKLEY COMPANY, INC., FALLS CHURCH, VIRGINIA, ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Ms. DAVID. Thank you, Ms. Dunn, thank you, Mr. Chairman, and thank you, members of this Committee. On behalf of the 600,000 members of the National Federation of Independent Business, NFIB, I appreciate the opportunity to present the views of small business owners on the subject of death taxes.

My name is Maria Coakley David. I have had the honor and privilege to watch the American dream unfold before my eyes. My parents founded a family business. It is known as the C.J. Coakley Company, Incorporated, which is a commercial construction company based in Falls Church, Virginia.

I have four children. My oldest is 16, and I hope that one day I will be able to pass on our family business down to our third generation.

My father and mother are first-generation Irish Americans. They started our business with 10 employees in 1962 out of the basement of our home in Arlington, Virginia. My father was laid off from his job as a plasterer at the time. I was 2 years old.

Running a family business is hard work. In fact, the likelihood of a small business passing successfully to the first generation is about 3 in 10, and passing again to the next generation is only 1 in 10.

With hard work and luck, we have built a solid, successful company, but through thick and thin, one overriding challenge has never been conquered. Its existence threatens our livelihood and the livelihood of our employees. It threatens the tax base of our community, our growth, and our ongoing charitable acts. The threat I am referring to is the death tax.

As many on this Committee know, the death tax taxes the same assets twice. As an honest citizen, I have paid taxes my whole life. Annually, I pay income taxes, employment taxes, property taxes, local taxes, Social Security taxes, Medicare taxes, and excise taxes, just to name a few. And after I pay all my taxes, I make a choice to invest these aftertax dollars into the business.

Sadly, the death tax will take away in after-tax dollars much of what we have built over the last 39 years. The death tax endangers both my family's business and the jobs of our valuable employees because much of our assets are tied up in the equipment, inventory, and other assets that are necessary to run our company. If we do not have cash assets available to pay the death tax, we will be forced to sell critical parts of the business or the entire business outright in order to cover these tax liabilities.

My experience with the death tax is extensive. I would estimate in my 17 years with our family business I have spent between 6,000 and 8,000 hours studying the estate tax law and what it is going to do to our company.

My father passed away 2½ years ago. Today, my mother is 72. While I pray that she will live a long life and outlive all of us, we know that a day will come when the business must move from its first generation to the next. When that day comes, the last thing I want on my mind is a critical business decision. But today, I am

left with little choice. The Federal government demands that I visit the undertaker and the IRS within months of each other.

I have been keeping tabs on this debate over the past two decades, and I often read that only 2 percent of American taxpayers actually pay this tax. However, I have also read that 77 percent of Americans feel this is an unfair tax.

Mr. Chairman and members of the Committee, I can assure you that way more than 2 percent of Americans do pay this tax, not necessarily to the Federal government but to lawyers, accountants, and life insurance agents. My family alone pays thousands of dollars a year in life insurance premiums to cover the liability in the event of my mother's death. Plus, I would estimate that annual legal and accounting fees cost us thousands more.

It is important to realize that this is money that is not available to be spent on growing our business, on providing better employee benefits, like better health care and better 401(k) benefits.

I know that opponents of repeal say that small business owners don't need to worry about the death tax because there is a special provision in the law to protect small businesses. Unfortunately, the small business exemption that we have on the books is useless. Very, very few people qualify. That is why NFIB and I support the full repeal, not a patchwork of reforms.

Additionally, I have heard opponents say that we should all just use insurance products to mitigate the effects of the death tax. Well, unfortunately, my father was uninsurable for many years of his life, as are countless other Americans. We have purchased a policy on my mother, but as you have heard, these products are extremely expensive.

In addition, the value of a family business is a moving target, dramatically impacted by our economy. This makes the liquidity issue that insurance addresses only a partial solution.

Personally, I would rather spend my time focusing our family company on growth, on employee benefits, and on community relationships. Since 1975, C.J. Coakley Co., Inc., has sponsored many charitable causes. One such cause was the philanthropic entity called Seton Centers, which my mother founded in 1975. This organization focuses on diagnosing and assisting children with learning disorders. We also are involved in supporting activities and scholarship at many universities, including Marymount University, Clemson University, Maryland University, and many others.

We do all of this and more because we truly are about these causes, not because a lawyer told us we could avoid taxes in doing so. For example, my brother suffered from dyslexia when he was growing up, and this was why our family was compelled to create the Seton Centers, which helps students in elementary and high schools throughout Northern Virginia.

Mr. Chairman, I hope you and the Committee will ignore the scare tactics surrounding the issue of charitable giving. Most Americans are generous to their fellow neighbors. We Americans give because we care, and, of course, we will continue to do so.

Finally, we all know that there are people out there on the other side of this issue who say we should keep the death tax. I could not disagree more. The death tax kills jobs, small business growth, and the incentive to work hard and take risk.

I implore you to stop holding family businesses hostage to the death tax. It is quite simply unfair to tax someone a second time at their death.

In closing, Mr. Chairman, I would like to strongly encourage this Committee and Congress to bury the death tax once and for all. I understand that a majority of Members in the House of Representatives has expressed support for completely eliminating the death tax by cosponsoring H.R. 8, the Death Tax Elimination Act. I hope this support will translate into action in the very near future on legislation that repeals this unfair tax on small business and on the economy as a whole.

I thank the Chairman of this Committee for holding this important hearing, and I thank all of you for the opportunity to present my views before you today.

[The prepared statement of Ms. David follows:]

Statement of Maria Coakley David, Chief Financial Officer, C.J. Coakley Company, Inc., Falls Church, Virginia, on behalf of the National Federation of Independent Business

Good morning. On behalf of the 600,000 members of the National Federation of Independent Business (NFIB), I appreciate the opportunity to present the views of small business owners on the subject of death taxes.

My name is Maria Coakley David. My family owns and operates C.J. Coakley Company, Inc., which is a construction company based in Falls Church, Virginia. Our business focuses on interior construction. We are currently working on rehabilitation at the Pentagon and the Interstate Commerce Commission. We also work on private buildings, commercial office space, residential buildings and had a contract for work at Redskins' Park. Additionally, our company completed work right here—modernizing the elevators in the Longworth House Office Building.

I have 4 children. My oldest is 16, and I hope that one day I will be able to pass our family business down to the third generation of Coakley-David's—my children and my nieces and nephews. My father and mother, who are first generation Irish-Americans, started our business with 10 employees in 1962 out of the basement of our home in Arlington, Virginia. I was 2 years old at the time and throughout my life, I have been involved in the business. As an adolescent, my father and mother regularly asked me my opinion on business matters and attempted to involve me in the workings of the business. After majoring in accounting and having a brief career as a CPA, I returned to the Washington, D.C. area to work in our family business. Since then, it has been my focus almost every day of the year.

Running a family business is hard work. In fact, the likelihood of a small business passing from the first generation to the next is about 3 in 10, and to pass this same business to the third generation is about 1 in 10. We struggle at times to keep the doors open during economic down times. With hard work and luck, we have built a solid, successful company. But through thick and thin, one overriding challenge has never been conquered—its existence threatens our livelihood and the livelihoods of our employees. It threatens the tax base of our community, our growth and our ongoing charitable acts. The threat I am referring to is the death tax.

As many on this Committee know, the death tax taxes the same assets twice. As an honest citizen, I have paid taxes my whole life. Annually, I pay income taxes, employment taxes, property taxes, local taxes, social security taxes, and excise taxes, just to name a few. After I pay all of these taxes, I make a choice to invest these *after tax* dollars back into the business. Sadly, the death tax will take away in *after tax* dollars much of what we have built over the last 39 years. **The death tax endangers both my family's business and the jobs of our employees because much of our assets are tied up in equipment, inventory and other assets necessary to run our company. If we do not have cash assets available to pay the death tax, we will be forced to sell critical parts of the business or the business outright in order to cover the tax liabilities.** This tax literally puts almost four decades of work, planning, blood, sweat and tears at risk.

My experience with the death tax is extensive. My father passed away two and a half years ago. Today my mother is 72 years of age. While I pray that she outlives us all, we know the day will come when the business must move from its first generation to the next. When that day comes, the last thing that I want on my mind

is a critical business decision. But, today I have no choice. The federal government demands that I visit the undertaker and the IRS within days of each other. I think it is terrible that our government places such burdens on families at a time when it should lend a helping hand.

Many in this room may remember a day in 1985 when a plane crashed onto the 14th Street Bridge in Washington, D.C. That is the day my parents decided to do something about the death tax burden. You see, my parents were on the plane that took off directly ahead of this flight. Their proximity to that event convinced my parents that it was time to be proactive about passing the business to the second generation.

Until that point, my parents did not think about death and taxes being linked. Like many small business owners, they did not think about anything other than running and building a successful business. Our business today provides good jobs to over 300 employees. We are a typical small business when it comes to job creation. In fact according to the U.S. Small Business Office of Advocacy report, since 1970, small businesses have created two-thirds of net new jobs in America. If it were not for the death tax, this job creation would be even higher.

I have been keeping tabs on this debate over the past couple of years, and I often read that only 2% of American taxpayers actually pay this tax. **Mr. Chairman and members of this Committee, I can assure you that more than 2% of Americans do pay this tax—not to the federal government, but to lawyers, accountants and life insurance agents. We get involved in estate planning, because if we don't, all that we have worked for will be eliminated.** To ignore the death tax statute is suicide for our family business. My family alone pays $100,000 per year on a life insurance policy to cover the tax liability in the event of my mother's death. Plus, I would estimate annual legal and accounting fees at $20,000.

It's important to realize that this $120,000 is money that is *not* spent on growing our business or on providing better employee benefits, like health care, dental plans or 401(K) plans. These are products that we want to offer to our employees in order to maintain a quality work force.

I know that opponents of repeal say that small business owners don't need to worry about the death tax because there is a special provision that protects small businesses already in the law. **Unfortunately, the small business exemption that we have on the books is useless. That's why NFIB supports full repeal, not a patchwork of reforms.** We have been down the path of reform before, as recently as 1997, and at the end of the day, it only led us to a more complex statute filled with provisions that just do not work, and require more legal and accounting fees.

Additionally, I have heard opponents say that we should all just use insurance products to mitigate the effects of the death tax. Well, my father was uninsurable when he was alive, as are countless other Americans. We have purchased a policy on my mother, but as you have heard, these products are extremely expensive. **Unfortunately, we have a tax law that forces small businesses to slow their growth and divert needed cash flow to inefficient endeavors.** Particularly in today's economy, one must wonder why this is so.

Personally, I would rather spend my time focusing our family company on growth, on employee benefits and on community relationships. Since 1975, C.J. Coakley, Inc. has sponsored a philanthropic entity called Seton Centers. It was founded by my mother. This organization focuses on diagnosing and assisting children with learning disorders. We work directly with schools—both at the elementary and high school level—in the Northern Virginia area. In 1997, we also started a foundation that fosters educational endeavors. We are also involved in supporting activities and scholarship at Marymount University.

We do all of this because we truly care about these individual causes, not because some lawyer told us we could avoid taxes by jumping through a few hoops. For example, my brother suffered from dyslexia when he was growing up, which is why our family felt compelled to create Seton Centers. I support Marymount University because I went to school there. I also support Marymount because it is a local school with a strong ethics and philosophy program. Mr. Chairman, I hope you and the Committee will ignore the scare tactics surrounding the issue of charitable giving. Most Americans are generous to their fellow neighbors. We give because we care.

Finally, we all know that there are people out there on the other side of this issue who say we should *keep* the death tax. I could not disagree more. The death tax kills jobs and small business growth in America. It also kills incentive to work hard and take risk. Why work so hard to give it all away? If guilt-ridden billionaires are worried about funding the government, then I would encourage them to fire their lawyers and accountants and dedicate their estates to the federal government right

now, today. I implore you to stop them from holding the rest of us hostage to the death tax.

In closing, Mr. Chairman, I would like to strongly encourage this Committee and the Congress to bury the death tax once and for all. I understand that a majority of members in the House of Representatives have expressed support for completely eliminating the death tax by cosponsoring H.R. 8, the Death Tax Elimination Act. I hope this support will translate into action in the very near future on legislation that repeals this unfair tax on small businesses and on all Americans.

I thank the Chairman of this Committee for holding this important hearing, and thank all of you for the opportunity to present my experience before you today.

Chairman THOMAS. Thank you very much.

Unless anyone does not believe what the American Farm Bureau does to have political acumen, it is my pleasure to introduce the national president of the American Farm Bureau from Columbus, Texas, Mr. Stallman.

STATEMENT OF BOB STALLMAN, PRESIDENT, AMERICAN FARM BUREAU FEDERATION

Mr. STALLMAN. Thank you, Mr. Chairman, distinguished Committee members. My name is Bob Stallman. I am a rice and cattle producer from Columbus, Texas, and do serve as the elected president of the American Farm Bureau Federation. Thank you for the opportunity to explain why the Farm Bureau believes that the death tax should be repealed.

Eliminating death taxes is the top tax priority of the American Farm Bureau Federation. Families own 99 percent of our Nation's farms and ranches, and unless death taxes are repealed, many of these family farms are at risk.

The impact of death taxes with rates as high as 55 percent is so severe that its imposition can destroy farm businesses. When this happens, open space can be lost. Surviving family Members can be displaced. Employees can lose their jobs, and rural communities can lose their economic base.

Excessive tax rates are not the only reason that death taxes are so damaging to farm and ranch operations. Farm operations are capital-intensive businesses whose assets are not easily converted to cash. In order to generate the funds that are needed to pay hefty death taxes, heirs often have to sell parts of the businesses. When parts are sold, the economic viability of the business is destroyed.

Death taxes can also affect the longevity of farm and ranch businesses while the owner is still alive. Children must decide whether or not they intend to continue the family business. When faced with the realization that their family farm may not survive death taxes, many choose to voluntarily leave farm operations. Without children interested in the business, it is common for farmers to sell. Where there are alternative uses for farmland, land is often developed for those other uses and open space is lost.

An increase in the estate tax exemption is not the answer. Only repeal can erase the burden and uncertainties of estate tax planning. Because it is often difficult to predict the future net worth of a farm or ranch operation, many farmers and ranchers feel compelled to spend money for estate planning and/or life insurance. This expense is a drain on ongoing farm operations, and for some,

particularly given the economic conditions we face in agriculture today, the cost prohibits estate tax planning. Even with the best of plans, no attorney or accountant can guarantee that the plans farmers pay for will actually save their farms.

Death tax relief that targets farmers and small businesses isn't the answer either. Congress tried to provide relief to just family businesses in 1997 when it created the qualified family owned business exemption. Even though well intended, the provision is so complicated that it is not widely used. Attempts to target death tax relief make the law even more complex and necessitate even more extensive and expensive death tax planning. Even with the best advice, estates may fail to meet eligibility criteria at death, making a bad situation even worse.

Those who support death taxes often say that the tax should not be repealed because only 1 to 2 percent of estates are subject to the tax. Farm and ranch estates pay taxes at a much higher rate than the population at large. In a 1997 report, USDA estimated that over 14 percent of our most productive farms would owe Federal death taxes. Farm Bureau considers the loss of the most productive of our Nation's farms and ranches unacceptable.

Farm Bureau supports H.R. 8, the Death Tax Elimination Act of 2001, introduced by Representatives Dunn and Tanner. The bill phases out death taxes by lowering rates 5 percent a year until death taxes are gone. The legislation offers the added benefit of doubling the exemption as a way of providing immediate relief while we wait for the phase-out to be completed.

Farm Bureau also supports H.R. 8 because it continues the stepped-up basis. This is important to farmers and ranchers because of the relationship between basis and the capital gains taxes that farmers pay. Complete elimination of stepped-up basis would impose a new, potentially huge capital gains tax on farmers and ranchers. This would occur because farmers and ranchers hold their land for as long as they are in business. Statistics show that 79 percent of a typical farmer's or rancher's assets is land that has been held for 30 years while increasing in value 6 times.

Capital gains taxes increase the price of land, making it more difficult for children to take over the farms while their parents are still alive. The tax makes it harder for farmers to acquire land to expand so that additional family Members can enter the business. In addition, capital gains taxes also make it more difficult for family Members who want to keep farming to buy out their non-farming relatives who may have inherited part of the farm.

Last year, Congress passed a death tax elimination bill with Farm Bureau's support that provided a limited step-up in basis of $5.6 million per couple. If a change in basis is unavoidable, improvements in last year's bill are needed to make sure that businesses with assets that are held for long periods of time are not subject to excessive taxation. Farm Bureau recommends increasing the threshold and taking steps to make sure that taxes are not triggered on highly leveraged property at death.

Farmers and ranchers and other small businessmen are not alone in their support for death tax repeal. Last year, Congress overwhelmingly passed the Death Tax Elimination Act of 2000. This year, over half of the House has cosponsored H.R. 8. Public

opinion polls consistently show that seven of ten Americans think that death taxes should be repealed. Now is the time for Congress to eliminate death taxes.

Thank you.

[The prepared statement of Mr. Stallman follows:]

Statement of Bob Stallman, President, American Farm Bureau Federation

Chairman Thomas, Ranking Member Rangel and distinguished committee members. My name is Bob Stallman. I am a rice and cattle farmer from Columbus, Texas, and serve as the elected President of the American Farm Bureau Federation. Thank you for this opportunity to explain why Farm Bureau believes that death taxes should be repealed.

Eliminating death taxes is the top tax priority of the American Farm Bureau Federation. Families own 99 percent of our nation's farms and ranches and unless death taxes are repealed, many of these family farms are at risk. The impact of death taxes, with rates as high as 55 percent, is so severe that its imposition can destroy farm businesses. When this happens open space can be lost, surviving family members can be displaced, employees can lose their jobs and rural communities can lose their economic base.

Excessive tax rates are not the only reason that death taxes are so damaging to farm and ranch operations. Farm operations are capital intensive businesses whose assets are not easily converted into cash. In order to generate the funds that are needed to pay hefty death taxes, heirs often have to sell parts of the businesses. When parts are sold, the economic viability of the business is destroyed.

Death taxes can also affect the longevity of farm and ranch businesses while the owner is still alive. Children must decide whether or not they intend to continue the family business. When faced with the realization that their family farm may not survive death taxes, many choose to voluntarily leave farm operations. Without children interested in the business, it is common for farmers to sell. Where there are alternative uses for farmland, land is often developed for other uses and open space is lost.

An increase in the estate tax exemption is not the answer. Only repeal can erase the burden and uncertainties of estate tax planning. Because it is often difficult to predict the future net worth of a farm or ranch operation, many farmers and ranchers feel compelled to spend money for estate planning and/or life insurance. This expense is a drain on ongoing farm operations and for some the cost prohibits estate tax planning. Even with the best of plans, no attorney or accountant can guarantee that the plans farmers pay for will save their farms.

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Farmers and ranchers and other small businessmen are not alone in their support for death tax repeal. Last year Congress overwhelmingly passed the Death Tax Elimination Act of 2000. This year over half of the House has cosponsored H.R. 8, the Death Tax Elimination Act of 2001. Public opinion polls consistently show that seven of ten Americans think that death taxes should be repealed. Now is the time for Congress to eliminate death taxes.

Chairman THOMAS. Thank you very much, Mr. Stallman.

Mr. Blethen.

STATEMENT OF FRANK A. BLETHEN, PUBLISHER, *SEATTLE TIMES*, SEATTLE, WASHINGTON

Mr. BLETHEN. Thank you, Chairman Thomas.

I am the fourth-generation publisher of a 104-year-old independent, family operated newspaper, the *Seattle Times*. We are the largest newspaper in the Pacific Northwest. We employ over 2,500 people. We are known as a model workplace. We have been named 9 years in a row to Working Mother magazine's top 100 list. We are one of the few employers in the Pacific Northwest with an on-site day-care center, which we started 13 years ago.

We are also known for our journalism. We won three Pulitzer Prizes and were a finalist seven other times in the past decade.

We are committed to diversity and racial justice. We have one of the Nation's five most diverse newsrooms. In 1999, the Washington, D.C.-based Leadership Conference on Civil Rights awarded me the Chairperson's Award for Special Merit for my family's fight against I–200, the anti-affirmative action initiative in Washington State.

We are a values-based organization that puts our public service stewardship ahead of profits. The average public newspaper industry profit margin is more than twice what we will accept. The average industry newsroom has one employee for every 10,000 circulation. We have two. This is because, like most other independent and family businesses, we choose to invest in our company, our employees, and our community.

There are 5 family shareholders in our fourth generation and 11 in the fifth. Nine of us are actively involved. One is terminally ill, and the others are still in school.

Having worked with three generations on estate planning for 30 years, I have seen firsthand why the death tax kills most family businesses after the first generation and the rest after the second generation. I have experienced the disincentive to build the business and to create jobs.

When I started my career, the newspaper industry was dominated by locally owned newspapers that served our democracy with

a wide variety of voices. Today, out of about 1,500 daily newspapers, there are fewer than 300 independents left.

During my career, I have watched the death tax kill this wonderful community service and diversity of voices by driving ownership into a handful of absentee conglomerates who worry about profit margins rather than local communities and the First Amendment.

There are other reasons independent businesses don't survive, but the root problem is clearly the death tax, a tax which takes the incentive out of investing in the business or developing competent successors.

Family newspaper owners have few choices when moving beyond the second generation and planning for the death tax. None of them are good for their employees or communities and all of them hurt job creation and investment.

My good friends, publisher Alexis Reeves and Alejandro Aguirre, will tell you the death tax is just as devastating to small- and medium-sized businesses as it is to larger companies. Alexis is a third-generation publisher of the twice weekly inner-city Afro-American newspaper, The Atlanta Daily World. She employs about 20 people. Alejandro is the second generation in the largest Spanish language newspaper in Miami. The existence of both newspapers is threatened if the death tax isn't repealed.

I urge you to ask: Why aren't there more multi-generation, independent family businesses in all industries?

In an era when we lament the corporatization and impersonalization of America, we have an ineffective tax that favors absentee public corporations over independent local ownership. Yet these disadvantaged businesses are where the bulk of living-wage job creation takes place in America.

Unfortunately, much of this job creation is currently offset by the rampant public company downsizing and layoffs hammering our national economy and our local communities today.

By repealing the death tax, you have an opportunity to repeal the one tax that would turn our tax system around to one that seeks to preserve, perpetuate, and protect independent businesses and all the jobs and investments that go with them.

Our economy is comprised of two parts: the publicly traded sector and the private, non-publicly traded sector. Federal taxes should be neutral in regards to these sectors. Unfortunately, the Federal inheritance tax is not neutral. It severely penalizes the most important sector for job creation: the private, non-publicly traded sector. And it is a tool for the publicly traded sector to competitively overwhelm and often eliminate private sector competition.

Repealing the death tax would be excellent public policy, strongly favored by a strong majority of voters. Repeal will finally level the playing field between public and private companies, and repeal will stimulate the economy by encouraging all sizes of multi-generation family businesses and entrepreneurs to grow their business through investment and job creation.

Thank you.

[The prepared statement of Mr. Blethen follows:]

Statement of Frank A. Blethen, Publisher, *Seattle Times*, Seattle, Washington

My name is Frank Blethen.

I am the fourth generation publisher of a 104-year old independent, family-operated newspaper, The Seattle Times. At 500,000 circulation, we are the largest Sunday newspaper in the Pacific Northwest, and we are the largest daily newspaper in Washington state.

We are known in the newspaper industry as a model workplace, having been named nine years in a row to *Working Mother* magazine's national top 100 list for best places for mothers to work. We are one of the few employers in the Northwest operating an on-site day care center, which we started 13 years ago, in 1987.

We are also known for our journalism. We won three Pulitzer Prizes and were a finalist seven times during the past decade.

We are committed to diversity and racial justice. We have one of the nation's five most diverse newsrooms. We are considered a civil rights and diversity leader. In 1999 the Washington, D.C.-based Leadership Conference on Civil Rights awarded me the Chairperson's Award for Special Merit for my family's fight against I–200, the anti-affirmative action initiative in Washington state.

We are considered to be progressive in the areas of race, equality, environment, domestic violence, education, job creation and ethical leadership.

We are a values-based organization that puts our public-service stewardship ahead of profits. The average newspaper industry profit margin is more than twice what we accept. The average industry newsroom has one employee for every 10,000 circulation, we have two. This is because we, like most other independent and family businesses, choose to invest in our company and our community for the long term. This is what distinguishes the independent, private, non-publicly traded sector of our economy from the publicly traded sector.

There are five family shareholders in our fourth generation and eleven in the fifth. Nine of us are actively involved. One is terminally ill and the others are still in school.

Having worked with three generations of the Blethen family on estate planning for thirty years, I have seen first-hand why the Death Tax kills most family businesses after the first generation and the rest after the second generation. I have seen the disincentive to invest in and to build the business and to create jobs.

When I started my career the newspaper industry was dominated by locally-owned, independent newspapers that served our democracy with a wide variety of voices and who served their local communities with strong connections and investments.

Today, out of about 1,500 daily newspapers there are fewer than 300 independents left.

During my career, I have watched the death tax kill this wonderful community service and diversity of voices by driving ownership into a handful of large, absentee, public-company conglomerates. Many now controlled by faceless, institutional investors who worry about stock price and profit margins, rather than local communities, journalism, public service and the First Amendment.

There are other reasons independent businesses don't survive. But the root problem is clearly the death tax. A tax which takes the incentive out of investing in the business or developing competent successors.

Family newspaper owners have few choices when moving beyond the second generation and planning for the death tax. None of them are good for their employees or communities and all of them hurt job creation and investment. They are:

- liquidate
- sell out
- go public
- do costly, extensive estate planning, which drags capital and precious time away from the business and often does not solve the problem.

Many weekly and daily newspapers are too small to sell or go public, even though their very existence is threatened by the death tax. The ones that are large enough to go public to preserve family control are living on borrowed time. Witness the recent acquisition of the *Los Angeles Times*, *Arizona Republic* and Indianapolis newspapers by large, faceless, institutionally-owned public chains.

My good friends publishers Alexis Reeves and Alejandro Aguirre will tell you the death tax is just as devastating to small- or medium-sized businesses as it is to larger companies. Alexis is the third generation publisher of the twice-weekly inner-city African-American newspaper, *The Atlanta Daily World*. She employs about 20 people. Alajandro is the second generation in the largest Spanish language newspaper

in Miami. Both businesses are faced with liquidation or sale if the death tax isn't repealed.

A holding company technique, such as what my family has adopted, will only work as long as you can get all shareholders to agree to forgo wealth and liquidity for modest dividends and possible employment participation. This happens through heavy restriction on selling stock outside the family, so as to limit the individual's estate tax bill and facilitate gifting. But, it necessitates reckless gifting, such as I was forced to do in 1976 when I gifted 50% of my stock to my then two and four year-old sons. That gifting could have put our company at unnecessary risk. How could I know, when my sons were two and four, what kind of people and stewards they would turn out to be? The death tax forces family business owners into risky and sometimes fatal decision making.

Even in a holding company model like this, there is an onerous financial burden placed on individual shareholders. In our case, each family owner is forced to spend personally between $30,000–$50,000 per year on life insurance and estate planning. This is money that would otherwise be invested back in the business or donated to the community.

I urge you to ask, why aren't there more multi-generational, independent and family businesses? Quite simply, the problem is the death tax.

In an era when we lament the "corporatization" and "impersonalization" of America, we have an ineffective tax that favors absentee, public corporations over independent, local ownership in a variety of industries—from newspapers, to funeral homes, to drug stores, to jewelry stores, to car dealerships. And these are the businesses that invest in our local communities, and it is where the bulk of job creation takes place in America.

Unfortunately, much of this job creation is offset by the rampant, public company downsizing and layoffs hammering our national economy and local communities today.

By repealing the death tax, you have an opportunity, for the first time in all of our careers, to repeal one tax that would turn around our tax system to one that seeks to preserve, perpetuate and protect independent businesses and all the jobs, investment and community benefits that go with them.

Our economy is comprised of two parts. The publicly traded sector and the private, non-publicly traded sector. Federal taxes should be neutral in regards to these two sectors. We need them both to be healthy, strong and balanced. Unfortunately, the Federal Inheritance Tax isn't neutral. It severely penalizes the most important sector for job creation and investment—the private, non-publicly traded sector. And, it is a tool for the publicly traded sector to competitively overwhelm and often eliminate private sector competition.

Repealing the death tax is a responsible measure and a critical component of tax reform. It will level the playing field between private and public companies and will certainly stimulate the economy by encouraging entrepreneurs to grow their businesses, grow jobs and increase their investment in local communities.

Thank you for considering these critical concerns.

Chairman THOMAS. Thank you, Mr. Blethen.

Dr. Thorning.

STATEMENT OF ALLEN SINAI, CHIEF GLOBAL ECONOMIST, CENTER FOR POLICY RESEARCH, AMERICAN COUNCIL FOR CAPITAL FORMATION, AND PRESIDENT, DECISION ECONOMICS, INC., AS PRESENTED BY MARGO THORNING, AMERICAN COUNCIL FOR CAPITAL FORMATION

Ms. THORNING. Thank you, Mr. Chairman. My name is Margo Thorning. I am the chief economist and senior vice president for the American Council for Capital Formation. For over 25 years, the ACCF has focused its attention on tax policies to encourage saving, investment, and economic growth.

Mr. Chairman, I appreciate the chance to appear before this Committee and to share with you the results of a new study which

I would like to ask be included in the record, "Macroeconomic and Revenue Effects of the Elimination of the Estate Tax."

Chairman THOMAS. Without objection, and any written statements on the part of any of the witnesses will be made a part of the record.

Ms. THORNING. This new study is based on an analysis by Dr. Allen Sinai, an internationally respected macroeconomic modeler, frequent consultant to the Federal Reserve Board, and other Government agencies. The Sinai-Boston Model, which the analysis uses, includes considerable detail on the demand, the supply side, financial flows, capital flows, and other macroeconomic variables.

Using a model like Dr Sinai's, it is possible to estimate the impact of a change in tax policy on all sectors of the economy. Since I have limited time, I just want to give you the principal findings, and then I would be pleased to answer questions if you have any.

Dr. Sinai modeled five different options for estate tax repeal or reform, and the uniform conclusion is that under repeal and reform options he looked at, gross domestic product increases by a range of $90 billion to $150 billion over 8 years compared to the baseline forecast. Furthermore, job growth increases in the range of 80,000 jobs to 165,000 jobs per year compared to the baseline forecast. New business incorporations rise in the range of 45,000 a year to as much as 190,000 per year. Finally, tax receipts, excluding estate tax receipts, increase due to the stronger economy. We see higher corporate tax receipts, higher income tax receipts, more capital gains, more payroll taxes. Dr. Sinai estimates that we get back 20 cents for every dollar we lose for estate tax reductions.

One of the options he modeled, which was immediate repeal and loss of step-up in basis, actually raises revenue, total Federal tax revenues, compared to the baseline forecast.

So, in conclusion, his model allows us to glimpse the direction of change that the major variables in the economy would show if we repeal or substantially reform the death tax. And I think his model rather well captures the stories that have been told to us by Ms. David, Mr. Stallman, and Mr. Blethen.

So, with that, let me stop and I would be pleased to answer any questions.

[The prepared statement of Mr. Sinai follows:]

Statement of Allen Sinai, Chief Global Economist, Center for Policy Research, American Council for Capital Formation, and President, Decision Economics, Inc.

Special Report—March 2001

Macroeconomic and Revenue Effects of the Elimination of the Estate Tax

For nearly a quarter of a century, the ACCF Center for Policy Research has sponsored pathbreaking research on tax policies to encourage saving, investment, and economic growth. As the Bush Administration and the U.S. Congress prepare to debate various tax reduction proposals, the Center, in order to focus the discussion on the macroeconomic impact of five different options for repealing or reforming the federal estate tax, offers this Special Report, based on macroeconomic estimates, ***prepared by Dr. Allen Sinai, chief global economist and president, Decision Economics, Inc.***

The key conclusions of Dr. Sinai's preliminary findings are that when his model of the U.S. economy is used, estate tax repeal or reform increases both real Gross Domestic Product (GDP) and U.S. employment, compared to the baseline forecast. In addition, there are more new business incorporations and greater potential output of

goods and services. Finally, federal tax receipts rise in response to the stronger economy, feeding back approximately $0.20 per dollar of estate tax reduction, to some extent helping to pay for the estate tax reduction. ***In fact, one of the options, immediate repeal and elimination of step-up in basis, could increase total federal net tax revenues by $55 billion over the 2001–2008 period due primarily to the repeal of step-up in basis. ACCF Chief Economist Dr. Margo Thorning was invited to testify on the ACCF/Sinai study's findings before the House Ways and Means Committee on March 21. Earlier, the study was released at a March 15 Senate Finance Subcommittee on Taxation hearing on death tax repeal and reform.***

Introduction

The Sinai-Boston Econometric Model of the U.S. is a large-scale quarterly econometric model that includes considerable detail on aggregate demand, financial markets, sectoral flows of funds and balance sheets, interactions of the financial system with the real economy, and detailed trade and international financial flows. The advantage of a general equilibrium macroeconomic model instead of a partial equilibrium model for analyzing the impact of a change in the tax code is that a general model measures how the economy will respond after all aspects of the economy, financial system, inflation, and potential output are allowed to adjust to the new tax rates.

Macroeconomic Impacts

Dr. Sinai estimates the impact of five different reform and repeal options, including: (1) immediate repeal coupled with elimination of the step-up in basis; (2) immediate repeal of the estate tax with step-up in basis retained; (3) phaseout of the estate tax over eight years; (4) reduction of the top estate tax rate from 55 percent to 20 percent (the highest capital gains tax rate); and (5) reduction in the top estate tax rate from 55 percent to 39.6 percent (the top current individual income tax rate). Option 3 passed Congress last year as H.R. 8, the "Death Tax Elimination Act of 2000."

Preliminary results from early simulations, subject to further work and analyses, suggest the following effects from immediate elimination or reform of the estate tax, retroactive to January 1, 2001.

- GDP increases a cumulative $90 billion to $150 billion over the 2001–2008 period, or 0.1 percent to 0.2 percent compared with the baseline for several years out of the eight years in the preliminary runs (see Figure 1 and Table 1).
- Job growth ranges from 80,000 to 165,000 per year and the unemployment rate is slightly lower as a result (by 0.1 percent), with essentially no change in the inflation rate (see Figure 2 and Table 1).
- Both consumption and personal saving rise, as does national saving, despite the loss in estate tax receipts to the federal government.
- The level of potential output is somewhat higher, by an average $6 billion to $9 billion per year.
- Tax receipts, excluding estate tax receipts, rise in response to the stronger economy and financial system, feeding back approximately $0.20 per dollar of estate tax reduction, to some extent helping to pay for the estate tax reduction. One option—immediate repeal combined with the elimination of step-up in basis—increases total federal tax receipts by almost $55 billion over the 2001–2008 period compared to the baseline forecast because of the tax saving from elimination of step-up and the increase in capital gains realizations (see Figure 3 and Table 1).

Dr. Sinai estimates that about $45 billion of the $55 billion revenue increase is due to the elimination of step-up, rather than to faster economic growth.

Phasing in estate tax relief over eight or 10 years obviously reduces the macroeconomic impacts as does eliminating step-up in basis.

Conclusions

While work remains to be done in simulating and estimating the effects of removing the estate tax, this early work provides a glimpse of the directions of movement for key parameters of the macroeconomy—economic growth, jobs, entrepreneurship, and potential output—in response to estate tax elimination. Dr. Sinai's findings about the positive economic impact of estate tax repeal buttress the results of a recently released ACCF Center for Policy Research analysis by Syracuse University Professor Douglas Holtz-Eakin, "Estate Taxes, Labor Supply, and Economic Efficiency."

Allen Sinai is President and Chief Global Economist of Decision Economics. PDE is a global economic and financial market information and advisory firm serving fi-

nancial institutions, corporations, governments, and individual investors, with offices in New York, Boston, London, and Tokyo. Dr. Sinai is a pioneer in econometric model building and the information systems approach to economic forecasting, analysis, and monitoring. His previous experience includes senior-level positions at Lehman Brothers, Inc., and Data Resources, Inc. (where he was a co-developer of the DRI model of the U.S. economy). He also has participated in finance and economic programs at several prominent universities, is a fellow and past president of Eastern Economic Association, and author of numerous articles and publications. His advice is sought by both political parties, Congressional committees, and he has served as a consultant to the Federal Reserve Board. Dr. Sinai holds a B.S. degree in economics from the University of Michigan and Ph.D. in economics from Northwestern University.

Table 1: Impact of Estate Tax Repeal/Reform on U.S. Economic Growth, 2001–2008

Changes from baseline, cumulative except as otherwise noted

	Immediate Repeal, Loss of Step-up	Immediate Repeal, Step-up Retained	8-Year Phase-out	Lower Top Rate From 55% to 20%	Lower Top Rate From 55% to 39.6%
Real GDP (billions of 1996 dollars)	$131.6	$149.4	$103.2	$124.3	$88.2
Employment (average difference in levels per year)	164,761	132,443	94,311	113,647	80,521
New Business Incorporations (average difference in levels per year)	45,736	261,181	130,859	188,929	145,427
Total Federal Tax Receipts (fiscal years)	$54.3	−$211.1	−$110.4	−$108.8	−$37.0

Note: Assumes the saving in taxes paid is treated as an increase in disposable income as opposed to reinvesting in assets or paying down debt. Under different assumptions about how the tax savings is taken, the quantitative estimates might change but the direction of the results would not.

Source: "Macroeconomic Effects of the Elimination of the Estate Tax," by Allen Sinai, chief global economist and president, Decision Economics, Inc., preliminary report prepared for the American Council for Capital Formation Center for Policy Research, Washington, D.C., March 2001.

Figure 1 Real GDP Growth and Estate Tax Repeal/Reform, 2001–2008
Cumulative change from baseline in billions of 1996 dollars

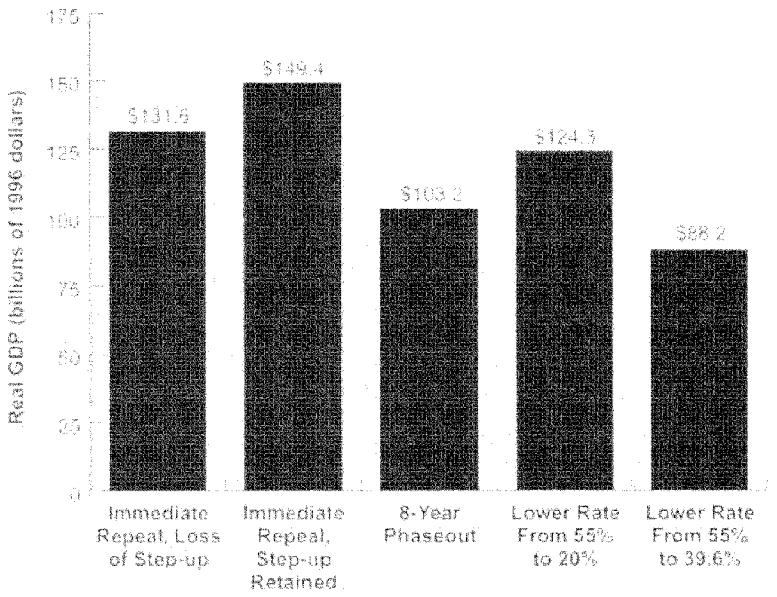


Figure 2 U.S. Employment and Estate Tax Repeal/Reform, 2001–2008
Annual average change compared to baseline

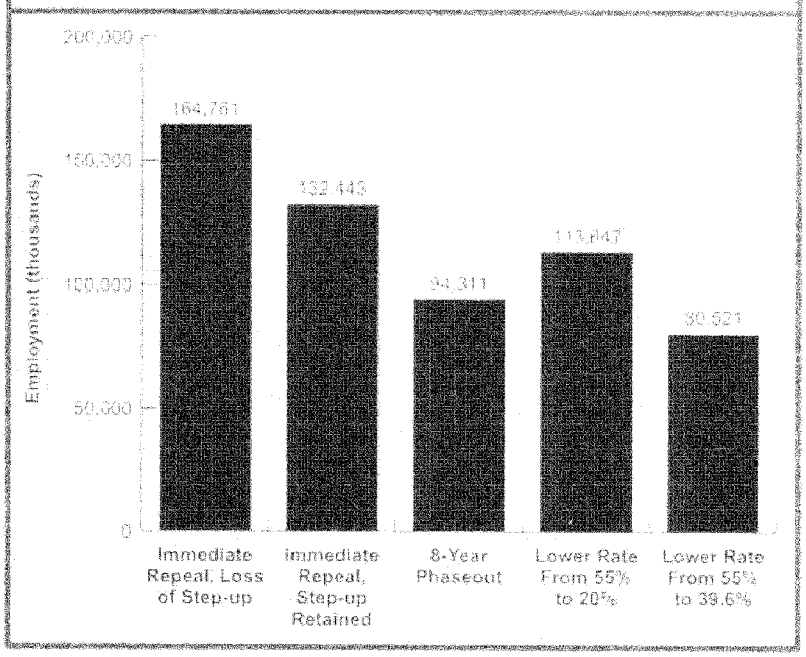
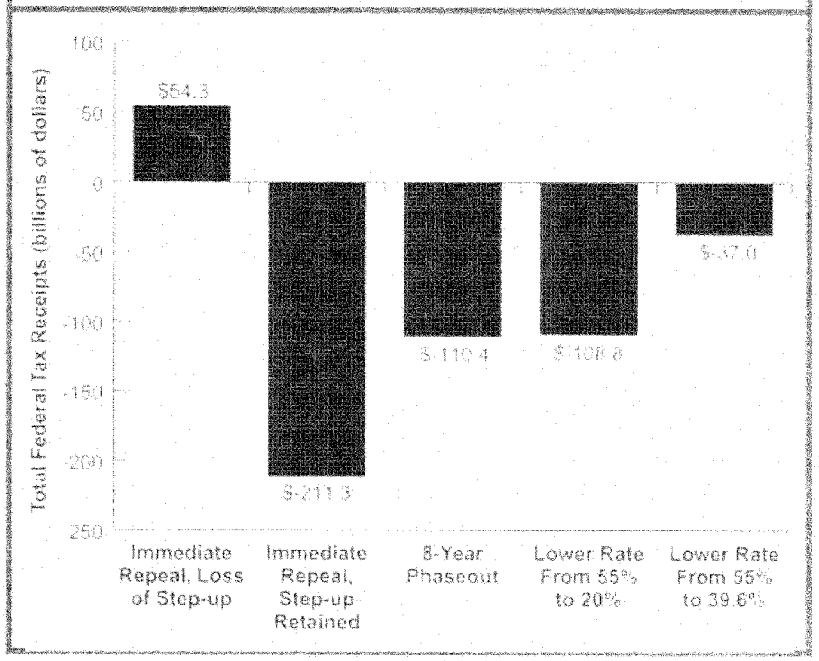


Figure 3 Total Federal Tax Receipts and Estate Tax Repeal/Reform, 2001–2008
Cumulative change from baseline, fiscal year basis, in billions of dollars



Chairman THOMAS. Thank you very much.

Ms. Detzel.

STATEMENT OF LAUREN Y. DETZEL, ATTORNEY, DEAN MEAD EGERTON BLOODWORTH CAPAUANO & BOZARTH, P.A., ORLANDO, FLORIDA

Ms. DETZEL. Thank you. My name is Lauren Detzel. I am an attorney from Orlando, Florida, and I have specialized in estate and tax planning for almost 25 years, and I am a former Chair of the Tax Section of the Florida Bar. I represent, among others, business owners, ranchers, citrus growers, and real estate developers, but I am here today representing the public sector for the sole purpose of bringing attention to some possible consequences of pending legislation dealing with the estate tax that may be overlooked or overshadowed by other testimony.

First, repeal may cost much more than $236 billion. While the White House administration claims that the proposed phase-out of the estate tax would cost the Federal Government $236 billion over the next 10 years, it may cost much more in lost revenue. How so?

Well, first, repeal of the gift tax will compromise the income tax because it will permit taxpayers to shift income to lower tax brackets. The present Federal gift tax system was adopted not just to supplement the estate tax, but also to preserve the integrity of the Federal income tax system. If the gift tax is repealed, the income tax will be compromised because it will permit taxpayers to give income-producing assets to others in lower income tax brackets at no gift tax cost and to reacquire the income again without tax. This will shift a heavier burden of taxes to those who work because this shifting of this tax can only be done with investment income, not earned income.

Second, continued step-up in basis for inherited assets will erode the income tax even further by allowing individuals to show low-basis assets to others who will die soon. Under current law, the income tax basis of an asset is changed to its fair market value when the owner dies. This is what has been referred to today here as a step-up in basis. Without a gift or estate tax, property owners will transfer their appreciated assets to others who will die soon and arrange fairly easily to reinherit the property in order to secure the step-up in basis. Neither the gifts to the others nor the reinheritance will be subject to gift or estate tax.

Income taxation of life insurance proceeds will have to be changed or carryover basis will be a hollow victory. Under current law, proceeds paid by reason of the death of an insured are not included in gross income. Unless this provision is repealed, individuals can move a significant portion of their wealth to life insurance policies to avoid income tax if a carryover basis system is enacted. Again, this favors those with investment type assets because this mechanism of moving assets to inside an insurance product umbrella would not be available to those owning farms, small businesses, real estate development, et cetera.

Carryover basis will represent a new complex tax system, which Congress has previously rejected. In 1976, Congress adopted a car-

ryover basis system for inherited wealth. Four years later, and after much study and analysis, it retroactively repealed that system, in large measure because it was regarded as too complicated and because it required too much recordkeeping by taxpayers. Nothing has changed, and the same will be true today.

Widows and many others will pay more tax with a carryover basis system and no estate tax. Today, a widow may inherit assets, pay no estate tax, due to the unlimited marital deduction, and secure a complete step-up in basis and assets so that no income tax is paid either. If carryover basis is enacted, along with the repeal of the estate tax, that same widow will now pay more tax. She will pay the income tax on assets sold during her lifetime.

Widows will be adversely affected by repeal of the estate tax in other ways. In addition to the added income tax burden, widows also may likely lose in two other ways if the estate and gift tax is repealed.

First, most States allow a widow to demand a minimum share of her deceased spouse's estate, but this share can be diminished in many States by her husband making gifts at least 1 year before death. This doesn't occur now because that would cost a gift tax. If the barrier of gift tax is taken down, individuals who want to disinherit their spouses will be able to do so much more easily.

Second, most married persons leave their entire estate to or in trust for their surviving spouses, primarily because no estate tax has to be paid under that arrangement until the surviving spouse dies. If there is no estate tax, fewer married decedents will choose to have their entire estate dedicated to their surviving spouses.

Severe complexity will arise from a phased-in repeal of estate tax. Many of the bills would phase in repeal of the estate tax. Such proposals would represent an enormously complicated system for individuals. Each person would have to prepare new dual track wills, providing at a minimum for different dispositions of their wealth upon death, depending upon whether they or their spouses die before or after the estate tax is totally repealed. Further, many taxpayers will be forced to do planning to save estate taxes now because they can't be assured that they are going to outlive the phase-in period. And after repeal, they will have to do planning again in many cases to attempt to unwind the planning that they have to do now. So they will get to pay me now and they will get to pay me later. Also, a carryover basis system will likely require as much or more planning for individuals.

A more sensible approach should be adopted. Virtually everyone agrees that the Federal estate tax system should be improved. It shouldn't apply to small family farmers, businesses, and others whose wealth is relatively modest. Provisions currently in the Code can be changed to accomplish that. What is critical is for Congress to thoroughly study the overall social, fiscal, and economic impact of any significant change to such an important part of our Nation's tax laws.

Thank you for your consideration.

[The prepared statement of Ms. Detzel follows:]

Statement of Lauren Y. Detzel, Attorney, Dean Mead Egerton Bloodworth Capauano & Bozarth, P.A., Orlando, Florida

I. SUMMARY

• **Repeal Will Cost Much More Than $236 Billion.** While the White House administration claims that the proposed phase out of the estate tax would cost the Federal government $236 Billion over the next ten years, it will undoubtedly cost the United States government much more in lost revenue.

• **Repeal of the Gift Tax Will Compromise the Income Tax Because it Will Permit Taxpayers to Shift Income to Those in Lower Tax Brackets.** First, the present Federal gift tax system, enacted in 1932, was adopted not just to supplement the estate tax but to preserve the integrity of the Federal income tax system. If the gift tax is repealed, the income tax will be compromised because it will permit taxpayers to give income producing assets to others in lower income tax brackets at no gift tax cost.

• **Continued Step-Up in Basis for Inherited Assets Will Erode the Income Tax Even Further by Allowing Individuals to Shift Low Basis Assets to Others Who Will Die Soon.** Second, under current law, the income tax basis of an asset is changed to its fair market value when the owner dies, in most cases. This basis adjustment is known as the "income tax free step-up in basis." Without a gift or estate tax, property owners will transfer their appreciated assets to others who will die soon and arrange to reinherit the property in order to secure the step-up in basis. Neither the gifts to the others who will soon die nor the reinheritance will be subject to gift or estate tax.

Not all the bills introduced to repeal the estate tax would permit an unlimited step-up in basis. However, all bills would provide a relatively high level of step-up. That means that the "gaming" of the type described above will continue. A limited step-up in basis merely means it will be harder to achieve a significantly increased basis when someone dies.

• **Income Taxation of Life Insurance Proceeds Will Have to be Changed or Carryover Basis Will be a Hollow Crown.** Under current law, proceeds paid by reason of the death of an insured are not included in gross income. In effect, life insurance proceeds are entitled to the income tax free step-up in basis enjoyed by most other assets owned at death. It seems certain that unless this provision is repealed, individuals simply will move all or a significant portion of their wealth to life insurance policies if a carryover basis system is enacted. If the exclusion from gross income for life insurance proceeds were eliminated as part of a carryover basis system, the impact on the life insurance industry and the beneficiaries of such policies would be significant.

• **Carryover Basis Will Represent a New Complex Tax System, which Congress Has Previously Rejected.** In the Tax Reform Act of 1976, Congress adopted a carryover basis system for inherited wealth. Four years later, it repealed the system retroactive to its original date of enactment in large measure because it was regarded as too complicated. The same will be true today.

• **Widows and Many Others Will Pay More Tax With a Carryover Basis System and No Estate Tax.** Today, a widow or widower may inherit assets, pay no estate tax (due to the marital deduction) and secure a complete step-up in basis. Others, under the current tax system, save more income tax from the stepped-up basis of inherited wealth than they pay in estate tax.

• **Widows, Charities and Others Will be Adversely Affected by Repeal of the Estate Tax.** As already discussed, widows and widowers will be disadvantaged by a repeal of the estate tax unless a complete step-up in basis system is retained. Widows (or widowers) also will likely lose in two other ways. First, most states require that a widow (or widower) inherit a minimum share of the deceased spouse's estate. Although that forced inheritance can be avoided in most states by making gifts to others at least a year before death, usually that does not occur because such gifts result in gift tax. If the barrier of gift tax is taken down, individuals who want to disinherit their spouses will be able to do so much more easily. Second, most married persons leave their entire estate to or in trust for their surviving spouses. The reason is because the tax allows the estate tax to be postponed until the surviving spouse dies. If there is no estate tax, fewer married decedents will choose to have their entire estate dedicated to their surviving spouses. The real impact will fall more severely on women than men because there are many more widows than widowers.

Charities will likely receive less from decedents' estates than they do today. Although it is difficult to quantify what the drop off in bequests to charity will be, many knowledgeable persons think it will be significant. It might be mentioned that the proposal to make the income tax deduction for donations to charity an "above

the line" deduction apparently is premised on the theory that giving tax breaks for gifts to charity will spur more charitable giving. The same is true for transfers at death. If there is no tax benefit to making charitable bequests, during lifetime or at death, fewer will do so.

• **Severe Complexity Will Arise From a Phased-In Repeal of Estate Tax.** Many of the bills would phase in the repeal of the estate tax. Such proposals would represent an enormously complicated system for individuals. Each person would have to have "dual track" wills and other estate planning documents providing, at a minimum, for different dispositions of their wealth upon death depending upon whether they (or, in some cases, their spouses) die before or after the estate tax is totally repealed. Also, a carryover basis system will likely require as much or more planning for individuals and as many decisions in post-death estate administration as does the current estate and gift tax system. Everyone, currently rich or currently poor, will have to retain records of purchases, sales, depreciation, trades and all other factors that could affect ownership and income tax basis to comply with carryover basis rules.

• **A More Sensible Approach Should Be Adopted.** Virtually, everyone agrees that the Federal estate tax system should be improved. It should be made not to apply to the estates of owners of small family farms and other small family businesses and others whose wealth is also modest. Provisions currently in the Code can be changed to accomplish that. What is critical is for the Congress to thoroughly study the overall social, fiscal and economic impact of any significant change to an important part of our nation's tax laws. The Federal estate and gift tax system certainly is one of those important parts.

II. ANALYSIS

• **Repeal Will Cost Much More Than $236 Billion.** The $236 Billion revenue loss over the next ten years attributable to the repeal of the estate, gift and generation-skipping transfer taxes (see Subtitle B of the Internal Revenue Code of 1986, as amended) is premised upon an eight- to ten-year phase-out of those taxes. The loss of revenue to our Federal government attributable to the collection of those taxes could be as great as $1 Trillion over the ten-year period following complete repeal. If the phase-in of repeal is faster, the cost will increase; if the phase-in is slower, the cost will decrease, all other things being equal. In any case, the $236 Billion estimate of lost revenue to the Federal government fails to take into account that the income tax revenues also will be substantially diminished if the estate and gift tax system is repealed. Income tax revenues will diminish because individuals will be free to transfer income producing assets to others in lower income tax brackets and to transfer assets to others who will die soon, thereby securing the income tax free change in basis that will occur upon death.

• **Repeal of the Gift Tax Will Compromise the Income Tax Because it Will Permit Taxpayers to Shift Income to Those in Lower Tax Brackets.** The present Federal gift tax system, enacted in 1932, was adopted not just to supplement the estate tax but to preserve the integrity of the Federal income tax system. See *Dickman* v. *United States*, 465 U.S. 330 (1984). Repealing that tax will compromise the income tax because it will permit taxpayers, without any gift tax cost, to give income producing assets to others in lower income tax brackets. For example, a father, rather than selling appreciated stock he owns, would give it to his daughter (or a trust for her benefit) who is in a lower income tax bracket than he is. She (or her trust) would sell it and pay a lower tax than her father would have paid. She then could give the proceeds back to her father, again without gift tax. Individuals, in fact, may gift all income producing assets, such as stocks producing dividends, real estate producing rents and bonds producing interest (as well as appreciated assets) to others in lower tax brackets. This will reduce income taxes on those whose income is derived from assets and shift a heavier burden to those whose income is produced by working. John Buckley noted in his article which appeared in *Tax Notes*, on January 22, 2001, that 70 percent of individual tax returns are filed by individuals who are totally exempt or in the 15 percent tax bracket, thus making the pool of individuals to be used for these purposes quite extensive.

Partnerships also will prove to be a convenient way to control the recognition of gain, the collection of income and its distribution. Without any concerns about estate and gift tax, individuals are likely to form limited partnerships of which they are the general partners and give away (non-voting) limited partnership interests to others in lower income tax brackets which will cause the taxable income and gain to be attributed to the limited partnership units to be taxed to the recipients of such gifts. Because the wealthy individual is the general partner, he can control the distribution of any actual cash to the limited partner and indirectly control the gift of some or all of such cash back to himself.

Individuals with trusted relatives overseas may be able to completely avoid paying any Federal income tax on their income producing assets. They will be able to give the assets to their relatives (either directly or through certain types of trusts or partnerships) who are neither U.S. citizens nor U.S. tax residents. The relatives (or their trusts or partnerships) will be able to invest to avoid U.S. income taxes (such as by investing in United States Treasury Bonds). In turn, these individuals will be able to give the income, directly or indirectly, to the original American property owner who made the gifts of the income producing assets.

Although some may contend that the "anticipatory assignment of income," "sham," and "step transaction" doctrines would prevent such income shifting, those claims probably are meritless unless significant new tax legislation is enacted. Proof of that is contained throughout the Internal Revenue Code, such as the so-called "kiddie" tax contained in section 1, the grantor trust rules contained in sections 671–679, and the family partnership rules contained in section 704(e). In any case, because such gifted transfers will no longer be reported (as the gift tax system will be repealed), enforcement will become extremely problematic. To think that individuals will not take action to reduce their income taxes when the barrier of gift taxation is removed ignores the history of our tax system and is naive.[1]

• **Continued Step-Up in Basis for Inherited Assets Will Erode the Income Tax Even Further by Allowing Individuals to Shift Low Basis Assets to Others Who Will Die Soon.** Under current law, the income tax basis is changed to the asset's fair market value when its owner dies, in most cases. See section 1014(a). This is known as the "income tax free step-up in basis." Without a gift or estate tax, property owners will transfer their appreciated assets to others who will die soon, thereby securing the stepped-up basis and arranging to reinherit the property when the others die.[2] Neither the gifts to the others who will soon die nor the reinheritance will be subject to gift or estate tax. And, under current law, the person to whom the assets will be given does not even have to be granted any ownership in the assets that will be included in his or her estate and which will receive the step-up in basis at death. All that need be granted is what is called a "general power of appointment." That is a power to direct that the property may be paid to the person who holds the power, his estate, his creditors or the creditors of his estate. Such a power causes the property to be included in the power holder's estate. See section 2041. But such a power causes estate tax inclusion even if it may be exercised only with the consent of someone who would not be adversely affected by the exercise of the power. For example, an individual holding appreciated property finds an unrelated person who will soon die. The property owner grants the dying person a general power of appointment that may be exercised only with the consent of the property owner's spouse, children, attorney and accountant. It is inconceivable that the person granted the power will be permitted to exercise it. Also, the power causes the property to be included in the power holder's estate even if he is completely unaware of the power. Of course, any system permitting even a partial step-up in basis at death will have to be revised to prevent that result. But other methods to "game" the system are certain to arise. It is appropriate to mention that gaming the system with a step-up in basis rule without estate tax will apply not just to capital gain property but virtually every other type of property, including inventory and other assets which if sold would be taxed as ordinary income.

Not all the bills introduced to repeal the estate tax would permit an unlimited step-up in basis. However, all bills would provide a relatively high level of step-up. That means that the gaming of the type described above would occur even with a limited step-up in basis. A limited step-up in basis merely means it will be harder to achieve a significantly increased basis when someone dies. For example, if a step-up in basis is permitted for $2.8 Million of assets and an individual owns $28 Million of appreciated property, he would have to find ten individuals who will die soon rather than only one. Senate Bill 275 introduced by Senator Kyl on February 7, 2001, provides for a step-up in basis at death equal to the aggregate basis of all of the decedent's property plus $2,800,000.00. Unlike H.R. 8 (the Death Tax Elimination Act of 2000, passed by Congress but vetoed by President Clinton on August 31, 2000) which utilized an asset by asset carryover basis approach, Senate Bill 275 would allow an executor to transfer basis from assets not likely to be sold or which

[1] An article written by Jonathan Blattmachr and Mitchell Gans cites numerous examples of the potential to "game" the income tax system. See "Wealth Transfer Tax Repeal: Some Thoughts on Policy & Planning", *Trusts & Estates*, Volume 140 #2 pg. 49 (Feb. 2001).

[2] Section 1014(e) disallows a basis adjustment for property given to a decedent within one year of his or her death but only if the property is reinherited by the donor. It is relatively easy to circumvent this provision by having the decedent create a trust for the benefit of the donor and others such as other members of the donor's family.

will depreciate (such as personal residences, cars, boats, art, jewelry, etc.) to investment assets to effectively reduce capital gains on the sale of such assets.

Also, depending upon the exact provisions enacted, bills that are intended to limit the level of step-up in basis actually will permit individuals to secure a much greater step-up in basis than the dollar limitation contained in the bill. The reason relates to debt on property. For example, an individual owns real estate having a current fair market value of $10 Million with an income tax basis of only $1 Million. The individual borrows $9 Million before death, securing the debt with the property. (The $9 Million of borrowed cash, of course, has a $9 Million basis). But now there would be an increase in basis because, under current law, which does not appear to be changed by the bills which would limit the step-up in basis, the debt against the real estate would be added to basis upon the individual's death. In fact, as explained in McGrath & Blattmachr, **Carryover Basis Under the 1976 Tax Reform Act** (Journal of Taxation, 1977) (hereinafter referred to as "McGrath & Blattmachr"), pp. 161–162, the basis of property subject at death to debt could be greater under a carryover basis system than the current system providing for a step-up in basis at death. Moreover, as that book details, other opportunities to avoid the carryover basis system exist and will be developed.

• **Income Taxation of Life Insurance Proceeds Will Have to be Changed or Carryover Basis Will Be a Hollow Crown.** Under current law, proceeds paid by reason of the death of an insured are not included in gross income. See section 101(a)(1). In effect, life insurance proceeds are entitled to the income tax free step-up in basis enjoyed by most other assets owned at death. It seems certain that unless that provision of the law is repealed, individuals simply will move all or a significant portion of their wealth to life insurance policies if a carryover basis system is enacted. Under the carryover basis system enacted by the Tax Reform Act of 1976, insurance proceeds continued to be excluded from gross income and that represented a severe threat to the integrity of that carryover basis system. For example, individuals will borrow against their appreciated assets, place them into cash value life insurance products, and have the same investments made inside the policy that the individual would have made (or continue to have made) if the cash had not been placed inside of the policy's cash value. If the exclusion from gross income for life insurance proceeds were eliminated as part of a carryover basis system, the impact on the life insurance industry and the beneficiaries of such policies would be significant. It would represent the most severe change in the taxation of life insurance proceeds since the adoption of the Sixteenth Amendment to the United States Constitution. Clearly, serious thought would have to be given to making such a fundamental change to the tax law. Yet serious thought must be given to eliminating or restricting the income tax free receipt of death proceeds under section 101(a)(1) if any type of carryover basis system is adopted as part of estate tax repeal. As pointed out earlier, failure to limit the step-up in basis at death will go far in destroying the integrity of the Federal income tax system.

• **Carryover Basis Will Represent a New Complex Tax System, Which Congress Has Previously Rejected.** In the Tax Reform Act of 1976, Congress adopted a carryover basis system for inherited wealth. Four years later, it repealed the system retroactive to its original date of enactment in large measure because it was regarded as so complicated. In fact, the House Ways & Means Committee (or subcommittees of the Committee) held extensive hearings about the system. Most witnesses stated that the system was "unworkable." The complexity of the system is discussed in detail in McGrath & Blattmachr. The same will be true for any carryover basis system enacted today. Yet, as explained above, some type of carryover basis system is certain to be adopted if the estate tax is repealed. Otherwise, the Federal income tax system will be at risk, as detailed earlier.

• **Widows and Many Others Will Pay More Tax With a Carryover Basis System and No Estate Tax.** Today, a widow or widower may inherit assets, pay no estate tax (due to the estate tax marital deduction allowed under section 2056) and secure a complete step-up in basis. As explained, some type of carryover basis system seems inevitable if the estate tax is repealed. Hence, surviving spouses will be disadvantaged by the new system. Allowing widows (or widowers) to continue to enjoy a complete step-up in basis will erode any carryover basis system intended to apply to others, such as children. For example, a man would leave his appreciated assets to his widow, who would secure the tax free step-up in basis. She could immediately give those assets to her children. The carryover basis system will be eroded, accordingly, if not made to apply to the inheritances of surviving spouses. Others, under the current tax system, save more income tax from the stepped-up basis of inherited wealth than they pay in estate tax. For example, under current law a man dies owning real estate having a gross fair market value of $10 Million, subject to a $9 Million debt, and a basis of close to zero (due to depreciation taken during

lifetime or for other reasons). He leaves the real estate to his son. Because the net value of the real estate is only $1 Million, the son will pay no more than $550,000[3] in estate tax, and likely less than that. The son's basis in the inherited real estate is the property's gross value of $10 Million. If he sells the property for its fair market value of $10 Million, he pays no capital gains tax, and so he nets $9.45 Million (after the $550,000 estate tax paid). (In fact, if the son could depreciate the basis of the property and deduct the depreciation against ordinary income the step-up in basis would save him even more.) But under the elimination of the estate tax/carryover basis system, he may be limited to his father's basis of zero. Hence, if he sells the real estate for $10 Million, he will net only $8 Million because he will have to pay $2 Million in capital gains tax, and if the debt is still owed, he will be $1 Million "in the hole."

• **Widows, Charities and Others Who Will Be Affected by Repeal of the Estate Tax.** As already discussed, widows and widowers will be disadvantaged by a repeal of the estate tax unless a complete step-up in basis system is retained. Widows (or widowers) also will likely lose in two other ways. First, most states allow a widow (or widower) to demand a minimum share of the deceased spouse's estate. See e.g., New York EPTL 5–1.1 and Florida Statutes §§ 732.201–228. Although that "forced inheritance" can be avoided in most states by making gifts to others at least a year before death, usually that does not occur because such gifts result in gift tax. If the barrier of gift tax is taken down, individuals who want to disinherit their spouses (or more severely limit what the spouse can demand upon death) will be able to do so much more easily. Second, most married persons leave their entire estates to or in trust for their surviving spouses. The reason is because the tax allows the estate tax to be postponed until the surviving spouse dies. See section 2056(a). If there is no estate tax, fewer married decedents will choose to have their entire estates dedicated to their surviving spouses. The real impact will fall more severely on women than men because there are many more widows than widowers.

Charities will likely receive less from decedents' estates than they do today. Although it is difficult to quantify what the drop off in bequests to charity will be, many knowledgeable persons think it will be significant. See *The New York Times* (National Edition), Saturday, February 10, 2001, page A–11, entitled, "A Bush Aide Faults Plan to Repeal Estate Tax" ("John J. DiIulio, Jr., Director of the New White House Office of Faith-Based and Community Initiatives, says repeal could undercut another administration priority: encouraging private contributions to charities, religious and nonreligious alike, that help the poor.") It might be mentioned that proposals contained in bills currently before the Congress to make the income tax deduction for donations to charity an "above the line" deduction apparently is premised on the theory that giving tax breaks for gifts to charity will spur more charitable giving. The same is true for transfers at death. In fact, there should be a greater incentive to give more to charity at the 55 percent estate tax bracket than at the lower income tax brackets. If there is no tax benefit to making charitable bequests, during lifetime or at death, fewer will do so.

• **Severe Complexity Will Arise From a Phased-In Estate Tax.** Many of the bills would phase-in the repeal of the estate tax. Such systems would represent an enormously complicated system for individuals. Each would have to have "dual track" wills and other estate planning documents providing, at a minimum, for different dispositions of their wealth upon death depending upon whether they (or, in some cases, their spouses) die before or after the estate tax is totally repealed.[4] These individuals also will face the uncertainty of whether total repeal will ever be achieved due to the needs of our government for additional revenue or because of change in political philosophy or change in governing parties. Individuals will be caught in a twilight zone of uncertainty on whether they should make tax-efficient gifts, use the marital deduction, and take other common estate planning steps, such as creating a so-called "personal residence trust" described in section 2702 or a "charitable lead trust" described in section 170(f)(2)(B) or family partnerships. Further, after the estate tax has phased-out, not only will new documents have to be redone, but it may be difficult to unwind the planning done in anticipation of estate tax being paid.

Also, a carryover basis system will likely require as much or more planning for individuals during life and as many decisions in post-death estate administration

[3] The Federal estate tax, in fact, can rise to 60% in some cases. See section 2001(c)(2).

[4] In addition, all wills that have previously been "estate tax planned" will need to be reviewed and/or revised, particularly those that provide a marital deduction formula bequest to a spouse equal to the amount necessary to reduce the estate tax to zero. If there is no estate tax or need for a marital deduction, these formula clauses could end up providing that the spouse receives nothing.

as does the current estate and gift tax system. See, e.g., McGrath & Balttmachr, Chapter 19. Everyone, currently rich or currently poor, will have to retain records of all purchases, sales, depreciation, trades and all other factors that could affect ownership and income tax basis of all assets (even personal use assets) they ever acquire to comply with carryover basis rules. No matter how high the step-up in basis level the law allows, each person will hope his or her wealth will exceed that level and, as a result, each will have to maintain the records. In fact, with respect to marketable securities, a carryover basis system will require much more record keeping than does the current estate and gift tax system. Under the current system, no records of basis, stock splits, stock dividends, tax free exchanges, etc. need be maintained for purposes of inheritance because of the step-up in basis at death, and the rule for valuation of marketable securities for estate tax purposes is simple and direct. See Treasury Reg. 20.2031–2. Under carryover basis, complete and lifelong record keeping for marketable securities (and all other assets that might be owned at death) must be kept for life. In fact, it might require multi-generational record keeping because assets inherited by a child might be kept until the child, in turn, dies and then inherited by members of the child's family. It is appropriate to mention again that Congress retroactively scrapped the carryover basis system it enacted in 1976 by the Windfall Profit Tax Act of 1980 in significant part on account of the record keeping and administration problems such a system presented.

• **The States Will Lose Enormous Revenue if the Federal Estate and Gift Tax Systems Are Repealed.** Every state will lose in one way, if the Federal estate and gift tax systems are repealed, and the 43 states (and the District of Columbia) which impose income taxes will lose to an even greater degree. First, every state, without exception, imposes a death tax equal to the state death tax credit allowed under section 2011. That credit reduces the gross Federal estate tax, dollar for dollar, up to the limit set forth in the section. In many states, the estate tax represents a significant portion of the state's revenue. In New Hampshire, for example, it is about 4.5%; in Florida and New York, it is approximately 2.7%. Although some states could enact an independent estate tax system to curb this shortfall, that will be politically difficult if not impossible for many and unconstitutional for others. For example, Florida's Constitution prohibits the imposition of any estate tax, except for the state death tax credit amount because that merely represents "free" revenue sharing from the Federal government to the state. Florida Constitution, Article 7, Section 5.

As indicated, the states (and cities) that impose an income tax will face a more serious erosion of revenue if the gift tax is repealed. The type of shifting of income producing assets to others, which is certain to happen to avoid or reduce Federal income tax, will occur to an even greater degree with respect to avoiding state (and local) income taxes. In fact, it will be easier to avoid state and local income taxes than Federal income taxes. There are several reasons. First, states are limited by the United States Constitution (and often their state constitution as well) as to their ability to tax property located outside of their jurisdiction. Second, individuals can create trusts for their own benefit outside of their home state in jurisdictions which impose no state income tax. That can be done even if the trust permits distributions back to the grantor only with the consent of an "adverse party." See section 677(a). Although trusts reach the top Federal income tax rate at very low levels of taxable income, so no Federal income tax may be saved by creating such a trust, all state and local tax may be avoided. If the Federal government loses no income tax revenue by such shifting of income, it will have no incentive to try to challenge such arrangements. And, of course, virtually every state (and local) income tax system relies on enforcement primarily by the IRS. That, in turn, raises another reason why the ability to shift income away from the states will occur. It simply will be impossible, as a practical matter, for the states to attack such arrangements. The states (and cities) will not even be aware that the shift of ownership has occurred because there need be no reporting of such gifts of income producing property because the Federal gift tax will be repealed.

As indicated, the impact on many states will be more significant than the loss of the state death tax credit amount. For example, in New York State, state income taxes on capital gains, dividends and interest comprise about 9% of that state's total revenues. Certainly, not all that tax will be avoided but it is likely a significant portion will be. New York's income tax reaches a level of only about 6%. In states, such as Oregon and California, where the tax rates are higher, the erosion will be greater.

It is incumbent upon the Congress to consider the impact on the states in considering what should be done with respect to the Federal estate and gift tax systems.

• **A More Sensible Approach Should Be Adopted.** Certainly, the Federal estate and gift tax system should be revised to make it apply in ways that are fairer

and which simplify the system. Provisions already in the Internal Revenue Code reduce or eliminate estate tax on farms and other closely held business and provide ways in which the estate tax may be paid over an extended time. See sections 2032A, 2057, and 6166. Certainly, the limitations contained in the Code should be increased and, perhaps, liberalized and the provisions simplified. Also, the basic estate tax exemption (currently $675,000) should be increased, and then "indexed" for inflation. Also, the initial rates above the exemption (now 37%) should be reduced, the "brackets" spread out and the top rate (of 55%) should begin only at a very high level (such as $10 Million). These brackets should also be indexed for inflation. However, as recently suggested by noted commentator, Steve Leimberg, "no matter which side of the repeal/reform issue you are on . . ., it is essential to perform a thorough and multi-dimensional (and ideally bipartisan and professionally conducted) impact study before any new major tax legislation is passed so that the overall economic and social implications and costs of proposed tax law changes are thoroughly considered." He goes on to note that "there is no 'free lunch' in the tax law. All change—no matter how it is presented to the public comes at a cost to someone. We need our leaders on both sides of the political fence to be more open, honest and provide better and more complete explanations of how tax law changes affect various segments of the population."

Chairman THOMAS. Thank you very much. This is the kind of panel that allows us to allow you to discuss among yourselves the arguments that are presented so that we can listen, and I appreciate the panel's willingness to present their positions.

I probably better understand Ms. Coakley David's position from a real-world situation, I guess, and, Mr. Stallman, I am little more familiar with farms and the problems especially of busting up farms and the inability to try to sell the pieces off to make them economically viable and that downturn, and I guess a family owned newspaper.

So if the panel will allow me for my time, I would like to turn to Dr. Thorning and ask her, first of all, to respond to some of the points that Ms. Detzel made and then give Ms. Detzel an opportunity to respond back.

In the spirit of expanding on the question of repeal/not repeal, rather than some interim position, which I think most of us can envision, which would basically be raising the threshold, would you comment on the arguments that Ms. Detzel made about the complications and difficulties of repeal, Dr. Thorning?

Ms. THORNING. Thank you, Mr. Chairman. I think it is possible to get there from here, basically. I think it would be possible to repeal the tax. The issue about step-up in basis, as the point was made at the Senate Finance Committee hearing last week, if a provision were structured so that relatively small estates don't have to keep track of the cost basis of assets, you would find the middle- or higher-middle-income people with their estates being able to keep track of the cost basis of their assets, especially given the change over the past few years in the composition of those assets. More and more wealth is held in the form of equities, and it is relatively easy to keep track of the cost basis of those.

So if a provision were structured to exclude a certain amount from the estate tax, I think most people would certainly be able to keep track of the basis. So I think that the fear of complexity from giving up step-up in basis should not be a reason to say that we don't repeal the estate tax. I think it can be addressed and can be handled.

Second, with respect to the overall impact of repeal of the estate tax, the estate tax is a tax on capital, it is a tax on business. It requires enormous planning to avoid. The efficiency cost of the estate tax is probably much greater than the revenue, $30 billion a year, that is being collected.

Many of our competitors around the world, including Canada and Australia, don't have an estate tax, and they seem to function just fine. And most other countries have much lower estate tax rates.

So for what we are getting, $30 billion a year, we are spending enormous amounts wasting society's resources trying to avoid it, and as the results of Dr. Sinai show and Professor Douglas Holtz-Eakin, who is also at Syracuse University in New York, has also done some work indicating the drag that this tax has on our economy in terms of job growth and GDP growth and other economic variables.

So it seems to me we can get there from here, and we certainly ought to do it.

Chairman THOMAS. Ms. Detzel, what about it? You argued that it costs a lot of money. Dr. Thorning and others are arguing that, in fact, it doesn't lose nearly as much and there may be an adjustment. Do you want to respond to any of the points?

Ms. DETZEL. Well, let me just say——

Chairman THOMAS. Microphone, please. It is hard to hear.

Ms. DETZEL. Let me just say that if we end up with a system that is something in between a full step-up and a full carryover, we have just now made the most complicated thing we could possibly do. A lot of people will spend a lot of time planning to utilize, whether it is 1.3 or 2.8 that is currently in the Kyl bill, whatever the partial step-up is, there will be a lot of planning that will be done to utilize that step-up in basis, and that will effectively erode the carryover basis.

In addition, if we bring in carryover basis, I thought I heard one of the gentlemen dealing with family farms was against the carryover basis because of all the problems that it gives for farms, particularly debt-financed farms. We would have to bring in some very complicated, difficult provisions in order to avoid having problems with debt-financed real estate. And if you do that, then you allow—if you have an exception for debt in the carryover basis, then you are going to give planners a great opportunity to completely avoid carryover basis by simply borrowing before death.

So every one of these impacts on something else, and my point here is not to be for or against one thing or the other, but simply to recognize that we have had the estate and gift Tax Code for 80-some years and it is integrally related with the income tax, and we must analyze what changes we make there, what that will have on other parts of our Tax Code.

Chairman THOMAS. And the fact that if we, in fact, make a decision, a better decision—it is always driven by revenue to a certain extent—would be to do whatever we do fairly quickly and fairly cleanly so that people can begin to transition into the system, although that is a function of revenue available with a number of other draws.

Ms. DETZEL. I would say that the absolute worst situation for my clients is a phased-in repeal, because they absolutely have no idea

what to plan. We don't have any idea what to plan right now. So I would hope that whatever it is that we are going to end up with, we would end up with it quickly.

But a phased-in repeal, most people are going to have to plan, anyway. How can you take the chance that you are not going to outlive the 8 or the 10 years? So you are going to have to plan. You are going to spend those dollars. You are going to make transfers that are irrevocable, create trusts that you can't terminate, because you really can't afford to buy life insurance products, because you can't afford not to. And then when the estate tax has phased out, you are going to do it all over again.

Chairman THOMAS. Well, my question would be to those who are in the very real-world situation of planning for that, you are planning under the current system, anyway. Is it that complicated?

Mr. BLETHEN. With all due respect, we are doing all that right now.

Chairman THOMAS. Yes.

Mr. BLETHEN. And the worst possible case is to not repeal the death tax, whether it is phase-out or immediately.

Chairman THOMAS. The idea being that you are doing all of that now and eventually you realize at some point someone won't have to do it if it is not you?

Mr. BLETHEN. And we are not only doing that, we are making decisions to not invest in our businesses and to not create jobs because of it.

Ms. DETZEL. Well, let me just say that the planning, this planning, as I am sure you all can appreciate, is ongoing. It is not something that you do, you put over in the safety deposit box, and you are done. This is something that you have to keep up with every year.

Mr. BLETHEN. I have been doing it for 30 years. I know it.

Ms. DETZEL. And so my point is that a phased-in repeal, you will have to continue to make these payments. It is not something you can just plan now and quit. You will be making these plans, paying these premiums, or paying me for practically the entire time of the phase-in.

Mr. BLETHEN. Right. But——

Ms. DETZEL. So I would say that a phased-in repeal is——

Chairman THOMAS. Let the gentleman who is living it now respond.

Mr. BLETHEN. You know, there is one consistency in all this, that the people who benefit are the insurance companies and the planners.

Chairman THOMAS. And even if it is a phase-out, it at least eventually comes to an end? Is that——

Mr. BLETHEN. Well, she is right. I mean, we have got to continue all that complexity with the phase-out. But at least there is a light at the end of the tunnel, and at least we can begin making investment decisions and decisions that will start in stimulating the economy. The sooner the phase-out, the more benefit we will get, and the more economic stimulation we will get.

Chairman THOMAS. Any last comments? My time is up.

Ms. DAVID. I would just say I would agree, and I think ideally a complete repeal immediately is the best scenario, because it stops

all of this spending and all of this wasted time that businessowners would prefer to invest in their employee benefits and economic growth.

Chairman THOMAS. And we would all like to pay cash for our house, too. You just have to deal with a lot of desires within a structure to try to make it as meaningful as possible, and we will take that advice.

Does the gentleman from Pennsylvania wish to inquire?

Mr. COYNE. Thank you, Mr. Chairman.

Ms. Detzel, as you know, the Democrats have proposed a $2 million per person exclusion in the proposal they have made relative to the estate tax. I wonder if you could describe who would be left if that were to be adopted. What types of payers would be left if that $2 million exemption was given?

Ms. DETZEL. Well, I am a Member of the American College of Trust and Estate Council. It is an organization comprised of estate planning attorneys, and we have been monitoring this closely. You will see a number of our members who have submitted comments on this legislation on both sides of this argument for as long as it has been proposed. And I would say that we spend a fair amount of time discussing that, and I think it is a pretty good consensus by most of us estate planners around the country that if you adopted an immediate $2 million or $2.5 million per person exemption, the vast majority of our clients would be exempted from the estate tax. And that would, you know, eliminate most of the planning, most of the problems for a large part of our clients.

Mr. COYNE. Could you explain more why you estimate in your testimony that the true cost of the estate tax repeal is nearly double than was originally estimated?

Ms. DETZEL. Well, I think that there are—first of all, I think that it is very difficult to estimate. I am not an economist. It is very difficult to estimate what the estate tax revenue will be year by year. But I know that from my practice I have seen more and more over the last few years. Since we adopted the unlimited marital deduction in 1981, of course, for the first years there was a significant reduction in estate tax revenue, and those revenues have been picking up, in large part because the second spouse—that gave us a deferral of estate tax until the second spouse died. And now the second spouses are beginning to die, and so we are seeing a lot more revenue. And, of course, assets have increased in value. That has increased the revenue.

Beyond the additional estate tax that I think will probably be raised because of these factors, there is a lot of income tax to be lost. A lot of income tax to be lost. I can tell you that if we get a repeal of gift tax, a lot of my clients will pay a lot less income tax. It will be very easy to avoid paying income tax or to move income tax down to lower bracket taxpayers.

All we have to do is create a—one example, one easy example is to create a family limited partnership with my investment assets. I am the general partner. I give away the limited partnership interest to my children or other family members in lower income tax bracket. I am the general partner. I control distributions. I control the disposition of those assets entirely. But the income tax, most of the income tax flows through a partnership to its partners. And

so that would go to the limited partners who are in lower income tax brackets, and I could—and the reason why that is not done now is because there is a gift tax that is associated with giving away those limited partnership interests.

So we can give those partnership interests away gift-tax-free, and then we can even get the income, if any is ever distributed to those lower bracket taxpayers, back through a gift that doesn't cost anything either. That is just one simple example of how income tax could be greatly disadvantaged by a repeal of a gift tax.

In fact, there was one statistic that was published last month or in January in Tax Notes that 70 percent of all individuals who file tax returns pay no income tax or are in the 15 percent bracket. That is 70 percent of America that can be used by the other 30 percent to reduce their income tax.

Mr. COYNE. Thank you.

Chairman THOMAS. Thank you.

Does the gentleman from Michigan wish to inquire?

Mr. CAMP. Thank you, Mr. Chairman. Thank you all for your testimony. And I understand there are differences of opinion on this issue, but when I think of lost income tax or lost estate tax revenue, it is assuming that this is the Government's money to lose. And, frankly, this is not the Government's money. It is the people's money.

So I come down on the side of trying to make sure that we preserve family-owned farms and family businesses because I think something is lost in the corporate structure that we have seen with a lot of our businesses that might have remained true to different principles or to their employees. So there is an intangible there.

Dr. Thorning, I just want to say I appreciate this report that you have brought to the Committee because the scoring that we have around here tends to show that full repeal is a large revenue loss, because we score under these very strict rules that don't really look at the real world. And so I think particularly your report is very helpful to show that employment would go up and that under some scenarios actually revenues to the Government would go up under a full repeal plan. So I appreciate that very, very much.

Mr. Stallman, do you have any comment on an exemption amount or level that you would support or feel comfortable with?

Mr. STALLMAN. Changing the exemption really doesn't address the fundamental problem that we see with the death tax. It is a tax policy that discourages savings and investment in favor of consumption, one that makes the hurdles higher for entrepreneurs to be successful who create most of the jobs in this country; and probably from our point of view, it is a tax that disproportionately and negatively impacts the most productive farms and ranches in this country.

No matter where you set an exemption, it is still going to have a definite negative impact on those most productive farms and ranches in this country who produce most of the agricultural products. And you don't do away with the burden of planning. You don't know what asset values are going to do for the future, and so you haven't really solved much of the problem. That is why we strongly support repeal of the death tax.

Mr. CAMP. I appreciate that, particularly also your comments on the fact that many agricultural assets are long-held, many have had debt, significant amounts of debt, and the distortion effects of not having a step-up in basis for those particular farms and ranches is a real problem.

Anyway, thank you all for your testimony, and I yield back the balance of my time.

Chairman THOMAS. I thank the gentleman.

Does the gentlewoman from Florida wish to inquire?

Mrs. THURMAN. Thank you, Mr. Chairman.

Mr. Stallman, and also to Ms. David, you know, last year we did have a piece of legislation, as you know, that would have gone to the President and that, in fact, would have been signed into law that would have put it at about $5 million or $4 million.

One of the things that I find interesting is that the plan that we have looked at over the years is something that is gradually going to go into effect over a 10-year period of time. We have seen what that potentially could do in damaging.

In offering something that could have gone into effect, quite frankly, I would have appreciated your support last year on that because—and I think some of your farmers and your small businesses would have appreciated that, because there are people who are now being affected in the fact that it wasn't done. And so the very same people you are here to protect may be the ones that fell or had a death in their family where this happened to them and they got no effect from any kind of a repeal in looking at this.

But in saying that, I will tell you that I would probably support that bill again. I probably cannot support the full repeal. Mr. Camp's issue about it being the people's money, he is absolutely correct. It is the people's money. But, Mr. Stallman, let me just suggest to you that one of the issues that we have been talking about on the Democratic side in the budget and something that I have looked at over the years in the agriculture area has been you come to us constantly to use the people's money to help strengthen agriculture, to do things such as research, disaster. This year you are asking—and have actually jumped up from $18 billion. So we are spending the people's money in ways that you have also asked us to do to support.

And, Ms. David, as well, if I look at all of the tax issues, we have small business tax exemptions for all kinds of things: health care, meals exemption, travel. We do a lot of things in the Code today to try to, in fact, take care of those kinds of issues.

So I think that while I don't disagree—and I certainly have farmers who would be beneficiaries. Actually, one family that has come to me most recently very concerned because they can't pay the death tax of $2 million. But you know what? If this law had been in effect when we wanted it to be, they wouldn't be sitting in that situation.

So I think that is a real downfall that we are looking at in any of these proposals or what has happened, and that is the immediateness of the issue. So I would appreciate it.

Ms. Detzel, I appreciate the fact that you have come here by yourself and the only one that seems to be kind of looking at this issue all the way across the income tax part of it. And in your re-

marks you said there are some things we could do to put into effect something that would be beneficial for all income taxpayers. Could you expand a little bit on that for us?

Ms. DETZEL. I am sorry. What——

Mrs. THURMAN. You had just said I think in part of your testimony——

Chairman THOMAS. Ms. Detzel, would you turn your microphone on?

Mrs. THURMAN. In part of your testimony, you talked a little bit about that there were things that we might could do to help people such as your clients, and maybe you have already had this——

Ms. DETZEL. Well, I can tell you that my clients would—and I represent a very broad base of individuals from small citrus growers to very, very wealthy people in the entertainment industry in central Florida. But the majority of the clients at my firm and most of my friends who are attorneys would really like to see an immediate increase in the exemption now. And whether that is $2 million or $5 million, I don't know. But a several-million-dollar increase in the exemption is, I think, extremely important to come in now.

I am just like you. I have a number of clients that I am filing tax returns for, people who, if the bill had gone in last year, we wouldn't be paying those checks. And they are not terribly thrilled that it is taking forever to get this relief, and they would like to see the relief at the lower level, not at bringing rates down gradually for the highest taxpayers over a number of years, but let's give the exemption to the people who need it the most, the ones that are just over the $675,000 level.

So I think that my clients would like to see something done quickly and something done that increases the exemption right away.

Mrs. THURMAN. I appreciate those comments, and I know I didn't give you all a chance to respond because I needed to get this other part in, but as you can see, I think that kind of made our point. Thank you.

Chairman THOMAS. Does the gentlewoman from Washington wish to inquire?

Ms. DUNN. Thank you very much, Mr. Chairman. I am listening, and I am intrigued by your testimony, Ms. Detzel, and I just am curious. It seems to me that if you do advocate an increase in an exemption—and I didn't see that in your written testimony, but I am hearing you saying now—that all these moves that you make to sound very fraudulent are going to still occur. What is to say that they won't?

Ms. DETZEL. There are tradeoffs with all of these, OK? And I am not advocating anything in particular. I am not advocating complete repeal, a phased-out repeal, exemption increase. My testimony was to understand that with every single thing that we attempt to do, there is an impact on others. And it will be choices. What you all do all the time is make choices between things. And I simply wanted everyone to understand what was the effect of particular choices.

Ms. DUNN. Good, thank you very much.

Ms. DETZEL. So every single thing has——

Ms. DUNN. That is interesting to me. Let me ask you another question. You talk about provisions already in the Internal Revenue Code reduce or eliminate a State tax on farms and other closely held businesses. I assume, in that one that you are referring, to the 1997 exemption, I would like to ask Mr. Blethen what he thinks about that.

Mr. BLETHEN. That was the stepped up basis that they—I am sorry.

Ms. DUNN. It was in 1997 we provided, the best of intentions, a $1.3 million exemption for family held businesses.

Mr. BLETHEN. Oh, excuse me.

Ms. DUNN. And I am curious to hear—and certainly, the other panelists can answer too—I am curious to hear how effective that has been for you.

Mr. BLETHEN. Well, it has not been effective at all. While it would certainly benefit my family personally, it would not be very good public policy. The issue for us is one of what is the best public policy that creates economic stimulation and job creation? And when you look at the private, independent, non-publicly traded business sector, I can just use my industry as an example of why raising the exemption doesn't work.

If the IRS were to value the smallest newspaper, daily newspaper in the State of Washington, from little Ellensburg, the value would be $10 million. Family-owned newspapers in Eugene, Oregon and Bangor, Maine, at today's prices, if the family-owners were to die, will probably be valued at 75 to 100 million by the IRS. Family-owned papers in Bakersfield, California, Spokane, Washington and Portland, Maine, would be valued around 200 million by the IRS. These are family businesses that all mirror what my testimony was. They have more employees than you have in public companies. They invest more. They have lower profit margins. They create jobs and they create investment. And today we all hold off on investment decisions and job creation decisions, and in our case, $200,000 a year just to pay the insurance companies and the planners so that we can have a chance of surviving another generation.

Mr. STALLMAN. As I said in my testimony, the Qualified Family-Owned Business Exemption was well intended, but the hoops you have to jump through in terms of definitions of active engagement of the owner, of the length of time the assets have to be held in production and several others, doesn't allow the flexibility you need in today's modern farming operations and family structures to make the changes you need. So it has been—hasn't been used just because of that complexity.

Ms. DUNN. In fact, between 1 and 3 percent of family held businesses have qualified for that exemption, and two-thirds of them have been challenged by the IRS, so I think you make a very good point.

I am concerned about the discussion of an exemption level, and I would just mention this to Ms. Thurman, because she is interested in that, and a proposal that came out last year. Any exemption level is going to be arbitrary, and I think you start with that as a base level of unfairness.

There is, for example, in my hometown, Seattle, Washington, an $80 million company, and you would think that sounds like a

wealthy company. They employ 1,000 people. It is called GM Nameplate. They are going to be forced, if we are not able to phase out this death tax, to repeal, to sell that company. And then you have to wonder, because it has happened over and over, and we all know of companies in our own communities that have been forced to sell because capital gains tax rates are lower than death tax rates and the family decides it cannot survive——

Mrs. THURMAN. Will the gentlewoman yield?

Ms. DUNN. But this is the kind of risk that we run into. Let me yield, when I am finished with my questions, to Ms. Thurman.

I would say too, as we discuss this setting arbitrary limits, people will try to stay within those limits. That is what compliance costs are all about. We are seeing compliance costs in the market right now, dollars being taken out of the private sector, to purchase life insurance policies, or to—to go to your business, Mrs. Detzel, and hire you for your services—that are huge amounts of money that aren't being used to stimulate job increase or to provide medical benefits to employees in companies. And I think we run into that danger if we don't take the opportunity we have now to phase this out.

I yield back, Mr. Chairman.

Chairman THOMAS. The gentlewoman's time has expired. We will pick you up. We have got some folks coming.

Does the gentleman from Pennsylvania, Mr. English, wish to inquire?

Mr. ENGLISH. Thank you, Mr. Chairman, I do. I am very intrigued by the testimony that this panel has presented. And, Ms. Detzel, I am curious about some of the details in your testimony, or lack thereof. You make the assertion that the—as I understand it, that the elimination of the estate and gift tax will have a significant impact on charities. And what you quote as a source on that is a New York Times article recently. Are you aware of any—and excepting that you have presented yourself not as an economist—are you aware of any economic studies that would support your position on that?

Ms. DETZEL. No, sir. And I deliberately stayed away from discussing the issue of impact on charities because it is a very controversial issue, as to whether the repeal of the estate of the gift tax will have impact on charitable giving. There are a number of different people who are commenting one way or the other. My personal viewpoint, from my own personal practice, is that the majority of charitable planning that is done in my firm is tax motivated, and whether that is what is around the country, I can't tell you. I know a number of people have commented. I know of no economic study.

Mr. ENGLISH. On that point, as I assume you are aware, Mr. Bush has also proposed some changes in the charitable tax treatment of charitable giving. Are you aware of that?

Ms. DETZEL. Yes, I am. And I guess I am a little confused, because it seems a little inconsistent to say that——

Mr. ENGLISH. Really?

Ms. DETZEL. Well, the provision in particular that says we are going to give an above-the-line deduction for income tax purposes, which generally lower brackets, we need to do that as an incentive

for charitable giving. We need to give that tax incentive. But we are not recognizing that when we take away a 55 percent benefit, that that might be a disincentive. I mean, we are saying on one hand we need to give the people an incentive to make gifts, but on the other hand we take away that tax incentive.

Mr. ENGLISH. Do you think that Mr. Bush's plan might, by providing a new charitable tax incentive, be compensating for the elimination of the estate tax, and isn't that good tax policy?

Ms. DETZEL. Well, again, I am not a politician or an economist, but I can simply say that the estate tax and gift tax rates are at the top end or at 55 percent, and the loss of a gift—individuals, if they are not able to take advantage of a 55 percent deduction, they may not make the charitable gifts that they otherwise would, and whether that will be compensated or not by the other ones, I can't tell you.

Mr. ENGLISH. Ms. Detzel, let us be clear, I only brought this up because it is referenced in your testimony. So you are the one who has raised the issue of the impact on charitable giving, which apparently you are not prepared to quantify.

Dr. Thorning, have you studied this issue, and are you aware of any scholarly work on the likely economic impact on charities of the repeal of the death tax?

Ms. THORNING. Yes, Mr. English. Let me just mention that this report issued by the Joint Tax Committee on March 21st contains some good scholarly references, and I believe the implication——

Mr. ENGLISH. More scholarly than a New York Times article?

Ms. THORNING. I think so. I mean, they are citing Jim Peterba at MIT and people like that. So this Joint Tax Committee document makes the case that charitable giving might actually increase with the repeal of the death tax. Furthermore, there was a Harris Poll recently that concluded that 71 percent of the people polled said that they would increase charitable giving if the estate tax were repealed. So I think there is at least a strong possibility that charitable giving would be positively impacted by estate tax repeal, and there is no real reason to conclude that it would drop off.

Mr. ENGLISH. Now, Ms. Detzel, in your testimony, you also intimated that the repeal would likely cost more than $236 billion, and the reason being in part, you indicate that income tax revenues would actually drop because of assets being transferred to other individuals who have lower tax rates and might even be transferred offshore.

Dr. Thorning, you have analyzed this. Would you care to comment on whether that is a serious issue?

Ms. THORNING. The question of how much repeal would cost, I noticed in Ms. Detzel's testimony, she suggested that repeal might cost a trillion dollars over 10 years, as opposed to the—I think it is $266 billion associated with the President's proposal. So I was wondering about that myself, and it seems to me, based on the macroeconomic analysis we have seen, for every dollar of estate tax repeal, we will probably get back at least 20 cents on the dollar. So you already shaved 50 billion off the 266 billion static revenue cost. And when you take account of other factors that may come into play, it seems to me that the case can be made that with a

stronger economy and more jobs, we are likely to see something much less costly than even the static revenue estimate.

Mr. ENGLISH. Well, doctor, my time has expired, but I would recommend to all of the panelists, and in fact, all of my colleagues on the Committee, a fine thin book by a constituent of mine, Dr. Hans Senhols, now retired, formerly of Grove City College. He wrote a book a number of years ago called "Death and Taxes," which suggests that perhaps the repeal of the estate tax might actually generate even more revenue than the estate tax currently generates through increased economic activity through the balance of the tax system.

But I thank you, I thank all of you for your testimony, and I yield back, having no time, to the Chair.

Chairman THOMAS. I told you I eagerly await an autographed copy of the book.

Does the gentleman from Missouri wish to inquire?

Mr. HULSHOF. I do, and thank you, Mr. Chairman. Thank all the panelists for being here. Several of you that I have met and had a chance to converse with on other occasions, and welcome.

I am mindful, Mr. Stallman, I think, of something you said as far as the consumer-driven nature that we are as a society. Our next-door neighbors, my wife and mine, in Columbia, Missouri, they are an elderly couple. They have got this huge RV, and a bumper sticker on that RV that says, "I'm spending my kids' inheritance." And of course, they go to Florida about 3 months every year, probably much to the chagrin of their children, who we know as well.

Ms. Detzel, let me ask you this, and this is really more of a rhetorical question. But I am the only son of a farm family in Missouri. My parents are both healthy, alive and well, and actively engaged in farming. We have a 600-acre farm. My question would be, does my father and mother need an estate plan? And that is a rhetorical question because probably the answer you would give me would say, "Well, it depends." It depends on many things. It depends on things within the decision-making control of my parents, depends on some things out of their control. For instance, if we were to draw an arbitrary line and say that family farms up to $1.3 million and below are not subject to the death tax, a 600-acre farm at $2,000 an acre, which is not that far afield, just the farmland itself would come underneath that arbitrary figure. On the other hand, if improvements were made to that farm and it were $2,500 per acre, that same 600-acre farm would be over the exemption at $1.5 million, and really, fair market value, is something that—and again, I am using this on personal example. But, Mr. Stallman, in your situation, or any farmer's situation, there are some things completely within the control of the individual or family owning the estate, and some factors completely out of the control, including, of course, when their time on Earth is gone, and some who have not put those estate plans in place.

So my real question to you is actually something that Dr. Thorning suggested, and I quoted Dr. Thorning's words, "wasting society's resources," and again, an anecdotal situation that occurred yesterday is the reason that I bring it before this Committee.

A representative of a family winery in my congressional district, second generation winery, and they are hopeful that it will be in the family to pass on to the next generation. They were very candid with me and said that they expend about between $30,000 and $50,000 a year on term life insurance, the proceeds of which would go to pay potentially the death tax. Now, I think that falls right in line with Dr. Thorning's representations, and others, who have said—Mr. Blethen, yours, that certain decisions about investments or whether to make them or not, or how to commit certain resources or not, is driven by the fact that we have this estate tax. Any comments on that, and not necessarily my family—I am not asking for a free estate plan here——

Ms. DETZEL. I have some ideas.

Mr. HULSHOF. But specifically, I mean, isn't that—in the example of my constituents say, that spending 30 to 50,000 a year in term life insurance, isn't that a waste of resources?

Ms. DETZEL. Well, I would absolutely agree, and I think that——

Chairman THOMAS. Ms. Detzel, I will have to remind you again, you need to turn the microphone on.

Ms. DETZEL. Sorry. I thought it was on. Excuse me.

I would have to say that I agree with you, and that I think that—and the worst situation that your parents would be in would be they don't know where they fall, they don't know whether they are going to outlive whatever the repeal phase-in period might be, and wouldn't they be better served by having certainty of knowing that the estate tax is either repealed, or they have some large exemption, that they know what it is going to be and be able to fall within, and not be in this world of maybe this and maybe that, so maybe I have to buy term insurance for a while.

Mr. HULSHOF. And my comment—because my time is short—I do appreciate your willingness to be here and have us think about some of these issues, but I think you have hit—really, you have come to the crux of the matter, and that is, so long as we maintain some sort of estate tax, there will always be that uncertainty. It could be that a new interstate is built alongside someone's farm and suddenly the value of that farm has skyrocketed well beyond someone's knowledge at the time that they created a estate plan. So my belief is—recognize the Chairman's tapping of the gavel—as a final comment would just be, that as long as the United States Tax Code, the Internal Revenue Code, continues to have estate taxes, there will always be that uncertainty as to whether or not a family farm or family business would come within that estate tax, and therefore, is a compelling reason, as far as this representative is, to the need to see its complete repeal.

Thank you, Mr. Chairman.

Chairman THOMAS. Thank the gentleman. Does the gentleman from North Dakota wish to inquire?

Mr. POMEROY. Yes, Mr. Chairman. I will begin by yielding 20 seconds to the gentlelady from Florida.

Mrs. THURMAN. Thank you, Mr. Pomeroy.

Back to Ms. Dunn. I just want to say first of all, we set limits on all tax bills. We always have 130, 150, 300,000, whoever, number one. And second, that was not an arbitrary number. It was based on the findings that it took in about 98 percent of small busi-

ness farmers, which was about 2 percent of the estate tax payers, and that is how that exclusion came up, which was how the whole dialog started, small businesses and farmers.

Mr. POMEROY. I thank the gentlelady, reclaiming my time.

Mr. Stallman, good to see you again. Used to see you up there on the Ag. Committee, reminded you that it was North Dakota's three votes in that exciting Farm Bureau election that put you in as president, so I know you will be very interested in the view from the northern plains.

Actually, there are two views from rural America about repeal of the estate tax, and the minority actually sought to have another farmer on this panel, but one with a very different position than yours, one opposing repeal. And I would just—you know, there is an awful lot of loose talk about the family farm in this estate tax debate. I just would like to put it into perspective.

In 1998 about 2 percent of all estates were taxable. Of that 2 percent, 1.4 of the 2 percent had 50 percent of their assets in farmland. And so we are talking about 642 estates nationwide. Now, in your testimony, Mr. Stallman, you talked about these being the most productive farmers. You know, I don't necessarily agree that the biggest farmers are the most productive, the very, very biggest few, you talk about them producing most of the produce. They don't produce most of the produce. Most of the produce in this country is produced by family sized farmers, whose problem is having any net worth, not having a taxable net worth at estate tax time.

I appreciate so the leadership though that you brought to your organization relative to farm program. You have asked for—actually, in January you signed a letter that indicated we ought to double ag. spending up to $18 billion a year. And your most recent position is we need $9 billion in emergency relief this year, an additional 12 billion over each of the years of the 9 years in this period, a total of 105 billion over 10 years over the baseline. I agree with you. I think we need that kind of new investment in agriculture. Unfortunately, it is not reflected in the President's budget.

And this really calls into focus, I think, what we are talking about with the tax bill. There are tradeoffs. We pass a larger tax bill, there is less we can do in other areas. Now you have said that repeal of the estate tax is your number one tax priority. Well, how does it compare to your priority of increasing the investment in agriculture along the lines that you have outlined? Would you say that building a farm bill with counter-cyclical price protection is a bigger priority for you than repealing the estate tax?

Mr. STALLMAN. We could probably debate farm policy far beyond the tolerance of the Chairman.

Mr. POMEROY. And that is why I didn't even ask you that question. I asked you a pretty straightforward one, estate tax repeal or price protection in the farm program?

Mr. STALLMAN. Well, my point would be that with respect to farm policy spending, where do those benefits go? You have a society where consumers spend the lowest amount of their disposable income of any society in the world. That is how you can——

Mr. POMEROY. In court, Mr. Stallman, we would say that is a non-responsive answer. Let us see you get one of these two priorities. I am just trying to understand your organization. Is improv-

ing the farm program your biggest priority of this Congress, or is repealing the estate tax your biggest priority of this Congress?

Mr. STALLMAN. Those are both our priorities. We don't assign rankings on those priorities.

Mr. POMEROY. So they are equal priorities. That is helpful. Let us say that the repeal, because of cost factors, would include carryover basis replacing the present stepped-up based. Under that circumstance, would you support repeal with carryover basis, or would that give you cause to look at maybe increasing the exclusion instead?

Mr. STALLMAN. Well, at the present time we are in support of the Dunn-Tanner Bill, and we don't speculate as an organization, about where we would be on particular issues or priorities until we see the legislation actually in place. We have an internal——

Mr. POMEROY. That is fair.

Mr. STALLMAN. We have an internal process——

Mr. POMEROY. Do you oppose carryover basis?

Mr. STALLMAN. Yes, we want to keep the stepped-up basis.

Mr. POMEROY. Again, to put it in perspective, I don't think the debate before this Congress is going to be repeal versus doing nothing, it is repeal versus reform. I favor a $5 million exclusion. I believe that the alternative considered will be in that range. Now, at that point in time, I mean USDA tells us 1½ percent of all farms exceed 3 million. Let us take it up to 5. We are clearly dealing, in terms of the issues impacting the farmer, with the greatest issues that they face.

Now, you mentioned that the estate tax is just so doggoned unfair we ought to repeal the thing. Do you think it is—you know, I got a lot more farms being lost and inter-generational transfer being disrupted due to nursing home costs than I do impact of estate costs. Do you think it is unfair that a family farm can't pass from one generation to the other due to nursing home costs?

Mr. STALLMAN. I think anything that prevents the intergenerational transfer of a farm and ranch is probably not, quote, "fair."

Mr. POMEROY. I absolutely agree with you. So then I think we need to deal with those points of unfairness interrupting transfer, that impact the greatest number of farms. I thank the gentleman.

Chairman THOMAS. I thank the gentleman. I thank the panel. I appreciate very much—oh, I am sorry, the gentleman from Texas, Mr. Brady.

Mr. BRADY. Thank you, Mr. Chairman, especially since we have a Texan on the panel, which I personally would like to point out, I like to have Texans on every tax relief panel that we have if we get a chance. Thank you, Mr. Chairman.

Ms. Detzel, thank you for making the most articulate argument for substantial reform of the Tax Code that I have heard in some time, and thank you too for exposing the flaw in our Democratic friends' proposal. It is time for Washington to stop picking winners and losers in the Tax Code.

And under their proposal, Mr. Stallman, many of your farmers we like under that proposal, so you win.

Mr. Blethen, I am sorry, you don't fit our type, you lose. It is time for us to stop picking winners and losers in our Tax Code.

Dr. Thorning, you made a very valid point, that if we look at it economically, repealing the death tax helps grow the economy, helps create more jobs, helps create new businesses, and actually helps pay for itself. Those are pretty strong arguments.

Mr. Blethen, you made a point, or inferred one, that is real important. Today minority—the two fastest business types, minority and women-owned businesses, fastest-growing, some are building wealth the first time their generation, are now finding that they cannot pass that new wealth, those new businesses, those farms, down to their next generation. It is very critical we give them a chance, for a lot of reasons, to do that.

Mr. Stallman, you know, it is easy. One of our former Presidents, in visiting Kansas City said, "It's easy to be the farmer when you're 1,000 miles from the field. You've got a pencil for a plow." That happens here all the time, and while we talk about the cost of death tax repeal, I don't think people realize the cost to our communities when we lose our family farms. I don't think they understand, even have a clue, as how devastating it is.

And my belief is we were asking you to make priorities here, but it seems to me if maybe we would just allow farmers to compete around the world for business, you wouldn't have some of these priorities that come up here. So thank you for being a leader in this effort.

Finally, Ms. Coakley David, let me tell you my story, in one minute, Mr. Chairman. I had a nursery from our district come up here to Washington, all the way to Washington, and the two children who worked in the family nursery, had for a long time—one of the brothers didn't—but they just went through on paper how the death tax worked for them. And what they showed me, was even with the improvements we made a couple years ago, that basically, if they could afford enough life insurance, and if they could get a loan when their parents died, they might be able to keep their family nursery. Now, think what they were telling me. "If we can make enough money off our parents' death, and if we can go back into debt, which we have worked a lifetime getting out of, by the way, then we might be able to keep our own business." That is wrong, and it is terribly unfair. And people have different visions of what Washington should be, but the least, we ought to be fair to people, and our Tax Code ought to reflect that. So I just want to thank all the leadership that you have given to NFIB and the farm bill, your personal perspective, Mr. Blethen, and thank the panelists.

Thank you, Mr. Chairman.

Chairman THOMAS. I want to apologize to the gentleman from Texas, and I do once again want to thank the panel. It was especially informative, especially your willingness to discuss each other's positions. It is very valuable for the Committee to see that sort of interaction. I know a lot of members would like to simply have it go one way, but having a three-way discussion allows us to better understand it from a real-world point of view. And I want to thank the panel very much for their time and consideration.

At this time the Chair would call, as we say, the last but certainly not the least, a panel, Mr. Edward O'Connor, First Vice President, Retirement and Education Savings at Merrill Lynch,

and he will be representing the Savings Coalition of America. Mr. Kenneth Gladish—Dr. Kenneth Gladish, National Executive Officer, YMCA of the United States, speaking for the Independent Sector. Mr. Robert Canavan, who is Chairman of Rebuild America's Schools Coalition, accompanied by Mr. Vallas, who is the CEO of the Chicago Public Schools System.

Given the way you sat down, I would tell you that each of you, if you have written testimony, it will be made a part of the record, and you can address us in any way you see fit. And perhaps we will start to your right and my left with Mr. Vallas, and then work to Mr. O'Connor and Mr. Gladish.

The microphone needs to be turned on, and you need to speak directly into it.

STATEMENT OF ROBERT P. CANAVAN, CHAIRMAN, REBUILD AMERICA'S SCHOOLS

Mr. CANAVAN. Mr. Chairman, just very briefly, I am Robert Canavan, chair of Rebuild America's Schools, and if I may, I will submit my written testimony for the record. Mr. Vallas, the chief operating officer of the Chicago Public Schools will present the Coalition's oral testimony.

Thank you for having us here, Mr. Chairman.

[The prepared statement of Mr. Canavan follows:]

Statement of Robert P. Canavan, Chairman, Rebuild America's Schools

Modern Schools: Helping Students Achieve Accountability

Mr. Chairman and Members of the Ways and Means Committee: Thank you for the opportunity to address the Committee in the context of the President's revenue provisions. Rebuild America's Schools recognizes the President's emphasis on education in his budget and revenue proposals. Leaving No Child Behind is the goal and objective of public education. We believe parents, school boards, educators, and community leaders in urban, rural and suburban school districts across America are committed to meet the President's challenge.

Rebuild America's Schools also supports the President's call for accountability. Schools boards, teachers, parents and students are ready to be accountable. But, as we call for greater accountability, we should also make sure that the students' workplace—where he or she is performing and being accountable—is a safe, modern learning environment.

We need to give students the classrooms that will help them succeed. A clean, safe, modern classroom is more likely to help a child succeed than a dark, overcrowded, hot or cold, under-equipped classroom built for the 1950's not the 21st Century.

We read an interesting parallel in the Wall Street Journal of March 19th about Treasury Secretary O'Neill's concern for safe working environments. Secretary O'Neill is quoted that his focus on worker safety and worker relations ". . . is a precondition for beginning to get people to believe that you care about them and that they matter as human beings." Our coalition asks what is the message we are giving to America's students if they are not provided clean, safe, up to date work environments in their schools?

Rebuild America's Schools thanks Congresswoman Johnson and Congressman Rangel for the leadership they are providing on the important issue of school facilities. Their "America's Better Classrooms Act" will give local communities a tool to finance modern schools to help students meet the President's challenge.

Rebuild America's Schools: $268 Billion Necessary to Modernize Schools

Rebuild America's Schools is a national coalition of education organizations, school boards and districts, PTAs, architects—all helping local communities find the resources to give their children modern classrooms.

Rebuild America's Schools Coalition was organized in 1997 in response to the 1996 Government Accounting Office Study documenting the national cost to renovate and repair school building at $112 billion. Communities across the country

knew they were struggling at the local level to find the resources to finance school repairs and renovations. The GAO study documented that schools in every state were in need of repair and modernization.

Since the GAO study in 1996 subsequent reports placed the estimates for school repair even higher. In 1999 the National Center for Education Statistics estimated repair costs at $127 billion. A study by the National Education Association projected the cost of renovating, repairing schools and building new schools, for rising student enrollments, to be $268 billion. This need was documented again in the recently released report of the American Society of Civil Engineers grading federal support for infrastructure. Schools again received the lowest grade, D−.

The American Institute of Architects estimates that thousands of schools—all across the nation in urban and rural schools are in desperate need of repair. Nearly, 60 percent of the schools need either new roofs, plumbing or heating systems, or electrical power and lighting systems. Many of these schools were built nearly 50 years ago and most cannot accommodate growing enrollments. The AIA also estimates that 36 percent of schools use portable classrooms. There are at least 16,000 portable classrooms in use in Florida. More than 2 million California school children attend classes in portable classrooms.

The need is real.

California: One State's Student Enrollments as an Illustration

The California Federal School Infrastructure Coalition supports Rebuild America's Schools. Cal-Fed has written to the Committee on this issue and I will use their information to illustrate one state's school construction situation. Every state faces the same problems to differing degrees.

The California Department of Finance estimates that California's student population will grow by an average of 37,653 pupils per year between 2000–2005. Currently, California has a K–12 student population of approximately 5,951,612 students. Projections are that by the year 2005, California will have a student population base of 6,134,412 students.

In 1998 California voters passed Proposition 1A that provided state funds for modernization and new construction. The state funding from the proposition requires a match from local school districts. The entire $2.1 billion has been apportioned to school districts and there is a pending project list totaling over $1 billion. These state funds were intended to last through 2002.

Despite this investment, the additional need for deferred maintenance and modernization in California over the next five years is estimated conservatively at $7 billion while new school construction needs are estimated to exceed $9.6 billion.

To illustrate these costs, a 1999 estimate placed the cost of a 600-student elementary school at $7.75 million in California. A 1,000-student middle school would cost $13.75 million and a 2,000-student high school would cost $36 million if not higher. Many communities in California will have to build more than one elementary school, more than one middle school and more than one high school per year.

School districts and voters in California are struggling to provide the resources to meet these documented needs. Federal support does help. California has succefully used the Qualified Zone Academy Bond program (QZAB) to renovate, repair, and reform programs helping to create innovative and model schools.

As of January 2001 California has fully allocated the QZAB allocations for 1998, 1999, 2000, and 2001 totaling approximately $222,488,000. Local districts have requested an additional $85,000,000 for QZAB projects.

Some of the successful QZAB projects include a Technology Academy in the Pomona Unified School District, the Center for Advanced Research and Technology in the Clovis and Fresno Unified School districts, and two Computer Certification Academies in the Baldwin Park Unified School District. An extension or expansion of the QZAB program would be quickly utilized in California and other states as well.

In addition to California, QZABs are being used in 23 of the 25 states represented by members of the Ways and Means Committee.

America's Better Classrooms Act: Leveraging Federal Support Through School Modernization Bonds

State and local governments are trying to provide the school facilities that will Leave No Child Behind. But, state and local resources cannot address the magnitude of the problem. There is a role for the federal government. The federal government supports transportation, and science—areas of national interest. Maintaining our public schools and providing students safe schools and classrooms is in the national interest.

Congresswoman Johnson and Congressman Rangel and members of this committee on both sides of the aisle have introduced H.R. 1076 the America's Better Classrooms Act. This bill will use an estimated federal investment of $2.7 billion over 5 years to leverage almost $25 billion in local school construction bonds. This is a frugal and wise investment.

In the 106th Congress 231 members of the House cosponsored the America's Better Classrooms Act. We expect a clear bipartisan majority of the House to again support this legislation. Providing students the decent, modern classrooms they need to learn and succeed is an issue that should unite members from both sides of the aisle.

As this Committee addresses the issue of tax reduction, Rebuild America's Schools believes Mrs. Johnson's and Mr. Rangel's bill provides local property tax relief. Local communities are constantly struggling to balance local tax rates with the need to modernize existing schools and to build new schools. The America's Better Classrooms Act uses a tax credit in lieu of interest to support local community efforts to finance school construction bonds. The interest saved through the Johnson Rangel tax credit over the life of the typical school bond will lessen the burden of local property tax necessary to finance the bond.

School Modernization Tax Credits: Local Decision Making

The school modernization bonds in the America's Better Classrooms Act provide a federal tax credit in lieu of interest. The responsibility for the bond principal is with the states and local communities.

At the same time, all decision-making prerogatives related to the actual school renovation and construction remains a local community decision. The federal government provides an interest subsidy while leaving the decisions about the construction of the schools at the local level. The Johnson Rangel bill allocates the credits to the states through the Treasury Department. States then make sub-allocations to school districts. That is the extent of the federal involvement. Decisions about where to build, how to build and what to build are made at the local level.

Private Activity Bonds: One of a Menu of Options

The President has proposed private activity bonds as a means to address the nation's school facility problems. We appreciate that this proposal recognizes the need for federal support for local school districts. Private activity bonds, which require the participation of a developer, can be used by some school districts. Some school districts may be able to find such a partner. But, other districts will not. Many more will have difficulty finding the resources through their operating funds to pay the required lease fees. For example, in California, school districts do not have the revenue source to make lease payments to a developer constructing a school through private activity bonds.

Many rural schools will have difficulty finding a developer to build a school with private activity bonds. Rebuild America's Schools and Organization Concerned About Rural Education (OCRE) estimate that one out of every two public schools in America is located in a rural area or small town. Thirty-eight percent of America's students go to schools in rural areas. Forty-one percent of public school teachers work in rural schools. Rural communities will have difficulty using the private activity bonds.

If combined with Mrs. Johnson's and Mr. Rangel's school modernization bonds private activity bonds could be part of a menu of federal options available to help school districts address their pressing school construction needs.

Conclusion

Rebuild America's Schools appreciates the attention the Ways and Means Committee is giving to the issue of federal support for local community efforts to modernize schools. The Committee included some components of the America's Better Classroom Act in the tax bill passed last year. Rebuild America's Schools asks the Ways and Means Committee to include the America's Better Classrooms Act school modernization bonds and the QZAB extension in addition to the private activity bond proposal in your education tax package this year.

Students need and deserve safe, modern classrooms to achieve the standards called for by the President.

Thank you Mr. Chairman and Members of the Committee.

Chairman THOMAS. Thank you for coming.

Mr. Vallas.

STATEMENT OF PAUL VALLAS, CHIEF EXECUTIVE OFFICER, CHICAGO PUBLIC SCHOOLS

Mr. VALLAS. Well, fine. Thank you very much.

As a member of the Coalition, I was asked to come here today to really put a human face on how school construction support can be of benefit to local school districts.

Very quickly, and I will certainly try to be quick, just a perspective on the Chicago Public Schools. Chicago has 601 schools, 435,000 students. In 1995, when the Mayor was given full responsibility over the schools, only 10 percent of those schools were in good condition and about a fifth of our schools were built right around the turn of the century and hadn't been renovated in decades. Today, 5 years later, we have 70 new schools, additions and annexes and over 500 major renovations. And by September of next year, all of my high schools will be fully wired and fully "Internetted" in virtually every single classroom.

If you are familiar with what has happened in Chicago, with the rising test scores, and the increasing graduation rates, and increasing enrollment, clearly, the success is, in part, due to the fact that our schools have been renovated, and most of them have been renovated, and they are modern facilities. But we still have about $2.5 billion in need. We have come close to addressing about 60 percent of our needs. Eighty-one percent of all of the money that has gone into renovating our schools, we have already spent close to $3 billion, has come from local effort, mainly property taxes—18 percent from the State and only 1 percent from the Federal government.

Our additional needs are to provide us with overcrowding relief, to continue to renovate our obsolete buildings, to upgrade facilities for our E-rate qualifications and to upgrade facilities for the ADA requirements, which remains an underfunded Federal mandate.

Let me point out that I would like to make a few comments about Johnson-Rangel proposal. First of all, we have been strongly in support of this proposal we consider it to be far-reaching. It also allows us, as a school district, to leverage a considerable amount of money at a modest cost to the Federal government. I think it is $6.8 billion over 10 years. Twenty-five billion would be raised. For Chicago, alone, that could generate $537 million and cut our borrowing costs in half.

We have been, in Chicago, strongly supportive of financial support to parochial and private schools. We share many facilities. We support parochial school charters. We don't oppose vouchers. We have a growing charter school population in Chicago, so it is not a public-parochial school issue.

The proposal requires local effort. We have to issue the bonds in order to take advantage of the tax breaks, so the local effort is there, and it also is a proposal that places maximum effort on local autonomy and local control. So, to a certain extent, school districts still control their own destiny because they are the ones who have got to decide whether or not they are going to make that a local effort.

Now, that said and done, that does not mean we are in opposition to other measures. We support the use of the Tax Code to promote investment in school construction and repair, whether they are things like investment tax credits or doing something through

the capital gains or doing something through private activity bonds. But the bottom line is, each of those proposals will always have a limited impact of the limited market. We think a combination of proposals will make a difference. We truly believe that the Johnson-Rangel bill is most far-reaching and will have the broadest impact, as pointed out by my testimony.

In the fifties, the Eisenhower administration built the interstate highway system in the name of the national security, and of course Governor Stratton, who recently passed away in Illinois, Republican Governor, was also instrumental using the national security issue to do the local investment in the interstate highway system. We certainly consider education and the building of the school infrastructure no less a national security issue today than the interstate highway system was in the 1950s. We certainly think it is something that is going to have a long-term far-reaching impact.

But we are a school district that has invested a considerable amount of money. We do need support to finish the job. There are districts in far worse shape than us who have not even begun to do their renovations, and we are certainly here to be supportive and cooperative in any way. We think, ultimately, a smorgasbord of proposals will probably be needed on the part of the Federal government to truly help the locals complete the job, but the Johnson-Rangel bill we think can be the cornerstone of any comprehensive approach to help local school districts, deal with their critical infrastructure needs.

Thank you very much.

[The prepared statement of Mr. Vallas follows:]

Statement of Paul Vallas, Chief Executive Officer, Chicago Public Schools

Good afternoon everyone, and thank you House Ways and Means Committee chairman and members for the opportunity to discuss how the federal government can help us at the local level rebuild America's schools.

Since 1996, the Chicago Public Schools has committed $2.6 billion to improving school infrastructure through our Capital Improvement Program.

Our main objectives have been to reduce overcrowding, improve the physical condition and operating efficiency of school facilities, and improve the overall quality of the learning environment at each school.

As a result, we have 15 new schools, 29 additions and 27 annexes completed or underway. We have more than 1,100 renovation projects such as new roofs, tuckpointing and windows; 70 campus parks; 247 new playlots; 14 athletic fields and stadium renovations; and have added 1,100 new classrooms. Overall, our efforts have increased student capacity by 32,000.

In order to fund these projects, we have utilized the Qualified Zone Academy Bonds thoughtfully created by Congressman Charles Rangel. Congressman Rangel, we thank you for your leadership in this program.

CPS was the first school district to use the QZAB, which helped build Chicago's first public JROTC academy. In December, CPS had its third consecutive annual QZAB issuance, which generated $13.4 million for school improvements at five high schools.

Now that the QZAB is in its last year, we are asking that it be extended so more CPS schools can benefit. We also thank Congressman Weller, for exploring the issue of reallocating unspent QZAB funds to states like Illinois, which have used their entire allocations every year since the program began.

We also have relied heavily on state and city revenues to rebuild the schools in the nation's third-largest school district.

However, more revenue is needed, and CPS and Chicago's taxpayers cannot continue to fund the expanding costs of this program alone.

CPS still needs an estimated $2.5 billion to complete additional improvements, and the federal government should help shoulder this load.

Federal funding could be used to construct more new schools to in turn relieve overcrowding and replace obsolete buildings. Funds, also, are needed to renovate existing schools, including the electrical upgrades necessary to support the low voltage E-Rate wiring discounts and bringing the schools in compliance with the Americans with Disabilities Act—an unfunded Federal mandate.

School construction is important in America for three reasons.

First of all, it allows students to learn in a clean and safe environment that does not distract from the school day.

How can students be expected to concentrate when there are leaks in the ceiling, a draft from a broken window or when they are housed in a building that is more than 100 years old? These problems send students the message that they are *not* important, and that's not the message we want to send.

In fact, what we are trying to do is fulfill a second purpose for capital improvement programs, which is to equip schools with state-of-the-art labs and technology. These facilities will prepare students to be a competitive part of America's workforce.

Lastly, school construction means more jobs for America's current workforce. Take CPS for example, 52 percent of our construction work has been done by Chicago residents and 54 percent of the work was completed by minority- and women-owned businesses. Every school district and city could benefit economically from construction programs like these.

To reiterate Chicago Board of Education President Gery Chico's 1999 testimony before the House Ways and Means Committee, the federal government's response to America's school construction needs must be simple, flexible, substantial and immediate.

We need to develop a significantly larger, long-term, permanent partnership between the Federal government and state and local governments in funding school infrastructure needs—a partnership similar to that which exists in transportation. Just as the Eisenhower administration justified the interstate highway system investment as necessary to protect the national security interest, the federal government must ensure the future security of the nation by investing in school infrastructure.

A federal program should also support infrastructure funding through a dedicated revenue source and include private and parochial schools, among other things.

President Bush's inclusion of private activity bonds in his Education Plan is proof that school construction is still a national issue. In Chicago, this has been our philosophy for the past six years.

That is because we have realized that what happens in our school district affects other school districts, and vice-versa. So together, we have and will continue to share ideas on how to improve America's schools for all students.

Now we are again asking the federal government to take a more significant role in improving schools as well.

Thank you.

Chairman THOMAS. We thank the Coalition very much.

Mr. O'Connor.

STATEMENT OF EDWARD O'CONNOR, FIRST VICE PRESIDENT, RETIREMENT AND EDUCATION SAVINGS, MERRILL LYNCH & CO., INC., ON BEHALF OF SAVINGS COALITION OF AMERICA

Mr. O'CONNOR. Thank you, Mr. Chairman and the Committee, for the opportunity to express our strong support for the President's proposals to promote education savings.

I am Ed O'Connor, first vice president of Retirement and Education Savings at Merrill Lynch & Co. I see day in and day out the challenges people face in trying to save for their children's education and for their own retirement. I must say I have been in the business for 15 years, and I have really sensed very recently the additional stress that American families are having in being concerned about retirement and education savings, more than any other time in my career.

I am here today on behalf of the 75-member organizations of the Savings Coalition of America that have joined together to support incentives to increase personal savings. At the outset, I would like to commend the President for his proposals to provide individual tax relief. One positive way to reduce the tax burden on Americans is to reduce the anti-savings bias in the Federal tax law. By giving incentives to save, we will not only reduce the individual tax burden, but also ensure that important future education and retirement needs are met and generate increased national savings that will fuel continued economic growth.

Mr. Chairman, your leadership on savings issues, including IRAs, is well-known. My testimony today focuses on the critical task of helping American families prepare for the cost of higher education, but before I discuss those issues, I would like to encourage this Committee to continue its great efforts to enact the truly bipartisan retirement savings legislation, like the bill introduced by Representatives Portman and Cardin.

Increasing retirement savings must be a critical national priority. Changes should include four key elements: The first is to increase the IRA contribution limit to $5,000; the second is to increase allowable contributions to the various salary reduction plans we have; thirdly, we should allow meaningful catch-up contributions to IRAs and salary reduction plans for those who are approaching their retirement; and, fourth, we should enhance the portability of the various retirement programs.

Efforts in the retirement area would address a very important issue for Americans, and efforts in education savings addresses the other one. The high cost of attending college is well-documented. In the past, most families have been forced to fund college through a combination of pay-as-you-go financing and pay-after-you-go student loans. Until recently, Federal government education programs focused only on financial aid and loans. Please don't get me wrong. Student loans have helped many millions of Americans, including myself, to attend college and should continue to play a part in financing higher education, but a college education financed merely with student loans can place a significant financial burden on an American family as they strive to build their career and/or their family.

A dear friend of mine and neighbor is just this week making her final student loan payment. She is a mother of three, and she is 46 years old. Just last year, she put her oldest daughter into college. So here she is beginning a new financial burden before she finished her first financial burden.

We believe that the best way to finance college is to save as much as possible and as soon as possible. If the Federal government provides meaningful saving incentives, millions of more Americans will begin to save more and start sooner, and be able to meet all or most of the college costs that are in front of them.

Only in the last few years, with the creation of the Education IRA and section 529-qualified State tuition plans, has the signal been sent that saving for college ahead of time is important. While both the education IRA and section 529 plans have helped, they have the potential to do much more than they do today. My written testimony highlights a number of relatively modest changes that

would improve education savings substantially. I will highlight two.

To date, the education IRA has had only a limited impact on education savings, and this is, in large part, because of the unrealistically low $500 annual contribution limit. Five hundred dollars per year clearly is not enough. For a child born today, if the maximum $500 contribution were made to a child's education IRA each year, that child will be lucky to have enough just saved for the first year of school in college. We support the President's proposal to allow at least $2,000 per year in education IRA contributions.

The second proposal is regarding section 529 programs. These are, as you do know, the State-run tuition programs, and they have become an effective savings tool for higher education, but here also certain modest improvements could greatly increase their effectiveness. In particular, distributions from section 529 plans that are used for higher education expenses should not be subject to Federal tax. American families should not have to save additional after tax dollars to pay taxes on dollars dedicated for college.

Thank you, Mr. Chairman and the entire Committee. Let us not forget that retirement savings is preparing for our future, and education savings is investing in our future.

Thank you.

[The prepared statement of Mr. O'Connor follows:]

Statement of Edward O'Conner, First Vice President, Retirement and Education Savings, Merrill Lynch & Co., Inc., on behalf of Savings Coalition of America

Thank you, Mr. Chairman, for giving us the opportunity to express our strong support for the proposals to promote education savings that are contained in the President's budget. I am Ed O'Connor, First Vice President, Retirement and Education Savings at Merrill Lynch & Co., Inc. In that capacity, I see day in and day out the challenges people face in trying to save for their children's education and their own retirement. The President's proposals and other similar pro-savings proposals of Members of this Committee will go a long way in helping Americans meet those critical savings challenges.

I am here today on behalf of the Savings Coalition of America. The Savings Coalition was established in 1991 to support incentives to increase personal savings in the United States. Its main objective is to win passage of expanded Individual Retirement Account (IRA) legislation for all Americans. There are approximately 75 member organizations of the Savings Coalition representing a wide variety of private interests including banking, securities, financial services, consumer groups, engineering, home-building, realtors, intangible assets, trust companies, health care industry, insurance, education and business groups.

At the outset, I would like to commend the President for his tax relief proposals, and, in particular, his proposals to provide American families with expanded tax incentives to save for education expenses. With taxes consuming an ever-larger amount of Americans' income, we salute the President's efforts to reduce the individual tax burden. One positive way to reduce the tax burden on Americans, while also to fulfilling other important national objectives, is to alleviate the anti-savings bias in the federal tax code. By providing families with enhanced savings incentives, not only will the individual tax burden be reduced, but important future education and retirement needs will be financed. As a bonus, we will generate the increased national savings that is critical to fueling continued economic growth in the future.

In recent years, this Committee has been pivotal in providing American families with exciting new tools for retirement and education savings. Mr. Chairman, your leadership on savings issues, particularly with respect to expanded IRAs, is well-known. Similarly, the bipartisan efforts of Representatives Portman and Cardin and many other Members of this Committee with respect to retirement savings are well documented. With the strong leadership of this Committee, I believe that we have a historic opportunity to reduce Americans' taxes, increase savings, and solidify the education and retirement future of millions of Americans.

In my testimony today, I will focus on the critically important task of helping American families prepare for the costs of higher education. Before reaching those issues, the Savings Coalition of America, on behalf of millions of American savers, would like to encourage this Committee to continue its efforts to enact bipartisan retirement savings legislation introduced last week by Representatives Portman and Cardin, along with more than 250 of their House colleagues. Enhanced retirement savings opportunities must be a critical national priority. Changes should include (1) increasing the IRA contribution limit to $5,000, (2) increasing allowable contributions to salary reduction plans (such as 401(k) plans, 403(b) arrangements, 457 plans and SIMPLEs), (3) allowing meaningful catch-up contributions to IRAs and salary reduction plans for those approaching retirement, and (4) enhanced portability of retirement assets between plans. Efforts in that area would complement the increased education savings opportunities that I will address in my testimony today.

Background

Families confronting college education costs for one child face a formidable challenge. For families with two, three or more children, college education costs can be overwhelming. In the past few years, Congress has created two new savings tools to help American families prepare for education expenses—the Education IRA and section 529 qualified state tuition plans (QSTPs). While both the Education IRA and QSTPs have helped American families meet their education savings challenges, they have the potential to do much more. Indeed, based on our experience on the front lines of college financing, we believe that enactment of a few relatively modest changes described below could improve Education IRAs and QSTPs substantially.

The high cost of getting a college degree is well documented. Since the early 1980s, the cost of college has increased at a significantly faster pace than inflation. Today, most families fund college education through a combination of pay-as-you-go financing (e.g., part time jobs for the student) and pay-after-you-go student loans. Over the last two decades, as college tuition and other education costs have continued to rise, direct financial aid has diminished. As a result, it has become more and more difficult for families to cover college expenses as they are incurred. That, in turn, has meant that student and parent loans have been used to finance an increasing share of higher education costs. For many, the price of a college education now involves having to deal with an overwhelming repayment burden for many years after graduation. When the interest costs on these loans are factored into the cost of education, the burden imposed on American families becomes even greater.

The difficulties in financing higher education are also getting worse because the level of education and specialization required to compete is rapidly increasing. In the 1970s, a college degree replaced a high school diploma as a prerequisite for many jobs. Today, four years of college is often not enough training. Instead, it has become increasingly common that graduate studies are necessary to stay current with either the technology or techniques in a given career. This necessary post-graduate study further increases the total costs of higher education.

Federal government programs and policies have historically been designed to help people deal with the burdens of college through assistance with these pay-as-you-go and pay-after-you-go methods of financing. Over the years, Federal assistance has taken many forms, including grants and other financial aid, tax credits, subsidized higher education loans, and tax advantages for student loans (such as the ability to deduct student loan interest). Until the last few years, those who have wanted to save for college in advance have received little incentive from the federal government.

Having said that, Mr. Chairman, I also want to stress that we do not believe that student loans (and other federal programs) to help pay for college education are bad. Just the opposite, student loans have helped many millions of Americans attend college. However, by focusing efforts primarily on assisting with pay-as-you-go financing and subsidized loans, the federal government has sent a strong signal that advance funding of college was not very important. To the contrary though, most families with children will need a wide range of resources—substantial education savings, federal grants and loans, student jobs, etc.—to meet their higher education needs.

With this backdrop, it becomes clear that the best way to finance college education with the least disruption for families, and the smallest financial burden after college graduation, is to save as much as possible for college in advance. By saving before a child reaches college age, families can help ensure that adequate funds will be there to allow their children to attend college. Moreover, by beginning an education savings strategy for a child at an early age, the family further reduces its overall burden through the so-called "miracle of compounding."

Education IRAs and QSTPs are excellent tools for increasing education savings for the entire family. One aspect of the Education IRA and QSTP savings programs that is often overlooked is that they are savings vehicles for the extended family. We have found that contributions do not only come from parents. They come from grandparents, aunts, uncles, and others who want to contribute to a loved one's future education. Often the grandparent may be uncomfortable giving money directly to the grandchildren (or the grandchildren's parents), perhaps because they are concerned that the funds may be expended for another purpose before matriculation. Yet those same grandparents are comfortable setting up an Education IRA or QSTP for each of their grandchildren. In providing a mechanism that allows these extended-family members to contribute to a child's higher education costs, these education savings vehicles have opened up new avenues for college savings.

Despite those and other advantages, there is still a need to improve education savings programs. Many commentators have rightly criticized the anti-savings bias in the tax code, and a logical step in alleviating that bias is through enhanced incentives for education savings—where there is a real chance that each dollar of new savings will also mean a dollar less of debt incurred through student and private loans.

Improving the Education IRA

When first created in 1997, the Education IRA held out hope as a potentially critical new education savings vehicle for American families. By giving a tax advantage for college savings, the Federal government sent out a highly visible signal to American families that saving in advance for a child's higher education costs must be a high priority.

In spite of this great potential, the Education IRA has had only a limited impact. While helping some families meet a portion of higher education costs, the Education IRA has not reached its full potential for a number of reasons—particularly the unrealistically low $500 annual contribution limit. Indeed, we frequently hear feedback from parents, grandparents, and other customers that the account is simply inadequate to meet more than a small fraction of the education savings need. In addition, the Education IRA rules need to be simplified. Complex restrictions on eligibility and "fine print" on the availability of favorable tax treatment confuse people and scare them away from contributing, further discouraging use.

Increasing the $500 Contribution Limit. The current $500 maximum contribution to an Education IRA is woefully inadequate. For a child born today, if the maximum $500 contribution were made to the child's Education IRA in each year, that child would only have about $17,000 by the time he or she reached college age in 2019 [1]—an amount that could be little more than is needed to fund one semester's tuition, room and board at an in-state public institution.

The $500 contribution limit also creates many other problems that severely limit the effectiveness of the Education IRA. First, during the early years of an Education IRA, the account balance is so small that the broadly available savings vehicles, whether bank or brokerage accounts, mutual funds, or annuities, have administrative costs that could exceed any earnings. For example, if a financial institution charges only $20 annually to administer an Education IRA, the assets in the account would have to earn more than 4 percent just to break even during the first year the account is in existence. In addition, many products require an initial investment greater than $500. People understand this, and many are reluctant to begin savings through a vehicle that could lose them money during the early years.

Equally important, the small account size that flows from the current $500 contribution limit has meant that many financial institutions do not even offer Education IRAs to their customers. For those institutions that have incurred the expense of offering Education IRAs, advertising has been minimal. If we are to get American families focused on the importance of saving for college early, we need to make them more aware of the scope of the financial crunch that comes when children begin college. Advertising of Education IRAs would be an effective instrument for educating the American people about the importance of college saving. Significant advertising is unlikely to occur as long as the maximum annual Education IRA contribution is $500.

For these reasons, we believe that the annual Education IRA contribution limit should be increased substantially and we commend the President for his proposal to provide up to $2,000 per year in contributions. At that level, significant advertising could be expected and many of the small account problems would be eliminated for most contributors. Equally important, if the savings begins early enough

[1] Assumes seven percent annual rate of return on investment in the Education IRA.

in the child's life, this higher contribution limit could go a long way toward financing the total cost of a college education.

Allowing Catch-Up Contributions. The members of this Committee may also wish to consider those who are already approaching college age. For a family with a child aged fourteen, even $2,000 per year would only fund a portion of the cost of attending college. In the retirement area, bipartisan proposals have included "catch-up" contributions that would allow those approaching retirement (*i.e.*, age 50 and older) to make increased contributions to their IRAs and employment-based retirement plans. A similar catch-up concept would make a great deal of sense for children over a specified age (*e.g.*, age 13 or older).

Extending the Deadline for Contributions. Further confusion is caused by the rules governing timing of contributions to Education IRAs. Today, an Education IRA contribution for a year must be made by December 31st of that year. This is different from the rule that applies to all other IRAs. For all other IRAs, contributions can be made at any time through the due date of the individual's tax return. People understand the IRA rule and do not understand why the Education IRA rule should be different. Having the same deadline for all IRA contributions (including traditional IRAs, Roth IRAs and Education IRAs) would reduce confusion.

Perhaps more important, the IRA approach to the timing of contributions has proven very successful in increasing IRA contributions. A substantial portion of total IRA contributions occur after the close of the year. We have found that one of the main reasons is that many individuals do not focus on the need to contribute until they focus on the amount of tax they are paying. For others, a tax refund may provide an ideal resource for saving. If that refund is not saved right away, however, it often will not remain unspent for long. For these reasons we strongly encourage the Committee to modify rules on timing of Education IRA contributions to track the rules currently applicable to all other IRAs.

Improving Distribution Rules. Another element of unnecessary complexity in the current Education IRA results from uncertainty regarding the tax treatment of distributions. Under the rules currently in effect, amounts distributed from Education IRAs are excludable from gross income to the extent that the amounts do not exceed qualified higher education expenses during the year of the distribution. That is a fair and easy rule to understand—if you use the money for college costs, you do not pay tax.

The problems with the current distribution rules arise in the interaction of the Education IRA tax treatment and the HOPE and Lifetime Learning credits. Today, if the HOPE or Lifetime Learning credit is claimed with respect to a beneficiary for the year in which the Education IRA withdrawal is made, then the Education IRA loses its tax-advantaged treatment. This is true even if the family is entitled to a HOPE credit or Lifetime Learning credit with respect to some college expenses and the student is making the Education IRA withdrawal to pay other expenses.

Although some type of rule to prevent "double dipping"—claiming the HOPE or Lifetime Learning credit for the same expenses that are paid out of the Education IRA—makes sense, the current rule is a clear case of overkill. For the Education IRA to be successful, individuals making contributions need to know with considerable certainty that they will get the tax benefit if they use the account to cover college costs. As a result, we recommend that the current rule denying all tax advantages to Education IRA withdrawals in any year in which HOPE or Lifetime Learning credits are claimed should be replaced with a narrower rule targeted to combat double dipping.

Expanding Eligibility. Today, eligibility to contribute to an Education IRA is limited depending on the contributor's modified adjusted gross income. Our experience with traditional IRAs, Roth IRAs and Education IRAs shows that limiting access based on income ends up reducing savings at all income levels. Right about the time someone starts getting interested in setting up a new IRA or Education IRA, they hear a disclaimer that only certain individuals are eligible and that they should immediately check with their tax advisor to see if they qualify. That scares people, especially middle income families who do not have a tax advisor. They automatically assume that they are one of the ones that are excluded. Or they decide not to start the pattern saving because they assume they will not be eligible next year and that it is just not worth the trouble.

The experience with the income limits that were placed on traditional IRAs in 1986 is illustrative of this point. Although the intention may have been to take the IRA away from more affluent households, the end result of the 1986 Act income limits was to drive over seven million Americans with income below $50,000 out of IRAs. In fact, IRA contributions dropped by more than 40 percent *for those who continued to be eligible for deductible IRAs* in the year after the income limits were im-

posed. Before the changes that went into effect in 1998, IRA participation among those with income under $50,000 had dropped by over 65 percent.

The lesson of the IRA experience is clear. Income limits confuse potential contributors and, in the end, also drive away people who are eligible to contribute. All Americans should have access to savings vehicles for their children's education. For these reasons, we strongly encourage elimination of complex Education IRA income eligibility rules.

Permitting Rollovers to Roth IRAs. A similar problem arises with the severe restriction on Education IRA withdrawals if the individual does not withdraw funds to go to college. Today, an individual must withdraw all Education IRA balances within 30 days after attaining the age of 30 and the earnings portion of such distribution is fully taxable and subject to a 10 percent penalty tax because the amount was not used for education.

To understand the uncertainty that this age 30 rule creates, you can put yourself into the shoes of a grandparent wanting to contribute to an Education IRA of a young grandchild. That grandparent may hope (or even expect) that the grandchild will go to college, but they have no way of being absolutely certain. In many cases, that uncertainty can be enough to cause the grandparent not to make the Education IRA contribution. If on the other hand, the grandparent knew that if the child did not use the funds for college they could be transferred to a Roth IRA as the start of a retirement nest egg, the chances are increased that the grandparent would make the contribution.

In fact, the large lifetime earnings differential between those who have a college degree and their peers who are high school graduates is well documented. A leg up on retirement savings for those who are more likely to work all their lives at lower wage rates would be an important and equitable step in closing that gap. Of course, the vast majority of the children will end up using the money for college as originally intended, but the added flexibility will provide the needed comfort to the individual making the contribution in the first place.

Qualified State Tuition Programs (QSTPs)

Section 529 of the Internal Revenue Code provides federal tax rules for state-run QSTPs. Merrill Lynch assists states by acting as program manager for QSTPs. In that capacity, Merrill Lynch and other Savings Coalition members provide management, investment, administrative and advisory services to the programs.

QSTPs operate differently than Education IRAs, and have their own federal tax rules. QSTP are sponsored by a State, and can operate either as a "pre-paid" tuition plan or an education savings account—(many states sponsor both). In most instances, states have contracted with a financial institution like Merrill Lynch to administer its QSTP. QSTPs are relatively new arrangements that are evolving as the different states continue to improve their programs to better meet the higher education savings needs of American families. For those who have become acquainted with the unique advantages of QSTPs, however, these state-run programs have become a powerful tool for higher education savings. Still, certain improvements could greatly enhance the effectiveness of QSTPs in helping children attend college. These include the following:

Improving the Tax Treatment of Distributions. Today, for federal tax purposes, QSTP distributions for higher education expenses are generally taxable to the student to the extent they exceed contributions. We urge enactment of proposals that would allow QSTP distributions (or education benefits) to receive tax treatment similar to that currently afforded Education IRAs (*i.e.*, distributions for higher education expenses generally would not be taxable). To the extent that American families are saving for higher education expenses and receiving distributions from QSTPs solely to meet those expenses, the federal government should exempt such amounts from federal taxation. By doing this, American families would not have to save additional amounts to pay taxes on QSTP distributions, and they would be provided an additional tax incentive to save for their children's higher education costs. Consequently, we support the President's budget proposal to provide a full tax exemption to all QSTPs.

Confirming That Periodic Rebalancing of Investments is Allowed. Section 529(b)(5) provides that a QSTP contributor or beneficiary may not directly or indirectly direct the investment of contributions to the QSTP. In other areas of the tax law where there are prohibitions on investor control by account or fund owners, those requirements have been interpreted to mean that the owner cannot select the individual, underlying investments of the account or fund (e.g., the owner would not be permitted to direct the purchase of stock in a particular company or companies).

With respect to QSTPs, however, the Internal Revenue Service (Service) has issued proposed regulations that imply that QSTP owners would generally be pro-

hibited from changing their broad investment criteria after the initial selection. The narrow interpretation of the law contained in the regulations is inconsistent with the underlying purpose of the legislation and is not supported by the statutory language or its legislative history.

With the kind of volatility we have seen in investment markets recently, it is understandable why many individuals would be reluctant to make an irrevocable investment decision for a period of perhaps twenty years with regard to a matter as important as a child's education. Yet, that would be the end result if the Service were to finalize the position taken in the proposed section 529 regulations.

While there are other issues that remain to be resolved in connection with the regulatory process, we urge the members of this Committee to clarify (either formally or informally) that the section 529(b)(5) prohibition on investment direction in the statute was not intended to preclude reasonable periodic rebalancing of broad investment choices within a QSTP. There seems to be no policy rationale for the view that an investment decision once made could *never* be changed.

Expanding the Definition of Qualified Higher Education Expenses. Section 529 currently limits the maximum amount of qualified higher education expenses for room and board to the minimum amount charged by an institution to any student, without regard to whether or not the student has reasonable living expenses that are higher than the minimum. This limitation can be particularly unfair to students living off-campus. Thus, the definition of qualified higher education expenses should be amended to permit reasonable room and board expenses.

Allowing Rollovers. Today, QSTP amounts cannot be rolled over to a first cousin of the designated beneficiary. Because the federal government should encourage higher education savings by extended family members, the rules should allow rollovers to first cousins. Under this more logical rule, a grandparent could contribute to a QSTP for one grandchild, but if it became prudent to transfer those amounts to the QSTP of another grandchild who is a first cousin of the original designated beneficiary, the grandparent would have the flexibility to do so. Similarly, when there is no change in the designated beneficiary, rollover from one QSTP to another should be allowed. We urge this Committee to provide that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary would not be considered a distribution, without any restrictions being placed on such transfers.

Conclusion

Thank you for giving me the opportunity to present this statement on the critically important issue of education savings. We need to give American families the best tools we can to help them prepare for their children's future education costs. While the Education IRA and QSTPs are a good start, modest improvements in these programs could help them reach their full potential—and unlock the key to the higher education dreams of millions of American families and their children.

In the end, each American must accept significant responsibility for saving for their future needs. But the government must help by reducing the tax burden on those who save and by making the savings choices simple and understandable. With that end in mind, our national savings strategy must include an effective set of incentives that will expand personal savings, especially for education and retirement. Improving existing savings vehicles like the Education IRA, QSTPs, IRAs, and employment-based plans should be the backbone of that effort. We need to give American families the best tools we can to help them prepare for the future.

Chairman THOMAS. Thank you very much, Mr. O'Connor.

Mr. Gladish.

STATEMENT OF KENNETH GLADISH, PH.D., NATIONAL EXECUTIVE OFFICER, YMCA OF THE USA, ON BEHALF OF INDEPENDENT SECTOR

Mr. GLADISH. Thank you, Mr. Chairman and Members of the Committee. I am Ken Gladish, national executive director of the YMCA of the USA. I am honored to testify today on behalf of the nation's 2,500 YMCAs (I might say, parenthetically, YMCAs in each of the districts of the Congressmen represented here) and on

behalf of Independent Sector, a nonpartisan, nonprofit coalition of over 700 national voluntary and philanthropic organizations.

We are heartened by President Bush's call for increased charitable giving and community involvement, and we strongly endorse his proposal to provide tax incentives to increase charitable donations by all taxpayers, not just those who itemize their deductions.

The YMCA itself reaches 17 million people across the country and provides a wide range of vital community services in such areas as child care, juvenile delinquency prevention, health and wellness classes, teen centers and family programs. To ensure that our programs are available to people of all faiths, ages, and abilities, and incomes, YMCAs collectively raised more than $682 million last year across the country to provide scholarships and subsidies for those in need. Every dollar of this makes a difference, and a lot of it comes a dollar at a time.

Take New York City, population 8 million. The YMCA of Greater New York, which I understand was Congressman Rangel's alumni YMCA, raised $1,700,000 last year in one particular program to provide low-income youth with financial assistance and subsidies. This $1.7 million came from 6,106 donors. Ninety-four percent of those donors gave $1,000 or less, 66 percent of those donors gave $100 or less. As a matter of fact, the most common contribution was $20.

Now look at Dubuque, Iowa, population 60,000. Last year, the YMCA of Dubuque raised $44,000 for their campaign called Partners for Youth. Average contribution: $100. This holds true in YMCA's throughout the country and for many not-for-profit entities and organizations of all kinds. A huge amount of our support comes from what most of you would consider small gifts and small givers. It is these small gifts we rely on, and it is this type of people that we need more of.

Our Tax Code is the most powerful tool available to send a message that we, as Americans, highly value and strongly support charitable giving, but today this message goes only out to the 30 percent of taxpayers who itemize their deductions. Mr. Chairman, the nonitemizer deduction would provide a strong stimulus for increased giving and new givers. My written testimony cites a recent report by PricewaterhouseCoopers which showed that had the President's nonitemizer charitable deduction been in effect in 2000, total charitable giving would have increased by $14.6 billion, an increase of 11.2 percent. And perhaps more importantly, 11 million Americans who are not currently givers would have been inspired to begin the habit of giving. And once you start giving and you see the amazing impact you can have on the life of another person, it is hard to stop.

When the Clippard family of Colerain Township outside of Cincinnati first started giving to the YMCA, their annual gift was about $100 a year. Over the years, their contributions slowly increased, the number of hours they spent volunteering slowly increased, and now thanks to a large and generous gift, this same family that started at $100 has named the new Clippard Family Branch of the YMCA serving Colerain Township.

I know that this Committee will be working to provide major tax relief for America's hardworking low- and middle-income families.

The nonitemizer deduction is an extremely attractive means of providing part of this needed tax relief since the deduction would achieve three important social goals rather than just one. It would reduce taxes, target those cuts to low- and middle-income taxpayers who make up the majority of nonitemizers and encourage increased charitable giving to the thousands of community-based and faith-based nonprofits that are on the front lines of helping our neediest citizens.

I mentioned earlier that YMCA has raised $682 million last year to provide programs for those in need. While we consider $682 million a good start, more needs to be done. We want more families to be able to afford high-quality child care; we want more teens to have safe and structured activities after school and in good school programs; we want more elderly people to be able to participate in our health and wellness programs.

Mr. Chairman and Committee Members, allowing nonitemizers to take the charitable tax deduction will be a powerful tool in helping charitable organizations address the pressing needs of communities and citizens throughout the country.

Thanks for the opportunity to share our views on this important provision in the President's tax plan to encourage increased charitable giving.

I speak on behalf of the YMCA of the USA, our 18 million members, and our colleagues of the Independent Sector.

[The prepared statement of Mr. Gladish follows:]

Statement of Kenneth Gladish, Ph.D., National Executive Director, YMCA of the USA, on behalf of Independent Sector

Mr. Chairman and Members of the Committee, I am Ken Gladish, National Executive Director of the YMCA of the USA. Together, the volunteer-run, community-based YMCAs are the nation's second largest national nonprofit organization. Across the country, there are nearly 2,500 YMCAs serving nearly 17 million people, half of whom are youth. We serve all ages, incomes, abilities and faiths through a variety of programs including child care, delinquency prevention, health and wellness, teen centers, and family programs. YMCAs collectively are the largest providers of child care and school age care in the country—serving 9 million youth in out-of-school time. To successfully provide these and other critical youth and family programs, last year YMCAs raised $682 million in charitable gifts and had over 600,000 volunteers give of their time and energy.

The YMCA of the USA is proud to be a member of Independent Sector, a nonpartisan, nonprofit coalition of over 700 national voluntary and philanthropic organizations that share a commitment to strengthening communities through philanthropy, volunteerism, and citizen initiative. I am honored to testify on their behalf this morning about the tax incentives President Bush has proposed to encourage charitable giving by all Americans.

America's charitable nonprofits, both secular and faith-based organizations, are vital to our democracy and our quality of life. We depend on a strong base of charitable giving to sustain programs and services that benefit all citizens, particularly our most vulnerable individuals and families. Our tax code has been and remains the most powerful tool available to send the message that we as Americans highly value and strongly support charitable giving. But today, that message goes out only to the 30% of taxpayers who itemize their deductions. The tens of millions of hard-working low- and middle-income Americans who claim the standard deduction do not receive any recognition or encouragement through the tax code for their charitable giving. Intended or not, the message those taxpayers receive is that their charitable contributions are not worth counting.

Tax policy should strongly encourage giving by all Americans—not just those taxpayers who itemize deductions. President Bush's proposal to extend the charitable contributions deduction to all taxpayers would provide that strong incentive and encouragement. We applaud and endorse the legislation introduced by Representative Philip Crane (H.R. 777) and Representative Jennifer Dunn (H.R.

824) which includes this critical provision of the President's tax plan. Enacting the charitable deduction for taxpayers who do not itemize their deductions is the only real way for Congress to send the message that charitable giving is an important value for **all** Americans.

Beyond its powerful symbolic importance, the non-itemizer deduction would provide a strong stimulus for increased giving and new givers. A recent report by the National Economic Consulting Division of PricewaterhouseCoopers concluded that had the non-itemizer deduction as proposed by President Bush been in effect in 2000, total charitable giving would have increased by $14.6 billion—an increase of 11.2%. Perhaps even more important, PricewaterhouseCoopers concluded that the non-itemizer deduction would have stimulated charitable gifts by 11 million Americans who would otherwise have given nothing. The long-term importance of encouraging these millions of Americans to develop the habit of giving will be invaluable to the ability of charitable nonprofits to carry out the programs and services so imperative to the continued health and vitality of communities throughout America.

There is further clear and compelling evidence that providing a non-itemizer deduction would dramatically increase charitable contributions. In 1981, Congress enacted the non-itemizer deduction on a 5-year trial basis from 1982 to 1986. The deduction was phased in gradually and was in full effect only in 1986. Significantly, between 1985, when non-itemizers were allowed to deduct only 50% of their contributions, and 1986, when non-itemizer gifts were fully deductible, total giving by non-itemizers increased by 40%, according to IRS data.

Sadly, since Congress permitted that legislation to sunset in 1986, seven of ten taxpayers can no longer deduct their charitable contributions and the resulting loss in charitable giving has been substantial. A recent analysis drawn from the Spring 2000 *IRS Statistics of Income Bulletin* shows a dramatic difference between the amounts contributed by itemizers and non-itemizers in every income group.

The increased charitable contributions that will result from the non-itemizer deduction will provide much needed funding to thousands of community-based and religious organizations that are addressing America's most urgent social concerns. Well over half of the contributions made by non-itemizers go to religious and human service organizations. A tax deduction for charitable contributions will provide additional funds to those non-itemizers who already give to increase their donations, and it will provide the needed incentive to new givers to make contributions to the agencies that serve their community.

With the increased contributions produced with the non-itemizer deduction, community-based organizations, like the YMCA, will be able to continue to provide vital social services. These very contributions will allow YMCAs to effectively serve the growing needs of our country's youth. The YMCA has recently launched the YMCA Teen Action Agenda—a national campaign to double the number of teens we serve from one in ten to one in five by 2005. We are committed to providing teens with the services and support, such as GED and job training, mentoring, tutoring, and computer skills training, to become contributing members of society. To succeed at this auspicious goal and effect change among disadvantaged teens and their families, in particular, the YMCA will have to raise substantial funding—much of which will have to come from individual contributions. We are currently partnering with JCPenney Afterschool Alliance and PepsiCo, which have generously provided critical corporate support for Y teen programs. But, this provides only a start. To serve 4.8 million teens, caring, committed individuals in communities across our nation will have to generously contribute to their local YMCA. The non-itemizer deduction will prove critical in making this a reality. No other measure could do more to strengthen America's vital infrastructure of community-based service organizations.

The non-itemizer deduction would be simple for taxpayers and easy for the IRS to administer. It is hard to imagine a tax provision easier to explain. The message to non-itemizers would be simple and clear: when you donate to a charitable nonprofit, you can take a deduction off your taxes. The deduction would require only a single additional line on the Form 1040EZ, and the IRS has already developed clear, user-friendly instructions explaining what types of contributions are and are not deductible for itemizing taxpayers.

A first-dollar non-itemizer deduction would not create an unreasonable compliance risk. Itemizers—whose gifts account for 80% of all charitable giving—have always been allowed a first-dollar deduction for their charitable gifts. Congress has never viewed this as creating an unacceptable compliance risk, and there is no reason non-itemizers should be treated less favorably.

A first-dollar non-itemizer deduction does not give an inappropriate double tax benefit for charitable contributions. Congress has never viewed the standard deduction as including an explicit charitable contributions component. In-

stead, Congress has fixed the amount of the standard deduction based on its desire to encourage a high proportion of Americans to use the simpler "short form" tax form. There is no policy tension between maintaining the standard deduction and allowing a first-dollar non-itemizer deduction. In fact, there is clear precedent in the 1981 legislation that permitted non-itemizers to take a standard deduction and to deduct their charitable contributions.

Implementing the charitable contribution deduction without a floor will have the most positive effect on increasing contributions and encouraging new givers. The PricewaterhouseCoopers study I referred to earlier found that a non-itemizer deduction without a floor would have produced a $14.6 billion increase in giving in 2000 and would have stimulated 11 million Americans who had not previously donated to begin to develop a lifetime habit of giving. By contrast, the PWC study showed that imposing a $500 floor would have stimulated only $3.7 billion in increased gifts.

Another study by the Urban Institute, using a different charitable giving model, also found that allowing non-itemizers to deduct charitable gifts beginning with the first dollar given would stimulate more giving than allowing a deduction only for gifts in excess of a floor of $250 for single filers.

Last, but not least, **the non-itemizer deduction would provide important tax relief to low- and middle-income Americans.** In recent months, broad consensus has emerged on the importance of enacting a significant, broad-based tax cut. Major tax relief for America's hard working low- and middle-income families must surely be a part of any such legislation. The non-itemizer deduction is an extremely attractive means of providing part of this needed tax relief since the deduction would achieve three important social goals rather than just one—it would reduce taxes, target those cuts to low- and middle-income taxpayers who make up the majority of non-itemizers, **and** encourage increased charitable giving to the thousands of community-based and faith-based nonprofits that are on the front lines of helping our neediest citizens.

It is important to note that this benefit will only extend to taxpayers at the lowest income levels if the legislation allows a deduction for the first dollar given. Adding a floor below which contributions could not be deducted would immediately put this important deduction beyond the reach of many low-income non-itemizers. Low-income non-itemizers considering making gifts early in the year often won't know whether they'll be able to make total gifts during the year in excess of the floor. And thus, they won't know whether any of their gifts will be tax deductible. This is hardly the way to affirm the importance of their gifts.

IRA Charitable Rollover Incentive Act

President Bush's tax proposals include other incentives to increase charitable giving which we know will receive careful attention from this committee. Before I conclude, I would like to add our voice of support for one other specific proposal, and that is the provision in the President's proposal that would make it easier for individuals to donate funds from their Individual Retirement Accounts to charities. The IRA Charitable Rollover Incentive Act (H.R. 774) removes the tax barriers to such donations by allowing donors to exclude from their taxable income any IRA funds rolled over to a charity. This proposal is widely supported in the nonprofit sector, and would, if enacted, unlock substantial new resources for the support of charitable organizations and their public-service missions. Although charitable organizations frequently receive inquiries from potential donors about giving regular IRA funds during their lifetimes, when donors realize that they may have to pay a significant amount of tax to make the contribution, these types of gifts rarely get made.

This proposed legislation is good public policy. It would unlock substantial new resources for the support of charitable organizations and their public-service missions. There are many middle-income Americans who have accumulated funds in their IRAs that, as a result of favorable markets and moderate inflation, now exceed their needs and expectations and who would like to contribute some of those funds to charity if it would not have detrimental tax consequences.

The work of our secular and faith-based charitable nonprofits is integral to strengthening communities throughout our country and addressing the pressing issues and concerns they face today. The non-itemizer charitable deduction will provide significant help in recognizing and encouraging charitable giving by all Americans to support these important efforts. Moreover, it will provide the needed incentive to spur more Americans to get involved in community-based organizations and begin a life-long habit of making charitable contributions. Thank you for the opportunity to share our views on these important provisions in President Bush's tax plan

to encourage increased charitable giving. I would be pleased to answer any questions that you may have.

Independent Sector

A CHARITABLE TAX DEDUCTION FOR NONITEMIZERS SHOULD BE ENACTED BY CONGRESS

Since Congress permitted the charitable tax deduction for nonitemizers to sunset in 1986, seven of ten taxpayers, the nonitemizers, can no longer deduct their charitable contributions and the resulting loss in charitable giving has been substantial. This becomes obvious when a comparison is made of the amount contributed by itemizers and nonitemizers who are in the same income groups.

Income Group	Amount Contributed by Itemizers	Amount Contributed by Nonitemizers	% of Income Contributed by Itemizers	% of Income Contributed by Nonitemizers
$1 < $5,000	$308	$29	10.6%	1.1%
$5,000 < $10,000	$738	$138	9.3%	1.8%
$10,000 < $15,000	$941	$216	7.4%	1.7%
$15,000 < $20,000	$1,186	$285	6.8%	1.7%
$20,000 < $25,000	$1,150	$330	5.1%	1.5%
$25,000 < $30,000	$1,333	$364	4.8%	1.3%
$30,000 < $40,000	$1,349	$465	3.9%	1.3%
$40,000 < $50,000	$1,425	$654	3.2%	1.5%
$50,000 < $75,000	$1,740	$965	2.8%	1.6%
$75,000 < $100,000	$2,357	$1,333	2.7%	1.6%
$100,000 < $200,000	$3,466	$1,254	2.6%	1.0%
$200,000 < $500,000	$7,694	$2,934	2.7%	1.0%
$500,000 < $1 million	$19,651	$6,876	2.9%	1.0%
$1 million or more	$140,972	$21,015	4.7%	1.0%

Source: Data prepared for *The New Nonprofit Almanac and Desk Reference by Independent Sector* (Jossey-Bass, 2001) using data from the *IRS Statistics of Income Bulletin*, Spring 2000.

The average annual amount contributed per tax return for itemizers is $2708; the average for nonitemizers is $328.

Eighty-seven million tax filers are nonitemizers. It is clear that if all nonitemizers raised their contributions to the amount given by itemizers, giving would increase greatly. In fact, charitable contributions by nonitemizers increased by 40% or $4 billion from 1985 to 1986, according to Internal Revenue Service data. Nonitemizers were permitted to deduct only 50% of their charitable contributions and they gave $9.5 billion that year. In 1986, they could deduct a full 100% and, according to the IRS, they gave $13.4 billion—an increase of 40%. The message from that experience is apparent. Charitable tax deductions do stimulate substantially increased giving from middle income Americans.

Nonitemizers are low to middle income American households (70 million have incomes under $30,000 a year) who support services such as the Red Cross and the American Cancer Society. They give to churches and synagogues, environmental organizations, schools, colleges, hospitals, food programs for the homeless, and the Boy Scouts and Girl Scouts. They give to advocacy organizations, health research, the arts, international development, and myriad activities in the public interest that enrich our society and protect its people. Congress should enact a legislation that will permit these moderate income Americans to take a deduction for their contributions to charity.

Mrs. JOHNSON OF CONNECTICUT. [Presiding.] Thank the gentleman and thank the panel.

Mr. McCrery.

Mr. MCCRERY. Thank you, Madam Chair, and I want to thank the panel for your testimony.

Mr. O'Connor, with respect to the Portman-Cardin proposal that would increase the opportunity to save and invest, you have mentioned that you considered this to be something that Congress could do to stimulate the economy. Could you go into a little more detail as to why the Portman-Cardin provisions would stimulate economic activity.

Mr. O'CONNOR. Let us look at the history. Today we have approximately $12 trillion that Americans have saved in some form of a retirement plan. That has been accumulating over the past 20 years, and I do not think that it is a coincidence that we have just experienced unprecedented economic expansion.

My previous position in Merrill Lynch, just to give it from another perspective, was an international assignment. And I must tell you, if you are not aware of this, that all of the other major countries in the world look at our retirement system and want to emulate it. However, when you look at our savings rate, as you well know, it is the lowest out there from all of the developed countries.

What I see in behavior, and this is from my marketing experience with Merrill Lynch, is today about 35 to 40 percent of the people who can make an IRA contribution do. The rest do not, for various reasons. We have done extensive research on why you do not do something that is good for you, and it comes down to complexity. Quite frankly, it is only $2,000 a year, and over the last 20 years inflation has eaten away at that value. So, hence, to grow it to $5,000 is just merely to begin to give back some of that inflation that is taken away from us.

I believe that if we increase the IRA contribution to $5,000, not only will the people who currently save $2,000 put more in, possibly as much as $5,000 if they can afford it, then many other Americans that have forgotten about the IRA will also be stimulated to save. And I see trillions more that will be saved in retirement plans that are securing the retirement of Americans in the future and providing capital to our small businesses and large businesses going forward.

Mr. MCCRERY. So, when people save, that helps small businesses and other businesses to expand and produce jobs; is that what you mean by the last statement?

Mr. O'CONNOR. Yes. Yes, clearly.

Mr. MCCRERY. Well, your speaking was a little fast for somebody from Louisiana, but I think I caught most of it. The gist of it is that Portman-Cardin would be good for the economy and would be a boost to economic activity.

Mr. O'CONNOR. Yes.

Mr. MCCRERY. Even maybe this year, in the anticipation that it would be coming.

Mr. BRADY. Would the gentleman yield?

Mr. MCCRERY. I would be glad to yield.

Mr. BRADY. I didn't catch quite all of it. What percentage did you say of those who can save do use IRAs?

Mr. O'CONNOR. There are 2 percentages, actually. The best way to compare this, there are two studies that were done.

In 1986, when we put the income limitations on the IRA, 40 percent of the people who could make an IRA deduction in the subsequent year, stopped making IRA deductions—people with an in-

come far below the income limitation. There have been studies done, and we have researched that, that once they saw an extra complexity coming into play, it scared people away. And some of the comments I heard earlier with regard to the death tax and the complexities that scare people away and cause more burden on people than you realize. I think that is what happened with the IRA.

Mr. BRADY. So we scared 40 percent of the proven savers away.

Mr. O'CONNOR. IRA contributions dropped 40 percent once we instituted the income limits.

Mr. BRADY. Thank you, Mr. McCrery.

Mr. MCCRERY. Mr. Chairman, thank you.

Mr. O'CONNOR. Was that slow enough?

[Laughter.]

Mr. MCCRERY. It could be better, thanks.

Mrs. JOHNSON OF CONNECTICUT. Thank you very much.

Mr. Coyne.

Mr. COYNE. Thank you.

Mr. Canavan, Mr. Vallas, we appreciate your testimony on behalf of the school construction and bond legislation, and Mr. Rangel from New York, I know, appreciates your endorsement of that concept and would have been here except that he was called to another meeting.

Mr. O'Connor, I wonder what extent your proposal, relative to the help with education bonds and education efforts, is geared toward the moderate and low income of the country?

Mr. O'CONNOR. Well, I believe a $2,000-a-year education IRA clearly is for middle class America.

Mr. COYNE. What about the lower income than middle class America, how would you—how would you describe your efforts on behalf of those people who don't consider themselves middle income?

Mr. O'CONNOR. Well, there are other programs that are helping lower income families.

Mr. COYNE. Are they a part of your recommendation?

Mr. O'CONNOR. I am sorry.

Mr. COYNE. Are they a part of your recommendation here?

Mr. O'CONNOR. Certainly, certainly. The education IRA today you can put away as little as you can afford, and we encourage you to put away whatever you can if you can, in fact, save. Today, though, if you are fortunate enough to save as much as $500, it is still not enough. And what we are really looking to do here is help middle-class Americans to be able to save for college.

Mr. COYNE. Well, if you are a family of four, with a $22,000-a-year income, it is very difficult to be able to put away $2,000 for education purposes.

Mr. O'CONNOR. It is very difficult.

Mr. COYNE. Yes.

Mr. O'CONNOR. But today——

Mr. COYNE. So your proposal, is there anything that addresses that instance, where the family has an income of $22,000, a family of four?

Mr. O'CONNOR. Well, I guess the best way to answer that, you are absolutely right, for that example of a family of four, at $22,000, it would be very difficult to put away that much money.

But, today, with the anti-savings bias we have, it is impossible for them today to put away that much money.

Mr. COYNE. All right. Thank you.

Mr. O'CONNOR. It is much more difficult.

Mr. COYNE. Thank you.

Mrs. JOHNSON OF CONNECTICUT. Mr. English.

Mr. ENGLISH. Thank you, Madam Chair.

This is an excellent panel. Mr. O'Connor, I appreciate your testimony, and I would be particularly interested if you could elaborate on a couple of points. For example, one of the points in your testimony relates to the income eligibility limits for participation not only in education IRAs, but also other IRAs. Can you comment, your experience has been that by putting in artificial income limits, for an instrument that is intended to attract people who are going to invest in the long term, that, as a practical matter, it ends up making the instrument substantially less attractive to the individual, as I understand your testimony. Would you care to comment on that, and how much more attractive would education IRAs be if we were to take income limits off them entirely?

Mr. O'CONNOR. Well, again, let us point to the history again. I will give you two examples. I will mention again the experience of 1986, where 40 percent of people who were eligible to make an IRA contribution who did the previous year stopped because of the additional complication that was applied to an IRA.

In Merrill Lynch's own business with their clients, we have noticed that it is closer to 66 percent of our own clients, who are essentially middle-class Americans who are eligible to make an IRA contribution each and every year, do not. And what we believe, also, we found with the education IRA, there are two reasons we believe, from our research, that has not become as popular as it should have. One is it is, again, only $500 a year, and it is something they realize is not nearly enough to save. So, again, it dissuades them from even considering it.

And, again, I really believe that complication, that there is an income limit, it is funny, and you would think people would be more rational, but clearly, from the behavior we have seen, once you put complications such as income limits, and again perhaps let us talk about the previous panel and the death tax, you put complications, it adds much more of a burden to an American family than you would think otherwise.

Mr. ENGLISH. One of the reasons why we put these income limits on is a concern that these provisions might ultimately come to benefit the affluent taxpayers. I am not sure why that bothers us as much as it does, but it certainly seems to figure large in the debate.

I noticed Mr. Bush's proposal, with regard to QSTPs, would substantially make them much more attractive, take much of the tax burden off of participants in State tuition assistance plans of various sorts. I have long supported liberalizing the tax treatment of these particular State-managed programs. But I noticed in 1997 the Treasury came out very strongly, at the last minute, against our inclusion of new tax breaks for the State programs, and the rationale that was provided was, to me, an astonishing one, that

somehow these QSTPs could become a tax break for the affluent, a loophole.

Can you visualize any situations where Bill Gates, for example, could utilize one of these tax-exempt—well, one of these tax-advantaged, and we hope in the future, tax-exempt programs to avoid the payment of taxes? Can you see any ways that these programs could be gamed from a tax standpoint?

Mr. O'CONNOR. It is very hard to visualize. If you treat these as education savings vehicles, which they are, and if you want to call it tax-favor treatment only applies to qualified expenses of a student going to school, I don't see how it could be created as a tax shelter for some other purpose.

Mr. ENGLISH. And I can't really picture that either, but that certainly has been a concern in the past. If we were to liberalize the tax treatment of QSTPs, say, make them completely tax free, which would be my preference, question one is should we include any income limitations, and question two is should we allow private institutions, for example, an association of private universities, to set up competing plans and manage plans with the same tax advantage, offering the same benefits to students?

Mr. O'CONNOR. Well, the Savings of Coalition of America is pro-savings. So any time we do hear about an income limitation of any sort, again, my previous discussion about what that does to the overall interests of Americans to the plan.

With regard to qualified State tuition plans and the ability for private institutions to have a plan, again, the Savings Coalition of America is pro-savings, and any vehicles that again provide tax incentives, really, I delay, when I say tax incentives, because we really start with a biased system for savings, and any of these programs to help alleviate that bias, we are for, for all income levels and from all sources.

Mr. ENGLISH. Thank you very much.

Mrs. JOHNSON OF CONNECTICUT. Mr. Hulshof.

Mr. HULSHOF. Thank you, Madam Chairwoman.

Earlier today, probably long before you all came into this magnificent hearing room and we were discussing the marriage penalty, maybe some of you were here, but our colleague, Mr. Ryan of Wisconsin, as we were discussing a marriage penalty, pointed out the fact that he has been now happily married for 3 months, and I think 16 days, and how that changed his perspective, as we were talking about the marriage penalty.

My wife and I have a 16-month-old daughter, and I will tell you, Mr. O'Connor, we seem to be focusing our entire questioning with you, but how our perspective has changed, as we think way down the road about college or education expenses. I was extremely pleased that in the last session of Congress the speaker asked me to take forward H.R. 7, which was the Education Savings and School Excellence Act, and we are working on that legislation again on this side. I know the Senate Finance Committee considered it last night.

So a couple of points I want to really echo and then maybe ask you to comment on. I think, and do you have any statistics to bear out the fact that there is a $500 annual contribution limit, that if we were to increase that, say, to $2,000 per year, the additional

savings that might occur? Do you have any numbers or statistics to help in that regard?

Mr. O'CONNOR. Additional savings, meaning additional savings——

Mr. HULSHOF. For education savings accounts.

Mr. O'CONNOR. Oh, no, we really don't because this is a new program. We suspect it will be a significant increase, significant for two reasons. One, as you may have noticed, when the education IRA was first passed, a lot of our colleagues in the industry, our competitors, didn't even bother to advertise the $500 education IRA because, quite frankly, we are profit-making enterprises, and it was very hard to justify significant advertising. So the awareness of education IRAs is still quite low.

I am, personally, proud of Merrill Lynch because we have been very active in telling our clients that we do have a vehicle here and we have been advertising it. Now, in our advertising, we have acquired approximately 60,000 families who have opened up an education IRA with us, and we are very proud of that.

I really don't want to try to put a number to this, but I believe that if we increase the education IRA to $2,000, not only would Merrill Lynch be more successful in acquiring accounts and getting families to save more, but many more financial service providers would get involved, and it would be manyfold more in savings, manyfolds.

Mr. HULSHOF. Let me pass along, at least, the best information that we have, at least under last Congress's bill, H.R. 7. First of all, if we were to increase the contribution limit to $2,000 and, as you also know, Mr. O'Connor, there are some limitations. You mentioned that the education expenses have to be qualified expenses——

Mr. O'CONNOR. Yes.

Mr. HULSHOF. And, of course, right now under current law, back in 1997, is that it is just the tax buildup or the interest buildup that is going to see the tax savings. I mean, these are aftertax dollars going into an education savings account. It is the compound interest that is derived over the life of this education savings account, and it can only right now, under present law, be used for a public college. And so we are trying to expand that option of not just public college, but any college or any K through 12 expense, regardless of where the child goes to school or whether the child is home schooled.

And some of the numbers that we have received in analysis by either Joint Tax or Congressional Budget Office is that 70 percent of the tax savings from an expanded education savings account would go to families with children in public schools making less than $70,000 a year. And so I think it really undercuts the argument. In fact, my colleague from Pennsylvania talked about there seems to be some skepticism of expanding these accounts because it would go to the more affluent, and I think, at least the best analysis that we have is that predominantly these tax savings go to middle-income families or those making up to or below $70,000 a year—roughly, 14 million families, of which about 11 million families have children who would attend public schools.

And, again, that is part of this discussion is people say, well, we can't do this because it is taking somehow money away from public schools into private schools, when, in fact, this has nothing to do with the amount of money we allocate or appropriate every year through the appropriations process. These are additional dollars not being committed to educating our kids that would now be part of the educational process, over and above what we are allocating and appropriating every year.

And so I want to thank you, particularly, and all of you for your viewpoints today, and thank the Chairman for yielding.

Mrs. JOHNSON OF CONNECTICUT. Mr. Brady.

Mr. BRADY. Thank you, Madam Chairwoman.

Dr. Gladish, growing up in a small to medium town, I can tell you the YMCA had a very positive impact on my life. We need to do what we can to keep encouraging contributions to organizations like yours.

Mr. Vallas and Mr. Canavan, I am not quite yet convinced about the Federal government's role in local school construction, but for the sake of not having the Chairwoman hit me in the head with her gavel, let me move on quickly to Mr. O'Connor on savings.

[Laughter.]

Mr. BRADY. For the life of me, I don't understand why we tax savings. We encourage people to save for the future, but we tax them when they do. We say, "Don't rely on Social Security for retirement. Build your own retirement plan," but we say you can only save this much without us taking our share of it.

And it seems like with Congressman Hulshof's bill, if education, if we save early, the interest works for us, the money builds for us, and it helps us reach our American dream.

I have a 27-month-old child, just a little older than Kenny's daughter, and so I am concerned about it, too. But if you wait or in a situation where you have to borrow, the interest and the money works against you. It makes it harder to reach that dream. It just makes good sense to encourage people, especially middle-income families. Thankfully, we have programs for a family that makes $22,000 with four children. Thankfully, we have Pell grants and student loans, work study programs and scholarships.

Those on the other end of the spectrum, who have plenty of money, don't worry about it. But it is a lot of middle-income families who really look at the cost of education and college these days and just swallow hard. I mean, how are they ever going to save enough money for that? And the only way they are going to stand a chance to do that is if we allow them, and get out of the way, to allow them to save.

And my final point is people say that savings reform is tax relief. I don't think it is tax relief for us to remove an artificial barrier for people saving their own money for their future, and I dare someone to call that tax relief. That is simply getting out of the way so that people can save their own hard-earned money, which has already been taxed at least once, and to allow them to move forward.

Any comments you have?

Mr. O'CONNOR. Well, just to add to that, you may recall, in the beginning of my oral statement, in the 15 years I have been in this

business, in trying to help people save for college, save for retirement, it really, in the last few years, it has really become a very big issue for Americans, and I am talking middle class Americans—middle class Americans who, because of a greater share of their income today than 10 years ago is taxed, because financial aid for college is down, housing costs are up, all of the other costs that are on a middle class family, and inflation of college has grown 1- to 2-percent faster than regular inflation and 2- to 3-percent faster than their incomes.

Education savings is a big issue for middle-class America, and I see it every day in my job.

Mr. BRADY. A final note. As you have noted before, even in our best economic times, we seem to be saving less and less. Since we have scared off 40 percent of our proven savers in 1986, we ought to try to do our best to attract them back into the savings effort.

Mr. O'CONNOR. I agree.

Mr. BRADY. So thank you, Madam Chairwoman.

Mrs. JOHNSON OF CONNECTICUT. Thank you.

Mr. Canavan, I do want to thank you for your intense interest in the issue of schools and their ability to build the schools that we need now and for communities and their ability to build the schools that we need now and to repair and modernize that our schools are in.

Would either you or Mr. Vallas like to comment on the difference between the money we appropriated last year, which I believe was $1.2 billion, which is a fair amount of money, and this leveraged approach that we are proposing in the bill that Charlie Rangel and I have sponsored? What is the relative impact of these two approaches?

Mr. VALLAS. Well, if I can just speak insofar as Chicago is concerned, we have once again, just to put it into perspective, we have 601 schools, 435,000 students. We are the third-largest school system in the country.

The emergency bill that was passed last year generated $25 million for Chicago. And, of course, it required really no local contribution. It was an allocation to us. The Johnson–Rangel bill would generate $537 million in reduced borrowing costs.

Mrs. JOHNSON OF CONNECTICUT. In other words, the local communities would still have to make——

Mr. VALLAS. That is correct.

Mrs. JOHNSON OF CONNECTICUT. Roughly the investment they are planning to make now, but by lifting the interest costs from their investment, just like a family who had a 25- or 30-year mortgage, the interest cost is often as much as the mortgage.

Mr. VALLAS. In effect, on like 30-year notes, it would reduce our borrowing costs by half, which would enable us to build twice as many new schools.

In Chicago, for example, while we have built 70 new buildings, and the price of an elementary school is roughly between $15 to $18 million, the price of a middle school is $20 to $22 million, and the price of a high school is $30 to $35 million.

Mrs. JOHNSON OF CONNECTICUT. And what were those prices about 10 years ago?

Mr. VALLAS. The prices are going up. I would say that the prices were about one-third less, but the ability to borrow now and to build now saves us money over the long term because the costs just continue to climb, and the ability to raise the money now and to invest now allows us to accelerate the progress that children have made academically.

Because let me tell you there is a direct correlation between the quality of the facilities, whether they are wired for the Internet, whether they are modern facilities, and the maintenance, the upkeep. For example, when I build new schools, when we built our 70 new buildings, our utility costs in those schools were cut in half, in part because we now have modern, efficient buildings. Despite the gas crunch, the natural gas crunch that everybody experienced over this past year, my utility costs last year went down about 15 percent, largely because we had so many new buildings online and because they were much more efficient. So investing now not only benefits us from an academic standpoint, but it actually saves school districts money over the long term.

But $537 million, the beauty of the Johnson–Rangel bill is it requires local match. It requires that local investment be made. It simply doesn't say we are going to give you money, and you don't have to exercise any local effort, and the fact that it leaves autonomy at the local level so that school districts can make their own choices about what to build, what to renovate, what to replace, and I think that is the great advantage of the proposal.

Mrs. JOHNSON OF CONNECTICUT. The great number of schools that a city like Chicago has to manage and the need to replace so many old schools, as well as repair and modernize, is simply an extraordinary need.

I believe that you said it went up a third in the last 10 years.

Mr. VALLAS. Yes.

Mrs. JOHNSON OF CONNECTICUT. If you look at the last big round of school building, I think costs have gone up more like double because of the greater code requirements, the greater wiring requirements, and in some places, earthquake requirements and so on.

Mr. VALLAS. In Chicago, we have been able to maintain very tight controls because we have, we take full advantage of the market, and while there is clearly school control and oversight over our construction programs, we have privatized much of the management of our construction programs.

For example, we have built—those prices I gave you are the prices that we spent on schools for the last 5 years—we have had maybe 5.5 percent change orders on our construction project. This is very well-managed. So there has been no controversies about the costs of our buildings. But for many smaller school districts—we are a large district, and it gives us the ability to leverage our resources. It gives us the ability to negotiate rate reductions on utility costs because we are so large.

But when you get into smaller districts, rural districts, downstate districts, they don't have that capacity. When a district just wants to borrow enough to build one new school or two new schools or maybe to renovate half a dozen schools, they don't have the capacity to control the costs because they don't dominate the

market. We are so big, and we are building so many new things, that we can literally, it becomes a buyer's market, and that gives us the ability to leverage.

But, certainly, some of the smaller districts, the rural districts, the suburban districts where you have three or four schools, their costs, their per-unit, per-classroom construction costs are probably increasing at a much faster rate than we are. The suburban schools have been built at more expensive cost to the school district than the city schools have been.

Mrs. JOHNSON OF CONNECTICUT. Thank you.

Bob, did you want to ask——

Mr. CANAVAN. Yes, thank you very much, and I will be extremely brief because I know it is the end of the day.

But one thing I wanted to point out on the strength of your bill and Mr. Rangel's bill is that you pay particular attention to the needs of rural school districts. Thirty-eight percent of the students in the United States are actually attending schools in rural areas. The balance that the Johnson-Rangel bill provides through these bonds is that urban districts, as well as rural districts, have the opportunity to use the tax credit to leverage their investment in schools in such a way that, in effect, in our opinion, it is local property tax relief because every dime of leverage they get from Federal support is one less dime they have to ask the local taxpayers to provide.

Mrs. JOHNSON OF CONNECTICUT. I think that is a very important point. Having been born and raised in Chicago, I understand the enormity of your challenge. But lots of the towns that I represent have had literally no growth in their property tax base in the last decade, and they aren't likely to have much, but the costs of school building continues to rise. And I would rather have good local schools than regional elementary schools.

And if we are going to be able to maintain that tradition of kids going to school close to where they live, we are going to have to find some way to create a partnership that is not just State and local in school building, but that is State, local and Federal.

Mr. O'Connor, I did want to close by asking you one question. Does it concern you that 50 percent of the workers in America have no access to pension plans?

Mr. O'CONNOR. Yes, it does concern me very much.

Mrs. JOHNSON OF CONNECTICUT. And does it concern you that, of that 50 percent, probably 30 percent of them, under today's rules, couldn't afford to save?

Mr. O'CONNOR. I am sorry, could afford to save?

Mrs. JOHNSON OF CONNECTICUT. Could not afford to save. In other words, they don't make enough really to save, and there is nothing we do that actually helps them save.

Mr. O'CONNOR. That is a very big concern.

Mrs. JOHNSON OF CONNECTICUT. Well, I really share that concern, and it is for that reason that I do worry about having no income limit on, and sort of Government incentives to savings. If you make lots of money, you can save whether we encourage you to save or we don't encourage you to save. You can still buy stocks, and the people still do. I mean, lots of their money is put into investments that are not rewarded through the Tax Code.

And I think we are doing such a very poor job of looking at how we might help people of very minimal means save for their retirement, much less their children's education. But I think we really have to look at how can we more creatively reach not only—and Portman-Cardin will change the rules so a lot more employers will be able to offer their employees a pension savings vehicle—but they all know, and we all know this is true, it is like health benefits, small employers are no margin, but low-income employees are not, those folks are not going to be able to save for their retirement unless we find a way to, in a sense, assist them in the same way we are assisting middle-class and upper-middle-class families in savings.

And I hope that you and your firm would be thinking about how we might do that.

Mr. O'CONNOR. We would do that. What I would suggest, though, we are very much pro-savings, and I am speaking here for both my firm and the Savings Coalition of America. We are pro-savings for all income groups because it is vitally important, particularly in the group you are discussing.

Mrs. JOHNSON OF CONNECTICUT. Yes.

Mr. O'CONNOR. But what I would recommend is, when we look at that, that we try to integrate that into current savings retirement plan systems we have today.

Mrs. JOHNSON OF CONNECTICUT. But in being pro-savings, I think your groups, and I am pro-savings, but I have come to be very sensitive to the amount of money that we are expending to encourage savings.

Mr. O'CONNOR. Uh-huh.

Mrs. JOHNSON OF CONNECTICUT. And it is all increasingly among the group that are saving. Now they are not saving enough, but we have got to, in addition to encouraging savings, in general, we have got to be sensitive to the fact that we need to broaden the savers' base, and to do that we need a broader array of approaches. And I really think you guys have got to take far more seriously what are the kinds of subsidies, like the earned income tax credit really helped people get off welfare because it reduces their tax burden even through the payroll tax.

But we have to find some way to help people save, even on low salaries, because Social Security is not going to be enough to live on, and if they don't have some additional income stream. In the same way, I would ask your thoughts on whether it might not be wise to tax reward, annuity-type vehicles, more than we tax reward just straight savings. Because Social Security is not going to be enough to live on, there is a social interest in making sure retirees are secure. Don't we have a higher responsibility to make sure that people develop a retirement income to complement Social Security than simply that they save so when they get to 65, they can buy a yacht? I mean, is there no social merit difference here?

Mr. O'CONNOR. Well, there is a social merit that perhaps we are not considering here. I think the best program would be for more jobs to be generated, better jobs to be generated, and that if there was more savings by all income groups, our economy would, in fact, be stronger, and there would be better jobs for everyone going forward. And, hence, they would maybe perhaps be able to save for

themselves better than they can today. That I think is the best program.

Mrs. JOHNSON OF CONNECTICUT. But that program is just more of what we have got, and more of what we have got are not helping a third of America's workers save, and they are not differentiating between savings that could create real retirement security and just savings that could buy a nice second home on retirement or buy a big sailing ship or whatever.

And I would say that when something is publicly subsidized, there ought to be a public purpose. So I am no longer, as I once was, comfortable with your position that savings is savings, and we ought to just foster more and more of it. We have got to look at the fact that there is a big slice of working America that can't afford to save, and their not being able to save is going to be a public burden when they retire because Social Security is going to be inadequate. It is inadequate now, but it is going to be really inadequate then and that we have to begin looking at this, and that, second, there is a different public policy benefit in making sure that people have a parallel income stream to Social Security than that they just have a lot of money on retirement.

So I think you guys need to start thinking deeper, more deeply, about this issue of savings. I want savings for jobs, too, but you know and I know that most of the investment capital in America just comes from people investing money in stocks, and they are not Government-incentivized savings. So, as important as Government-incentivized savings plan are, and I think they are terribly important, our policy is too narrow and too broadly focused.

Now I think the education issue is separate because that is another one of these issues in which we really need to help people save more because the product has gotten so expensive, but I think we need to begin to differentiate between savings, savings, savings and subsidizing savings versus who are we helping to save, how much of America is being benefitted by Government savings policy, and are there some savings that are a greater public policy purpose than other savings?

So I just hope that your group will be more aggressive in thinking more broadly about the needs of America because just sitting here yesterday, the estimates were that by 2030, that is 29 years from now, Social Security, Medicare and Medicaid will take every single dollar of revenue, every single dollar of Federal revenue. Now no society can sustain that. We can't let that happen. But it does tell you how big our problems are for retirees and for the working families of the future. And I think we can no longer be quite as simplistic about things as we have been in the past, and I would encourage your group, who has been so important to our thinking through savings, to begin thinking through savings, who is saving and what are they saving for.

Thanks.

Mr. O'CONNOR. We will do that. Thank you.

[Whereupon, at 3:46 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Howard E. Abrams, Professor of Law, Emory University, Atlanta, Georgia

Mr. Chairman and Members of the Committee, my name is Howard E. Abrams and I am submitting these comments to you today on the issue of the income tax consequences of repeal of the federal estate, gift, and generation-skipping taxes. I am a professor of law at Emory University specializing in the taxation of corporations and partnerships. These comments are my own. However, I undertook this study at the request of The Real Estate Roundtable.

There is broad bipartisan support for repeal of the federal estate and gift taxes. If repeal is forthcoming, though, and a change is not made to the rules governing the basis of property received through the estate of a decedent, repeal of the death taxes will have the effect of exempting substantial unrealized appreciation from all federal taxation, income as well as estate. Accordingly, Congress may seek to preserve taxation of this unrealized appreciation by providing, as to property passing through the estate of a decedent, that the donee will take a carry-over basis in such property, much like a gift is treated under current law. In general, such a rule will tax the heirs on the eventual sale of devised property as the decedent would have been taxed had he sold it prior to death; that is, the heirs will step-in-the-shoes of the decedent for income tax purposes.

If the property transferred is encumbered, application of current doctrine to this new regime might impose taxation not when the heirs sell the property but rather when it passes to them from the decedent or from the decedent's estate. Such a result can be easily avoided by enacting language applicable to death-time transfers modeled after current code section 1041, the Code section currently applicable to transfers of property between spouses or ex-spouses. Section 1041, another step-in-the-shoes rule, accomplishes in the context of divorce precisely what a carry-over basis at death rule is intended to accomplish in the context of death-time transfers. The discussion that follows includes a proposal for such statutory language.

A carry-over basis rule can impose substantial hardship on the heirs if devised property is encumbered. Especially in the context of family farms and other real estate holdings, substantial encumbrances are the norm. When such property is transferred in a carry-over basis regime, upon eventual sale of the property the heirs will be required to pay both the lender and the taxes. If the debt is relatively high and the carry-over basis relatively low, it could be the case that these two payments *exceed* the full value of the property. In such circumstances, the heirs would have in fact received *negative value assets*. To ensure that the death-time transfer of property does not result in a net detriment to the beneficiaries, either the amount of the gain could be limited or a partial step-up in basis could be provided for certain specified debt. The discussion that follows includes alternative proposed statutory language for reducing the hardships imposed on the heirs in either of these ways.

Thank you.

Benefits and Implications to Real Estate Owners of Estate Tax Repeal and Carry-Over Basis at Death

HOWARD E. ABRAMS,[1] PROFESSOR OF LAW, EMORY UNIVERSITY

Overview

Any tax lawyer will tell you that the best way to minimize income taxes is to die, though few clients are willing to act on that advice. But even those clients who seek to prove their immortality can take comfort that if they depart, the income tax man may be left behind. For individuals with substantial assets and insubstantial planning, the grim reaper can bring a potentially crippling estate tax liability. But for astute taxpayers who hold appreciated assets until death, gains so far deferred become gains forever exempted.

[1] Mr. Abrams has been a professor of law at Emory University since 1983 and has taught at Cornell Law School, the University of Oklahoma School of Law, the University of Georgia School of Law, and at Leiden University in the Netherlands. He is the author of four books on the taxation of corporations and partnerships, and his articles have appeared in the Harvard Law Review, New York University's Tax Law Review, the Virginia Tax Review, and other periodicals. Mr. Abrams is a regular speaker at the American Bar Association's Tax Section: Committee on Real Estate meetings, New York University's Institute on Federal Taxation, the AICPA National Real Estate Conference, and similar events. Mr. Abrams spent the 1999–2000 academic year with the national office of Deloitte & Touche, LLP, as the Director of Real Estate Tax Knowledge.

This favorable outcome results from the step-up basis at death rule.[2] Under our current income tax system, death is not a taxable event,[3] which means that those who die owning appreciated assets are not by the fact of death alone taxed on their accumulated gains. Taxes not visited on the dead, though, would be visited on the survivors were it not for the statutory step-up basis at death.

Thus, if I purchase real estate for $1,000,000 and hold it throughout my life as it appreciates to $5,000,000, I pay no taxes on that appreciation because I have yet to sell or exchange the property. If I continue to hold that property at my death, I will never pay income tax on the $4,000,000 of increased value. Further, my heirs will be treated as if they bought the property for $5,000,000, ensuring that when they sell the property they will pay taxes, if any, only on the increase in value of the property occurring after my death: the $4,000,000 of gain that accrued in my hands is simply untaxed forever. Of course, whether the $4,000,000 of accrued gain escapes the income tax or is captured by it because I sell the property prior to my death, the entire $5,000,000 value of the property will be ensnared by the federal estate tax.

Estate Repeal May Include Carry-Over Basis at Death

President Bush has proposed repeal of the existing federal estate, gift and generation-skipping taxes. By itself, this represents substantial tax reduction benefiting a variety of taxpayers including all those owning assets at death sufficient to generate an estate tax liability; under current law, those are taxpayers with estates of more than $675,000. The current estate tax rates range from 18 percent to 55 percent, with the 55 percent rate applying to estates of $3 million and over. Estates between $10 million and $17,184,000 pay a 5 percent surcharge on amounts in excess of $10 million in order to phase out the benefit of the graduated rates.

There exists broad bipartisan support for repeal of the federal estate and gift taxes not only because repeal represents tax reduction but more generally because of a shared sentiment that taxing income when it is earned and second time when it is transferred is inappropriate double taxation. In addition, by taxing wealth when it is transferred, the federal estate and gift taxes can impose a tax burden when there are no liquid assets with which to pay the tax liability, forcing a sale of farms and small businesses.

However, political realities suggest that repeal of the estate, gift and generation-skipping taxes likely will bring with it some form of income tax alternative to the step-up basis at death rule. Otherwise, untaxed appreciation would escape estate *and* income tax entirely. A *carry-over basis at death rule* would treat my heirs not as if they bought the property for its death-time value of $5,000,000 but rather for the $1,000,000 I actually paid. This carry-over basis rule would mean that my heirs step-in-my-shoes for income tax purposes: when they sell the property, they are taxed on the amount of gain that I would have been taxed on had I sold it during life. As a result, if the sale proceeds amount to $5,000,000, the taxable gain will be $4,000,000.

The step-up basis rule likely will be repealed only in part, with some limited step-up continuing to be available. For example, the Kyl–Breaux bill (S. 275) proposes a $2,800,000 step-up cap; other limits, both lesser and greater, have been suggested. Under the Kyl-Breaux bill, for example, if I die holding a piece of real estate with a basis of $1,000,000 and a value of $5,000,000 at my death, my heirs would take a basis in this property of as much as $3,800,000,[4] leaving the heirs with a taxable gain of as little as $1,200,000.

Ensuring Death is Not a Recognition Event

For decedents whose estate consists exclusively of cash and unappreciated property, estate tax repeal is pure tax reduction and the basis rule is irrelevant. Indeed, for taxpayers leaving large estates with significant basis, the trade-off of carry-over basis in exchange for estate tax repeal will be favorable. Even for taxpayers with moderate estates comprised of low-basis assets, the trade-off can be positive. For example, consider the case of a taxpayer who dies leaving a single piece of real estate valued at $5,000,000 and having an adjusted basis of $1,000,000. Under current

[2] *See* §1014(a)(1).

[3] *E.g.*, Rev. Rul. 73–183, 1973–1 C.B. 364.

[4] Senate bill 275 proposes a partial step-up basis rule limited to $2,800,000 of step-up apportioned over all property gratuitously transferred by the decedent at death and during life (and still held by the donee at the moment of the donor's death). Without knowing the gross unrealized appreciation in all property transferred by the donor, it is impossible to know the precise basis that any particular asset will take in the hands of the donee under the terms of this bill.

law, the estate tax burden should be about $2,169,450.[5] If the estate tax is repealed and in exchange the heirs are forced to take a carry-over basis in the property, the income tax burden on a subsequent sale will amount to $800,000 if the gain qualifies as long-term capital gain (or more if the property is subject to the 25% depreciation recapture capital gain rate). Thus, estate tax repeal saves $1,369,450 in federal taxes even with the carry-over basis change. Of course, carry-over basis will also force the taxpayer to recognize gain for state income tax purposes (in those states having an income tax), so that the effective rate of taxation on the gain might be somewhat larger.

If the property is encumbered, though, repeal of the estate tax coupled with carry-over basis can be much worse for the heirs. Suppose this piece of real estate is encumbered by a nonrecourse debt of $4,500,000, so the decedent's equity is but $500,000. In such circumstances there is no estate tax liability at all under current law because the decedent's taxable estate value is determined net of the debt, and estates less than $675,000 in net value are not subject to estate tax under current law. However, if the heirs were burdened by a carry-over basis, the income tax liability again would be at least $800,000. That is, repeal of the estate tax and imposition of a carry-over basis rule would increase net taxation from $0 to at least $800,000. Even under the Kyl–Breaux partial step-up bill, the heirs would be saddled with an income tax liability of at least $240,000 despite receiving no benefit from the estate tax repeal.

And what is worse, *much of that tax liability might be due not when the heirs sell the property but rather at the moment of the decedent's death*. To be sure, no one yet is proposing to treat death as taxable event under the income tax. However, if the current step-up basis rule is changed to a carry-over basis rule, death likely will be a taxable event for those who die holding heavily mortgaged property. And while Congress could avoid that result by enacting specific language to the contrary, such a fix might (in limited circumstances) be worse than the cure. To understand why, we must first look at the tax treatment of sales and gifts of mortgaged property under current law.

When property is encumbered by indebtedness in excess of adjusted basis, transfer of the property can result in uncomfortable tax consequences for the transferor. Debt may exceed adjusted basis because the owner has borrowed against unrealized appreciation in the property, because depreciation has been claimed at a rate faster than the mortgage has been paid down, or by a combination of the two. Regardless of the cause, transfer of such excess mortgaged property generally will produce gain to the transferor.[6]

Thus, if a taxpayer owns property with adjusted basis of $1,000,000, current fair market value of $5,000,000, and subject to a nonrecourse debt of $4,500,000, sale of the property for $500,000 cash (subject, of course, to the debt) yields a gain to the seller of $4,000,000 because, for computing the seller's gain, both the actual cash received as well as the debt transferred are treated as sales proceeds.[7] This taxation is appropriate because the seller has pocketed not only the $500,000 cash received at closing but also the $4,500,000 received previously as loan proceeds, loan proceeds that were not taxable when received and which will no longer have to be repaid because the debt has been transferred along with the property.

Essentially the same analysis applies if the owner makes a gift of the property rather than selling it. To be sure, if the property is gifted rather than sold the owner will not receive any cash at closing. Equally true, though, is that the owner received $4,500,000 tax-free when the loan was taken out, and because the loan again goes with the property, those tax-free proceeds will not have to be repaid by the donor. As a result, the law is clear that if property is gifted having adjusted basis of $1,000,000 and subject to a nonrecourse debt[8] of $4,500,000, the donor

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[5] The estate tax liability on $5,000,000 is $2,390,000 less the current credit of $220,550, for a net estate tax liability for $2,169,450. This liability might be reduced if the decedent devised some of the property to charity or to a surviving spouse; it could be greater if the decedent made significant life-time transfers.

[6] *See generally* New York County Lawyers' Assn., Committee on Taxation, *Excess Mortgaged Property*—Caveat Venditor: *A Report on Some of the Consequences of the Carryover Basis Rules on Inherited Excess Mortgaged Property*, 33 Tax. L. Rev. 139 (1977).

[7] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[8] If the debt is with recourse, then the loan will have to be repaid by the estate prior to the transfer to any heir, either forcing the taxable sale of the property or consuming other assets of the estate so that the property can be passed on unencumbered.

must recognize income of $3,500,000, that being the excess of the loan proceeds over the donor's adjusted basis in the property.[9]

Because the donor is taxed on some of the accrued appreciation, the donee's basis must be adjusted upward to ensure that this appreciation will not be taxed a second time. Despite the general carry-over basis rule for gifted property, the regulations properly provide that the donee may increase his basis for any gain recognized by the donor on the transfer.[10] Thus, in this example the donee will take a basis of $4,500,000 in the property, so that if the donee eventually sells the property for $5,000,000, there will be only $500,000 further gain to be recognized.

If the current step-up basis rule at death is changed to a carry-over basis rule, the taxation of death-time transfers becomes virtually identical to that of gifts. And because we know that gifts of heavily mortgaged property are taxable to the donor when the gift is made,[11] presumably the same rule would be applied to transfers at death. Thus, a carry-over basis rule at death not only preserves substantial gain not taxed under current law but likely accelerates taxation of that gain to the moment of the decedent's death.

In the context of death-time transfers under a carry-over basis regime, it might be the case that transfer from decedent to executor is ignored and that the recognition event for heavily mortgaged property does not occur until transfer from the executor to the ultimate beneficiary. This does not solve the problem of accelerating recognition but merely postpones it slightly. Indeed, in some jurisdictions real property is not treated as passing through the executor's hands; rather, title is treated as flowing directly from decedent to beneficiary, and in such cases the recognition event would have to be the time of death. In the following discussion when I refer to taxation at the time of a decedent's death, it should be understood that this reference includes the possibility that such taxation might not occur until the property passes through the hands of the executor.

Death as a recognition event would also arise, if property is not given a full step-up in basis at death, upon the death of a partner having a negative capital account. For example, suppose four individuals contribute $100,000 to a partnership, and the partnership uses its $400,000 of equity plus a loan of $1,600,000 to purchase improved real estate for $2,000,000. After 10 years, the partnership has claimed depreciation of about $800,000, so the partnership's adjusted basis in its property equals $1,200,000. The outstanding balance on the loan is about $1,400,000 (assuming a 30-year amortization schedule), which means that each partner's capital account is negative by about $50,000.

Current law's step-up basis at death ensures there is no taxation to a partner who dies at this point, and his share of appreciation in the partnership assets escapes income taxation, now and forever. But if Congress enacts a carry-over basis at death rule, the partner who dies presumably will be taxed at once on a gain of about $50,000.[12] *And this taxation is imposed independent of the current value of the property.* This problem of negative capital accounts is especially likely to arise in connection with highly-leveraged real estate contributed to an umbrella partnership as part of an UPREIT roll-up.

Congress could, of course, carefully specify that death-time transfers will not be taxable to the decedent even if the property is encumbered. Such language would ensure that if I die holding property with value of $1,000,000, adjusted basis of $100,000, and subject to a nonrecourse debt of $850,000, I would not be taxed on the death-time transfer.[13] Indeed, since my estate may have no liquid assets with which to pay a substantial income tax liability, failing to prevent acceleration of the gain risks forcing an immediate and distressed sale of assets by the estate.

Unfortunately, no current legislative proposal actually includes language to ensure this result. If such language were included, however, it would then be the case that whoever inherited the property would receive a basis of only $100,000, precisely the result that a carry-over basis regime presumably intends. To accomplish this result, Congress should amend section 1014 as follows:

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[9] *Levine v. Commissioner*, 634 F.2d 12 (2d Cir. 1980); *see Diedrich v. Commissioner*, 457 U.S. 191 (1982). If the gift is to a charitable organization, the taxation is even greater by reason of §1011(b). *Ebben* v. *Commissioner*, 783 F.2d 906 (9th Cir. 1986).

[10] Treas. Reg. §1.1015-–4(a) (1972).

[11] See sources cited at note 9 above.

[12] Upon the sale or exchange of a partnership interest, the transferor partner's share of liabilities are treated as part of the amount realized. Treas. Reg. §1.752–1(h).

[13] This is how property is treated when transferred between spouses or between ex-spouses incident to divorce. *See* §1041.

§ **1014. Property acquired from a decedent** [carry-over basis]

(a) **In general.**—In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and

2. The basis of such property in the hands of the person acquiring it from the decedent shall be the basis of such property in the hands of the decedent immediately prior to death.

(b) **Property acquired from the decedent.**—

[no change to existing law]

Highly Mortgaged Property Can Be Underwater to the Heirs

But now consider the hapless beneficiary who has just inherited property with current value of $5,000,000, carry-over basis of $1,000,000, and subject to a debt of $4,500,000. This inheritance may not be quite so good as getting the property free and clear, but the equity of $500,000 is still real money. Or so it seems.

If the property is sold for its current value of $5,000,000, the loan must be paid off before the new owner is entitled to keep any of the proceeds. Thus, of the $5,000,000 received for the property, $4,500,000 must be given to the lender, leaving the new owner with only the equity value of $500,000. That would still be a good day's work were it not for the pesky carry-over basis rule; because the new owner's basis in the property was carried over from the decedent, the sale is taxable to the tune of $800,000.[14] As a result, the new owner now not only owes the bank $4,500,000 but the IRS some $800,000 as well, so that the inheritance of $500,000 in equity is in reality worth *negative $300,000*. Well advised individuals might know to reject an underwater bequest, but who without a tax lawyer in the family would suspect that receiving property with $500,000 in equity puts your out-of-pocket by $300,000 or more?

Not all highly mortgaged property will be underwater in the sense that a sale yields proceeds insufficient to both pay of the mortgage holder and pay the income taxes on the gain. For example, property with current value of $5,000,000, adjusted basis of $1,000,000, and encumbered by a debt of $3,000,000 offers net value to a donee who takes this property with a carry-over basis. Assuming capital gains are subject to a total federal and state tax burden of 25%, our donee can sell the property for $5,000,000, pay off the debt of $3,000,000 as well as the tax burden of $1,000,000, and still have $1,000,000 in hand. Heavily mortgaged property will only be underwater if the amount of the outstanding encumbrance plus the tax burden on the unrealized appreciation exceeds the value of the property.

What should Congress do? Under current law, this problem is solved by the step-up basis rule at death by eliminating the income tax liability. A carry-over basis rule, though, leaves the income tax liability intact, which means someone—decedent, heirs, or a combination of the two—must both pay off the loan and pay off the taxes.

Current legislative proposals include only a partial repeal of the step-up basis at death rule. The Kyl–Breaux bill (S. 275), for example, eliminates current death taxes yet retains the step-up basis rule to the extent of $2,800,000 in unrealized appreciation. It thus provides complete tax relief for individuals whose assets at death include appreciation of $2,800,000 or less, regardless of any encumbrance. For an individual who dies owning property with value of, say, $10,000,000 subject to a debt of $9,000,000 and with adjusted basis of $500,000, this relief will be partial at best even though the net value of the estate is well under the $2,800,000 amount. That is, there will still be taxable gain of $6,700,000 (value of $10,000,000 less carryover basis of $500,000 plus step-up basis of $2,800,000), of which most presumably will be imposed on the decedent at death (gain at death presumably will equal outstanding loan amount of $9,000,000 less total basis of $3,300,000, or $5,700,000 of taxable gain).

Imposing a heavy tax burden on the decedent both accelerates the tax liability and imposes it at a time when there may be no funds with which to pay the taxes. Letting the decedent escape taxation shifts that burden to the heirs who, when they sell the property, will end up with far less than the equity they anticipate. Indeed, they might even end up out-of-pocket.

The most direct solution to this dilemma would be to defer taxation of the unrealized gains until the heirs sell the property—that is, provide by statute that no gain

[14] Sale for $5,000,000 with a carry-over basis of $1,000,000 yields a taxable gain of $4,000,000. Taxed at the lowest income tax rate applicable to long-term capital gain produces a tax liability of $800,000. State taxes would add to this amount.

is recognized on the devise of encumbered property—and then limit the tax liability to ensure that the heirs are not out of pocket by reason of the inheritance. Putting such a limitation into law would require something like the following:

§ 1014. Property acquired from a decedent [gain limitation]

(a) **In general.**—In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and

2. The basis of such property in the hands of the person acquiring it from the decedent shall be the basis of such property in the hands of the decedent immediately prior to death [possibly including a partial step-up].

3. Upon the disposition of such property by the person acquiring it from the decedent, any gain recognized shall not exceed the value of the property less the amount of debt encumbering such property at the time it was acquired from the decedent times the highest tax rate applicable to net capital gain.

(b) **Property acquired from the decedent.**—
[no change to existing law]

Alternatively, Congress could eliminate the problem entirely by providing that (1) the decedent is not taxed on the death-time transfer of property even if encumbered and (2) the heirs get a step-up for the amount of any encumbrance existing at the time of the debt. This would avoid the problems indicated above, but it would do so only by bringing back—at least in part—the step-up basis rule.

An astute taxpayer who owned appreciated assets could exploit such a rule by borrowing against low-basis property shortly prior to death. For example, suppose T owns land with adjusted basis of $0 and current value of $10,000,000. Under a carry-over basis at death regime, someone—decedent or heir—is supposed to be taxable on the $10,000,000 appreciation when the property is sold. Yet, if property transferred at death qualifies for a step-up basis at death to the extent of any encumbrance on the property, T should borrow as much as possible against the property immediately before dying.

For example, suppose T places a $9,000,000 mortgage on the property prior to death and then devises both the encumbered land and the $9,000,000 loan proceeds to his child. Child takes the property with a basis of $9,000,000 rather than $0 if a step-up is provided for the debt. However, Child can use the cash to retire the debt and thereby own the land free and clear. By running the debt through the decedent's estate, the carry-over basis rule has been almost entirely avoided.

This tax avoidance technique could be eliminated by providing a step-up basis only for old and cold debt; that is, for debt placed on the property more than one, two or even three years prior to the death-time transfer. Careful taxpayers could still exploit this rule by borrowing early enough, but in such circumstances the loan likely would have some business legitimacy because interest would have been paid for months or years. Nevertheless, probably the best way to limit gain recognition on heavily mortgaged assets without opening the door to wholesale tax avoidance is to provide for a basis step-up only as to excess qualified nonrecourse financing (within the meaning of §465(b)(6)(B)). By incorporating the definition of "qualified nonrecourse financing," the partial step-up is targeted to real estate activities and excludes the potential abuse areas of related party debt and seller financing. And by further limited the partial step-up to excess debt (that is, a step-up for such debt only to the extent it exceeds adjusted basis), the step-up will be limited to those cases in which the basis is low and the gain to the heirs will be substantial; that is, to cases in which the property's equity may not be sufficient to cover the eventual tax liability. To enact this result, Congress should enact language such as:

§ 1014. Property acquired from a decedent [debt step-up]

(c) **In general.**—In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and

2. The basis of such property in the hands of the person acquiring it from the decedent shall be—

i. the basis of such property in the hands of the decedent immediately prior to death [possibly increased for a partial step-up], plus

ii. the amount of any qualified nonrecourse financing as described in § 465(b)(6)(B) to the extent the amount of such debt exceeds the adjusted basis of such property determined under subparagraph (i).

(d) **Property acquired from the decedent.**—

[no change to existing law]

Conclusion

Repeal of the estate tax is not intended to be fundamental income tax reform. Yet, if a carry-over basis rule at death replaces the current step-up basis rule, the death-time transfer of encumbered property might well include not only a new and substantial income tax liability but also an acceleration of that liability to the moment of death. Carefully drafted language can avoid that acceleration. In addition, a tailored step-up for qualified nonrecourse financing can ensure that heavily mortgaged real estate will not be a negative value asset in the hands of a decedent's heirs.

Statement of Larry Taylor, President, Air Conditioning Contractors of America, Arlington, Virginia

On behalf of the Air Conditioning Contractors of America (ACCA), I would like to thank the Committee for holding this hearing which is of vital importance to the economic health and future of working families across our nation. In addition to being President of ACCA, I am President of Air Rite Air Conditioning Company, Inc., a Fort Worth, Texas, company that specializes in heating, ventilation, air conditioning and refrigeration (HVACR) systems.

Mr. Chairman, I began my HVACR career working for a company known today as TD Industries and stayed with them for over 19 years before purchasing Air Rite in 1990. My wife Linda and I, along with our son Toby, operate Air Rite and employ 33 "partners" who work together to make it a better workplace for future "partners."

Air Rite is a fair representation of the typical member company of ACCA, and like many of the family-owned company members of ACCA, it is Linda's and my sincere hope that we will be able to pass along our business to our children.

Mr. Chairman, ACCA is the nation's premiere trade association of those who maintain, design, and install heating, ventilating, air conditioning and refrigeration (HVACR) systems. We have 60 state and local chapters, representing approximately 9,000 members nationwide, the vast majority of which are family-owned and operated small businesses. We appreciate the opportunity to support President Bush's proposal to repeal the death tax. Repeal of the estate and gift tax has long been a legislative priority of ACCA, and we hope the Committee's efforts will help focus attention on the need to restore a measure of common sense to our nation's tax code by passing H.R. 8.

Death tax relief is long overdue for four principal reasons. First, as you are aware, the death tax is the single greatest threat to family-owned businesses. It is estimated that 90 percent of small businesses that fail shortly after the death of the founder do so because of the punitive estate tax burden placed on the surviving family members. In an effort to soften the blow of the death tax and to beat these sobering odds, small family businesses spend approximately $6 billion a year on lawyers, accountants, and insurance. This is money that could be put to better uses, such as growing their businesses. Nevertheless, some 70 percent of family businesses still do not survive into the second generation. By the third generation, the loss is 87 percent. H.R. 8 recognizes that this is money that should be used to grow business. Eliminating the death tax will dramatically reduce the time, money, and energy spent on estate planning, thereby freeing up scarce resources and allowing business owners to concentrate on growing their businesses, which in turn will produce more revenue to hire new employees and expand the family business.

Second, the death tax lacks economic rationale. If the business of the federal government is to confiscate assets simply because it has the power to do so, then the death tax is the perfect expression of that power. But if the goal of our federal tax policy is to tax economic activity, then the death tax merely repeats action already taken. It's important to remember that the assets of a deceased business owner's estate have been subject to previous taxation. As such, it is thoroughly perplexing to family-owned businesses that they should be singled out for double, sometimes triple, taxation.

Third, the death tax exposes the foolish complexity of our tax system. Due to the inordinately high rates of the death tax, it is more cost effective for families to sell the family business before the death of the owner and pay the dramatically lower rates of the capital gains tax than to pass the business to the next generation.

Fourth, and perhaps most troubling, the death tax borders on the immoral and runs counter to the ideals upon which this nation was founded. This tax, more than any other in the entire Internal Revenue Code, singles out and penalizes those Americans who work hard and save for their children. There is nothing more inher-

ently wrong than taxing the loved ones of a deceased family member upon his death. For an air conditioning contractor or other small business owner to work hard all of his life, pay business and income taxes, contribute to his community, and then to have family members taxed on whatever remains upon his death is simply wrong, especially if they are forced to sell all or part of the assets to satisfy the tax man.

There are a couple of arguments levied against adoption of H.R. 8 that need to be addressed. Opponents of repealing the tax assert that H.R. 8 is simply a tax break for the wealthy and that repeal risks bankrupting the country. Such assertions make for nice soundbites, but the truth is far different. Regarding the charge that only wealthy Americans will benefit, it is important to note that, on average, 46 workers lose their jobs every time a family-owned business is forced to shut its doors. And let me assure you that I am not spending my weekends with the Rockefellers. The families of deceased HVACR contractors are not typically bequeathed stacks of money. In fact, what they are left is a business that requires a lot of hard work, time, and energy.

And concerning the suggestion that the national budget will be placed at risk, one need only look at the fact that revenues from the death tax account for just a little over one percent of federal revenue to know that this tax actually provides little benefit to the federal treasury. As you know, the government spends considerable funds to collect the tax so the net gain is minimal. Further, this argument proves too much: if the federal government is truly strapped for cash, then why wait until someone dies to confiscate his assets? Why not simply raise the marginal tax rates today? But curiously, we don't hear calls for such action. In fact, we're currently debating the merits of providing long overdue relief on marginal rates as well. Perhaps this is because the federal treasury is not in such dire straits as opponents of death tax relief would have us believe.

Mr. Chairman, the death tax combines two certainties, death and taxes, into one onerous liability for family-owned small businesses. We urge you and members of the Committee to put an end to the death tax by supporting H.R. 8. ACCA appreciates this opportunity to testify on this issue and believes your role in addressing this critical issue, which is of vital concern to small businesses across America, deserves to be recognized. We at ACCA are pleased to do so, and thank you for your attention to the needs of family-owned small businesses.

CAL-FED SCHOOL INFRASTRUCTURE COALITION
SACRAMENTO, CALIFORNIA 95814
March 20, 2001

The Honorable Bill Thomas
Chair, House Ways & Means Committee
Attention: Bob Winter
House Ways & Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Subject: School Construction Needs

Dear Chairman Thomas:

We appreciate the opportunity to provide information regarding school construction needs in California as part of the House Ways & Means Committee hearing on the Budget Proposal.

In California the school facilities problem is at critical proportions and necessitates partnerships among local, state and federal governments. Based on the California Department of Finance's estimated public school enrollment for 2000–2005, California's student population will grow by an average of 37,653 pupils per year. Currently, California has a K–12 student population of approximately 5,951,612. Projections indicate that by the year 2005, California will have reached a student population base of 6,134,412.

California passed Proposition 1A in 1998 that provided State funds for modernization and new construction needs with a match from local school districts. *All $2.1 billion allocated for modernization has been apportioned with a pending project list totaling over $1 billion*. New construction funding is available to school districts that qualify under a complex priority point system and funds are going quickly. These funds were intended to last through 2002. Estimated needs for deferred mainte-

nance and modernization in the next five years begin at $7 billion as a conservative estimate while new construction needs will exceed $9.6 billion.

It is important to remember that school district capital needs are greater than the resources that can be provided from one or two government entities. Participation by local, state and federal governments is the only way we will develop the resources to build and modernize the schools our country needs to serve all our children in the future.

As an example of the above-mentioned support, the Qualified Zone Academy Bond Program (QZAB) has been extremely successful in California. All funding allocated in 1998, 1999, 2000 and 2001, totaling approximately $222,488,000, was fully allocated as of January 2001. The State of California has received over $85,000,000 in additional requests for QZABs that the State cannot meet. An extension or expansion of this program would be well utilized in California. Some examples of successful QZABs include a Technology Academy in the Pomona Unified School District, the Center for Advanced Research and Technology in the Clovis and Fresno Unified School Districts and two Computer Certification Academies in the Baldwin Park Unified School District, all exemplary programs featured on the U.S. Department of Education website.

In addition, the America's Better Classroom Act, introduced last week as H.R. 1076 by Congresswoman Nancy Johnson (R) of Connecticut and Congressman Charles Rangel (D) of New York, is an important bill addressing the need to assist local communities in the building of schools. H.R. 1076, providing a federal investment of $2.76 billion will generate $24.8 billion in interest-free school construction bonds. The federal government provides a tax credit in lieu of interest and the responsibility for the bond principal will be at the state and local level. All decision-making prerogatives related to the actual school renovation and construction remains a local community decision. The success of the QZAB program illustrates this fact—the federal government provides an interest subsidy while leaving all school construction decisions to the local community.

California is in the process of developing a program for the School Renovation Program providing $133 million in school renovation, IDEA, and technology funds included in the FY 2001 budget. It is expected that these funds will be depleted immediately upon implementation of the program.

Cal-Fed is aware of alternative funding sources such as private activity bonds. However, these alternatives do not provide the assistance that can be gained through the QZAB Program and most importantly the school modernization bonds proposed under H.R. 1076. For instance, in California, school districts do not have the revenue source necessary to make lease payments to a developer constructing a school through private activity bonds. The QZAB Program and H.R. 1076 would utilize tax-credits thereby providing a better alternative source for school districts and better leverage of federal dollars for school construction.

California, like the rest of the nation, has an immediate need for school construction funds through a partnership between local, state and federal governments. We request your support for the inclusion of school construction funding in the current Budget Proposal as well as the passage of H.R. 1076.

Thank you for your consideration.

Sincerely,

TERRY BRADLEY
Chair

COLLEGE SAVINGS PLANS NETWORK
LEXINGTON, KENTUCKY 40578–1910
March 22, 2001

The Honorable William Thomas
Chairman
Committee on Ways & Means
United States House of Representatives
Room 1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the College Savings Plans Network ("CSPN"), which represents the college savings programs of all 50 states and the District of Columbia, I am writing to express our support for legislation to provide an exclusion from gross income for

distributions from the qualified state tuition programs. CSPN applauds your leadership on legislation to encourage saving for college. Section 529 programs now represent over 1.5 million families who have invested over $9 billion for their children's future higher education.

The state-sponsored college savings programs have achieved tremendous success. Since enactment of the Small Business Job Protection Act, the number of children participating in the programs has skyrocketed, and the number of states with programs has nearly doubled. The state-sponsored college savings programs help families save for the high cost of a college education. As a result, many more of our children will have the opportunity to gain a higher education, which benefits the entire nation through a better educated, more productive workforce.

The College Savings Plans Network believes that establishing an exclusion from gross income for distributions from the qualified state tuition programs is essential to encouraging savings and college attendance. An exclusion from gross income would also recognize that contributions to the programs cannot be used for any purpose other than higher education. Any tax withheld from the distribution would reduce funds available to pay college expenses, increasing the cost to attend college. The public policy of this proposal is to enable and motivate families to save for college by providing clear and easily understood tax treatment of the qualified state tuition plans.

The states also support three additional amendments to Section 529. The first is an increase in the amount plans are allowed to pay out for room and board costs. The current off-campus amounts are fixed and do not take into account geographic differences in the cost of living and are not indexed for inflation. The College Savings Plans Network also supports the inclusion of first cousins in the definition of "member of family," which will allow grandparents to transfer accounts among all of their grandchildren. Lastly, the Network supports an amendment that would allow for rollovers among qualified state tuition programs without having changing the beneficiary. These amendments were included in the Senate Finance Committee Chairman's mark of the "Affordable Education Act of 2001" and the modifications (JCX–9–01 and JCX–11–01) approved on March 13, 2001.

As the administrators of the state-sponsored college savings plans, we are concerned about proposals to expand Section 529 to permit private colleges and universities to establish qualified savings trust programs. CSPN supports proposals designed to encourage families to save for their children's higher education. But, as the proposal to permit private institutions to establish qualified savings trust programs moves forward in the legislative process, we urge the Committee to ensure that there is effective oversight and financial security of the private institution programs.

The College Savings Plans Network supports allowing private institutions to establish qualified prepaid tuition programs under Section 529(b)(1)(A)(i), but believes these institutions must be subject to regulation and oversight as rigorous as the oversight to which the state programs are subject. Limiting these types of programs to prepaid tuition plans rather than savings trusts, we believe, would provide adequate safeguards for the sound operation of independent school programs.

The state-sponsored college tuition programs are secured by the moral obligation of the states. To back this moral obligation, the state programs are subject to multiple levels of oversight. Oversight examples include state boards; gubernatorially appointed boards with specific qualifications; state audit review; legislative oversight committees; public audit reports; required public disclosure; and open meeting laws, as well as public record accessibility requirements. These oversight mechanisms protect the financial integrity of the programs, ensuring that the contributions to the programs are soundly invested and that the actuarial goals of the plans are met. Safe financial operation of the programs means that when a beneficiary enrolls in college, the program can pay out the proper amount of tuition.

The passage of legislation to improve the tax treatment of state-sponsored college savings programs is crucial to states currently administering a college savings plan, as well as to those states implementing new plans for the benefit of their residents. Thank you again for your leadership and strong support of the state college savings programs and the hundreds of thousands of families who participate in them. We look forward to working with you as this legislation moves through Congress.

Very truly yours,

GEORGIE THOMAS
Chairman, College Savings Plans Network and
New Hampshire State Treasurer

Statement of the Hon. Constance A. Morella, a Representative in Congress from the State of Maryland

I am here to applaud the President's proposal to increase the child tax credit from $500 per child to $1,000 per child. Throughout America, families with children struggle with the extra cost associated with raising children today—especially child and health care costs.

During the President's inaugural remarks, he said, "America, at its best, is compassionate. In the quiet of American conscience, we know that deep, persistent poverty is unworthy of our nation's promise." With much applause, the President continued, "And whatever our views of its cause, we can agree that children at risk are not at fault. Americans in need are not strangers, they are citizens, not problems, but priorities."

The President's proposal to double the child tax credit from $500 to $1,000 is an important first step towards achieving our shared goals. Unfortunately, the child tax credit expansion, as proposed, discounts over 16 million children because they live in families with no federal tax liability and therefore will receive no benefit from an increase in the child tax credit because it's not refundable—it's not available to families without federal tax liability.

An additional 7 million children live in families who will not benefit from an increase in the child tax credit unless it's refundable due to their *limited* tax liability. Yet, these families pay taxes. They pay federal and state taxes, payroll taxes, gas taxes, phone taxes, and other taxes. Overwhelmingly, they represent working families. Yet, at $12,000 or $20,000, they have no federal tax liability and therefore *unless the child tax credit is made refundable, they will receive no benefit from an increased child tax credit*.

Making the child tax credit fully refundable would lift more than 2 million poor children out of poverty (one in six). It would lift 1.6 million extremely poor children (one in three) above one-half of the poverty line (above $6,645 a year for a three person family). While it may not be realistic to achieve full refundability in this tax bill, I believe it is important to take the first step towards helping those children most in need.

To that end, I, along with several of my Republican colleagues, have formulated language that duplicates the President's proposal to double the existing child credit from $500 to $1,000 and increase the income phase-out from $110,000 to $200,000. Our bill simply makes $500 of the credit refundable to low and middle income families. This step, modest as it is, would lift over 1 million children out of poverty.

Certainly, if we agree that children in higher income families need help from the child credit, we can agree that low-income children need that help as well. It is unconscionable that in America today, federal budget experts predict a federal budget surplus of $5.6 trillion over the next 10 years and an "on-budget" surplus of $3.1 trillion over the next 10 years—that over 12 million children live in poverty.

We can take advantage of the current resources our great nation has, by attempting to move children out of poverty—to ensure that no child is hungry or homeless, without health coverage, unable to concentrate in school because their parents cannot afford a decent apartment or a balanced meal. Making the child tax credit refundable would be one of the most effective antipoverty strategies in years. While I support expanding the Earned Income Tax Credit (EITC) for large families, making the child tax credit refundable is several times more effective in moving children out of poverty.

Often people talk about the complexity of the tax code. The beauty of making the child tax credit refundable is its simplicity. Families in need, regardless of income tax liability, would receive much needed benefit—*no marriage penalty and very little chance for fraud*. Unlike some programs, a refundable credit would not result in fraudulent claims because children must qualify as dependents. The IRS already has an effective system in place to verify any claim of dependents. The credit is not income-based so you don't have to have systems set up to track parents as they navigate their way through a series of low wage jobs.

Mr. Chairman, I supported the President's income rate tax proposal because, like many of my colleagues, I believe Americans pay too much in several sections of the tax code. The concept of a refundable child tax credit is not new. Back in 1991, the Bipartisan National Children's Commission that included the former President George Bush's nominee for HHS Assistant Secretary for Families, Youth, and Children Wade Horn recommended that Congress should enact a refundable child tax credit.

Certainly, making the child tax credit refundable will not solve child poverty but, it is a step in the right direction, and moving over 1 million children out of poverty is a giant leap in poverty reduction. During the President's inaugural address, he made this pledge: "When we see that wounded traveler on the road to Jericho, we will not pass to the other side." Thank you, Mr. Chairman, for this opportunity to submit my testimony to your committee. I know we share a commitment to our nation's children and look forward to working with you on this issue.

NATIONAL ASSOCIATION OF REALTORS
WASHINGTON, DC 20001
March 22, 2001

The Honorable Bill Thomas, Chairman
Committee on Ways and Means
1100 Longworth House Office Building
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The National Association of Realtors (NAR) appreciates the opportunity to comment on features of President Bush's tax cut proposal. The National Association of Realtors represents more than 760,000 Realtors who are engaged in every facet of real estate brokerage, leasing, property management and sales.

Our members generally favor low tax rates. Presently, they are hopeful that Congress and the Administration can strike a balance between tax cuts and reducing the debt. Real estate is particularly sensitive to interest rates, and we believe that the combination of tax and fiscal policy should foster the lowest possible interest rates and tax rates.

Two features of the President's tax cut plan are the subjects of hearings on March 21. NAR wishes to express concerns about marriage penalty relief and about some technical aspects of estate tax repeal.

Marriage Penalty Relief

NAR supports the marriage penalty relief specified by both Candidate Bush and in the Administration's "Blueprint for New Beginnings" (the budget plan). The budget plan reinstates the Reagan solution to the marriage penalty. The proposal allows a deduction for two-earner families that allows the lower-earning spouse to deduct 10 percent—up to $3,000—of the first $30,000 of income. An identical provision was in effect from 1981–1986. The provision was repealed as part of the Tax Reform Act of 1986 because the low tax rates enacted in that legislation significantly reduced the impact of the marriage penalty. Since 1986, however, tax rates have increased and the marriage penalty has again become an anomaly of the Code.

NAR favors the Bush budget solution to the marriage penalty over methods that focus on the standard deduction. In 1999 and 2000, the House passed marriage penalty relief that would have doubled the standard deduction. Thus, the provision would have gone beyond the scope of simply reducing the marriage penalty by providing tax reductions to couples who do not experience the penalty because only one spouse earns income. Doubling the standard deduction is a simple method for addressing this problem, but it excludes working couples who itemize their deductions. We cannot discern any policy reason why those families who itemize should be denied marriage penalty relief.

NAR believes that two-income families who itemize their deductions should also receive marriage penalty relief. We believe that fundamental fairness requires this result. Therefore, we support the Administration's budget proposal over relief methods that focus on the standard deduction.

Provisions similar to those found in this year's H.R. 6 were advanced in 2000 to correct the marriage penalty. Those provisions were vetoed in 2000. This year, H.R. 6 doubles the standard deduction, widens the 15% bracket and mitigates the marriage penalty in the earned income credit. The sponsors of H.R. 6 acknowledge that it provides no relief to individuals who itemize their deductions. They attempt to correct this disparity by widening the 15% bracket for married joint filers. While this will provide relief to all married taxpayers, including those in higher brackets, we note that those who utilize the increased standard deduction will also receive the benefit of the bracket changes, while those who itemize will receive only the relief of the bracket widening. Moreover, since the bracket widening provision is

phased in, it will take several years before taxpayers who itemize will receive relief. Again, we can find no policy basis for providing immediate relief to non-itemizers while providing only a single form of phased-in relief to itemizers.

Estate Tax Repeal—Support for H.R. 8 as Introduced

When H.R. 8 was debated in Congress in 2000, NAR sent House and Senate members a letter of support for final passage of the conference report on the bill but expressed concerns about that bill's provision eliminating stepped up basis in favor of carryover basis. In this Congress, Ms. Dunn and Mr. Tanner have again introduced H.R. 8 and have retained stepped up basis. **NAR strongly supports repeal of the estate tax and thus supports H.R. 8 in its current form.** We believe that the Committee should adopt H.R. 8 *in its current form*, as it achieves both objectives of repealing the estate tax and retaining stepped up basis for all assets.

Challenges of Carryover Basis

Because Congress has passed carryover basis once, however, we wish to express our concerns about many of the problems associated with that change. Our concerns about carryover basis are based largely on administrative challenges for property owners, estate administrators and tax administrators. We believe that carryover basis is unduly complex. Indeed, the carryover basis provisions enacted in 1976 were delayed in 1978 until 1980. The Joint Committee "General Explanation of the Revenue Act of 1978" noted that

> Congress believes that it should thoroughly review the concept of carryover basis in addition to considering its effect on the administration of estates. The Congress believes that the effective date should be postponed in order to review the provisions before they become effective. (General Explanation, p. 294.)

Congress undertook that review, and concluded that while carryover basis was perhaps a supportable policy, it was almost impossible to implement. Thus, the carryover basis rules were never put into effect and were repealed in the 1980 Crude Oil Windfall Profit Tax Act of 1980. In fact, the IRS and practitioners were unable to design rules to make the carryover basis concept operational. The Joint Committee "General Explanation of the Crude Oil Windfall Profit Tax Act of 1980" that accompanied the repeal of carryover basis described the "Reasons for Change" as follows:

> A number of administrative problems concerning the carryover basis provisions have been brought to the attention of the Congress. Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. Congress believed that the carryover basis provisions are unduly complicated and should be repealed. (General Explanation, p. 120.)

Advocates of carryover basis have expressed concern that the repeal of the estate tax, coupled with retention of stepped up basis, would permit substantial amounts of built-in gain in appreciated assets to completely escape taxation. Their concerns must be weighed against the problems inherent in designing workable carryover basis rules.

Even when the estate tax is repealed, the effects of inheriting assets will still be felt by heirs because the assets that the heirs receive will remain subject to the income tax rules. Thus, rules for determining the value of the assets that the heirs receive are essential. Current law permits the heirs to receive assets at their fair market value by providing a stepped up basis. Carryover basis requires that the heirs receive the assets at the value they have in the hands of the decedent.

The vetoed 2000 version of H.R. 8 would have permitted a stepped-up basis for $1.3 million of assets. All other assets would be subject to carryover basis. This rule has an effect similar to an exclusion and would eliminate the complexity of carryover basis for smaller, relatively simple estates. This year, Senator Kyl, an advocate of carryover basis, has introduced S. 275, which repeals the estate tax and institutes carryover basis, subject to a stepped up amount of $2.6 million per decedent. Thus, under S. 275 a couple could convey assets with a value of up to $5.6 million with a stepped-up basis. This provision will eliminate some of the challenges of carryover basis and will reduce the number of taxpayers subject to the carryover basis regime. The remainder of estates and their administrators and heirs will, however, face new complexities. The discussion that follows enumerates some of the problems with carryover basis and/or a part step up, part carryover model.

Recordkeeping: Carryover basis requires meticulous recordkeeping. Heirs will need to know when an asset was acquired and at what price. Additional costs arising from acquisition might also have changed the basis of the asset. These costs could include items such as commissions paid, title search costs and legal and/or financial advice related to the acquisition. In the case of stocks and other securities, the heir would need to know whether there had been splits and/or mergers or acquisitions that applied to the stock. In the case of real property or certain tangible personal property, the heir would need to know the costs of improvements and repairs, as well.

Some would say that this is no different from the information the recipient of a gift would need to have because gifts are subject to a carryover basis. The stark difference between a gift and a bequest, however, is that the donor is alive and able to provide information in the case of a gift, but the person with all the information is dead in the case of a bequest and so cannot provide information.

Liabilities in Excess of Basis: Under current law, the amount property that is subject to the estate tax is the *net* value of the property in the estate. Thus, in a taxable estate, an individual might have a property with a fair market value (FMV) of $4 million at death, a basis in that property of $300,000, and a debt on the property of $3 million. The estate tax on this property would be imposed on a value of $1 million—the *net* FMV of the property ($4 million less $3 million debt). If an heir later sold the property for $4.5 million, the taxable gain would be $500,000 ($4.5 million sales price less stepped up basis of $4 million). The debt would have no effect on the stepped up basis of the heir at the time of disposition.

By contrast, the transfer of a debt-encumbered property with a FMV of $4 million, debt of $3 million and a basis of $300,000 would be treated much differently under carryover basis. The heir would have a basis in the property of only $300,000 (the same as the decedent's). A subsequent sale of the property for $4.5 million would generate a capital gain of $4.2 million ($4.5 million less $300,000—the debt is given no effect for measuring gain). At a tax rate of 20% on the capital gain, the tax due would be $840,000. This is substantially higher than the $550,000 that would be due under the estate tax with stepped up basis *even if* the decedent's estate had been subject to the highest estate tax bracket. When the heirs in the stepped up basis example above sold the property for $4.5 million, their capital gain was $500,000 for an income tax liability of $100,000. The *combined* $550,000 estate tax and $100,000 capital gain tax are *still* less than the $840,000 capital gains tax due in this carryover basis example. The $840,000 amount would be even higher if the transaction involved recaptured depreciation allowances (which are taxed at 25%).

Capital gains taxes are imposed on *gross* amounts, while the estate tax is imposed on *net* amounts. Low basis property with debt encumbrances might thus actually be subject to greater tax burdens under carryover basis than those imposed by the estate tax. A low tax rate imposed on a large base can, depending on circumstances, yield a higher tax liability than a high rate tax imposed on a small base.

A Tax at Death?: Another anomaly might occur with carryover basis transfers of low basis, debt-encumbered property. This anomaly arises because of the operation of the income tax law, not the estate tax. Under current income tax law, the disposition of debt-encumbered, low basis property results in a gain to the transferor if the property is sold and both the property and the debt are conveyed to the purchaser or if the property and the debt are transferred as a gift. The rules of Section 1014 operate to require immediate recognition of gain in these circumstances.

If the estate tax were repealed, the income tax rules may affect the transfers of property from an estate to an heir. If the basis of the property were stepped up as in the example above, the recognition provisions of Section 1014 would generally not apply to the estate or heir. Current law taxes the net estate and then steps up the basis for the heir so that the debt is generally covered by the new basis. By contrast, carryover basis could trigger a taxable event at death. If the transferor is an *estate* transferring encumbered property to an heir, there may be an immediate tax due because of these income recognition rules of current law. The fact that the estate tax is repealed would not change the income tax outcome for these assets if carryover basis applied. Similar results (i.e., a tax at death) could occur when property is distributed from a trust to a beneficiary pursuant to a bequest.

Although the number of assets that would be debt-encumbered and low basis is relatively small compared with all assets, we urge Congress to correct this anomaly so that the inheritance of debt-encumbered, low basis property will not trigger an immediate income tax event. A stated goal of advocates of repeal is to assure that death is not a taxable event. Correction of this problem will assure that result.

Tax Attributes: Congress will need to make determinations about how to treat the various tax attributes that accompany both individuals and their property under the income tax. While the estate tax burden would be eliminated with repeal, the estate

and its assets will still be subject to income tax rules. Congress will need to determine, for example, how to treat suspended losses under the passive loss rules under Section 469. Will the heir receive a basis adjustment for them, or will they disappear, or will they simply remain suspended losses?

Similarly, Congress will need to make determinations about the treatment of charitable contribution carryforwards for individuals and businesses, net operating loss carryovers for small businesses, investment interest carryforwards and capital loss carryovers. Whether these attributes continue to have separate identity and remain subject to various limited or unlimited time constraints, or whether they become adjustments to basis, administrators will have new burdens as carryover basis requires them to attempt to determine which assets produced which attributes. These burdens will be magnified in a part step up, part carryover scheme like the 2000 version of H.R. 8 or this year's S. 275.

Allocations of Basis: Part carryover, part step up models such as last year's H.R. 8 or the current S. 275 will create unique problems for administrators of estates that are larger than the allowable step-up amount. Administrators will need to allocate the step-up amount among assets. They will be required to make market predictions about the probable subsequent appreciation of the decedent's assets and the probable pattern of asset retention and disposition among the heirs so that they can make the most favorable allocations for the heirs. Even in the absence of an estate tax, it can be assumed that heirs will want to minimize their exposure to subsequent capital gains (and, if applicable, recapture) taxes. When the size of estates is only marginally less than the step up amount, administrators (or Congress) will need to devise both taxpayer and IRS recordkeeping rules that will allow subsequent heirs to verify either the stepped up or carryover basis of each asset.

Multiple Heirs/Multiple Generations of Heirs: Estate administrators of estates larger than any step-up amount will be particularly challenged in allocating the step-up amount among two or more heirs. In the absence of instructions from a decedent, how would an administrator choose to distribute cash, appreciated real estate, appreciated stock (whether these appreciated assets were high or low basis) and the residue of an IRA or 401(k) plan? Under stepped up basis, the determination of comparable value among these assets is relatively simple, because the value of each asset in the estate and thus to the heir is stepped up to its fair market value.

Under carryover basis, there would be no consistent method of valuing the assets for the assets for the heirs. To the extent that heirs disagreed with either the type of property received or its basis allocation and potential value, there could be increased controversy about disposition of estates. Heirs would likely prefer to receive either cash or high basis assets. Because of the potential tax exposure for low basis assets, those may become undesirable bequests. Moreover, there would be substantial differences in the yearly income tax benefits and liabilities to an heir of receiving these different types of assets.

Even more complicated problems arise for multiple heirs and multiple generations. Assume that a decedent had an estate with $8 million of stock in various companies, all acquired on different dates. The decedent leaves this stock to each of 3 children, and the allowable step-up amount is properly allocated. (This assumes that it is possible to make a basis determination and that the decedent had sufficient records on all of the stock with which to make the determination.) Each of those 3 children holds the stock until his or her death, and each of them also has sufficient other assets for his or her own step up amount and some carryover basis assets, as well. Further, each of the 3 children has heirs.

How will the third generation heirs trace their basis from the first generation bequest? from the second generation? How will the records—which could cover a period of 40 or more years—be kept and retained? Who will bear the responsibility of keeping the records for the original bequest? How will the IRS know what assets from the original bequest received the step up and which received carryover basis? Will it be necessary to file returns, even for stepped up amounts? Will the IRS still have those records in a readable format after 40 or 50 years? Who will bear the burden of proof for establishing basis in multi-generation property? What if some of the assets become capital loss property?

Inevitably, the movement of property from generation to generation under carryover basis will compound the complexity of the taxpayer's obligations—even in the absence of an estate tax.

Potential Lock-in Effect: Over time, the basis of some assets will become very low relative to the appreciation and built-up gain in the assets, especially when the assets are carryover basis assets. This will be particularly true of depreciable assets, where, in theory, at least, the basis could be reduced to zero if it is not increased by improvements and renovations. While we have no empirical data to test our

view, we believe that, over time, there could be an increasing lock-in effect as heirs find that the tax costs of selling low basis appreciated assets become increasingly disproportional. Historically, Congress has sought to eliminate the lock-in effect for appreciated assets. A long holding period for appreciated property with a low basis would surely have some lock-in effect.

Impact on Surviving Spouses: Under current law, an unlimited marital deduction permits a spouse to leave all property to the surviving spouse without an estate tax consequence. The basis of the assets is stepped up to their fair market value. Then, when the second spouse dies, the estate tax is imposed on the value of the remaining assets. Under carryover basis, the marital deduction disappears, so any assets a surviving spouse will receive will be subject to the carryover basis rules. Even with a partial step up as under S. 275 (or last year's H.R. 8), a surviving spouse who needs cash or income could be forced to pay substantial taxes that would not be due under current law.

This will be particularly true in the case of an estate with a limited number of illiquid assets. For example, a spouse might inherit a going concern small business. The survivor may not wish or be competent to operate the business and may wish to derive her income from other, more stable sources such as fixed income funds or annuities. Under current law, if the spouse sold the business, he/she would incur only a capital gains tax on the difference between the fair market value of the business at the decedent's death and the sales price of the business. Under carryover basis, depending on the relationship of sales price, carryover basis amounts and stepped up basis amounts, the income tax/capital gains tax liability to the spouse at the time of sale might be significantly greater than any estate tax might have been.

Conclusion

The National Association of Realtors supports President Bush's original marriage penalty relief provision and is hopeful that any marriage penalty that the Committee crafts will apply equally to those who itemize their deductions and those who do not.

NAR also supports full estate tax repeal as found in the 2001 Dunn–Tanner version of H.R. 8. Despite our concerns from 2000 about carryover basis, we believe that its impact can be mitigated by assuring that only the most sophisticated taxpayers are subject to it. This mitigation can be accomplished by assuring that a step up amount at least as great as the $2.8 million in S. 275 is provided. NAR's Federal Taxation Committee and leadership have reviewed this issue carefully, and believe that full estate tax repeal is in the best interests of our members and the clients they serve.

Should you or your staff have questions related to these issues, please feel free to contact me at 202 383 1083 or at lgoold@realtors.org.

Sincerely,

LINDA GOOLD
Tax Counsel

Statement of Robert J. Maguire, Chairman, National Automobile Dealers Association

Mr. Chairman and members of the Ways and Means Committee, I am Robert J. Maguire, CEO of Saturn of Bordentown, Saturn of Toms River, Bob Maguire Chevrolet Inc., Bordentown, N.J., Windsor Nissan, Highstown, N.J., and 2001 chairman of the National Automobile Dealers Association. On behalf of NADA, I commend you for holding this hearing and am pleased to submit this testimony in favor of eliminating the federal estate tax.

NADA represents more than 19,500 franchised new car and truck dealers who employ more than one million people nationwide. The majority of NADA's members are small family-owned and community-based businesses. Many dealerships span two, three or four generations. I am a second-generation dealer myself. My father started his business in 1938, and I joined him in 1962 before beginning my own in 1976.

The estate tax in its current form is destructive to America's entrepreneurs. Under the current law, heirs could be required to pay up to a 55 percent tax on the estate when the owner dies. There is something very wrong in our system when a small businessman or businesswoman spends a lifetime building a company, pay-

ing taxes, providing jobs and serving the community only to have the government step in and take 55 percent of everything at death.

The death of the owner of a small business can trigger an estate tax obligation that has immediate adverse consequences. The surviving family members often do not have sufficient cash reserves to cover the estate tax bill, so they have to borrow money to pay the IRS. This increased debt severely restricts the ability of the surviving entity to obtain additional capital, which can cripple or kill the business.

Even the most sophisticated estate tax planning and the purchase of life insurance cannot mitigate the effects of the death tax. Most assets of automobile dealers are not liquid. A dealer's capital is invested in the land under the dealership, buildings housing showrooms, vehicle repair equipment, and other facilities. Also, dealers need substantial working capital to finance new and usedcar inventory, as well as parts and accessories. If the government demands half of the fair market value of the business just because the owner dies, families in the automobile business are left with few options but to sell their businesses or incur substantial debt to pay the tax.

The estate tax also negatively impacts businesses before the death of an owner. Dealers spend thousands of dollars each year in fees to attorneys, accountants and life insurers in an attempt to prepare for an eventual estate tax liability. Dealers have paid taxes on these assets and are frustrated by throwing money at preparation costs rather than on more productive measures such as business expansion and employee benefits.

Moreover, the notion that death taxes affect only the rich is wrong. To the extent that these taxes reduce savings and investment, they slow economic growth and job creation. When a family-owned business has to curtail growth or, in many cases, liquidate part or all of the business to pay estate taxes, it hurts everyone involved—owners, customers, suppliers, employees, and their families.

Preserving family-owned and community-based businesses is crucial to the health of the national economy and essential to the economic welfare of local communities. These businesses provide the majority of new job growth in the country. Very often, family-owned businesses are central to the economic vitality of local communities, providing career opportunities for millions of working Americans. The vast majority of the one million people that dealers employ depend on the stability of our businesses to provide for their families. The elimination of the estate tax will enable dealers to continue to provide these jobs and will help assure the continuity of family business ownership for generations to come.

The death tax is anything but fair. I urge Congress to bury the death tax for good.

Statement of Bruce R. Bartlett, Senior Fellow, National Center for Policy Analysis

Mr. Chairman, thank you for the opportunity to testify today on issues relating to the marriage penalty and child credit.

To begin with, I would like to say that my general philosophy of taxation is that tax policy should influence individual decisionmaking as little as possible. People should neither be encouraged nor discouraged from getting married because of the Tax Code. Nor should their choice to have or not have children, or to have many or few children. These are extremely intimate aspects of family life that I think the government intrudes upon only at its peril.

In short, I favor tax neutrality to the greatest extent that it is possible to achieve it. Of course, I recognize that no tax system can be completely neutral. But there are degrees of non-neutrality and I believe that our current tax system strays very, very far away from neutrality and would be improved by moving back in that direction.

Some people take the position that since perfect neutrality is impossible and that tax policy must necessarily influence such things as marriage and child bearing to some degree, it follows that it should actively promote them. I think this is wrong and leads down a very slippery slope that advocates of an aggressive "pro-family" policy have not fully considered.

I think it is important to recognize that the current pro-family bias of the Tax Code did not come about because Congress made an explicit decision to aid families. It resulted from a Supreme Court case that gave residents of community property states a tax cut unavailable to those in common law states. In effect, the former allowed married couples to split their income for tax purposes—each spouse being taxed as if he or she earned half the couple's total income. With income tax rates

much higher than those today and few women in the labor force, this meant that married couples in community property states paid far less federal income taxes than couples in common law states or singles with the same income.

Eventually, Congress codified income splitting, extending the benefits to couples in every state. This created, for the first time, an explicit pro-family tax policy, insofar as a married couple constituted a family. Prior to this time, couples and singles with the same aggregate income paid the same tax. Henceforth, couples would generally pay less taxes than a single person with the same income.

Today, single-earner couples continue to receive the benefit of this policy change that took place in 1948, under pressure from a court case and without any conscious intent on the part of Congress. Such couples generally receive a bonus from the Tax Code, meaning that they pay less federal income taxes than a single person with the same income.

By the late 1960s, the gap between a married couple and a single person with the same income became so great that it was viewed as unfair. Some couples were paying more than 40 percent less income taxes than their similarly-situated single counterparts. This led Congress to reconfigure the rate schedule such that no married couple would pay more than 20 percent less than a comparable single person.

The unintended result of this policy change was to create a marriage penalty for the first time. I define a marriage penalty as a situation in which a married couple pays more federal income taxes than a single person with the same income. In response to outcries, Congress enacted a second earner deduction in 1981, which substantially mitigated the effects of the marriage penalty. However, this deduction was eliminated in the Tax Reform Act of 1986. Since then, there has been growing agitation to once again redress the marriage penalty, a situation intensified by the growing role of women in the labor force.[1]

At this point, I would like to emphasize something: the marriage penalty only affects two-earner couples. No single-earner couple ever pays a marriage penalty. For the most part, the latter continues to receive substantial bonuses from the Tax Code. Thus, the so-called marriage penalty is less a penalty for marriage than a penalty for work by the secondary earner; usually the wife, but increasingly the husband.[2] Although there is some evidence that the marriage penalty affects marriage and divorce decisions, mainly through timing, the impact is minuscule.[3]

Of much greater importance is the impact of the marriage penalty on the work decisions of secondary earners. A large body of economic literature, as well as anecdotal evidence, indicates that such earners (i.e., the lower-paid spouse) are much more sensitive to marginal tax rates than is the primary earner.[4] Thus there is reason to believe that the marriage penalty is discouraging a not-inconsiderable amount of labor at a time when the national unemployment rate is historically low.

Once it became clear that the major effect of the marriage penalty was in discouraging paid labor by married women, the terms of the debate changed. Previously, many pro-family advocates had strongly opposed the marriage penalty, believing that it discouraged marriage and encouraged cohabitation. But when they realized that the marriage penalty actually had a trivial effect on marriage, but a big impact on the labor supply of married women, they altered their position. Instead of abolishing the marriage penalty, many now want more bonuses for married couples instead.

Thus we see that one of the main marriage penalty relief bills in the last Congress would simply have increased the standard deduction for married couples, so that it would be twice that for singles. While it is true that the current break points for the standard deduction do contribute to the marriage penalty, this proposal would only offset about one-fourth of the total marriage penalty. Moreover, almost half the benefits, in terms of tax savings, would go to couples who have no marriage penalty.[5] In short, it is more of a general tax cut for married couples with low incomes—or at least those that who do not itemize—than relief of the marriage penalty.

To really get rid of the marriage penalty, Congress must allow couples to choose their filing status. That is, they could continue to file jointly or with each spouse

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[1] For further details, see Bartlett (1998a).

[2] According to the Census Bureau, 22.3 percent of married women earned more than their husbands in 1999, up from 15.9 percent in 1981.

[3] See Alm and Whittington (1992, 1995a, 1995b, 1997 and 1999); Alm, Thatcher and Whittington (1999); Dickert-Conlin (1996); Gelardi (1996); Sjoquist and Walker (1995); Whittington and Alm (1997).

[4] See Boskin and Sheshinski (1983), Congressional Budget Office (1996), Eissa (1996), Feldstein and Feenberg (1996), Leuthold (1978, 1979 and 1984), Neff (1990), and Quester (1977 and 1979).

[5] See Bull et al (1999).

filing as a single, depending on which way they come out ahead, tax wise. Of course, there are important administrative and technical problems with this approach. For example, regulations would have to specify how income and deductions from jointly-held assets are to be divided. There is also the question of who gets the personal exemption and tax credit for the children.

Although these are important issues, I think they can be dealt with. The real problem is that once we have adopted a system in which couples can choose their filing status, it will become clear that the sensible thing to do would be to adopt a system in which the individual, rather than the family, is the basic unit of taxation. This has been advocated for some years by a number of tax theorists.[6]

Of course, a major consequence of this would be to eliminate existing marriage bonuses from the Tax Code. This is never going to happen for obvious political reasons. Nevertheless, it is the logic of where a comprehensive effort to eliminate the marriage penalty leads us, which is why I think there has been a fall-off in support for comprehensive solutions, in favor of half-way measures.

While the notion of moving away from the family as the basic filing unit for taxation may sound like an anti-family policy, I do not believe that it is. In my view, a childless married couple has no greater claim to be considered a "family" for tax purposes, and thus entitled to pay lower taxes under the joint schedule, than a cohabiting couple or those living in any arrangement considered to be a household by the Census Bureau.

In my view, it is the presence of children that defines a family. Thus one cannot separate family tax policy from tax policy regarding children. This brings me to the question of the child credit.

The proposal for a child credit grew out of a concern that the personal exemption had not kept pace with inflation for many years. The feeling was that the cost of raising children had grown, while the exemption had not.

Implicit in this concern about the erosion of the personal exemption was the idea that the exemption ought to be related to the actual cost of child rearing. This is consistent with the notion that all taxpayers should receive some allowance for the necessities of life.[7] But, of course, there has never been any serious effort to calculate such necessities and tie the personal exemption to it. Rather, we get at this in a round about way through a combination of the personal exemption, standard deduction, EITC, deduction for mortgage interest, the child credit and other provisions of the Tax Code.

In any event, the feeling among many Members of Congress was that current economic circumstances justified additional tax relief for children. The sensible thing to have done, in my opinion, was to raise the personal exemption for children. As far as I can tell, the tax credit route was chosen primarily for mathematical simplicity, rather than any considered notion that tax credits are inherently superior to tax exemptions. From my research, it seems that it was too difficult for some people to calculate the dollar value of a higher personal exemption, because it is a function of their marginal tax bracket. The credit approach simplified this calculation, since almost everyone got the same dollar amount of tax saving.[8]

I think this was an unfortunate decision. I believe it has moved us down a slippery slope of increased government intervention in the family. The credit is also inferior from the point of view of economic incentives.

The problem with the child credit, in my view, is that tax credits in general are too much like direct government spending. Whereas a deduction, exemption or exclusion implies that a taxpayer is only keeping his or her own money free from the government's grasp, tax credits imply that the government is making taxpayers a gift. Tax credits also lend themselves more easily to refundability, as with the EITC, which blurs the distinction between tax savings and a direct government handout.

I believe it is only a matter of time before demands that the child credit be made fully refundable are heard. And once the credit becomes refundable and it becomes more like a direct spending program, there probably will be calls to formally establish a system of family allowances, as are common in Europe. Not only will this put virtually every family with children on the dole, but it will open the way for government regulation of the family.[9] As we all know, government aid never comes without strings. State and local governments, for example, are continually threatened

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[6] See Davis (1988), Gann (1980), Kornhauser (1993), McCaffery (1993), Munnell (1980), Rosen (1977), and Zelenak (1994a).

[7] See Seltzer (1968) and Groves (1963).

[8] See Bartlett (1998b).

[9] See Brannon and Morss (1973) and Zelenak (1994b).

with loss of federal aid unless they change their laws or policies in some way favored by Washington.

Furthermore, tax credits are generally inferior to tax deductions or exemptions precisely because they are not impacted by one's marginal tax bracket. Work, saving and investment decisions are all made at the margin. Thus the tax rate on the marginal dollar—the last dollar earned—is the critical one for economic decisionmaking. Although there are those who say that exemptions and credits can be made to be economically equivalent, this is a fallacy. They arrive at this conclusion only by looking at the effective tax rate and ignoring marginal rates.[10] The logic of this approach is that there is no economic difference between a flat rate of 10 percent on $40,000 of taxable income, yielding a tax of $4,000, and a tax rate of 100 percent with a $36,000 tax credit. Obviously, the incentive effects are going to be quite different, even though the same tax is paid in each case.

Because exemptions and deductions affect marginal tax rates, by raising the income level affected by higher rates, they improve incentives to work, save and invest. Although tax credits can be designed to increase work, saving and investment, they are inferior to deductions. That is because, as I noted earlier, credits are too much like subsidies. Government subsidies are almost always bad, because they divert economic activity away from those areas established by the market toward those dictated by government. The result is malinvestment that can cause productivity to fall even when the volume of seemingly productive economic activity rises. This is the reason why European economies have been less competitive than ours in recent years despite higher ratios of saving and investment. Because such investment was encouraged and directed by government, rather than market forces, much of it simply is wasted.

The same principle applies to individuals. We want to lower marginal tax rates because we want more productive economic activity. For this reason, I applaud this Committee's recent action to lower marginal income tax rates for all workers and investors. However, increasing the child credit cannot be justified on the same grounds. Its purpose is not to increase growth or even to increase births, it is simply a way of lowering the tax burden on families with children, in the belief that they need it.

I certainly would not argue with the proposition that raising children is an increasingly difficult and expensive proposition these days. However, the logic of giving a tax credit to families solely because they need it, without any underpinning in tax or economic theory, poses a danger. It will be much harder in the future to resist direct subsidies for families that will bring along increased government control as well.

I would urge the Committee at some future date to perhaps commission a study by the Joint Committee on Taxation on the question of what principles should underlie tax policy toward children and the family. I think the current approach of making ad hoc adjustments in response to political pressure is not the best way to go about it.

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[10] See, for example, Turnier and Kelly (1984).

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Statement of Michael Dennis, Vice President and General Counsel, Nature Conservancy, Arlington, Virginia

Mr. Chairman and members of the Committee, thank you for the opportunity to submit testimony on the critically important issue of tax incentives for land conservation. I am speaking today on behalf of The Nature Conservancy, a private conservation organization that protects the land and water needed to protect the diversity of life on earth. For fifty years, we have worked with the private sector, using the tools of the market place and the best available scientific information, to conserve the special places that ensure the survival of plant and animal species. To date, we have helped protect more than 11 million acres of land in the United States. Our experience working hand-in-hand with landowners in diverse communities has led us to seek changes in the federal tax code that would more effectively encourage and reward private conservation actions.

I am pleased to be testifying at a time when the White House has joined with members of this committee and others in Congress in supporting just such a change to the federal tax code. President Bush included in *A Blueprint for New Beginnings: A Responsible Budget for America's Priorities* a proposed 50% reduction in capital gains tax on sales of land or easements for conservation. This is the proposal that Congressman Rob Portman has championed over the last several Congresses, and I would like to congratulate Congressman Portman for his leadership on this issue. He has been joined in his support of this legislation by colleagues on this committee Congresswoman Johnson and Congressmen Matsui, Tanner, Houghton and Neal. I urge the Committee to support this provision and to include it in tax legislation that it sends to the floor.

In September 1999, I appeared before the Oversight subcommittee to outline a number of federal tax code changes that would provide the most benefit for conservation. As I testified then, the sustainability and quality of life in every region of the country is in danger. The rate of the development of land exceeds by far both the rate of population growth and the rate of open space conservation. For example, between 1987 and 1997, California lost 3 million acres of rangeland. The cumulative effect of seemingly unrelated activities such as deforestation, the paving over of agricultural land, the filling in of wetlands and urban sprawl has been to fragment the landscape and strain the fabric of wild and human habitat. We need better tools to encourage private landowners to protect their land.

Today, I urge you to take the first step by enacting the proposed provision that speaks to one of the most important conservation needs in our country today: allowing landowners to protect the ecological values without forfeiting the economic value of their land.

What the proposal does

The proposal included in the President's Blueprint excludes from taxation 50% of any gains realized from private, voluntary sales of land or easements for conservation. It creates a vitally important incentive for "land-rich, cash-poor" landowners who voluntarily chose to protect their land. Although every landowner's financial situation is unique, I believe that such an incentive would encourage more landowners to consider favorably a conservation option for their land because they would realize a higher return from such a sale after the taxes were paid than if this provision were not in place.

For example, the Conservancy is working with the owners of Cherry Hill Dairy to protect 170 acres of critical upland and wetland habitat on the shores of Utah Lake near Provo, Utah. Cherry Hill Dairy has been a well-known farming operation and the property has been in the family for over 100 years. Should the family sell and easement for the agreed upon price of $400,000, the capital gains taxes would be steep and has been a barrier to the owners' decision to sell. If President Bush's proposal were enacted, the tax savings on such a sale would persuade the owners to protect the farm permanently.

How the proposal works

The capital gains tax conservation incentive is a fiscally conservative, market-based approach to land conservation. It achieves environmental objectives without imposing new land use regulations. The provision is strictly voluntary, administratively simple, and uses definitions and tests for conservation purposes that are already contained in the tax code. It provides capital gains tax relief for sales of land for conservation to government agencies or qualified conservation nonprofits. The bill would allow landowners to financial value. It would exclude 50% of any gain

realized from private, voluntary sales of land or interests in land for conservation. The land must be used to protect fish, wildlife or plant habitat or open space for agriculture, outdoor recreation or scenic beauty.

The proposal also helps states and local governments leverage funds and accomplish more with their tax dollars. Estimates indicate that, for every dollar of lost revenue from this tax provision, almost two dollars worth of land would be protected. Sales of land to state and local governments for conservation would qualify, in addition to such sales to federal agencies and conservation nonprofit organizations. Citizens who vote to increase their taxes to fund bonds for land conservation will benefit because the funds raised will go farther toward reaching the community's conservation goals.

Conclusion

Land conservation is a growing national need. Private landowners hold the future of biodiversity in their hands. The tax incentives the Conservancy recommends would provide interested landowners with the tools to conserve their land and contribute to the public interest in the preservation of the diversity of life.

We appreciate not only the support of President Bush, but also the leadership of Congressmen Portman and Congresswomen Johnson and Congressmen Matsui, Tanner, Houghton and Neal and encourage the other members of Congress to support the innovative, voluntary tax proposals that we are discussing today.

Thank you for your consideration of The Nature Conservancy's testimony and the proposal for public incentives for private conservation actions.

Statement of Judith A. Carsrud, Niche Marketing, Inc., Newport Beach, California, and Tracy Sunderlage, Professional Benefit Trust, Chicago, Illinois

Chairman Thomas and Members of the Committee, thank you for this opportunity to describe the benefits working Americans receive from welfare benefit trusts set up under Internal Revenue Code (IRC) Section 419A(f)(6). We urge you to take the necessary steps required to assure that these valuable benefits remain available to employees of America's small businesses.

First, let us introduce ourselves. Niche Marketing, Inc. is itself a small business. We have three owners, with seven full-time employees. We sponsor three 419A(f)(6) trusts, with over 452 participating employers. Our trusts provide life insurance and severance benefits to all of the participating employers' employees, including the owner-employees.

Professional Benefit Trust is based in the Chicago area, and sponsors one 419A(f)(6) trusts, covering 384 employer participants and their employees. Benefits available to plan participants include life insurance, severance benefits long term care and post-retirement medical benefits. PBT employs 3 owners, with six full-time employees.

The Purpose of 419A(f)(6) Trusts: Provision of Welfare Benefits

The ability to participate in a multiple employer welfare benefit plan allows all employers—especially small employers—to offer a benefits package that enables them to attract and retain a quality workforce. In addition to the traditional life and health insurance type benefits, the benefits package frequently includes severance benefits. These severance benefits give employees a measure of confidence and security in making a decision to work for a small company that is more vulnerable to dissolution, acquisition, or outright failure as a result of market swings, economic downturns, under-capitalization, cash flow shortages, and other known plights of small business. Both the amount and the timing of severance benefits are limited by law—benefits can be paid only when severance occurs unexpectedly, and they are limited by Department of Labor rules to no more than twice the amount of the worker's annual compensation.

Welfare benefits provided pursuant to Section 419A(f)(6) are bona fide benefits to the employees whose employers adopt such plans, and are necessary to the ongoing success and prosperity of such businesses. Continuing to allow a tax incentive to provide these benefits is in the best interest of the business community, and the workers, who in most cases would not otherwise be covered by such benefits.

The welfare benefits typically provided by a multiple employer plan include death benefits and severance benefits.

Many small businesses provide welfare benefits in addition to retirement plans, such as a 401(k) or a pension/profit-sharing plan. Severance benefits are not pro-

vided as an alternative to pension plans. In fact, severance benefits are forfeited to the multiple employer trust (not the remaining employees of the employer group) at the retirement of the employee.

A software company in California is a fair example of how severance benefits have provided meaningful benefits to its employees and allowed the business to recruit top-level employees in their field. Technology is a highly competitive field, with fluctuating ups and downs for smaller firms. However, the ability of these firms to recruit and retain skilled employees is crucial to the firms' success.

The California company we're describing here employed 12 people. Their adopted welfare benefit plan levels included a death benefit of ten times compensation and a severance benefit of 10% of compensation per year of service. Following a financial setback, a much larger firm purchased the business in March 1999. The successor firm did not employ the employees, except for the owner-employees. But the employees of the old, small firm received severance benefits—taxed as ordinary income—from the welfare benefit plan, giving them the financial cushion they needed while they found new employment.

If the employer had not been allowed to contribute the cost of the current liability for the stated benefits, then there would have been no money available to provide severance benefits at the time the business was sold. These workers would then have had to deplete their savings, if any, or try to live on unemployment compensation. In other words, small businesses typically do not have the same ability to "pay as you go" as do larger firms. These plans do not offer an unfair advantage to small business—large businesses are also eligible to participate in multiple employer welfare benefit plans. In fact, they instead help to level the playing field.

In short, participation in a 419A(f)(6) trust levels the playing field. It helps minimize a competitive advantage a bigger employer would otherwise enjoy in putting together a compensation package. It puts small employers on a more equal footing as they compete with larger, more established employers for quality workers.

Here's how it works. IRC Section 419A(f)(6) authorizes a tax deduction for contributions to welfare benefit plans within a framework of defined rules. Generally, 10 or more employers must band together to provide welfare benefits; no one participating employer can normally contribute more than 10% of the total plan contributions; there can be no experience rating by employer—i.e., all of a trust's assets at all times must be available to pay benefits to any participating employee; and there can be no retirement or other deferred compensation type benefits provided through the plan. Assets are independently trusteed and administered, and can never revert to the employer.

The rules seem clear to many 419A(f)(6) plan sponsors, administrators and participants. However, in recent years some of the rules have been questioned, and some advisors have recommended strategies that make aggressive use of the 419A(f)(6) rules. Consequently, there has arisen some concern about whether the rules need to be tightened to be sure they work as Congress intended—to provide a way to allow 10 or more employers banding together to offer real benefits to real workers.

Initial Proposal to Clarify, Tighten Falls Short

The first salvo in the debate on whether or how to clarify the rules occurred almost two years ago in then President Clinton's FY 2001 budget submission. That proposal would have limited the 419A(f)(6) deduction to contributions to trusts that offered only group term life, health and disability income insurance.

This proposal is fatally flawed in that it would eliminate important welfare benefits—including severance, post-retirement medical, and long-term care coverage. Further, in disallowing the use of permanent life insurance in a trust, it would impose the very cash flow hardship that IRC Section 419A seeks to mitigate—protection of employees. At the same time, the proposal, while making the trust benefits more expensive and less useful, would not adequately address the problems that are causing concern among policymakers.

The proposal was defeated in a variety of contexts in 2001, but the underlying concerns that prompted the proposal in the first instance were not addressed. As a result, a cloud remains hovering over the 419A(f)(6) marketplace. Employers are uncertain about whether they can continue to participate in multiple employer welfare benefit trusts; and trust sponsors, administrators and participants cannot rely on the continued viability of this important employee benefits tool.

As a result, the usefulness of this tool as a way to attract and retain quality workers is being eroded. The very existence of businesses like ours that focus on the operation of these multiple employer welfare benefits trusts is threatened.

Clarification Is Urgently Needed

The uncertainty surrounding the continued existence of multiple employer welfare benefit trusts makes the need for clear rules, as soon as possible, urgent. The rules must assure that these benefit plans operate as intended—that 419A(f)(6) trusts cannot be used as a way to fund deferred compensation on a tax-favorable basis, or as a way to circumvent pension contribution limitations. But clarifying rules, which need to be tight and clear, must also allow continued operation of trust benefits.

Proposed Modification: Experience Rating, Nondiscrimination, Funding Limits

To achieve clear, appropriate rules, we respectfully offer a proposal that would eliminate the abuses that cause concern among policymakers and industry representatives alike, but at the same time allow continued availability of multiple employer welfare benefit trusts. Our proposal, described in detail in the chart below, would clearly restate the current law rule that prevents "experience rating" by employer. This means that no participating employer would realize the results of its own experience with respect to benefits claims paid or forfeited, or with respect to segregated asset performance or variance from actuarial assumptions.

This is crucial to the appropriate use of permanent life insurance. It is important to emphasize that we believe that current law prevents use of experience rating by employer, whether overt or covert. But it is apparent that some in the marketplace do not read current law rules as restrictively as we do, and so it is appropriate to restate, with complete clarity, the rule that disallows experience rating by employer.

Our proposal also sets out rules that will assure that all of a participating employer's workers will benefit under the plan. Generally, the proposal follows the IRC Section 410 rules as to eligibility—an employer's plan must cover all workers who are at least age 21, who have one year of service, and who work at least 1,000 hours per year. Limitations on both the level of benefit and on the allowable deduction for the annual funding of accrued benefits are offered. Finally, the proposal includes a fair effective date rule—one that gives participating employers and plans two years to make the changes that would be required by this proposal in order to bring the plan into compliance with the new, clarifying rules.

In short, our proposal suggests rules that would: (1) result in multiple employer welfare benefit plans that cover all a participating employer's workers; (2) appropriately limit the annual deduction available to help fund the benefits; and (3) assure that the plan works equally and as a whole for the benefit of all the workers of the participating employers.

We have tried to design a proposal that meets tax and social policy goals and that works for the entire, diverse Section 419A(f)(6) marketplace. Our own trusts will have to make extensive and expensive modifications to comply with these rules. It is likely that no multiple employer welfare benefit trust currently in existence will not face the same need to amend plan rules in order to comply. We believe this proposal will eliminate the ability to make aggressive and inappropriate use of IRC Section 419A(f)(6), and will allow continued availability of this important tool for designing practical and attractive employee compensation and employment packages.

The Details of the Proposal

The chart below lays out the various elements of our proposal. It describes funding requirements, antidiscrimination rules, and appropriate limitations on the annual deduction. It delineates the types of benefits that should be available in a multiple employer welfare benefit plan. Finally and very importantly, it offers an effective date rule that protects employers who have already entered into a Section 419A(f)(6) trust, but requires the trust to make the changes required to come into compliance with the new rules.

MULTI-BENEFIT EMPLOYER PLAN FOR TEN OR MORE EMPLOYERS REFORM OF SECTION 419A(f)(6): Alternative Proposal (March 2001)

Funding Requirement	The plan must provide that at all times, all plan assets are available as a single, undivided pool to provide benefits to the covered employees of all individual employers participating in the plan. The definition of experience rating will apply as defined by the Tax Court in June 1997 in *Booth* v. *Commissioner*, 108 TC 524 (1997).

MULTI-BENEFIT EMPLOYER PLAN FOR TEN OR MORE EMPLOYERS REFORM OF SECTION 419A(f)(6): Alternative Proposal (March 2001)—Continued

Benefits available from the plan, on a nondiscriminatory basis	Plans will be non-discriminatory: (1) Participation in plan benefits will be provided to any employee meeting these standards: Age 21, 1,000 hours of service annually, one year of service. (2) All benefit formulas must provide a uniform multiple of compensation to all participants. (3) A look-back rule would apply at employer termination from the trust, to include all former eligible employees terminated 24 months prior to employer termination from the trust. All eligible employees would be entitled to a prorata share of a plan's assets. (4) Each employer plan must benefit at least one non-owner employee for each two owner-employees who benefit; trust must benefit at least three non-owner employees for every owner-employee benefited.
Distribution rules for benefits and plan assets	***In General:*** No assets of the plan may revert to the employer. No assets may be loaned to an employee participant. An employer can only terminate its participation based on a bona fide business purpose. ***Forfeiture Pool:*** All assets in forfeiture pool must be used in a nondiscriminatory manner solely for the benefit of plan participants. ***For employers without severance benefits:*** An employer can only terminate its participation if all employees of the employer receive a pro-rata share of the plan assets. ***For employers with severance benefits:*** If an employer offers severance benefits, the plan assets used to fund the severance benefits cannot be distributed for a purpose other than severance benefits, which are limited to 200% of compensation (as defined in IRC Section 401(a)(17)) and payable over not more than 24 months, as defined under DOL Regulation 2510 3–2(b), or other benefits as provided under the plan. ***For employers with post-retirement medical benefits:*** No assets used to fund post retirement medical benefits can be distributed for any reason other than post-retirement medical benefits. If a plan participant—including the owner—dies prior to using all his/her post-retirement medical benefits, the unused amounts revert to the plan (a forfeiture). Even when a participating business terminates participation in the plan due to insolvency, sale, merger-acquisition, or other Treasury-approved event, assets attributable to post-retirement medical benefits must stay in the plan until/unless they are paid in the form of medical expense reimbursement after retirement. ***Rollover:*** The trustee to trustee transfer of benefits from one multiple employer welfare benefit plan to a similar multiple employer welfare benefit plan will be permitted and not cause constructive receipt to a plan participant.
Benefit Levels	***Death Benefits:*** (1) The maximum benefit will be governed by the life insurance company providing the benefits and by the life insurance industry's standard financial underwriting guidelines. (2) Minimum death benefit amounts will be determined either by the plan's formula for benefits or by the life insurance company's minimum issue, if greater than the plan formula.

MULTI-BENEFIT EMPLOYER PLAN FOR TEN OR MORE EMPLOYERS REFORM OF SECTION 419A(f)(6): Alternative Proposal (March 2001)—Continued

Benefit Levels cont.	***Severance Benefits:*** (1) The maximum severance benefit will be in accordance with Department of Labor regulation 2510 3–2(b) (not in excess of 200% of compensation), with countable compensation limited by pension law (IRC Section 401(a)(17). ***Post-Retirement Medical Benefits:*** (1) Normal retirement would be the year of eligibility for Medicare or total and permanent disability, as defined by Social Security. (2) Forfeiture: Assets to fund these benefits remain in the plan to pay benefits. If benefits are never collected, the result is a forfeiture of those assets to the welfare benefit trust. (3) Pre-retirement death of the employee: medical reimbursement funds would be available to pay any uncovered medical expenses of the deceased employee's estate.
Cost of Benefits	Deductions would be limited to: ***Death Benefits:*** (1) If term insurance, the annual term insurance premium. (2) If whole life insurance, the level annual premium to normal retirement age (non-vanish) contract premium. (3) If universal life, the guideline level annual premium (IRC Section 7702). The Section 7702 guideline level annual premium is the level annual premium amount payable over a period not ending before the insured becomes age 95, computed in the same manner as the guideline single premium, except that the annual effective rate remains at 4% (IRC Section 7702(c). ***Severance Benefits:*** (1) Reasonable actuarial principles to purchase the level benefit stated in the plan document. (2) No prefunding in excess of the current level of liability for the stated level of benefits annually. ***Medical, health, disability benefits:*** (1) Insurance company premiums, and self-funding up to deductibles and elimination periods. But, self-funding would be subject to forfeiture at an employee's death or termination or termination of an employer from the welfare benefit trust.
Application of new rules to existing plans	These new rules would be effective as of the date of enactment, but benefits earned as of the date of enactment would be grandfathered at their existing level and previous deductions would be grandfathered at their existing level, if the plans are brought into compliance within 24 months of enactment.

Contact Dani Kehoe (202/547–7566) or Bill Himpler (202/661–6361).

Summary: Multiple Employer Welfare Benefit Trusts Allow Employer To Offer Well-Designed Employee Compensation Packages, But Current Law 419A(f)(6) Rules Require Clarification

It is important to the competitive well being of many American small businesses to assure the continued availability of the multiple employer welfare benefit trust mechanism. The benefits packages of life and health insurance, and severance benefits payable when termination is unexpected and without cause, are significant tools for small business' ability to attract and retain quality workers.

However, the rules governing 419A(f)(6) plans need clarification. The proposal we offer, which makes clear that all plan assets are available to pay benefits to all plan participants, eliminates the possibility of offering benefits on a discriminatory basis, and appropriately limits the annual deduction available for the funding of these benefits, solves the concerns of policymakers who seek to prevent misuse of IRC Section 419A(f)(6) as a way to circumvent pension limits and/or provide deferred compensation, but at the same time assures the continued viability of the 419A(f)(6) plan.

We respectfully request and encourage Congress to enact this proposal, as swiftly as possible.

Thank you. We would be happy to discuss any part of this proposal or issue in more detail. You can contact us through our Washington Representatives, Bill Himpler for Professional Benefits Trust, 202/661–6361; or Dani Kehoe, for Niche Marketing, 202/547–7566.

Statement of Charles E. Collins, Responsible Wealth, Boston, Massachusetts

My name is Chuck Collins. Thank you for allowing me to submit testimony in opposition to the repeal of the federal estate tax.

I am testifying on behalf of Responsible Wealth, a national association of business leaders and investors concerned about economic inequality in America. I am coordinator of a petition signed by over 700 business and philanthropic leaders entitled the Call to Preserve the Estate Tax.

Last Thursday, William H. Gates, Sr., testified on behalf of Responsible Wealth before the Subcommittee on Taxes and IRS Oversight of the Senate Finance Committee.

Our petition reads as follows:

> We believe that complete repeal of the estate tax would be bad for our democracy, our economy, and our society. Repealing the estate tax, a constructive part of our tax structure for 85 years, would leave an unfortunate legacy for America's future generations.
>
> Only the richest 2 percent of our nation's families currently pay any estate tax at all. Repealing the estate tax would enrich the heirs of America's millionaires and billionaires while hurting families who struggle to make ends meet.
>
> The billions of dollars in state and federal revenues lost will inevitably be made up either by increasing taxes on those less able to pay or by cutting Social Security, Medicare, environmental protection, and many other government programs so important to our nation's continued well-being. The estate tax exerts a powerful and positive effect on charitable giving. Repeal would have a devastating impact on public charities ranging from institutions of higher education and land conservancies to organizations that assist the poor and disadvantaged.
>
> We recognize the importance of protecting America's family farms and small businesses, and the estate tax has many special provisions that do so. But this concern, the rationale usually advanced for eliminating the estate tax, can be addressed by amending the existing estate tax system.
>
> Let's fix the estate tax; not repeal it.

To date, over 700 individuals have signed the Call to Preserve the Estate Tax. Recent signers include:

Robert Crandall, retired Chairman, AMR Corporation (American Airlines)
Ted Turner, Vice Chairman, AOL Time Warner
Paul Brainerd, developer of PageMaker software
Adele Simmons, former President, The MacArthur Foundation
Sol Price, founder, Price Clubs and Chairman, Price Entities
J.P. Guerin, former Chairman, Pacific Southwest Airlines

Arthur Rock, Venture capitalist, Arthur Rock & Co.

A complete list of signers to date can be viewed on our web site: www.responsiblewealth.org.

There are many well known and super-wealthy individuals who have signed the Call to Preserve the Estate Tax. But the majority of the signers are more like the "millionaires next door" described in the recent book by Thomas Stanley and William Danko, those with wealth between one and ten million dollars. Many of the signers have family enterprises and will pay estate taxes, yet we believe it would be bad for our country to completely repeal it.

The signers of the Call to Preserve the Estate Tax want to stimulate a national dialogue about the potential negative consequences of estate tax repeal. We hope the Committee will address important fiscal and social questions, such as: What will a $7 billion reduction in charitable giving do to our hospitals, universities, nature conservancies, and human service organizations? How will states manage without the $5.5 billion in their annual revenue that comes linked to the federal estate tax? What is the true 20-year fiscal impact of repeal? What will be the impact on our economy, democracy and civic life of further concentrating wealth and power in the hands of a few, at the time of the greatest inequality since the 1920s?

Some might argue, "It's easy for these super-wealthy to call for preservation of the tax. After all, they can afford high-priced accountants and lawyers to avoid it." But the estate tax toll is paid primarily by the richest half of 1% of households, the 4,000 people who die each year with estates over $5 million. Many wealthy people do estate planning to reduce their estate taxes by gifts to family members while alive, and through charitable giving. But unless they leave their entire legacy to charity or a spouse, they cannot escape death nor estate taxes.

We believe, along with Theodore Roosevelt, Louis Brandeis, Herbert Hoover and scores of other wise observers in the early 1900s, that it is not in the interest of this country to have large fortunes passed from generation to generation creating great concentrations of wealth and power.

While we may not be able to insure that all children start their lives on a level playing field, that is something we should strive for and the estate tax brings us closer to that ideal. A good life should be something that is achieved. It should not be delivered as a result of the womb you happened to start out from.

We believe that the estate tax is an appropriate tax and accept it, as we do federal income taxes, as the price of living in the United States and being a U.S. citizen. It is appropriate that a special tax be imposed on those who have so very fully enjoyed the benefit of the things this country provides: schooling, order, freedom and encouragement to succeed and models of success. In a very practical sense the wealth one accumulates derives as much from the environment which this grand nation makes available and it is perfectly appropriate that the cost of its maintenance be paid back in proportion to what has been extracted.

In the present setting when new tax packages are being designed it seems to us particularly bad policy to subtract from the necessary revenue the sums produced by the estate tax when those dollars are going to have come from somewhere else; someone else. It is perfectly clear that that someone else will be a citizen with much less ability to pay than the heirs of our wealthiest people. We are concerned about the true fiscal impact of repeal. Revenues from this tax will grow dramatically in the future. The personal wealth that has been created in this country in the last 10 or 20 years is immense and will be reflected in sharply increased estate tax revenues.

We believe that repeal of estate tax will be harmful to our charitable institutions and vital civic sector. While many Americans give generously regardless of tax consequences, the estate tax greatly enhances giving, particularly among those with estates exceeding $20 million. Charities hurt by repeal would include religious organizations, which receive almost 60% of all bequests representing 10% of total bequest dollars. Educational, medical and scientific institutions receive 31% of bequest dollars. And 30% of bequest dollars go to private foundations, accounting for one-third of foundation assets. We do not know what the full consequences of wholesale repeal will be on our nation's hospitals, universities, land conservancies and private charities.

We know this Committee is discussing a proposal to make charitable contributions tax deductible for non-itemizers because it would encourage charitable giving. We support this proposal and believe the same logic applies to the estate tax. Tax policy is an inducement to enable already generous people to give more.

People oppose the estate tax claiming it is not fair. Each tax that we have will elicit those who feel this way. But we ask, "Fair compared to what?" Is it unfair to tax the accumulated wealth of the richest 1% of households, much of which is

in the form of unappreciated capital gains that have never been taxed? Is it more fair to tax the wages of low wage workers trying to survive today? Is it fairer than a sales tax or property tax? We accept that we must have taxation, and that within the spectrum of taxes, the estate tax is among the most fair.

We do not deny that there are some situations where the application of the estate tax leads to a result that is undesirable. We are concerned that the current estate tax may still affect a small number of small farms and family-owned small businesses. The estate tax was reformed in 1997 to provide further protections for these enterprises through lower asset valuations, higher exemptions and extended low-interest payment terms. We advocate further reforming the estate tax by simplifying it and raising exemptions.

While we support reform of the estate tax, we strongly oppose outright repeal. Society is the co-creator of wealth and as such, we believe it is entirely reasonable that a portion of wealth be returned to society upon the death of those who have been blessed with great wealth. In this manner, the estate tax undergirds social investment that will allow the next generation their opportunity at the American Dream as our country's founders envisioned.

Statement of Former Senator Alan K. Simpson, Washington, DC

Chairman Thomas, Ranking Member Rangel, and all the other distinguished Members of the House Ways and Means Committee. I am very pleased to have this opportunity to submit testimony today on the issue of the federal estate tax.

First let me express my strong support for the President's efforts to substantially reduce taxes for all Americans. President Bush, Vice-President Cheney, and the entire Administration have successfully and commendably changed the course of the debate in this country from *whether* we should cut taxes to *how* we should best do it. This is the most talented group of men and women to serve in the highest levels of an Administration in my lifetime. They are also extremely savvy and fully understand the legislative process. Lawrence Lindsey, the President's chief economic advisor, recently discussed the tax package with the Republican leadership saying: "You guys make the sausage, I just brought the meat and spice." To me, this indicates that the President, the Vice-President, and other key officials who crafted the Administration's plan would not summarily reject constructive dialogue on how best to achieve their legislative goals. Even from my perch here in the private sector, I too would like to engage in such a dialogue. However, at the end of the day, when the discussions and the debate are over, this country deserves the strongest possible bipartisan tax reduction plan, and I for one fully intend to be a very vocal supporter of that package.

In the spirit of early, constructive dialogue I would also respectfully recommend to this Committee and to my friends in the White House, that as an alternative to a phase out of the estate tax over an 8 to 10 year period, they might take a serious look at providing immediate and dramatic estate tax relief by greatly increasing the exemption over which an estate would be liable thereby immediately eliminating nearly 90% of those estates that, under current law, would have to pay an estate tax. For the small number of estates left that would still have to pay, I would further recommend a reduction in the rates. I am not attempting to advise you what the exemption should be, but it should be large enough to protect the family ranchers and farmers that I have known from ever having to worry about this liability. In fact, to ensure that result, due to their unique status I think it would be worthwhile to craft a special exemption from estate taxes for family ranches and farms. There are several reasons why I believe that this method of reform is the best route to take, and I will briefly list them in this testimony.

I support the efforts of Americans for Sensible Estate Tax Solutions (ASsETS) a coalition including charities, academics, tax experts, farm and ranch groups, and estate planners. ASsETS does have members who have an economic interest in this matter. There is nothing wrong with that, but my participation in this effort is primarily motivated by what I believe a phased-out repeal of the tax would do to charitable giving in this country. My wife, Ann, and I have spent a substantial part of our lives serving on the boards of institutions such as Fords' Theater, the Folger Shakespeare Library, the Buffalo Bill Historical Center, the Kennedy Center, the Terra Museum, the University of Wyoming Art Museum, and the Smithsonian Institution. I have seen first hand how the estate tax promotes charitable giving. In fact the U.S. Treasury has estimated that a total repeal of the estate tax would result in a decrease of up to $6 billion annually in charitable giving. Charles Collier, Sen-

ior Philanthropic Advisor at Harvard University, has said that "wealthy donors will clearly leave more money to their heirs than they will to charities if this repeal goes through." Multibillionaire, George Soros calls the estate tax "one of the main incentives for charitable giving." From a practical perspective, it's easy to see that without any estate tax, even on the very wealthiest, potential heirs may likely say: "Dad, don't leave the Picasso to some museum. Sell it or give it to me, instead." And it's not just the Picasso, it's also real money to universities, hospitals, and other nonprofit health and educational groups throughout the country.

My second concern is that there is a great benefit in being able to obtain tax advice which has certainty. Under the President's tax proposal, estate tax *rates* would gradually be phased-out over 8 years—but the limited exemptions in current law would be kept. Today, a person can exempt $675,000 from estate tax liability. That will go up to $1 million in 2006. Under the President's bill, if your estate exceeds the current exemptions, your family would still have to pay estate taxes. To believe that an estate phase-out won't be changed by a future Congress is really betting the farm! As I don my Republican hat, I would like the Members of this distinguished Committee, particularly the majority, to assume the possibility—however frightening you think it may be—that (1) control of Congress shifts and (2) a future Congress needs revenues in order to fund some disaster relief.

Knowing what we all know about politics, one of the most likely, logical revenue raisers would be to further delay or even cancel the phase-out. So if we are to leave the final decision to future Congresses, the estate planner cannot render the kind of tax advice that Americans deserve. Death is quite bad enough. It's even worse in combination with financial uncertainty!

The ASsETS Coalition is promoting immediate, drastic reform of the estate tax. We leave it to Congress to decide the exemption, but consider this: In 1998 the last year for which we have national records, less than 48,000 estates paid *any* estate tax. That represents 2% of the number of deaths that year. If you set the exemption at $2.5 million rather than the current law, you would have eliminated nearly 40,000 of those estate taxpayers. If you set the exemption at $5 million, you would have knocked out nearly 4,700 more estates. That would leave about 3,000 estates in the entire country owing any estate tax at all for that year. Using these 1998 numbers for my state of Wyoming, of 4,000 deaths in 1998, a $2.5 million exemption would have eliminated all but 6 estates. A $5 million exemption would have totally eliminated all but 2 estates. But under the proposal to gradually phase-out the rates, 40 Wyoming families would have still had to pay an estate tax!

I think most Wyoming folks would rather have a guaranteed higher exemption *now* and pay nothing, rather than have some "Congressional promise" to gradually reduce rates and still have to cough up based on current exemptions.

Contrary to some of the hot and heavy rhetoric out there, I am *not* an advocate *for* the estate tax. It is burdensome, unfair, and ought to be changed. I specifically do not want the estate tax to be a threat to Wyoming's, or to the rest of the country's family farmers or ranchers and their ability to pass those properties down to the next generation. In fact, I would even favor a form of legislative "carve out" to ensure their protection. As stated, it is not a question of *whether* to change the estate tax, but *how*. I prefer a dramatic, immediate reform which would exempt 99% of Americans from paying anything at all. I would also prefer immediately lowering the top rates for the eight to ten thousand estates that would still be subject to the tax.

One other aspect of total repeal which should be considered is its impact on hard pressed state budgets. Many states have estate tax revenues which are dependent on the Federal version. The February 20, 2001, *Dallas Morning News* cited that Texas stands to lose $300 million a year. My state of Wyoming derives $9.7 million in these kind of estate taxes each year. A total repeal would put a hole the size of a .45 caliber slug in my state's budget!

In summary, I very much want the President to succeed with a $1.6 trillion tax cut. According to the February 18 *Washington Post*, Lawrence Lindsay stated that the President wants to see his approach adopted, but is leaving the structure up to the Congress. In order to keep the package at $1.6 trillion, a less costly, long-term phase-out of the estate tax was chosen. My position, respectfully submitted to you, is to keep the package's total price tag, but to provide dramatic benefits *immediately*, provide additional protection for family farms and ranches, eliminate all but the super wealthiest from paying any estate tax at all, then reduce the rates for the remaining estates which do have to pay. That's it. Such an approach will cost less, will maintain incentives for charitable giving, will protect farms and ranches, will protect state revenues, and will provide clarity and certainty in tax planning.

I would earnestly trust that such an approach would merit your full consideration. Thank you so much. My best personal regards to all of you.

Statement of LaBrenda Garrett-Nelson, Phillip D. Moseley, and Robert J. Leonard, Washington Council Ernst & Young

Washington Council Ernst and Young (a division of the National Tax Practice of Ernst & Young, LLP, a professional services firm) represents a variety of clients on tax legislative, regulatory, and policy issues.

Introduction

As Chairman Thomas recognized in his announcement of today's hearing, now that the House of Representatives has passed the heart of President Bush's tax relief plan for individuals, the Ways and Means Committee can "turn to fixing other problems in the tax code." Rationalizing and simplifying the most complex provisions of the code is one way to reduce significantly the burden on individual taxpayers. In this regard, the personal holding company ("PHC") penalty tax ranks among the most outmoded provisions in the Code. This statement highlights the need to rationalize the PHC provision to prevent the treatment of an active franchising business as a passive personal holding company. Several years ago the Congress took action to update another aspect of the PHC tax—the provision dealing with lending or finance businesses in the Taxpayer Refund and Relief Act of 1999—but that legislation was vetoed by former President Clinton.[1] As was proposed in the 1999 PHC legislation for lending or finance businesses, the PHC provisions should be modernized to address the treatment of franchise royalties.

- The Outdated Personal Holding Company Tax Targets Individual Taxpayers

The PHC penalty tax was intended to prevent individuals from avoiding the graduated individual tax rates by holding investments through corporations. A corporation constitutes a PHC if at least 60 percent of its adjusted gross income is PHC income and if more than 50 percent of its stock is owned by five or fewer individuals at any time during the last half of the taxable year. PHC income generally is defined as interest, dividends, royalties, and rents. Section 541 of the tax code imposes a 39.6% tax on undistributed PHC income (in addition to the normal corporate tax).

When the PHC tax was originally enacted in 1934, the maximum corporate tax rate was only 13.5%, but the top individual rate was 63%; this rate differential created an incentive for individuals to organize closely held corporations to hold their personal investments. Income on the investments would be taxed at the much lower corporate rate, and when the individual wanted to unwind the investment, the corporation could be liquidated on a tax-free basis. Today, the differential in the tax rates no longer provides the same incentive (as the maximum corporate tax rate is 35%, only 4.6% less than the top individual rate of 39.6%) and a PHC can no longer be liquidated free of tax. Thus, commentators have long argued that the PHC tax has outlived its original rationale.[2]

- The Current Treatment of Franchise Royalties Fails To Take Account of Active Businesses that Generates This Income

As one commentator noted "the 1934 regulation that included franchise royalties in the definition of PHC taxable income (the predecessor of Reg. 1.543–1(b)(3)...) has remained virtually intact since its inception."[3] The current regulation simply fails to take account of active franchisors that have numerous employees and provide substantial services to franchisees (such as training programs, assistance in site selection, building plans, marketing, research and development, and managerial services).

- Congressional Precedents for Updating the PHC Penalty Tax

The PHC provisions were never intended to apply to active business income. Thus, from time-to-time, the Congress has updated the PHC provisions to take ac-

[1] *See* section 1114 of the "Taxpayer Refund and Relief Act of 1999," H.R. Conf. Rep. 106–289, 106th Cong. 1st Sess. (1999) at page 486, describing a provision to modify the PHC "Lending or Finance Business" exception.

[2] *See*, *e.g.*, comments of the American Bar Association Section of Taxation, Committee on Corporate Tax, *reprinted in* Tax Notes Today (July 26, 1999), presenting arguments in support of repealing the PHC penalty tax on the grounds that "the personal holding company tax adds significant complexity to the tax law but raises little revenue," the tax is a penalty tax that no longer serves its historical purpose; and repeal would "advance the simplification cause without undermining the corporate income tax."

[3] Accounting and Tax Aspects of Franchising, Schaeffer & Allbery (Aspen Publishers, Inc.), page 66.

count of modern practices.[4] More generally, the Congress has acted many times to prevent the treatment of an active business operation as a passive activity under the PHC rules.[5] As traced by one commentator:

> From the inception of the personal holding company tax, banks, life insurance companies and surety companies were . . . recognized as active businesses, and were excluded from the personal holding company provision. Thereafter, . . . [relief] has been granted . . . by Congress for comparable reasons: holders of mineral, oil or gas royalties (in 1937), licensed personal finance companies (in 1938), affiliated groups of railroad corporations (in 1938), industrial banks and Morris Plan companies (in 1942), other small loan companies and finance companies (in 1950), corporations renting property to shareholders for use in an active commercial, industrial or mining enterprise (in 1950, retroactive to 1945), domestic building and loan associations (in 1951), shipping enterprises depositing amounts in Merchant Marine Act reserves (in 1954), corporate affiliated groups generally (in 1954), corporations renting property to shareholders but not having other significant personal holding company income (in 1954), small business investment companies (in 1959), music publishers (in 1960), movie producers (in 1964 and again in 1976), securities dealers handling U.S. government bonds (in 1964), manufacturers leasing their products and also realizing related royalty income (in 1964 and again in 1966), corporate affiliated groups with life insurance subsidiaries (in 1974), and franchisors leasing the franchise and other property to shareholders for use in an active business (in 1976). Congress, in aiding those afflicted, has repeatedly expressed the intention to keep active businesses out of personal holding company entanglements.[6]

More recently, the Congress acted to modify the application of the regulation that produces an inequitable result in the case of franchise royalties—the Tax Reform Act of 1986 amended Section 543 of the tax code to exclude active software royalties from the definition of PHC income.[7] Based on these precedents, a similar amendment should be made to exclude active franchise royalties from the definition of PHC income.

Conclusion

A review of the legislative history of the PHC provisions supports the view that, notwithstanding the language of the relevant Treasury regulation, the Congress did not intend to subject active business format franchisors to the PHC penalty tax. Under the mechanical approach of the regulations, however, the risk of accidental inclusion is real and the stakes for individual taxpayers are substantial. Modernizing the PHC penalty tax by excluding active franchise royalties would greatly simplify the tax code as it applies to individuals, and reduce an unnecessary level of complexity.

WHITE HOUSE CONFERENCE ON SMALL BUSINESS
March 21, 2001

The Honorable William Thomas
Chairman
Committee on Ways & Means
United States House of Representatives
Washington, DC 20515

Re: Statement for the hearing on the President's Estate Tax Proposals

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[4] 1982 amendments took account of the fact that lending or finance companies were making loans of longer maturities and of the increasing use of indefinite maturity loans. H.R. Rep. No. 404, 97th Cong., 1st Sess. 20 (1981).

[5] *See*, *e.g.*, S. Rep. No. 1707, 89th Cong., 2d Sess. 7, 63 (1966) ("Your committee believes that . . . rental income arising from property manufactured by the taxpayer, in reality, is no more passive than sales income derived from property manufactured by the taxpayer.")

[6] Morgan, "The Domestic Technology Base Company: The Dilemma of an Operating Company Which Might Be a Personal Holding Company," 33 Tax L. Rev. 241–244 (1978) (footnotes omitted).

[7] *See General Explanation of the Tax Reform Act of 1986*, prepared by the staff of the Joint Committee on Taxation (May 4, 1987), at page 371.

Dear Chairman Thomas:

The undersigned are the elected Regional Taxation Chairs representing the 2000 delegates to the last White House Conference on Small Business. We were delegated the responsibility for advancing implementation of the Conference's recommendations with regard to the tax issues and reporting progress back to the delegates.

The President has proposed a tax relief measure that incorporates full repeal of the estate tax, phased in over a period of years, and making permanent the tax credit for research and experimentation. We are gratified his proposal addresses these elements of tax relief which our Conference recommended to Congress, and which we have personally recommended to your Committee in past testimony.

We have said in the past that the White House Conference endorsed full repeal of the estate tax, but the delegates have been grateful for any changes that reduce the tax heirs to a business might pay at the death of a principal owner in order to preserve what is the single largest source of new job opportunities in America, the small business. The passage of a small business from one generation to the next also has a positive impact on the community, promoting stable employment, long-term community support of community groups, and an active interest in maintaining the quality of education and life in the "neighborhood." Whatever could be done to increase the exclusion or move family-owned business or farm property out from under the estate tax is welcomed.

The President's proposal does not appear to specify how property that passes to heirs is to be treated for tax purposes. The Congress will decide whether the property receives a stepped up basis, or whether the old basis is carried over to the heirs. A number of the members of our White House Conference group are concerned about the complexity and difficulty of keeping adequate records to support a carry-over basis. The country has been down this road before and the tax practitioner's within our group still get severe headaches whenever they recall the difficulty of reconstructing the basis of business (or other) property that has been in a family for a lifetime. If the revenue were necessary to make the President's tax plan feasible, we would urge the committee to raise the threshold for property excluded from any estate tax to a sufficient level to ensure that most small businesses are completely excluded. In the alternative, we ask the committee to consider some simplified system of evaluating the basis of property (a safe harbor) that will not require weeks or months of evaluation and paperwork.

The White House Conference on Small Business Tax Issue Chairs welcome the opportunity to continue our work with Congress to suggest ideas that would help the nation's small business community. We hope Congress continues to listen to the recommendations of small businesses and analyze all legislative proposals for their impact on small businesses and their employees. Small businesses, after all, provide most of the new jobs for our economy. With this in mind, we have attached a copy of our latest "Tax Action Plan" for you and your staff to review. Thank you for your time and attention to our needs.

Sincerely,

THE WHITE HOUSE CONFERENCE TAX CHAIRS
DEBBI JO HORTON, *Region I, East Providence, Rhode Island*
JOY TURNER, *Region 2, Piscataway, New Jersey*
JILL GANSLER, *Region 3, Baltimore, Maryland*
JACK OPPENHEIMER, *Region 4, Orlando, Florida*
PAUL HENSE, *Region 5, Grand Rapids, Michigan*
TOMMY BARGSLEY, *Region 6, Austin, Texas*
EDITH QUICK, *Region 7, St. Louis, Missouri*
JIM TURNER, *Region 8, Salt Lake City, Utah*
SANDRA ABALOS, *Region 9, Phoenix, Arizona*
ERIC BLACKLEDGE, *Region 10, Corvallis, Oregon*

WHITE HOUSE CONFERENCE ON SMALL BUSINESS

Small Business Tax Issue Priorities

This Tax Issue Priority Listing was developed by the Regional Tax Issue Chairs representing the 2000 delegates to the White House Conference on Small Business. These priorities were developed with the input and active assistance of thousands of small business people who were Delegates to the last White House Conference on Small Business. Because federal tax laws impact every small business, it is critical to the growth and progress of the small business community that the law reflect sound public policy and fundamental fairness while imposing as little administrative burden as possible.

The Tax Chairs were elected by Delegates from each region of the country, and given the responsibility for advancing implementation of the Conference's recommendations on tax issues and reporting progress back to the delegates. The Tax Chairs have testified before Congress on ten occasions, and meet periodically with the staffs of the Ways and Means Committee, the Finance Committee, and the House and Senate Small Business Committees to help further develop clarifying legislation. In addition, the Tax Chairs have worked with IRS Commissioner and the Office of Tax Policy at Treasury to create policies that are helpful to small businesses.

TAX SIMPLIFICATION IS KEY

The unifying thread running through all the recommendations of the White House Conference is a desire to reduce the overall complexity of government for small businesses. The most significant benefit to small businesses would come from simplifying the tax code. Allocating and reporting income taxes and payroll taxes is the one common experience of every business, and may be the only interaction that most businesses have with the federal government. Simplifying the tax process would, therefore, improve the situation for every small business. Federal government studies demonstrate that it costs small businesses considerably more, as a percentage of revenue, to comply with the tax laws than it costs large businesses.

The conclusion is that small businesses are at a significant competitive disadvantage from the start due to governmental requirements. For this reason, the Tax Chairs fully support the restructuring passed by Congress and implemented by the IRS, and urge that the focus remain on helping small business comply with the law and reducing the administrative burdens the tax system imposes.

One of the major recommendations of the White House Conference urged Congress to concentrate on creating a simpler and fairer tax system. The Conference attendees did not specify what that system should be, but the overriding principle, whether the entire system is overhauled or the existing system is streamlined, is that each new tax proposal be thoroughly analyzed for its impact on small business. New systems which increase the tax or the record keeping burdens on small business, prolong the existing problem.

Within the context of the current tax code, the following items top the list of the recommendations made by the delegates to the White House Conference and are items we believe should be addressed by Congress. Each item reduces the complexity of the Code or extends to small businesses reasonable incentives to ensure that government requirements do not unfairly reduce their competitiveness.

100% HEALTH CARE DEDUCTION EQUITABILITY

The tax issue chairs are gratified with the progress that has been made to achieve the full deduction of health care expenses for the self employed partnerships and S corporations, but remain disappointed that the full deductibility enjoyed by larger business will still only be phased in over 5 years for smaller businesses. Equal treatment with large businesses should dictate that small businesses be able to deduct 100% of the cost immediately. The White House Conference recommendation called for the immediate increase to 100% deductibility to encourage more small businesses to provide insurance for their employees.

Additionally the White House Conference recommendation called for the cost to be deducted from business income *prior to* the calculation of FICA, Medicare, or self employment tax as larger businesses do. Parity with other forms of business organization and with non-self-employed workers can never be achieved without recognizing the business nature of worker health care costs. It is un-reasonable to allow full deductibility and excludability of these benefits for large corporate employers and to subject these same benefits to Section 1401 SE taxes (or FICA and Medicare in the case of S corporations) for the owners of smaller businesses.

Although there is some tax loss, the immediate increase helps serve the policy goal of providing health insurance for as many people as possible. When there is a reduced tax incentive for a small employer to buy health insurance for themselves and their family (note that 1.4 million children of self-employed individuals have no health coverage), they may decide to forgo offering it to their employees as well. In C-corporations, the health insurance of the principals in the business has always been fully deductible. Unrelated employees of all types of business organizations are also allowed full deductibility and excludability of such benefits. The Tax Chairs feel tax based decisions should not be substituted for sound business judgment in the selection of business structure. The 107th Congress should enact, and President Bush should support legislation to allow immediate full deductibility at the business level as a matter of equity for all business owners.

ESTATE TAX REFORM

One of the strongest recommendations of the White House Conference on Small Business was a call for the repeal of the estate tax. The Taxpayer Relief Act of 1997 included a provision that provides some help for some qualifying small business (in cases where the value of the small business is over half of the gross estate). While this is welcome relief, more needs to be done to protect businesses from being dismantled at the death of the principal. The passage of a small business from one generation to the next has a positive impact on the community, promoting stable employment, long-term support of community groups, and an active interest in maintaining the quality of education and community infrastructure.

If outright repeal is viewed as too costly, proposals that provide for a larger, more effective, targeted reduction of the tax burden on small business assets would be helpful. By focusing the legislation, Congress can provide relief directly to farms and small family businesses with a relatively small loss of revenue. The Congress should adopt a tax policy that moves the country toward the positive goal of sustaining the economic vitality of a small business and away from a policy which requires expensive, complex estate plans and insurance. The reality today is that elaborate and costly estate plans must often be developed to protect a family business, which drains assets from productive business investment. Without such complex plans, there is no assurance that the business will survive to serve the next generation of owners and workers.

INCREASED SMALL BUSINESS EXPENSING

Internal Revenue Code §179 Expensing—The expensing limit of IRC §179 was gradually increased to $25,000 (by the year 2003) as a result of the Small Business Job Protection Act passed by Congress in 1996. We appreciate the attention past Congresses gave to this issue, but believe there is a need for additional increases and quicker implementation. The Tax Chairs would support, for example, the increase of the expensing limit to at least $30,000 effective immediately. Expensing is one of the most useful tax simplifiers for small business, but its use still remains limited. In addition, Congress did not correspondingly raise the $200,000 phase-out limit on purchases. These days, one piece of machinery (even for a very small business) can exceed this limit, effectively eliminating many small businesses from any benefits.

Expensing Extended to Costs of Fixing Up Property—The Tax Chairs support extending Section 179 expensing provisions to cover property fix up and improvement costs. Small business store owners should be able to expense the costs of improving their store front or the building which houses their shop to remain competitive and to help ensure that the shops "on the downtown square" remain an attractive shopping destination for the community. Legislation such as S. 1341, The Main Street Business Incentive Act, which was introduced in the last Congress, could provide substantial assistance to small business for a reasonable cost.

Software Expensing—One area where the Tax Chairs feel Congress could make a tremendous contribution is to allow expensing in the year a business purchases standard software for business purposes. It is practically impossible to determine what the useful life of software will be. With the pace of technology, useful life gets shorter and shorter as better products that exploit hardware advances seem to hit the market continuously.

DEDUCTION FOR MEALS AND ENTERTAINMENT

The White House Conference on Small Business recommended restoration of the full deduction for meals and entertainment directly connected to business. Although no legislation has yet received the support necessary for enactment of full deductibility, the Tax Chairs would support any increase in deductibility as a step in the right direction. Provisions that would raise deductibility to 60% or 80% would be valuable to small businesses. This issue is very important to those whose business depends on networking contacts or personal presentations to close a deal. The "shop floor," or the kitchen table of a small business, are unsuitable for marketing or negotiations and the best alternative is usually meeting over meals. The tax chairs believe that reasonable limits could be placed on full deductibility, similar to the governmental "per diem" amounts, if needed to prevent abuse.

NO INCREASE OF PAYROLL TAX

The payroll tax can be especially burdensome on a small business because it is a regressive tax which must be paid whether or not the business makes any profit. The White House Conference was concerned that increasing the payroll tax not be viewed as a "quick and painless fix" for structural deficiencies in federal employment benefit trusts. The Conference recognized the importance of public confidence

in the programs but felt the problem should be addressed directly. Other correction proposals, such as fund diversification or partial privatization, should also be analyzed for their potential impact on small business.

CLARIFICATION OF THE INDEPENDENT CONTRACTOR DEFINITION

Resolving the long-standing employee vs. independent contractor controversy was the number one recommendation of the White House Conference on Small Business. The current vague standard leads to retroactive reclassifications by the IRS and substantial tax assessments plus interest and penalties. For example, the IRS assessed almost $750 million using such reclassifications between 1987 and 1994. While there have been a number of improvements in "safe harbors" to reduce overzealous enforcement, as long as the standard remains unclear, worker classification is a problem. There must be a clear standard defining the difference between an employee and an independent contractor so that a business can utilize contract service providers with confidence. The Tax Chairs have worked with key House and Senate Committee staff members and Administration Officials to indicate the types of legislation that would set a clear standard to provide security for small businesses while protecting the rights of workers who are properly classified as employees. The Tax Chairs believe that a reasonable consensus can be reached on this issue and should be adopted in the 107th Congress.

ALTERNATIVE MINIMUM TAX REFORM

One of the top 60 recommendations made by the White House Conference delegates to the President and Congress included an overall concern for a simplification of the tax code, particularly as it related to small business. One major source of complexity is the Alternative Minimum Tax, which was originally targeted at wealthy taxpayers with low taxable income, but now impacts many average taxpayers. With the passage of provisions such as Section 1202, lower individual income tax rates, various new tax credits and other similar legislation, without a corresponding update of the alternative minimum tax provisions, these newer provisions are having the unintended effect of subjecting middle income taxpayers, and particularly small business owners to its impact and significantly eliminating some of the benefits intended to be provided from the tax provisions mentioned earlier.

Accordingly, the White House Conference Tax Chairs urge the Members to seriously address alteration of the Alternative Minimum Tax rules to limit it's application to truly high income taxpayers, so that tax incentive provisions can have the broad benefits which Congress intended.

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