REPLACING THE FEDERAL INCOME TAX

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

VOLUME III

Impact on Small Business of Replacing the Federal Income Tax

APRIL 24, 1996

Impact on State and Local Governments and Tax-Exempt Entities of Replacing the Federal Income Tax

MAY 1, 1996

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IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX

WEDNESDAY, APRIL 24, 1996

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 Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
April 1, 1996
No. FC-13

CONTACT: (202) 225-1721

Archer Announces Hearing on the Impact on Small Business of Replacing the Federal Income Tax

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing to examine the effect of some of the proposed replacement tax systems on small businesses, entrepreneurs, and start-up companies. **The hearing will take place on Wednesday, April 24, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

Oral testimony at this hearing will be heard from public witnesses. Also, any individual or organization may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

In two previous hearings, the Committee on Ways and Means has heard witnesses testify on the problems with the current system and some of the economic effects of changing it. In this and future hearings, the Committee will examine how the proposed replacement systems would affect specific segments of society and the economy. Witnesses will be asked to focus on the advantages and disadvantages of some of the proposed replacement tax systems using the following guidelines:

1. The basic alternatives are: an income tax (with one or more rates); a flat tax (such as the one introduced by House Majority Leader Dick Armey); a national sales tax (such as the one introduced by Reps. Schaefer and Tauzin); a value added tax (both invoice-credit and subtraction methods); and an income tax system with an unlimited savings deduction (such as the USA tax system introduced by Senators Domenici and Nunn).

2. The alternatives, whenever possible, should be considered in their pure, conceptual form (i.e., witnesses are discouraged from focusing exclusively on all the permutations of a so-called "flat tax" or on which items should (or should not) be exempted from a tax).

3. Any new tax system would replace the individual income tax, the corporate income tax, and estate and gift taxes. Witnesses could also consider replacement of payroll taxes and excise taxes, as long as they consistently considered such replacement for all proposed tax systems.

4. Replacement must be deficit-neutral, both in the short-term and the long-term.

Following this hearing, the Committee will continue to examine the impact of the proposed alternatives, including the effects on: individuals and families; employee benefits and retirement and personal savings incentives; international trade; home ownership and real estate generally; agriculture; domestic manufacturing; energy and natural resources; retail sales; financial services; service industries; health care; State and local governments; and tax-exempt organizations. Dates for hearings on these topics will be announced in one or more future press releases.

In announcing the hearings, Chairman Archer stated, "This hearing is a continuation of our effort to replace the Federal income tax. My goal is to tear out the income tax by its roots so that it can never grow back. I believe that small businesses will be significant beneficiaries of a new, simpler tax system."

FOCUS:

The focus of this hearing will be limited to the impact of fundamental tax reform on small businesses, entrepreneurs, and start-up companies.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business Tuesday, April 16, 1996. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff at (202) 225-1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Committee office, 1102 Longworth House Office Building, no later than 10:00 a.m. on Monday, April 22, 1996.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Wednesday, May 15, 1996, to Phillip D. Moseley, 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 deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least one hour before the hearing begins.

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 typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

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, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. 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 now available over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

*****

Chairman ARCHER. The Committee will come to order.

Today we hold a series of hearings to examine the impact of fundamental tax reform on various groups and economic sectors. The subject of today's hearing is the impact on small business. I don't intend the general order of our sectoral hearings to create any inference as to the relative importance we attach to the various sectors. However, I will say that, if the hearing order did matter, the small business hearing would still compete for the No. 1 slot.

Our goal must be to create new jobs, better paying jobs, and the economic growth that accompanies that. And, as we know, most of the new jobs overwhelmingly have been produced by small business in the last years. From my vantage point in this hearing room, sometimes I think the only jobs created by our current tax system are in the accounting and tax fields.

Tax reform should promote job growth and economic productivity for all, and jobs that produce wealth and not simply shift wealth. Since we rely on small businesses to provide the bulk of new jobs in our economy, we must consider how tax reform will contribute to helping small businesses do even better the job creation task at which they already excel.

In prior hearings, we have received a great deal of testimony on the impact of replacement of the Federal income tax with a new type of tax, which I believe, in the end, will be a consumption tax. I look forward to hearing from our witnesses today on how the elimination of the income tax will affect small business. I also look forward to hearing about the impact of repealing the Federal estate tax, which has a massive negative impact on small businesses, and the retention of those businesses within families.

Certainly, there is little to be said for a tax which raises only 1 percent of Federal revenues, grabs the bulk of one's lifetime savings when one dies, causes the breakup of family businesses and, according to some estimates, costs 65 cents to administer for every dollar raised. I don't believe that any witnesses will be testifying today in favor of retaining the Federal estate tax.

Now I yield to my colleague, Sam Gibbons, for any statement he might like to make and, as usual, all Members will have the opportunity, without objection, to insert written statements in the record.

[The opening statement of Mr. Ramstad follows:]

STATEMENT OF REP. JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON REPLACING THE FEDERAL INCOME TAX
April 24, 1996

Mr. Chairman, I am grateful for another opportunity to examine and discuss the need to reform our tax system.

It is very fitting that we are studying the impact of tax reform on small businesses, entrepreneurs and start-up companies.

Small businesses are being crushed not only by high taxes, but also by mountains of tax paperwork. In fact, small corporations spend over seven times what they actually pay in income taxes, just trying to comply with a hopelessly complex tax code.

Family-owned businesses are squeezed by the federal estate tax, which makes it difficult for entrepreneurs to build a business that can be passed on to their children.

The current system also discourages investment, robbing small businesses of the opportunity to grow and create more new jobs.

But in spite of the obstacles presented by our current tax system, small businesses that manage to survive are the engine driving job growth in our economy, creating over sixty percent of the new jobs in America. Imagine the productivity that could be unleashed through small business if we had a simple tax system that actually encouraged investment and innovation.

Mr. Chairman, thank you for your leadership in convening these important hearings. I look forward to hearing from our distinguished guests and working with them to overhaul our fatally flawed tax system.

Chairman ARCHER. Mr. Gibbons.

Mr. GIBBONS. Mr. Chairman, I worry particularly about small businesses and the burden that we have placed on them for collecting taxes from different sources and remitting all of those and all of the reports they have to file and all of the compliance that is heaped upon them by the current Tax Code.

I think these hearings come at a very important stage in our deliberations, and I look forward to the development of the ideas here.

Chairman ARCHER. Thank you, Mr. Gibbons.

Our first witness today is no stranger to the Committee, one of our own. The gentleman from Texas, Sam Johnson, who I must say is one of the great patriots for freedom and one of the great Americans in this body. And, Sam, we are delighted to hear from you. You know the rules, and you may proceed.

STATEMENT OF HON. SAM JOHNSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. JOHNSON. Thank you, Mr. Chairman. I tell you what, it is great to testify before the Ways and Means Committee on a subject that is on everyone's mind, the income tax. I thank the Chairman for his determination to tear the income tax out by its roots.

Today, I am introducing the Tax Freedom Bill to repeal the 16th amendment to the Constitution. The Freedom Bill is going to reverse one of the most destructive amendments to the U.S. Constitution and, at the same time, deny Congress the ability to lay and collect taxes on income.

It is appropriate that the repeal of the income tax amendment is part of today's hearing on the effects of tax reform on small businesses. As a former small business owner, I understand the problems they face. The 16th amendment has allowed a system to develop that has become economically destructive, impossibly complex, overly intrusive, unprincipled, dishonest, unfair, and inefficient.

Now is the time for us to restore freedom to the American taxpayer. The Tax Freedom Bill will encourage constructive debate about why our current tax structure has failed and what we should expect in a new system. We must adhere to the principles of freedom. I have a chart over there that talks about it. Freedom creates a system that is fair and simple, reduces the Federal bureaucracy, encourages savings and investment. It is efficient, drives the economy, and creates opportunity for all and, best of all, puts more money in your pocket. Those, in my view, are the principles that we should follow in any tax revision.

The current system fails to meet these commonsense criteria. We need a system that is fair and simple. The current system isn't fair or simple. The IRS has 480 different forms plus 280 more to explain how to fill out the 480. The original Tax Code had 11,000-plus words in it. Today it has over 7 million.

We need a system that reduces bureaucracy. The IRS has become an overly intrusive agency with a staff of over 110,000 people. It is the most blatant example of an out-of-control big government I can think of. They have more employees, believe it or not, than the FDA, EPA, DEA, and OSHA combined. And, although they expect

you to know exactly where your money is, they can't seem to account for $6.7 billion of their own funds that were appropriated in 1992.

We need a system that encourages savings and investment. The current system has caused the United States to have one of the lowest savings rates in the world. High taxes on capital and double taxation are largely responsible for this problem, and that is tough on small businesses. The U.S. Government taxes your income when you earn it, they tax your income when you invest it, and they tax it again when you die. Is that a fair system? Does that encourage savings? I don't think so. We need a system that is efficient. The current system is highly inefficient. Complying with the Federal Income Tax Code costs taxpayers more than $200 billion a year. In 1991 the Tax Foundation reported that small corporations spent a minimum of $382 in compliance costs for every $100 that they paid in income taxes.

The Tax Foundation said that, even in a worst-case scenario, those compliance costs would be reduced by 90 percent, whether it was a flat tax or a national sales tax. We need a system that drives the economy. Several economists in testimony in this Committee indicated that replacing the current tax system will cause interest rates to go down and savings and capital investment to increase. This means a better environment for businesses, both large and small.

We need a system that provides opportunity. We have stifled opportunity by designing a system that picks winners and losers, one in which Washington decides what is best for the people instead of letting the people decide what is best for America.

We need a system that leaves more money in your pocket. The Federal Government takes too much money from Americans. As recently as 1982, Americans paid only 19.9 percent of their income in taxes. New data reveals that in 1995 Americans paid 31.3 percent of their income in taxes, the highest level in history.

This ever-increasing burden has fallen disproportionately on the backs of small businesses. Today, many small businesses pay the top Federal income tax rate of 39.6 percent. For those who say the system can be fixed, I disagree. It has had 31 major revisions and 400 minor ones all in the past 40 years, and each time the system has become more, and more, and more complicated. Furthermore, it is wrong that the IRS can and does seize property, wages, and personal records without first coming to court.

Mr. Chairman, whether you like a flat tax, value-added tax, consumption tax, or a national sales tax, now is the time to come together and focus on one common goal, and that is replacing the current system. The Tax Freedom Bill gives us that chance. We must eliminate the income tax, as we know it, and restore freedom to all Americans.

Thank you, Mr. Chairman. I am happy to answer any questions.

[The prepared statement follows:]

Statement of Representative Sam Johnson
Before the House Ways and Means Committee
on the Tax Freedom Bill

April 24, 1996

It's great to testify before the Ways and Means Committee on a subject that's on everyone's mind--the income tax. I thank the Chairman for his determination to tear the income tax out by its roots.

Today I will introduce the Tax Freedom Bill to repeal the 16th Amendment to the Constitution. The Tax Freedom Bill will reverse one of the most destructive amendments to the U.S. Constitution and deny Congress the ability to lay and collect taxes on income.

It is appropriate that repeal of the income tax amendment is part of today's hearing on the effects of tax reform on small businesses. As a former small business owner, I understand the problems they face.

The 16th Amendment has allowed a system to develop that has become economically destructive, impossibly complex, overly intrusive, unprincipled, dishonest, unfair, and inefficient. Now is the time for us to restore freedom to the American taxpayer.

The Tax Freedom Bill is the first step to do that. It will encourage an open, honest and constructive debate about why our current tax structure has failed and what we expect in a new system.

By embracing the principles of freedom, we can create a system that is fair and simple, that reduces the federal bureaucracy, that encourages savings and investment, that is efficient, that drives the economy, that creates opportunity for all, and that puts more money in your pocket.

The current system fails to meet these common sense criteria. These criteria are embodied in the word FREEDOM.

Fair and simple

The current system isn't fair or simple. The IRS has 480 different forms plus 280 more to explain how to fill out the first 480. The original tax code had 11,400 words; today it has 7 million. Fifty tax experts recently were given the same information on a family of four and asked to figure their taxes. They came up with fifty different answers.

Reduces bureaucracy

The IRS, with a staff of 110,000, is one of the most blatant examples of out-of-control big government. They have more employees than the FDA, the EPA, the DEA and OSHA combined. And, although they expect you to know exactly where your money is, they can't seem to account for $6.7 billion of their own funds appropriated for 1992.

Encourages savings and investment

The current system discourages savings and investment. It has caused the United States to have one of the lowest savings rates of any industrialized country in the world. High taxes on capital and double taxation are largely responsible for this problem.

The U.S. Government has a very high capital gains tax rate of 28 percent. Japan's is only one percent and Hong Kong's, Germany's and South Korea's are all zero. This puts U.S. businesses and workers at a competitive disadvantage with other countries.

In addition, the U.S. Government taxes your income when you earn it, taxes that same income when you invest it, and then taxes it once again when you die.

Efficient

The current system is highly inefficient. Complying with the federal tax code costs taxpayers more than $200 billion each year. In 1991, the Tax Foundation reported that small corporations spent a minimum of $382 in compliance costs for every $100 they paid in income taxes. The Tax Foundation said that, even in a worst case scenario, those compliance costs would be reduced by 90 percent under either a flat tax or national sales tax.

Drives the economy

Several economists, in testimony before this committee, indicated that replacing the current tax system will cause interest rates to go down and savings and capital investment to increase. This means a better environment for businesses, both large and small.

Opportunity

We have stifled opportunity by designing a system that picks winners and losers: one in which Washington decides what is best for the people, instead of letting the people decide what is best for America.

For instance, a small business paying $100,000 in federal income taxes could hire 15 new productive workers at $25,000 per year for what they pay accountants and lawyers to comply with the current system.

More money in your pocket

The federal government takes too much money out of people's pockets. As recently as 1982, Americans paid only 19.9 percent of their income in taxes. New data reveals that in 1995 Americans paid 31.3 percent of their income in taxes: the highest level in history.

This ever-increasing burden has fallen disproportionately on the backs of small businesses. Today, many small business owners pay the top federal income tax rate of 39.6 percent.

A change will put more money in their pockets and their employee's pockets.

For those who say this system can be fixed--I disagree. It has had 31 major revisions, and 400 minor ones in the past 40 years, and each time, the system has become more and more complicated, not less.

Mr. Chairman, it's time for all of us--whether you like a flat tax, a value added tax, a consumption tax, or a national sales tax--to come together and focus on our one common goal: replacing the current system. The Tax Freedom Bill gives us that chance. It's time to restore freedom to all Americans.

Thank you Mr. Chairman. I would be happy to answer any questions.

Chairman ARCHER. Thank you, Mr. Johnson. I applaud you for he initiative that you are undertaking to repeal the 16th amendnent.

I think, as we look back over our history and we look at what he thesis of our Founding Fathers was that, No. 1, the basis for he creation of this country in the first place was the fear of taxtion and the way taxes were collected. That precipitated the initition of our Revolutionary War for independence. And, clearly, the 'ounding Fathers of this country had a very, very strong view bout how taxes should be collected by the Federal Government, nd they wrote a Constitution to embody that view. That view was hanged dramatically by the passage of the 16th amendment. I on't believe that those who passed it had the vision of our Foundng Fathers. I don't think they understood what they were creating nd what they were doing.

So I personally applaud the effort that you are undertaking and ommencing today, and I also thank you for your testimony before he Committee.

Mr. Gibbons.

Mr. GIBBONS. Sam, I listened with interest and wish you well in our endeavor. I won't be here to celebrate that occasion with you, ut good luck to you.

I have come to the conclusion that the fundamental mistake that ve made here in Congress or, perhaps, in this government is to get ocial and economic engineering involved in our tax collections, in ur revenue raising to operate the government. What we ought to o is to try to do our social and economic engineering to the extent hat we feel it ought to be done outside of the Tax Code. The very omplexity of the Tax Code has evolved out of all of our attempts, s well intended as they were at the time, to do some kind of ecoomic or social engineering in the collection of revenue.

We have imposed a horrible burden on small business, just in ecordkeeping, and in reporting, and in meeting deadlines, and in oing all of those things. I share Chairman Archer's feeling that we ught to get all of this out of the law, but I want you to think and nswer me, if you can, how we are going to run the rest of the govrnment if we don't figure out some way of keeping track of peole's income. We have to have people's income records in order to ay Social Security benefits. We have to have people's income ecords to distribute food stamps. We have to have people's income ecords to comply with some of the housing laws that we have. As uch as I have thought about it, maybe there is some way we ould change all of this, but I think we are going to have to keep rack of people's income, but on a much more simplified, undertandable basis than we do now.

Have you thought about that?

Mr. JOHNSON. Certainly have, and I agree with everything you ave said. I think that what I was talking about, about having a ore efficient system, means that, if you recall, and I know you do, do, that over the past 60 years there has been an insidious incurion into our lives by the tax revenue collection agency, the IRS. am not trying to knock them because Congress makes the laws hat they follow, theoretically. However, just yesterday, if you reall, they passed rules that require businesses to file more forms

if they are going to combine or sell, stockholder reports. It is just every time you turn around they put more rules out there that are tantamount to law, and we have got to stop that.

Back in the fifties you didn't have to report your savings. You didn't have your bank accounts photographed. Banks didn't have to file 1099s. All of those forms that have come about as a process because, theoretically, people are avoiding tax because they don't like it. The reason they don't like it is because it is too onerous, and you made that point earlier. So I think that the key here is simplifying the tax so that we collect it voluntarily from the American people without having a police force out there trying to figure out whether you have more cars than you are reporting on your income or not.

Mr. GIBBONS. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, sir. Are there further questions?

Mr. THOMAS. Yes, Mr. Chairman.

Chairman ARCHER. Mr. Thomas.

Mr. THOMAS. Sam, I want to thank you as well. This effort is going to be monumental and, as we have discussed privately, it was a bit serendipitous that in some of the Presidential primaries on our side of the aisle that alternative tax systems were discussed and got the American people, to a certain extent, focusing on some of the issues that we thought we were going to have to generate.

Notwithstanding, perhaps, the disagreement about some of the choices that were being advocated, all of them, as you indicated in your testimony, are predicated on a system other than the 16th amendment, except for some of those that are minor modifications which probably don't go as far as we want to go. Your moving forward on this front gives us an opportunity to explain why we want to make the changes and separate it from any legislative effort that the Committee, under the leadership of the Chairman, may initiate. I want to applaud you on that.

Part of my concern is, and it is perhaps underscoring some of the points that Mr. Gibbons made about the fact that we have used the Tax Code because it is tied to individual income for a lot of efforts, the fight currently on health care over the fringe benefit question. I look forward to the day when a dollar is a dollar between the employer and the employee, and they can either move it toward wage or toward a fringe benefit, as they see fit, without being influenced by the Tax Code, having someone else hold the bag on the payment of the taxes and, therefore, loading it in the direction of fringe benefits.

But I want to ask if you think that one of our problems is that, since it is government and it is controlled by us, World War II, it is another legacy from that period in which because we won and were so dominant for so long we didn't make some of the changes that other countries made fundamentally because they had to restructure. They changed their forms of government, many moving from a dictatorship and autocracy into more of a democracy. They didn't have the powerful role that we played, and so they had to figure out a way to survive, and changed their Tax Codes. All we did was fiddle with ours, and we have reached a point where we just can't continue to fiddle because Rome really is burning. Do you

think that has anything to do with it and that, perhaps, we are almost a generation late in facing this issue?

Mr. JOHNSON. Well, yes. But, if you recall, there was a major revision in 1954, which followed World War II. But, as I said earlier, we have fiddled with it, as you said, and fiddled with it until it is so complicated that nobody can understand it.

If you recall testimony that when about 50 accountants were given the job of coming up with a tax for a family that they came up with 50 different solutions, all of which were correct under the Code because nobody knows what the Code is all about.

So it is so complicated, and it is not all Congress. I said part of it is Congress because we pass the laws, but it is the IRS, and the Treasury Department that implement those laws, and they are the ones that write the rules that make it so complicated that even the Chairman has to get an extension this year.

Mr. THOMAS. And if we, in fact, change the system modestly, go to a flat tax, for example, which retains the Code, all of the pressures to do the social engineering through the income structure of the Tax Code remain in place. If we got the Tax Code down to one page, those pressures would begin to multiply to two, three, four, five, six, seven pages, and we would be right back where we started, and that is why I applaud your approach. As the Chairman has said, Pull it out by its roots and remove that temptation. Move it over to the other policy Committees and let's raise revenue to run the government.

Mr. JOHNSON. You are exactly right, and Mr. Gibbons brought it up. It is the special interests that want their process taken care of in the Tax Code, and they can do that as long as we have that income tax.

Mr. THOMAS. I want to thank you for your efforts. Thank you.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Mr. Johnson, I thought when our Chairman said he was going to pull the tax system up by its roots that this was enough to gain attention by the press, but you have outdone him now. You are going to change the Constitution and get rid of the whole tax system?

Mr. JOHNSON. I would never try to overshadow our Chairman, Mr. Rangel.

Mr. RANGEL. But you did this time because you notice, all of his friends are saying they want to do both; pull it up at the roots, and welcome and encourage you to continue in this effort.

If what you are trying to do is focus attention that we have to do something with the existing tax system, I would agree. If you would say that this is all you intend to do, there is no need to go any further into questioning you because I think these things are important, especially during election years. But I think the taxpayers, since the beginning of written history, have always hated the tax collector, and when things go bad in a speech, I always talk about we have got to get rid of this tax system, as we know it today. I support what you are doing in that area, but you don't mean this, do you?

Mr. JOHNSON. Certainly. I think that the only way we are going to get at the problem is to get at the root of the problem.

Mr. RANGEL. But you don't mean that you are going to ask all of the States to amend the U.S. Constitution to eliminate——

Mr. JOHNSON. That is what a constitutional amendment requires. Yes, sir. If you agree that the system is bad, then you should be in favor of doing this.

Mr. RANGEL. Let me ask you this, Sam. I am in favor of anything you do because you are a great American, and you are a credit to the Congress. So you can depend on my support of most of your efforts.

Mr. JOHNSON. Thank you.

Mr. RANGEL. But I am just asking do you intend to do this by having the Speaker send this directly to the floor or would you want your bill to go to the Judiciary Committee?

Mr. JOHNSON. I have already discussed that with Mr. Hyde, who is the Judiciary Committee Chairman, as you know, right now, and he is open to having hearings on it. I agree with you that we should have every bill that we pass go through the Committee process, otherwise it is not, in my view, the right way to do business, and I think you agree with that.

Mr. RANGEL. I do.

Mr. JOHNSON. The way this is written it would require Ways and Means' positions to determine what steps are taken as far as implementing the taxes, changing the Tax Code, and doing business with the IRS, and so on. So it is our view that it would have to go through two Committees, both Judiciary and Ways and Means.

Mr. RANGEL. But you would admit under the existing policy, that 73 percent of the bills that reach the floor don't go through any Committee. The last constitutional amendment that I remember, a couple of weeks ago, that dealt with tax policy, it certainly didn't go through this Committee, even though my distinguished Chairman had a chance to review the language—which I think was a courtesy that I should thank the Speaker for—but it never went through the Judiciary Committee in terms of hearings.

Mr. JOHNSON. Mr. Rangel, I believe that constitutional amendments should have full consideration by the Congress, by the Committees of jurisdiction, and, in this case, it is the Judiciary and Ways and Means, and I would hope and suggest that that is the way we reform our Tax Code. We don't do it by autocratic means.

Mr. RANGEL. You have convinced me now of your sincerity. Could you share with me at what point in time in our history would you suspect that this constitutional change might go into effect?

Mr. JOHNSON. Well, I think most people have agreed that it is going to be very difficult to have any total tax reform in this year. So I would suggest that it is probably going to be discussed. At least we are getting the debate out in the open. We are talking about reforming our tax system, which everyone agrees has become——

Mr. RANGEL. Now you have got me totally.

Mr. JOHNSON. And, in the next session of the Congress, I would suggest that we would probably be able to see some action.

Mr. RANGEL. The constitutional amendment you expect in the next Congress would pass?

Mr. JOHNSON. I am not sure it will pass, Mr. Rangel, but we need to get out there and discuss the issue, and if we can get it

past the Congress, then I would suggest that the several States that are required, 38 I guess it is——

Mr. RANGEL. So then we are in accord with what I said that this isn't for passage. This isn't for amending the Constitution. This isn't for pulling anything up by the roots. This is an educational effort to focus attention on a system that should be reformed and, to that extent, I want to join with my colleagues in congratulating you on this.

Mr. JOHNSON. Thank you, sir. I appreciate it. I hope we can pass it, as well.

Mr. RANGEL. Well, that is a far hope, but, you know, it springs eternal. Thank you.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Sam, let me thank you for your testimony. I join you in looking forward to the debate on changing our income tax structure. I strongly support us looking at replacing it with some form of a consumption-based tax, at least a significant part of our income tax. But I am somewhat concerned by the approach that you are taking in suggesting the repeal of the constitutional provision.

If my recollection is correct, before we had an income tax, our Nation relied primarily on tariffs in order to finance government, and I don't believe you are suggesting by the introduction of this amendment that we go back and try to impose high tariffs on goods that come into this country as the primary way to replace the taxes that would be lost by the repeal of all income taxation.

Mr. JOHNSON. Well, I think the decisions of the past, which ruled on the legality of our income tax, simply said that we shouldn't be taxing property. But certain forms of income were considered as excise under those decisions and, even the economists, which sat here several weeks ago, indicated that even a flat tax could be considered a consumption tax.

Mr. CARDIN. If your amendment were to become law, that is, if we were to repeal the constitutional provision, you don't believe that we could consider a flat income tax and be in compliance with the——

Mr. JOHNSON. The law talks to direct versus indirect taxation, and it says that you shouldn't directly tax the people, a person's income, and that is what that amendment allowed.

Mr. CARDIN. So a flat tax, that option would no longer be available to us?

Mr. JOHNSON. That is not true, according to the consultants that I have talked to.

Mr. CARDIN. Couldn't we then have our current income tax, under that logic, we could just use our current income tax and repackage it, and get around the Constitution no problem?

Mr. JOHNSON. No. There are some parts of it that would have to go away.

Mr. CARDIN. How about the Social Security taxes?

Mr. JOHNSON. We did not touch Social Security taxes, and I think that is——

Mr. CARDIN. But that is based on income.

Mr. JOHNSON. Sir?

Mr. CARDIN. That is based upon income.

Mr. JOHNSON. No. According to the court rulings, that is considered excise, believe it or not.

Mr. CARDIN. Not self-employed taxes, though.

Mr. JOHNSON. Your Social Security taxation is considered excise and so is——

Mr. CARDIN. Maybe we should leave the record open because I would be curious as to how you would get around the court opinions if we didn't have the constitutional provision for the self-employed's contributions to the Social Security system. I am curious, also, what impact it would have on the Medicare tax.

Mr. JOHNSON. Yes, but it is my view that, if we adhere to these principles, any solution we come up with will be good, and the Social Security system, as you know, should be reformed as well. It is going to have to be.

Mr. CARDIN. No question about it, but we are struggling with a Medicare solvency issue in which a large, significant part of the Medicare funds come from payroll taxes.

Mr. JOHNSON. Right.

Mr. CARDIN. Based upon income in which we have removed the cap. So, regardless of a person's salary income, they contribute to Medicare. I am concerned as to whether that would comply with the court opinions if we do not have the 16th amendment.

Mr. JOHNSON. Yes, it does. It surely does, and I don't think we are going to mess with Social Security or Medicare, although it is my opinion that we should be fixing them today.

Mr. CARDIN. Well, Mr. Chairman, I would hope that we would hold our record open. Obviously, the Judiciary Committee will look into these matters, but my interpretation of those court opinions are different than your interpretation and, before we move forward with a constitutional change, we better understand what impact it has on the Medicare system, the Social Security system, the options that are being considered. Although I don't favor a flat tax, I think it is a healthy debate for this Nation to have on the flat tax, and I am not so sure you could consider a flat tax if the constitutional amendment were to be passed.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman. As the gentleman from Texas knows, I am 100 percent in agreement with what he is talking about doing. There are a couple of questions, though, that I think we ought to consider.

One thing I disagree with is the fact that throughout history people have hated the tax collector. Actually, when it started in a lot of jurisdictions and a lot of countries, they didn't hate them until the tax collector got oppressive. Then they started hating the tax collector. In fact, I have had a lot of individuals, say, "Hey, I am willing to pay more in taxes, but quit using that money to take away my freedoms," and I think that is where we are.

The question I have is, Who actually pays the ultimate cost of the compliance of our tax laws? Who actually puts up that money and who is paying for it?

Mr. JOHNSON. For the compliance, it is the taxpayer.

Mr. HANCOCK. Now, wait 1 minute. I realize that. But when the person isn't paying taxes directly, who actually pays? Could we say the consumer?

Mr. JOHNSON. Oh, surely.

Mr. HANCOCK. That is right. We keep talking about the people that pay taxes. The person out there that doesn't pay taxes is quiet. Even the people who are drawing welfare and food stamps pay. Their food stamps buy less because they are having to help pay for the compliance costs. So the ultimate consumer pays the total cost of government, regardless of how you get there.

Mr. JOHNSON. It is a hidden tax.

Mr. HANCOCK. That is right. So we are talking about almost as much money in compliance as we are talking about the amount of money the government gets.

Mr. JOHNSON. That is right. I just said it is almost a 4-to-1 ratio of what a company spends to comply with the Tax Code for what they make.

Mr. HANCOCK. But the consumer of that good or service pays the total cost of compliance, the taxes and everything.

Mr. JOHNSON. That is right. That is because that 4-to-1 ratio that it costs to comply with the Tax Code is passed on in the form of pricing.

Mr. HANCOCK. The second question. Who benefits the most from our Tax Code, our tax law? Who actually benefits the most?

Mr. JOHNSON. You probably wouldn't like my answer. I would say the IRS and their employees.

Mr. HANCOCK. That is exactly right. The people that benefit the most from our tax laws are the people that are involved in the enforcing of compliance of our tax law. It has created a whole economic organization; the attorneys, the CPAs, the people that are employed administering the programs. Only 30 percent of our welfare programs get to the people that are needing help. So the people that benefit the most from what we are doing up here are the people that are administering the programs. There is only one way to put a stop to it and to get back to the deal where people say, 'I want to pay my fair share of taxes, but quit using it to take away my freedoms," and I think that is what the whole debate is all about.

Mr. JOHNSON. The Congress was charged in the original Constitution with coming up with a budget, and then figuring out what they had to spend and then going to the various States and letting the States collect it for us. Until we can come up with a budget and know what we are going to spend and not overspend what we receive, I think it is going to be a while before we get the system under control, and that is why we are debating it at this point in time.

Mr. HANCOCK. The only thing I would say is let's talk about who pays for it and let's talk about who actually ends up with the biggest portion of it. It isn't going to pay for the cost of government. It is going to pay for compliance costs more than anything.

Mr. JOHNSON. You are right, and if you agree with my concept of those principles that we should base any tax reform on, bringing freedom to the American taxpayer.

Mr. HANCOCK. Well, that is the name of the game. Thank you.

Mr. JOHNSON. Thank you.

Chairman ARCHER. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman.

Sam, thanks very much. I certainly concur with the thinking that you and others have expressed in terms of the need to do something to change very dramatically the Tax Code, and I think you have laid out the case very, very well for some changes.

I am concerned, though, about your particular solution in terms of repealing the 16th amendment to the Constitution. I say that because I think, if we did that, that we would no longer have the option of having a flat or a flatter tax; that that one would disappear, and we would be looking, basically, at some kind of consumption tax, whether it is a value-added tax or whether it is a national sales tax. And from what we have heard from people who have talked about those taxes here, I have three concerns that may be overcome, but I am not sure that they can be.

First, as we replace the income tax with a consumption tax, if we are to do that on a revenue neutral basis, people have come and testified before us that it would take about a 20-percent tax on everything that we buy in terms of our goods and services, and they recommend we not exclude anything. So doctor's visits, and college tuition, and home building and so forth would be taxed in order to come up with the same amount of money.

I don't think we know that the taxpayer would feel better about a system that eliminated the income tax if, in fact, every single thing they bought in goods and services they had to pay 20 percent more to replace the lost revenue, and that is a question that we will certainly need to deal with as we move forward.

Second, is that we, by going to a consumption tax, generally are making businesses—small and large—our tax collectors because they are the people who will be responsible for making sure that we collect this money. I have heard from a number of businesses who have some real concerns about being put in that position, and I will be interested to hear what some of the folks today have to say about that, and I think that is a concern that we need to address as well.

Third, we have not seen any other industrialized nation in the world that has yet moved to a total consumption tax system. Generally, they have some consumption taxes, value-added taxes, but they also have some income tax component as well.

First of all, I commend you, and I agree that we definitely need to make changes, and I think what you are proposing is a very large change. I wonder, though, if we are not getting the cart before the horse a little bit, and we need to answer some of these other questions about the alternatives before we move forward to repeal the 16th amendment.

Mr. JOHNSON. Well, I appreciate your comments, and I'll tell you, if nothing else, we have stimulated debate. You have already mentioned some of the areas of concern, as have others. But the court cases do not prohibit a flat tax, if that is what you prefer. I know that whatever form the tax takes, it ought to meet those requirements that I stipulated. I don't think that this amendment, whether it passes or fails, is going to limit us on what kind of tax solution we come up with.

But, surely, we don't want two taxes. You mentioned the foreign countries. As you know, a lot of them have not only that, but also income, and their tax rate is very high, and we were trying to preclude that in this instance.

Mr. PAYNE. I think one of the big issues is whether a flat tax could, in fact, be levied if we repeal the 16th amendment. But thank you very much, and I thank you for your good work.

Mr. JOHNSON. Thank you. I appreciate it.

Chairman ARCHER. Are there further questions for the witness?

Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman, and thank you, Sam, for being here. I agree fully with your amendment and your proposal.

Your past work, before you came to Congress, was in the real estate industry, isn't that correct? Home building?

Mr. JOHNSON. Right.

Mr. CHRISTENSEN. There have been a lot of witnesses that have testified in other hearings that we have had about the flat tax. If a flat tax were to be one that we examined on a very serious nature, which of the flat tax proposals have you seen that you like, if you like any of them more than another one, and then what is your reaction, also, to the mortgage interest deduction? Is that something that is sacred or is it not sacred? Any thoughts on that, as far as where we are headed with that kind of discussion if we were to pursue the flat tax?

Mr. JOHNSON. Well, Mr. Christensen, I'll tell you what, I don't think it matters, as long as we stick to the freedom principles and put good principles behind any tax reform we do. What this bill does is bring all proponents of tax reform, including flat tax supporters, together behind one common goal, and that is replacing the current system. Whether we get there with a flat tax, a VAT tax, or a national sales tax is kind of immaterial. We need to reform the system, and we only need one tax system in this country.

This amendment to the Constitution, if we can repeal it, will give us the opportunity to implant one tax system on this Nation that is beneficial to all Americans.

Mr. CHRISTENSEN. If we don't get to where you and I both want to be, as far as pulling the Tax Code out by the roots and repealing the 16th amendment, in the area of priority, if we look at personal income, corporate tax, estate tax, payroll tax, excise taxes, which would you want to focus on and which is the most important to reform?

Mr. JOHNSON. We have got to eliminate the current system, as it exists today, and repealing the 16th amendment is a start for doing that, and I think that that is the only way we are going to get the IRS under control.

Mr. CHRISTENSEN. Well, I agree 100 percent, and I hope to be working with you on that and to see it come to fruition.

Thank you, Sam.

Mr. JOHNSON. Thank you, sir.

Chairman ARCHER. Are there further questions?

Mr. Ramstad.

Mr. RAMSTAD. Mr. Chairman, very briefly, because I know there are a lot of other witnesses waiting. But let me just applaud you,

Sam, for your leadership in this area and state that your legislation is absolutely critical. In fact, it should be a condition precedent to adopting any alternative form of taxation. My greatest fear is that we retain the current income tax system and adopt some other system, be it a national sales tax or a value-added tax or a flat tax or a modified flat tax, whatever alternative, and end up with a dual system which is the last thing our economy or our country or our taxpayers want or need. So I think your legislation is very critical, and I applaud your efforts.

Thank you, Mr. Chairman.

Mr. JOHNSON. Thank you, sir.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. One quick question, Mr. Chairman.

Congressman Sam Johnson of Texas, I want to ask the question that the gentleman from New York asked you. You are sincere in this endeavor of repealing the 16th amendment to the Constitution of the United States?

Mr. JOHNSON. Yes, sir. I think any idea of changing our Constitution ought to be serious. And, as Mr. Rangel pointed out, it ought to be considered by the various Committees of jurisdiction and be well thought out and very carefully done. It won't happen overnight, but what happens this year will at least begin an open and honest debate about what is wrong with our current system and help us provide an alternative for this Nation.

Mr. COLLINS. Well, I appreciate that. That is the reason I signed on to your bill.

Thank you, sir.

Mr. JOHNSON. Thank you, sir.

Chairman ARCHER. Are there further inquiries? If not, Sam, thank you very much.

Mr. JOHNSON. Thank you, sir.

Chairman ARCHER. You have done a great job in presenting your case to the Committee.

Our next witness is Congresswoman Jan Meyers from Kansas. Jan, would you like to come to the witness table. I think you probably know, having appeared before other Committees and, perhaps, this Committee, also, what the rules are. If you have a written statement, without objection, it will be inserted in the record in full, and you will be recognized to orally present your testimony and, hopefully, keep it within 5 minutes. You may proceed.

STATEMENT OF HON. JAN MEYERS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KANSAS; AND CHAIR, HOUSE COMMITTEE ON SMALL BUSINESS

Ms. MEYERS. I have submitted a longer statement for the record and will keep my testimony to 5 minutes, Mr. Chairman.

Good morning, Chairman Archer and Members of the Committee, and thank you for asking me to be here this morning.

As you are aware, there are more than 21 million small businesses in this country. In recent years, these small enterprises have employed 54 percent of the private work force, contributed 52 percent of all sales in the United States, generated 50 percent of the private gross domestic product, and in 1994 they were responsible for an estimated 62 percent of the new jobs created. Thus, the

term "small" is rather misleading when it comes to the impact of small business.

I don't think there is any question, Mr. Chairman, that small business favors major structural change in our tax system. I think there is some question as to exactly what form that should take, but they do favor major structural change.

The Committee on Small Business has held a number of hearings focusing on the need for reform of our current tax system, and last week we heard from three of the members of the Kemp Commission on Tax Reform; Jack Kemp, Jack Faris of the NFIB, and Shirley Peterson, former IRS Commissioner. With these hearings in mind, I would like to highlight a few of the recommendations that we have received from the small business community.

First, the new tax system must reduce the regulatory and paperwork burdens on small businesses, and it must emphasize simplicity. According to recent estimates, taxpayers spend in excess of 5 billion hours annually to comply with the current tax laws, and the time dedicated by businesses makes up better than one-half of that time. For small businesses, this burden is especially significant because they are often forced to hire outside bookkeepers, accountants, and lawyers to make sure that records are correctly kept and tax returns are filed on time. The time and money committed by small businesses to tax compliance would be better spent doing what they do best: developing innovative ideas for new products, services, and creating much needed jobs.

Second, the new tax system must eliminate the multiplicity of taxation that exists currently. If you ask small businessmen and women, they will tell you that money saved in taxes will be plowed back into their businesses for growth and expansion. In light of this fact, we can go a long way toward priming the economic engine of this country by eliminating the tax on capital gains.

Most importantly, the new tax system should abandon the current estate and gift tax. The Committee on Small Business has heard repeatedly that when the owner of a small family-owned business dies, the family is often forced to close the doors and liquidate the business merely to pay the Federal estate taxes. Regrettably, the current system prompts many small businessmen and women to divest themselves of their business as they approach retirement in order to reduce the impact of estate taxes, rather than pass their business on to the next generation. This scenario is counterproductive for the small business and the economy. It also makes little sense when we consider that estate and gift taxes only account for about 1 percent of all Federal revenues.

Third, small businesses have repeatedly emphasized the need for immediate expensing of capital asset acquisitions. This change would obviously free up additional capital for businesses by allowing them to recover the costs of their investment sooner than is allowed under the existing depreciation schedules. In addition, there would be the added benefit of reducing paperwork and recordkeeping burdens associated with the current depreciation rules.

I know that there has already been considerable debate about which of the current deductions will be preserved under a new tax system. I would offer only a broad suggestion. Whatever form that the system takes, please give careful consideration to the expenses

that businesses are permitted to offset against their profits to arrive at the amount of income subject to tax. For many small businesses, the cost of payroll taxes and employee benefits, for example, can be an enormous expense. Eliminating the deductibility of these expenses, therefore, could have significant adverse consequences for many small firms.

And, finally, I would urge you to begin considering the difficult, but critical, issue of transition provisions. This is something that we need to start addressing now rather than when the new tax system is completed and approved.

In conclusion, let me point out that nearly all of the small businessmen and women with whom I have spoken have stressed that they are willing to pay their fair share of taxes, but without real reform, the cost of the current system, both in terms of dollars and time spent on compliance, is robbing our country of the tremendous potential for sustained economic growth and jobs creation that small business represents.

Thank you, again, for the opportunity to be here today.

[The prepared statement follows:]

STATEMENT OF
REP. JAN MEYERS (R-KANSAS)
CHAIR
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

April 24, 1996

"Replacing the Federal Income Tax and Its Impact on Small Business"

Good morning Chairman Archer and members of the committee. Thank you for the opportunity to be here this morning to discuss an issue that is particularly important to me and the Committee on Small Business, which I chair.

As you may be aware, there are more than 21 million small businesses in this country, according to current estimates. In recent years, these small enterprises have employed 54 percent of the private workforce, contributed 52 percent of all sales in the United States, generated 50 percent of the private gross domestic product, and in 1994, they were responsible for an estimated 62 percent of the new jobs created. Thus, the term "small" is rather misleading when it comes to the impact of small businesses. Moreover, an issue like tax reform, which will affect small businessmen and women across this country, will have wide-spread consequences, and I believe benefits, to the economic and social welfare of our local communities and national economy.

Since I assumed leadership of the Committee on Small Business last year, my committee has held a number of hearings focusing on the need for reform of our current tax system. In addition, as a continuation of the efforts undertaken by our Subcommittee on Taxation and Finance, last week we heard from three of the members of the Kemp Commission on tax reform: Jack Kemp, Jack Faris of the National Federation of Independent Business, and Shirley Peterson, former Commissioner of the Internal Revenue Service. These three witnesses, as well as the many experts and small-business owners who testified at our field hearings, gave us invaluable insights into the issues and concerns particular to small business.

I would like to take a few moments this morning to highlight a few of the recommendations that we have received from the small-business community. While the debate is only beginning on what America's tax system should ultimately look like, I would urge you to keep in mind that the new system must be "friendly" to small business before it can be called a complete success. With that in mind, let me emphasize four points of particular concern to small business.

First and foremost, the new tax system must reduce the regulatory and paperwork burdens that small businesses currently endure. According to recent estimates, taxpayers spend in excess of 5 billion hours annually to comply with the current tax laws, and the time dedicated by businesses makes up better than half of that time. For small businesses, this burden is especially significant because they are often forced to hire outside bookkeepers, accountants, and lawyers to make sure that records are correctly kept and tax returns are filed on time. In addition, as a fixed cost, tax compliance represents a substantially larger percentage of a small business' income than it does for a large corporation with in-house tax professionals.

I am sure we can all agree that the time and money committed by small businesses to tax compliance would be better spent doing what they do best: developing innovative ideas for new products and services and creating much needed jobs. To foster their efforts, I recommend that the new tax system emphasize simplicity. A simple, easily understood system of taxation will not only minimize compliance burdens, but also have the added benefit of producing better accuracy in tax reporting.

Second, the new tax system must eliminate the multiplicity of taxation that exists currently. If you ask small businessmen and women, they will tell you that money saved in taxes will be plowed back into their businesses for growth and expansion. In light of this fact, we can

go a long way towards priming the economic engine of this country by eliminating the second layer of taxation imposed on capital gains. We can go even further by eliminating the onerous alternative minimum tax.

Most importantly, the new tax system should abandon the current estate and gift tax. At the hearings that my committee has held, we heard repeatedly that when the owner of a small family-owned business dies, the family is often forced to close the doors and liquidate the business merely to pay the Federal estate taxes. Regrettably, the current system prompts many small businessmen and women to divest themselves of their business as they approach retirement in order to reduce the impact of estate taxes, rather than pass their business on to the next generation. This scenario is counterproductive for the small business and the economy. It also makes little sense when we consider that the estate and gift taxes only accounts for about one percent of all Federal revenues.

Third, small businesses have repeatedly emphasized the need for immediate expensing of capital-asset acquisitions. This change would obviously free up additional capital for businesses by allowing them to recover the costs of their investments sooner than is allowed under the existing depreciation schedules. In addition, there would be the collateral benefit of reducing the paperwork and record-keeping burdens associated with the current depreciation rules. As you may be aware, a company may have to maintain as many as four different depreciation schedules in order to comply with the income tax, alternative minimum tax, and financial statement rules.

I know that there has already been considerable debate about which of the current deductions will be preserved under a new tax system. Recognizing that other witnesses will have substantial comments and recommendations on those issues, I would offer a broad suggestion. Whatever the form that the system takes, please give careful consideration to the expenses that businesses are permitted to offset against their profits to arrive at the amount of income subject to tax. For many small businesses, the cost of payroll taxes and employee benefits, for example, can be an enormous expense, frequently more than the Federal income taxes they owe. Eliminating the deductibility of these expenses, therefore, could have significant adverse consequences for many small firms. While the effects of lower rates, less paperwork and recordkeeping, and increased availability of capital will certainly mitigate the loss of some deduction, the balance between the costs and the benefits deserve special attention with respect to small business.

Finally, I would urge you to begin considering the difficult but critical issue of transition provisions. This is something that we need to start addressing now, rather than when the new system is completed and approved. For many small enterprises, some of their most significant assets are their deferred tax attributes, such as business tax credits and net operating losses. To make the transition to a new and improved system will require considerable attention to the treatment of these attributes as well as methods for handling such issues as existing inventories, depreciable assets, and outstanding debt obligations. Moreover, we must consider how the conversion to a new tax system will affect the financial statements of businesses and ways to address the resulting consequences.

In conclusion, let me point out that nearly all of the small businessmen and women with whom I have spoken and those who have appeared before my committee have stressed that they are willing to pay their fair share of taxes. But without real reform, the cost of the current system, both in terms of dollars and time spent on compliance, is robbing our country of the tremendous potential for sustained economic growth and jobs creation that small business represents.

Thank you again for the opportunity to be here today.

Chairman ARCHER. Jan, thank you. As Chair of the Small Business Committee, your testimony is particularly welcome today in highlighting the negative impact of the current tax system on small business.

On a personal note, I am going to regret your retirement and that you will not be with us in the next Congress because you have done an outstanding job in your career in the Congress and, particularly, on small business issues. I am very grateful for your testimony.

Ms. MEYERS. Thank you.

Chairman ARCHER. Are there any questions?

Mr. Gibbons.

Mr. GIBBONS. I would just like to say to Mrs. Meyers it has been a privilege and a pleasure to know you and to congratulate you for the fine contribution that you have made to this Congress and to our country.

Ms. MEYERS. Thank you.

Mr. GIBBONS. We wish you well.

Ms. MEYERS. Thank you.

Chairman ARCHER. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. I would just like to make a couple of comments, and maybe you could respond to them.

As a small business owner myself and knowing how the Tax Code has affected me over the last several years, I know Congressman Archer fills out his own tax return, but I am no longer able to fill out my own tax return. As a matter of fact, every year when I go through it with my accountant, I hope he has done it right. I know I sign it, and I know I am responsible for it, but I have no idea because of the complexities of the law. Once you own a small business, the complexities from that are so enormous and so difficult to keep up with that it is very, very difficult.

A couple other things that hit me. The first year I opened my business and, as I started to grow, you have various FICA taxes that you have to pay for your employees. Depending on the number of employees that you have will depend on when you have to file those FICA taxes and, depending on the amount that you paid and all of that. The penalties that come from ignorance are astounding and can add up to quite a bit to small businesses. I was a veterinarian. I was working 90 to 100 hours a week just trying to make my business grow that first year. The last thing that a small businessperson seems to need is to have to worry about the complexities of our current Tax Code. They want to worry about making it that first year because that first year is critical to survivability.

Just your comments on the burdens that we could lift from small business people in easing the complexities in our Tax Code.

Ms. MEYERS. Your comments are very valid, Mr. Ensign. The first point that I stressed was that we have heard over and over from the small business community that simplicity is the most important thing. Whatever we do with the Tax Code, they say make sure that it is simple. Everyone feels like that, but it is more important for a small business than for a big business probably because big business will have an office manager or a tax consultant or an attorney, perhaps, right on staff or on consistent call. Where-

as, for a small business, the cost and the time of compliance are very difficult for the owners to handle. It is often the small businessman or woman, himself or herself, that is sitting there late at night doing all of the depreciation schedules, the paperwork associated with taxes. So the point you make is very valid, and the first point that I made was that the tax system must be simple.

Mr. ENSIGN. Very good. Just a couple other brief comments, and that is, when we are looking at reforming the Tax Code and taking into account that the engine that drives our economy is small business—and I applaud your efforts for being an advocate of small business—I think that this Congress has to take into account the engine that drives the economy as one of the No. 1 priorities in reforming our current Tax Code.

I think that, in the small business community, it is very easy to have a very large underground economy because when you are a small businessperson it is easier to do cash transactions. I think that that is a large part of our underground economy right now because people perceive the tax rates as being punitive, as being too high, and they figure there are a lot of people that want to get around paying necessarily what others might consider their fair share. They try to get around that. I think that that is another thing that I am sure, being involved with the small business community as you have been, you see that underground economy.

The point that I would like for you to very briefly comment on is that the rates have to be low enough, in my opinion, whatever tax system we go to, to discourage the underground economy because people are going to be smart enough, whether it is a national sales tax, a flat tax, a value-added tax, they are going to be smart enough to game the system if they feel that the rates are too high.

Ms. MEYERS. Yes. You have touched on another factor that is extremely difficult for small business, and that is that they just don't have the margin. They don't have the cash flow. If we reduce the burden on the small business, frequently I think we find that we get better compliance and, actually, more money would come in. I thank you for making that point.

Mr. ENSIGN. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. I want to thank you, Congresswoman Meyers, for your testimony but, as Sam Gibbons had said, that when they created the word "gentlelady" they probably were thinking about you. It has been an absolute pleasure to see you as an oasis of civility in this House, and we are going to miss you and, certainly, I hope that, even though you are leaving Congress, that you don't give up the fight for us to make the tax laws for small businesses more simple.

I come from a community that without the local small businesses, some of the young people would have no idea as to how to go about getting to the so-called multinational corporations.

Even worse than that, I had a business meeting to talk about the earned income tax credit, to talk about the targeted jobs credit, to talk about the empowerment zone, and after two or three meetings I was shocked and embarrassed to find so many of these small business people were actually working off of the books because of the complexity of the Tax Code and because they had no one there

to assist them in knowing what was expected of them. So that, if you make it so difficult for people to do the right thing, then the temptation to do the wrong thing is there. So, while missing you in the House, I do hope that you continue to work with us and to continue to provide the leadership, and I would look forward to working with you.

Ms. MEYERS. Thank you very much, Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Portman.

Mr. PORTMAN. I thank the Chair, and I want to echo the comments of Mr. Rangel, both in terms of his tribute to Jan Meyers and his comments on small business. You were my first Committee leader, and I am glad you are here before us today bringing this perspective of small business and being such an able advocate.

You talked about the need for simplicity, predictability, sort of the safe-harbor notion, so small businesses don't have to waste all of their time complying with the Code and worrying about whether they are complying. You talked about estate taxes, which I think is something this Committee will focus on more and more as we get into tax reform and its importance to small business.

One issue that didn't come up, and I just wondered if you had any input on it from all of your experiences, is the notion of fringe benefits and how they should be treated. In most of the tax reform proposals that are in the flat tax area, we talk about taking away the deductibility for health care costs, also for pensions and so on, and this is an issue that I have heard different things about from different people. It, obviously, depends on where the rate ends up. But what have you heard from small business in terms of the deductibility of fringe benefits?

Ms. MEYERS. Well, in my longer statement, I said that for many small businesses the cost of payroll taxes and employee benefits can be an enormous expense, frequently more than the Federal income taxes that they owe. Eliminating the deductibility of these expenses could have significant adverse consequences for many small firms. While the effects of lower rates, less paperwork and recordkeeping, and increased availability of capital will certainly mitigate the loss of some deductions, the balance between the costs and the benefits deserves special attention with respect to the small business.

So the point you make is good. The cost of payroll taxes and employee benefits must continue to be a deductible item.

Mr. PORTMAN. That is helpful. I think, increasingly, as we are concerned about coverage for the uninsured and, as we are concerned about retirement savings, we are trying to figure out ways to get small business to provide more of that. I think we are leaning on small business more and more, and I think we need to be sure that we are not missing that in our discussion of tax reform; that we need to encourage and not discourage that kind of benefit being offered if, indeed, we want to see people covered and want to see an increased retirement savings.

One final question, and that has to do with the individual income tax rates. I think a lot of the businesses that you have focused on and are concerned about pay taxes at the individual rate, sole proprietors, partnerships, subchapter S corporations, and I just won-

dered if you had any comments on that. It seems to me that the rate that individuals pay is particularly important to small business people and that, perhaps, was missed during the OBRA 1993 discussion. We wouldn't want to miss that in this discussion.

Ms. MEYERS. Of course, the Small Business Committee has worked hard for subchapter S reform, and Mr. Crane has a bill that would call for a change in the rates for subchapter S corporations so that they can pay the same rate as C corporations.

Mr. Crane might like to know I just spoke to the small manufacturers this morning. They are very interested in that bill because right now small manufacturers, because of the fact that you mentioned, pay taxes at the individual, 39-percent rate, and other corporations pay at the 34-percent rate. Of course, that 5 percent differential, if it is plowed back into the business, certainly should be allowed for subchapter S manufacturers, also.

Mr. PORTMAN. Thank you very much, and we will miss you, Jan.

Ms. MEYERS. Thank you.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Briefly, Ms. Meyers, it was a pleasure to have served my first term on the Small Business Committee under your leadership.

In your statement, you mentioned the double layer of taxation on investments of small business. You mentioned that we could go even further by eliminating the erroneous alternative minimum tax. Normally, the alternative minimum tax affects small businesses that have a heavy capital investment. Have you received testimony from any of the small businesses in relation to their behavior or how it has affected their behavior of investment for capital assets based on the alternative minimum tax?

Ms. MEYERS. I don't pretend to be an expert on the alternative minimum tax. That is certainly one of the things, though, that we have heard about with respect to the complexity and the difficulty of the current system, and it is another example of the duplication of taxes. This was one of the points that I made previously; if we could do away with capital gains or get some special treatment for capital gains and eliminate the alternative minimum tax, I think it would stimulate the economy in this country enormously.

The other industrialized nations of the world that are the most progressive and the most successful have no capital gains tax at all, and so my answer to your question would be, yes, Mr. Collins.

Mr. COLLINS. Thank you. I know the alternative minimum tax is often triggered when a business, whether it be small or large, has a heavy capital investment. As you make those investments, it can put you in more of a tax-liable situation than what you had anticipated before making those types of investments and, once you do, you get caught into that situation. It has a way of discouraging investment behavior in the future. Those heavy capital investments are often equipment investments that are made on a manufacturing line or an assembly line for the benefit of, oftentimes, union labor. As Mr. Gephardt agreed with us last year, AMT, the alternative minimum tax, is one provision in the Tax Code that probably eliminated more assembly line jobs and union jobs than any other provision in the Tax Code. I hope we can repeal the alternative minimum tax.

We appreciate your testimony and your dedication to the Con-
;ress. Thank you.

Ms. MEYERS. Thank you for your comments, Mr. Collins. I might
ay, Chairman Archer, that in looking around your Committee I
ee a number of former Members of my Small Business Committee,
ınd I think I trained them extremely well.

Chairman ARCHER. Are there further inquiries? If not, thank you
'ery much, Jan. We appreciate your testimony and your response
o the inquiries.

Ms. MEYERS. Thank you, Chairman Archer.

Chairman ARCHER. Our first panel today is Jack Faris, president
ınd chief executive officer of NFIB; Paul Huard, senior vice presi-
lent for NAM; and Kevin Kearns, president of the United States
3usiness & Industrial Council. If you three gentlemen would have
ı seat at the witness table.

If you have a lengthy written statement, without objection, it will
ıe inserted in the record, and we would like for you to give a short-
:r oral statement, within 5 minutes, if you will. Mr. Faris, if you
vill, we would like for you to proceed first.

STATEMENT OF JACK FARIS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. FARIS. Mr. Chairman, thank you very much and thanks for
ıaving the written testimony in the record. Thank you for having
his Committee hearing. Also, I would be remiss if I didn't thank
'ou for your 100 percent voting record for small business consist-
:ntly through the years. So it is no surprise to us in the small busi-
ıess community that under your leadership we would not be talk-
ng about adding taxes or adding ways to get more money for the
;overnment. We would be talking about doing something about the
;.3 million words and phrases in the IRS Code and regulations. So
ve thank you very much, Mr. Chairman.

The small business community is a very strong, vibrant part of
ıur community. If, in fact, it was a stand-alone nation, it would be
he third largest industrial power of GNP in the world.

NFIB, the National Federation of Independent Business, is very
ıleased to represent what we think is the most special interest of
ıll Americans, and that is the "mom and pops," the entrepreneurs
ın Main Street.

We have 600,000 members in 50 States. We are issues based.
)ur members dictate what stands we take on issues. For example,
n the health care issue, 87 percent of our members were opposed
o an employer mandate in health care, so we took a strong stand
ın that issue.

When the NAFTA issue came up, we had one-third for NAFTA,
ıne-third against, and one-third that thought NAFTA just might be
ın auto parts house. Because, to many of us in small business, for-
ıign trade is the next county.

On this issue of tax reform then, our members take a very, very
ıositive strong stand in terms of need for reform. Our average
nember has five employees, $250,000 in volume a year, and they
verage having $42,000 a year left over after paying everything
lse.

The NFIB, in representing small business, we see that 53 percent of all Americans live and work in a small business, 53 percent. Forty-two percent of all Americans say they live in a small business household—owner, manager, or employee. We found out after the elections in November 1994, 61 percent of everyone who voted said they live in a small business household. We also know from our survey work 72 percent of all Americans one day would like to own their own business. Eighty-five percent of all employers have six or fewer employees, and those businesses that have six or fewer, 2.4 are in the same family, very much a family business. Those businesses create over three-fourths of the new jobs in America.

Small business owners are the community leaders, the people that pay for the little league programs, that are standing on the corners on Saturday with the buckets to get change to help the charity of the community. They are the same ones that come in Monday mornings sometimes with three jobs; owner, manager, and filling in for who doesn't show up.

These people on Main Street are very concerned about tax reform, and what are they telling us? Our members are telling us three things very specifically about tax reform.

First, we need tax reform, and we need it badly. Small business owners are paying disproportionately in terms of especially compliance costs that this Committee has already heard about today, from $3 to $7 for compliance costs for every $1 paid in taxes.

We also know, in looking at the cost of doing business, that the dreaded, feared IRS is a real component part of how everybody does business every day. No one enjoys paying taxes. But if we feel it is a fair system, that everybody is paying their fair share, that it is as simple as possible to understand, and, in fact, if we are not spending too much money, then our people will say we are for that tax reform.

Second, we need reform, and we say no to the value-added tax. I have talked to my counterparts around the world. Our members agree with what they have found. It is an insidious tax. It is easiest to change. There are a lot of negatives we can go into about the value-added tax at another time, but to put on the record, our members are very much opposed to it.

Third, we are very open to a newer, simpler tax system. Our members are not set on an income tax or a sales tax, which is shown in the Kemp Commission on Tax Reform report that we had a single-rate system, but did not specify income or sales. Our members are open to it, but they do know that three things have to be bottom line in tax reform.

First, we need to reduce the size and cost of government and what taxes we pay in the first place. Any other reform means we just start shifting around who pays the burden.

Second, we must do something about the payroll tax. We must. Small business owners pay more money in payroll tax than they do in income tax.

Last, we must have transition rules in any major substantial tax reform in America. The transition rules we didn't have in 1986 killed many small business owners and caused a great deal of problems on Main Street. Transition is very important.

The bottom line for us is we need reform. We need substantial reform. We are willing and open to see any and all comers in terms of a plan. What we hope everyone will do, and the last point, Mr. Chairman, is that they will look at the tax test that we came up with in the Kemp Commission after going from one part of the country to the other. I think in Mr. Rangel's district we had some very interesting comments from some of your constituents, Congressman, about the need for tax reform. Six points of policy and six points of principle. Our members say, if you go by this, we will have a much better tax system than we have today.

Mr. Chairman, thank you for your leadership and for the opportunity to testify today.

[The prepared statement follows:]

STATEMENT OF

JACK FARIS

PRESIDENT
and
CHIEF EXECUTIVE OFFICER

NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

Subject: Tax Reform and Small Business

Before: House Committee on Ways and Means

Date: April 24, 1996

Mr. Chairman, my name is Jack Faris and I am the President and Chief Executive Officer of the National Federation of Independent Business (NFIB). NFIB is the nation's largest small business advocacy organization, representing more than 600,000 small business owners in all 50 states and the District of Columbia. The typical NFIB member employs five people and grosses $250,000 in annual sales. NFIB's membership mirrors the nation's industry breakdown with a majority of its members in the service and retail sectors.

I want to thank you Mr. Chairman and the Committee for having me here today to discuss one of the greatest concerns of our membership: tax reform. But before I go into the impact of tax reform on small business it is important for the Committee to understand the composition of the business community and some demographics of small business owners.

Small Business: America's Job Growth Engine

First, it is important to look at the business community as a whole. One inaccurate perception in this country is that all business is big business. This is not correct. There are five million employers in the United States today. Of those five million, 60 percent of them employ 4 employees or fewer and 94 percent employ fewer than 50 employees. These figures illustrate a fact that is typically lost during debates on the impact of certain government policies -- small business by pure volume dominates this country's economic engine.

Another misleading perception is that a small business is a smaller version of a big business. Nothing could be further from the truth. For example, one-half of small business owners start their business with less than $20,000, most of which is from personal or family savings. Most small business owners do not make a lot of money (40 percent earn less than $40,000); they survive on cash flow not profitability. Start-up small businesses are the most vulnerable. Of the 800,000 to 900,000 businesses that start each year, half will be out of business within five years. Many small business owners will tell you that the burden of government regulation has much to do with whether they survive or perish. While it is rough going at the start, the small businesses that do make it are the major job generators in this country. From 1988 to 1990 small business with fewer than 20 employees accounted for 4.1 million net new jobs, while large firms with more than 500 employees lost 501,000 net jobs.

There is growing national recognition by politicians, economists, and all citizens alike of a disturbing fact -- the burden created by federal regulation falls predominantly and disproportionately on the very people who we rely upon to create jobs: small business owners.

Small Business Owners Want Tax Reform

In addition to my role as President and CEO of NFIB I also served over the past year as a Commissioner on the National Commission on Economic Growth and Tax Reform. In my role on the Commission I represented the interests of small business but I should emphasize that NFIB's members have not voted to specifically endorse the Commission Report. I do, however, believe that

the principles advocated in the Commission's report largely reflect the general consensus of what we have heard from small business about how the federal tax code should be changed.

For instance, our members have told us repeatedly that tax regulations and the compliance burden still rank highest among their problems and priorities. In our most recent monthly "Small Business Economic Trends," taxes and regulations were the top problems facing small businesses in America. In an extensive survey of our members on tax policy ("NFIB Tax Survey"), completed last year, 79 percent of those responding said we should substantially change the federal tax code as it affects both businesses and individuals; 5 percent said the code is generally o.k. as is.

Importantly, our members believe that tax reform should encompass two main facets: 1) lowering taxes, and 2) simplification. In an NFIB tax survey question on the greatest burden created by our federal tax system, the amount of tax paid, at 42 percent, was followed closely by the complexity of the tax laws/rules, at 39 percent.

The Findings of the National Commission on Economic Growth and Tax Reform

The report produced by the 14 member Tax Reform Commission and issued this past January attempts to lay out a blueprint for a completely new tax system in America. How did we design this blueprint? We listened. In 12 public hearings all around the country, in Omaha, Nebraska; Palo Alto, California; Harlam, New York, and other locations we listened to over 120 witnesses, which included a great number of small business owners from all walks of life -- farmers, high-tech entrepreneurs, retailers, accountants and manufacturers who were simply fed up with the current tax code. The Commission received letters from thousands of U.S. citizens, including many NFIB members.

What did the Commission hear? We heard overwhelmingly that the current tax code is irreparably broken. The seven million word mess is economically destructive -- it discourages savings and investment; it's impossibly complex; it's overly intrusive; it's unfair. We heard American taxpayers tell us that they want change -- a completely new tax system in America.

Yes, this sounds overly simplistic, but the idea of throwing out the current system and creating a new one gives us a starting point, a goal. Many have found seemingly limitless reasons to criticize tax reform proposals, -- it'll only benefit the rich, it'll hurt senior citizens, it'll raise the deficit, it'll destroy the housing industry, it'll hurt holders and purveyors of municipal bonds. Not to say these are not valid concerns, because all potential impacts should certainly be carefully considered and examined as we proceed with tax reform. But the problem with many of these critics is that they only know how to criticize. The implication is that they support continuing the status quo.

For small business owners, perhaps the worst thing the government could do in tax reform is have no reform at all.

The current tax code hurts small businesses

What's wrong with the status quo? It's smothering small business. It's a wonder that small businesses continue to survive despite the burden of high taxes and endless tax paperwork.
In a study recently presented in testimony to your committee, Arthur Hall of the Tax Foundation found that small corporations (assets of $1 million or less) had to pay a minimum of $724 in compliance costs for every $100 paid in income taxes -- a total of $28.6 billion in compliance costs for these small business owners compared to $3.9 billion paid in income tax. A truly staggering amount. Additionally, small firms, Hall reported, bear a compliance burden at least 24 times greater than big business.

Statistics, however, do not do justice to the real story told by the thousands to the Tax Reform Commission, or the hundreds of thousands to NFIB. Real small business owners are struggling and even being put out of business every day because of the current tax code.

They have told us that endless paperwork associated with tax regulations takes more and more of their time, allowing less and less time to run their business. They have told us that Alternative Minimum Tax and depreciation calculations mean endless hours of work and high

accountants fees, often for little bottom-line tax benefit. They have told us that the federal estate tax, which reaches 55 percent, destroys a business owner's will to grow a business and preserve it for their heirs. They have told us that the payroll tax represents for the majority of small business owners their largest single tax burden, and a great disincentive to hiring additional employees.

The Tax Reform Commission Recommendations

Contrary to the assertions of some critics, the Tax Reform Commission report makes very bold recommendations. It is important that the report recommendations not be taken lightly. The Commission recognized that there is no single "correct" way to reform the tax code, and so we did not recommend a particular plan. There are many options that could provide revolutionary improvements in the way our government collects necessary revenue. The Commission therefore laid out "The Tax Test" that we believe any tax reform plan must pass:

Six Points of Principle

* Economic growth through incentives to work, save and invest.
* Fairness for all taxpayers.
* Simplicity, so everyone can figure it out.
* Neutrality, so people and not government make choices.
* Visibility, so people know the cost of government.
* Stability, so people can plan for the future.

Six Points of Policy

* A single tax rate.
* A generous personal exemption to remove the burden on those least able to pay.
* Lower tax rates for America's families.
* Payroll tax deductibility for workers.
* Ending biases against work, saving, and investing.
* Making the new tax system hard to change.

What, specifically, does a reform plan that passes this test mean for small business owners?

It means investments can be expensed in the year they are made, rather than depreciated over time -- an enormous incentive for small business growth and an elimination of one of the most onerous tax regulatory requirements -- depreciation. Out of six areas of tax law considered some of the most complex for small business owners (independent contractor, depreciation, alternative minimum tax, inventory accounting, employee benefit rules, and home office deduction), depreciation ranked 2nd only to employee benefit rules as the most complex in the NFIB tax survey.

It means separate taxation of capital gains would be abolished, opening the floods gates of capital to help the business grow.

It means elimination of federal estate and gift taxes -- perhaps the most anti-growth and anti-family tax in today's code. Of nine types of taxes (business income, personal income, FICA, FUTA, personal property, real property, estate and gift, retail sales, and other), estate and gift taxes ranked as the most unfair tax in the NFIB tax survey.

It means enhanced stability in the tax code and greater confidence in business decisions because a supermajority 2/3rds vote would be required in Congress for any tax increase. In a June, 1995 mandate question asked of all 600,000 plus NFIB members, 74 percent of respondents supported a supermajority requirement for tax increases.

And it means a disincentive to job creation is alleviated though allowing full deductibility of payroll taxes for both employers and employees. Of five major tax burdens, payroll taxes were listed as the most costly tax in the NFIB tax survey, just ahead of personal income taxes. Additionally, 53 percent said payroll taxes are less fair or much less fair than business income taxes.

In his testimony, Arthur Hall estimates that major tax reform could reduce the cost for businesses of complying with the current tax code by as much as 95 percent. Harvard University Department of Economics Chairman Dale Jorgenson, also in testimony before your committee, asserted that tax reform could result in an immediate increase in the Gross Domestic Product of 13 percent. With these potential benefits, it is clearly imperative that Congress reform the tax code.

The Transition -- Things to consider

So, tax reform must be accomplished, but how do we get there? Indeed, there are no simple answers, and this testimony does not attempt to provide them. As pointed out in the Commission report:

> Emerson once said that 'The field cannot well be seen from within the field.' Status-quo thinkers are so bent on preserving the present system that they have blinded themselves to the brilliant rainbow of new benefits a new system would bring -- from more jobs to higher wages, to lower interest rates, to greater compliance. These rewards will help ease transition, and help pay for the changes involved.

Yes, we must take care to protect existing savings, investments, and other assets. Some of the issues of specific concern to small business owners are the following:

Treatment of existing debt. If, as under some reform proposals, a borrower is no longer allowed to deduct interest paid on loans, we must consider some kind of grandfather provision that continues deductibility for old debt, or at least makes it easier to refinance.

Treatment of unused depreciation. Possible options are to allow immediate write-off of unrecovered basis, a grandfather for old depreciation schedules, or accelerated depreciation to hasten transition.

Treatment of net operating losses. A grandfather provision might allow continuing to carry the losses forward. Another option would be to allow some kind of a cash-out credit.

Treatment of fringe benefits like health insurance. Losing deductibility would certainly be a negative for small business owners, but, if necessary, this would certainly be a small price to pay for the benefits of complete tax reform. Additionally, it would level the playing field between the self-employed, who currently are allowed to deduct only 30 percent of their health insurance costs, and C-corporations, who today are allowed a 100 percent deduction.

Treatment of mortgage interest deductions. As outlined in the Tax Reform Commission materials, allowing a deduction for mortgage interest while the interest to the lender is taxable is no more expensive than denying the deduction and not taxing the interest to the lender. Consequently, tax reform and transition to it might be made easier by retaining the deduction.

Conclusion

However we handle the issues of transition, which will surely not be easy, it is abundantly clear that America's small business owners, perhaps more than any segment of our society, are ready and eager for change. Small business owners have survived and served as this nation's job growth engine, despite the overwhelming burden placed upon them by today's tax code. By lifting this burden we will allow them to reach their full potential, and be able to see the true power of the American entrepreneurial spirit.

Thank you Mr. Chairman for your leadership on this issue and for holding this important hearing. We look forward to much more dialogue like we have had today.

Chairman ARCHER. Thank you, Mr. Faris.

Our next witness is Mr. Huard. Mr. Huard, you may proceed.

STATEMENT OF PAUL R. HUARD, SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman. I, too, want to congratulate you for holding these very important hearings on the effect of replacing the current income tax on small business.

NAM, the National Association of Manufacturers, has 14,000 manufacturing members and of these over 10,000 are small firms that employ 500 or fewer employees. Therefore, this issue is of particular importance to them. At least one-third of those members are also subchapter S corporations and I, therefore, want to congratulate Mr. Crane for his very strong efforts to redress the situation where a subchapter S corporation can actually pay a rate five points higher than a subchapter C Fortune 500 corporation on its reinvested profits, something which we think ought to be fixed immediately, and then we will reform the system maybe next year.

We believe the single biggest obstacle now to economic growth in this country is the current Tax Code. We think there are two principle reasons for that. One, particularly, for small businesses, which is the subject of this hearing, is the aggregate levels of tax are just simply excessive. When you look at the fact that the vast majority of business taxpayers pay at the personal rates rather than at the corporate rates and you look at the cumulative effect of the personal rates, plus the payroll tax rates, plus lousy depreciation systems, often complicated by the alternative minimum tax, they just don't have the cash flow to reinvest in additional capital equipment, in R&D, in more jobs, in higher wages. The money is just not there. It is going into the tax system, and that is depressing the growth rates in this country.

The other major issue has already been alluded to. I will reinforce it. The compliance costs of the current system are just grossly excessive. I guess, with the Fortune 500 companies, the IRS actually raises more in taxes than those companies spend on computing the tax, but it is certainly not the case with the small business, which doesn't have an in-house tax department and ends up paying professionals to do their returns and spending $3 to $7 I have heard, according to one estimate, for every $1 the IRS gets out of the process. That is just ridiculous.

We, therefore, think that the current system needs to be replaced. It ought to be replaced with a system which, in our view, follows three major principles; simplicity, fairness, and stability. Simplicity is obvious. We have to get rid of these ridiculous compliance costs so that we can raise an adequate amount of revenue without wasting money that could be otherwise used for R&D, for capital investment, for jobs, for wages, and for employee benefits.

Fairness, in our view, means, if you are going to tax income, you should only tax it once. You shouldn't tax wage income twice through the payroll tax and the income tax. You shouldn't tax corporate income twice by taxing the corporation and then taxing the dividends paid to the shareholder. You shouldn't tax income that

saved rather than consumed by taxing again any income it ırns, and on and on.

Finally, stability, perhaps one of the most important elements of ıy significant tax reform. Once you make a decision that you have ıt a system you like that you think is fair, that you think is rea- nable, you should have some kind of super majority requirement that it becomes very difficult to change.

I have watched the process by which the so-called Historic Com- ıct of the Tax Reform Act of 1986 has been eroded. The deal was ıpposedly we will lower the rate and broaden the base. Some of thought, well, are they going to narrow the base when they start ising the rate? Of course, they didn't. The rate, top margin rate income on earned income, has gone up by one-half. It used to be percent. In 10 years it has gone to about 42 percent. So we ink you have to have something that prevents that, and I think super majority voting requirement is essential.

That concludes my testimony, Mr. Chairman. Thank you.

[The prepared statement follows:]

TESTIMONY ON THE IMPORTANCE OF TAX REFORM TO SMALL MANUFACTURERS

BY PAUL R. HUARD
SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

APRIL 24, 1996

Thank you, Mr. Chairman. I am Paul R. Huard, Senior Vice President of the National Association of Manufacturers. It is a pleasure to be here this morning to present the NAM's views on the importance of tax reform to small manufacturers.

The NAM is the nation's oldest and largest broad-based industrial trade association. Its nearly 14,000 members include more than 10,000 small firms having fewer than 500 employees each. Our members are located in every state, produce about 85 percent of U.S. manufactured goods and employ about 85 percent of the U.S. industrial workforce.

The need for tax reform is urgent. We have concluded that the single biggest obstacle to increased economic growth and rising living standards is our impossibly complex and ever-changing tax code. While the problems of the current federal tax system are many, two are of paramount concern: [1] the system's generally excessive levels of taxation on income from work, savings and investment; and [2] the almost universally excessive costs of complying with the system. I will comment on each of these in turn and include some specific observations on the effects on small manufacturers.

The ways in which the current tax code penalizes work, savings and investment are almost too numerous to mention. Here, however, are a few of the more egregious examples:

- Wages, salaries and self-employment income are subject to both income taxes and payroll taxes, and the latter have risen so high that many workers now pay more in payroll taxes than they do in income taxes.

- The regime for taxing capital gains fails totally to reward entrepreneurial risk-taking and, even more perniciously, often taxes as a "paper gain" what is actually an economic loss if inflation is taken into account.

- Our capital recovery system is one of the worst in the industrialized world, particularly in those numerous instances when an already weak depreciation system is further exacerbated by the applicability of the corporate alternative minimum tax [AMT].

- The personal and corporate tax systems are not properly integrated, so that corporate earnings paid to shareholders are doubly taxed.

-- Whether earned or unearned, taxable income that is saved and re-invested -- rather than consumed -- is taxed again and again and again, until withdrawn from savings or investment and consumed.

Let me comment now on how some of these problems are especially harmful to small manufacturing firms. Foremost is the rate of tax on personal earned income. This is important because the vast majority of U.S. businesses pay tax at the personal rather than the corporate rates, because they are either sole proprietorships, partnerships, or Subchapter S corporations. While only a few small manufacturers are sole proprietorships or partnerships, it has been estimated that more than a third of them are Subchapter S corporations.

Tax rates were lowered substantially under the Tax Reform Act of 1986, although even then -- particularly for small manufacturers that tend to be capital intensive -- this rate reduction did not fully compensate for the loss of the investment tax credit and the significant weakening of the depreciation system that also occurred under the 1986 Act.

The governing principle of the 1986 Act -- much touted at the time -- was the trade-off of lower rates for a larger taxable base. Some skeptics at the time expressed the fear that rates would soon be raised again without any commensurate narrowing of the base. This, of course, is precisely what has occurred. The top marginal rate of tax on income under the 1986 Act was 28 percent. Today's top rate -- appropriately calculated to take into account back-door increases through reductions in personal exemptions and itemized deductions -- is about 42 percent, a staggering 50 percent increase! Narrowing of the base has been nonexistent or at best negligible.

The negative effect of all this on a family held capital-intensive small manufacturing firm whose owners pay taxes under the personal rate structure is hard to overstate. In order to grow and create jobs, such a firm must constantly make new investments in plant, machinery and R&D. More often than not, such investments are financed from current cash flow rather than by raising new debt or equity capital. This is where the current tax system is extraordinarily harmful.

Increased personal income tax rates, combined with higher payroll tax burdens and lower depreciation deductions, make retention of profits for reinvestment much more difficult for a small closely held firm than for a large publicly held corporation. Perversely, the large firm will very likely have a lower effective rate of income tax on retained earnings. And in most cases it will also enjoy a lower dependence on cash flow, since typically it will be in a much better position to leverage the present value of a stream of future depreciation deductions into additional capital.

Let me now turn briefly to the issue of the cost of complying with a system whose complexities have grown so byzantine as to be incomprehensible to all -- whether the legislators who wrote it, the Internal Revenue Service personnel who have to enforce it, or the taxpayers who have to live with it.

Few would challenge the proposition that the costs of complying with the current federal income tax are grossly excessive. This is especially true of smaller firms which tend not to have in-house tax departments. One Tax Foundation study estimated that small corporations having assets of $1 million or less paid <u>over seven times more in compliance costs than in actual taxes</u>! That's at least $7 billion in compliance costs for each $1 billion in taxes collected from these firms.

In a recent survey of the NAM's small manufacturing members, more than a third of the respondents identified the IRS as the federal agency for which their compliance costs were the highest. The IRS ranked higher than all other agencies, including EPA and OSHA.

The bottom-line effect of excessive compliance costs to a small manufacturer -- who as I mentioned previously is likely to be extremely dependent on current cash flow -- is less money for new machinery and equipment, less money for R&D, and less money for higher wages or additional jobs.

That's why tax reform is so urgently needed. The NAM believes a reformed system should have the following characteristics:

-- Simplicity. What's needed is a simple low-rate system with relatively few deductions or other adjustments, so that the many billions of dollars currently wasted on complying with the current system can be applied to more productive uses.

-- Elimination of Multiple Taxation. Income once taxed should not be taxed again just because it is saved or reinvested rather than consumed. Wage income should not be subjected to both income and payroll taxes. Similarly, business income should be taxed only once so that, among other things, corporate profits paid as dividends should not be taxed to both the corporation and the shareholder. Further, business taxes under any new system should be compatible with those of our trading partners so that, for example, American exports are not double-taxed by the U.S. and the destination country.

-- Stability. Present taxes are both disliked and hard to deal with in large part because they are in a constant state of flux. Procedures such as supermajority voting requirements should be adopted to ensure that future revision is both difficult and infrequent.

Adoption of a simple tax system that taxes all income but once and that is not biased against work, savings and investment should be one of the nation's highest priorities. The resulting dynamic increase in economic growth would benefit businesses and their employees alike. We can see no other way to improve incomes and living standards for all Americans while at the same time maintaining the global competitiveness of U.S. businesses, especially small manufacturers.

Thank you, Mr. Chairman. That concludes my prepared remarks on this subject. I would be pleased to address any questions you or other members of the Committee might have.

Chairman ARCHER. Thank you, Mr. Huard. Our last witness on this panel is Mr. Kearns. Mr. Kearns, you may proceed.

STATEMENT OF KEVIN L. KEARNS, PRESIDENT, UNITED STATES BUSINESS & INDUSTRIAL COUNCIL

Mr. KEARNS. Thank you, Mr. Chairman. We appreciate these hearings today, and last year you held another excellent set of hearings on tax issues of concern to small business.

I represent 1,500 companies in the U.S. Business & Industrial Council and a sister organization of 250,000 grassroots members in the Council for Government Reform.

We believe that the two largest impediments that small and mid-size businesses in this country are facing are overtaxation and overregulation. Overregulation is an issue for a different hearing and a different set of circumstances.

I think my value added to this hearing, to add to all of the things that have been said this morning, is maybe to step back and point out that in one generation the United States has gone from the world's largest creditor Nation to the world's largest debtor Nation. It is clear that savings and investment in the United States are the lowest among the industrial world, lowest among our rivals.

We have seen a decline in the size, the number, and the size of the wealth of American corporations involved in manufacturing and a serious decline in the number of manufacturing jobs in this country. I think it is imperative then that we, as a nation, stress the importance of investment-oriented tax policy.

There has been a longstanding bias in our tax policy against savings and investment, and the effects seem to be accelerating. In things like capital gains taxation, our major competitors in the world have either nonexistent or very low rates of taxation on capital gains.

If free enterprise is to survive in this country, as we know it, and the Nation's citizens are to enjoy a high standard of living, we simply must reform the Tax Code. Citizens must be allowed to retain their earnings and be given incentives for investing in the productive future as opposed to consuming and spending.

The estate tax, I want to point out, in particular, is a very onerous tax on small businesses. It successfully targets family-owned businesses. It makes it nearly impossible for a business to get from a first to a second generation and even more difficult for a business to get from a second to a third generation.

It certainly discriminates against many of my members who work in family-owned businesses and have put in almost a lifetime of work waiting to inherit the business from their parents without a true ownership share of the business.

When the estate tax hits on the death of the principal owner, these people are, in effect, disenfranchised. All of their hard work is for naught.

The estate tax forces liquidation of these businesses. It causes business failure as heirs struggle to comply with IRS regulations and to pay the tax. It curtails the growth, and it harms the entire American economy.

I think that often, too often today, the owners of successful family businesses are forced to sell out to larger corporations, and we

are seeing a change in the scale of businesses affecting many communities. The businessowners that I represent, as Mr. Faris has pointed out with his businessowners, are the bedrocks of their communities. They are large fish in small ponds. They are large-scale employers. They have a different relationship with their employees than managers, say, or directors of Fortune 500 companies who can lay off 40,000 people that they have never seen.

Our members employ people in the communities. They worship together. They shop at the same grocery stores. Their kids go to the same schools. So preserving these businesses is actually a way of preserving American communities. It is very important in farming and ranching that rural America, the way of life there, be preserved by eliminating estate taxation, capital gains taxation on these businesses.

We have five tests for a reformed Tax Code. It must be simple. It must be fair. It must be stable and allow businesses to plan. It must be neutral, so that government is not a large factor in the businessowners trying to plan the direction of his business, and taxation should be visible so all Americans know what they are paying in taxes.

We have not made a final decision about the shape of a reform tax, whether it be flat tax, consumption, and so forth. We tend, at this point, to favor a consumption tax, but it is clear that we need complete reform of the Tax Code. We need government out of our business decisionmakings, and we need to free the American businessmen to compete in this globalized marketplace that we have created in America through our trade agreements.

Thank you, Mr. Chairman.

[The prepared statement follows:]

UNITED STATES

BUSINESS AND INDUSTRIAL COUNCIL

Americans Need and Demand Tax Reform

Chairman Archer and Members of the Ways and Means Committee, thank you for inviting the United States Business and Industrial Council (USBIC) to testify on tax reform.

The U.S. Internal Revenue Code is a bureaucratic nightmare that must be reformed if American businesses are to compete successfully in the 21st Century.

In one generation, the United States was transformed from the largest creditor nation in the world to the largest debtor nation, with a national debt of over $4.7 trillion dollars. Tragically, the United States has the lowest rate of savings among the industrial nations and the lowest percentage of capital investment in new plant and equipment. With accelerating de-industrialization has come the loss of world leadership in key industries, obsolescence in industrial facilities, a decline in the size and wealth of American corporations engaged in manufacturing, and a serious decline in the number of manufacturing jobs.

Therefore, USBIC holds that it is imperative to stress the importance of an investment-oriented tax policy. There has been a longstanding bias in U.S. tax law against savings and investment whose effects are now worsening. The economy will not improve without strong incentives for investments in private sector projects; there will also be a concomitant diminished ability to grow and fewer jobs.

Rapid capital formation is the key to a prosperous economy. Unfortunately, U.S. tax policy discourages capital formation. If free enterprise is to survive and the nation is to enjoy a high standard of living, capital formation must be encouraged. Citizens must be given incentives for investing instead of spending. The creation of such incentives means allowing citizens to retain their earnings. Therefore, USBIC believes in tax reform that will encourage capital formation. A full scale reform in the form of a consumption tax, for example, would dramatically simplify the tax code and encourage savings.

Regardless of the form that a new tax code would finally take, USBIC advocates complete and immediate repeal of the federal estate tax.

American Business and the Federal Estate Tax

Today, when a business owner dies, the federal estate tax confiscates 37 percent of his assets valued between $600,000 and $1 million, rising to 55 percent of his assets valued more than $3 million. Gifts valued at more than $1 million to grandchildren are taxed at 55 percent. Many, if not most businesses are crippled severely or closed by this unfair tax hit.

USBIC strongly believes that taxing a business just because its owner died, even though he had payed taxes every year of his life is not only wrong, but immoral – and it damages the entire American economy.

The federal estate tax ought to be repealed immediately for two reasons. First, family-owned and closely-held businesses are the backbone America's economy and a bedrock of America's culture. They must be preserved. Second, excessive estate taxes prevent business owners from giving the fruits of their lifelong labors to loved ones, destroying businesses, jobs, and communities in the process.

Clearly, repealing the federal estate tax represents an investment in the future of families, businesses, and communities.

Estate Tax Relief: Good for Business, Imperative for Our Economy

Close examination of the federal estate tax code reveals extremely disturbing facts about the "philosophy" behind the code and about the harsh reality and harmful effects of this particular tax. Let us discuss the negative aspects of this onerous estate tax in detail:

- **Targets successful family businesses** – The federal estate tax unfairly singles out family-owned businesses. It confiscates a massive 37 percent of assets valued between $600,000 and $1 million. Assets valued above $3 million are taxed at an outrageous 55 percent! Publicly-held businesses are not subject to this tax.

- **Discriminates against the successor generation** – The heirs to a family business have spent their entire adult lives building value to the concern through "sweat equity." The estate tax wipes our heirs' years of contributions to the business in one instant.

- **Forces liquidation** – Successful family enterprises are often "ownership-rich" but "cash-poor." Estate tax bills force heirs to liquidate a business, often which they have worked in their entire lives with the expectation of inheritance

- **Causes business failure** – When a business owner is determined to pass his business onto the next generation, it is often impossible to pass the business on intact. The costs of insurance, estate planning, legal fees, and accounting fees often turn a profitable business into a marginal one.

- **Curtails growth** – The Tax Foundation, a respected economic think-tank, concluded in a recent study that the current high rate of the estate tax produces the same disincentives to growth as ***doubling*** the current income tax rates.

- **Harms the economy** – Although the estate tax takes a toll on family entrepreneurs, the toll on the American economy is much greater. This burden on our nation's most productive citizens eliminates jobs, permanently damages communities that rely on their businesses, and hampers our nation's international competitiveness.

The last point is of critical concern to USBIC members.

Owners of successful family enterprises often are ownership-rich but cash-poor. Therefore, the opportunity to maintain the family business is often limited to developing incentives for their heirs to remain actively involved in the management of the business. Unfortunately, the only other alternative often is to sell the enterprise to a larger business organization.

USBIC is concerned about the structure of an American national economy increasingly dominated by large-scale enterprises. Tax policy should not operate so that family-owned businesses must be sold to satisfy estate tax obligations. Attempts at reforming U.S. Code Section 2036(c) were largely unsuccessful in this respect. Because of discrimination against families in the tax code, greater numbers of small and medium-sized businesses, farms, and ranches will increasingly be acquired and controlled by large corporations.

The Council believes that America's family enterprises are tremendously important to the economic and social structure of the nation. These businesses have become the most fertile environment for the innovations that have accounted for the United States' success in the international trade arena. Most Americans undoubtedly believe tax policy should promote the health of family businesses, including family farms and ranches. However, tax laws discriminate by making it difficult for a family business to pass from one generation to another.

Nearly all new jobs are created by family-owned and closely-held businesses, not large corporations. In fact, Fortune 500 companies have failed to create a single new net job during the past 15 years.

Furthermore, this federal "death tax" is the main reason why fewer than one-third of the family owned businesses are successfully passed from the first generation to the second, and why only one in

ten family-owned businesses is successfully passed from the second generation to the third.

Unfortunately, when the business is sold to pay estate tax debts, it is often purchased by an out-of-town, large-scale corporation, which proceeds to lay off employees because of job duplications created by the merger.

It is much easier for out-of-town employers to lay off workers unknown to them. These layoffs affect the entire community. Sales drop at department and grocery stores. Restaurants and other entertainment businesses lose revenue. These losses, in turn, inhibit new job creation in the community.

Family business owners know their employees and maintain personal relationships with them. They worship together, shop at the same grocery stores, and send their children to the same schools. In short, employees are not just arbitrary numbers to the local business owner – they are neighbors.

Finally, USBIC is also concerned about the basic issue of fairness in an economy in which entrepreneurial opportunities are denied to succeeding generations in order to raise the relatively small sum of a few billion dollars in estate taxes.

Penalizing those family members who worked to build a successful business is obviously a short-sighted, short-term approach to revenue generation – one which will actually decrease revenue over the long term.

The American People and Tax Relief

The American people have been sending Washington loud and clear signals over the last several years. They demand LESS government, LOWER taxes, and MORE control over their own destinies. These demands have been building throughout the country, and clearly have emerged as national issues today.

Anti-government sentiment among the American public is stronger than ever. People are convinced that governmental programs and policies such as estate taxation are wasteful and harmful. In addition, the general population does not believe the government has the ability to operate efficiently or even accomplish its stated policy objectives. Consider the fact the more young Americans believe in UFOs than believe that they will receive Social Security in their own lifetime.

Public concern about the consequences of excessive taxation is great. People are "pre-sold" on the notion that most taxes are unfair to some people and that widespread reform is needed to correct injustices that have crept into the tax code.

Let us further look at the injustices of the federal estate tax.

In 1994, the federal government received $15 billion in estate tax revenue of which 12% was collected from closely-held businesses. In fact, the entire $15 billion sum represents less than 1% to total federal receipts. Collecting this less-than-1-percent of federal revenue resulted in the destruction of 8 percent of Americans' savings.

Furthermore, the federal estate tax is so complex that it comprises 82 pages of the U.S. Internal Revenue Service Code and an additional 289 pages of Internal Revenue Service Regulations. This complexity results in endless litigation. More than 10,000 federal estate tax-related cases are pending before federal courts.

As a result, the IRS spends an inordinate amount of time and money processing and enforcing the federal estate tax statute. One estimate shows that 65 cents out of every dollar raised from the federal estate tax is spent on enforcement and compliance. Instead of protecting local private sector jobs, the federal estate tax just provides guaranteed employment for IRS bureaucrats.

The outcome of spending so much money on enforcement and compliance is that the federal government would be able to raise significantly more money over the long term if the estate tax was repealed. Economists Gary and Aldonna Robbins show that net federal revenue would have been $21 billion more and the America's stock of private capital $400 billion higher in 1991 if the federal estate tax had been repealed in 1971.

During the same twenty-year period, America's Gross Domestic product would have increased

by almost $50 billion and over 250,000 new jobs would have been created had the transfer tax been repealed. Over the next seven years, the stock of private capital is projected to increase by $630 billion coupled with the addition of nearly $80 billion to the Gross Domestic Product and more than 225,000 newly created jobs.

Finally, because the 1981 increase in the exemption of federal estate tax to $600,000 was not indexed to inflation, this exemption is now worth less than $380,000 in 1981 dollars.

Clearly, the cost of this business-destroying tax far outweighs the benefits to communities and the economy.

The reconciliation bill vetoed by President Clinton increased the personal exemption from $600,000 to $750,000 over six years, a step which merely addresses the effects of inflation. It also allowed $1 million in family-owned business assets to be exempted and gave a 50% tax break on the next $1.5 million in assets. These provisions of the reconciliation bill represented an excellent down payment on total estate tax repeal.

Estate Tax Repeal Legislation: An Overview

Legislation introduced last year and supported by USBIC should be included in any comprehensive tax reform legislation considered by Congress.

The Senate version, S. 628, introduced by Senator John Kyl (R-AZ), and the House version, H.R. 784, introduced by Representative Chris Cox (R-CA), repeal all provisions of the estate tax code and allow family-owned and closely-held businesses to be willed by a deceased owner without the recipients incurring any additional tax liability as a result of the transfer.

These bills have solid support in Congress. S. 628 has eight cosponsors and H.R. 784 has 90 cosponsors.

Conclusion

The Congress should reform the U.S. Internal Revenue Code in its entirety immediately. A consumption tax would alleviate nearly all of the inequities in the current tax structure. Any tax reform plan, however, should repeal the federal estate tax.

Let me again remind the Members of the Ways and Means Committee of the consequences associated the federal estate tax:

- Targets family business with double taxation
- Forces liquidation of family business
- Causes business failures
- Harms the economy

The current repeal proposal is the best viable plan to address the real issues concerning estate tax relief.

USBIC's fundamental position is that estate tax relief is critical for the long-term health of the American economy and that legislation aimed at total repeal <u>must</u> be enacted at the earliest possible opportunity.

Please ensure that American business will have the tax code it needs to compete in the 21st Century. Simplify the tax code and repeal the federal estate tax.

Chairman ARCHER. Thank you, gentlemen. We thank all three of you for excellent input for the Committee. You represent probably a majority of the employers, the job creators, in this country between the three of you, I would think and, as such, represent one of the most important aspects of our economy, because jobs and the opportunity to produce and to move forward in one's individual life economically is what it is all about for almost all Americans. So I attach a great deal of weight to your testimony.

You, also, are individuals, as all of us are in this country, and we wear two hats, basically. We can have our own profession or our own business interests, but we are still individuals. We are individual taxpayers. We are individual voters. We are really, as individuals, the core of what makes this country great. The one thing that people seem not to talk about is what value do you place on individual freedom and privacy as individuals? Because all of the people that you represent are individuals, and all of the people that they employ are individuals. You, also, have to deal with the tax system.

It is my belief that the hallmark of America is individual freedom; that that is a basis on which this country was founded, and it still remains the beacon for the entire world. I am coming to the point of asking you what you, personally, individually would attach as a value to the freedom of not having to deal individually with the IRS in your lives each year?

Mr. FARIS. Two answers, Mr. Chairman. First, I am here to speak for the National Federation of Independent Business and small business owners.

Second, I tried last year, Mr. Chairman, to do my own taxes, again, after being in business for a number of years and selling the business and after spending the next 3 years trying to get the government to understand that I am not in business any more, and they kept sending me the forms, and they kept sending me the letters and the threats. And, in doing so, I learned to go back to my friendly entrepreneurial CPA and to save me a load of grief, and the load of grief was trying to get one piece of information corrected.

I called IRS, and I found out what it is like to hear various kinds of music, listening and waiting for the next machine to answer, to tell you the 12 different options you have, which you cannot remember. You have to call back again, and then when you do get the recording, the recording tells you all of the things you have to have to answer the questions, and you don't have all of that information. So you have to call back again. And then when you do, you get a recording that says, "We will call you back," and then 4 days later at 2 o'clock in the afternoon at my home someone called me back with a message on my machine that said, "Start all over again."

We seriously need to do something. I have met with the Commissioner of IRS. She is, I think, trying her very best to simplify, to do what she can as a Commissioner, but we have so far to go from the lifestyle audit intrusions that we have today, from the guilty until proven innocent attitude that I am personally incensed by, and I can tell you it represents the 600,000 small business owners that are members of NFIB. It must be dealt with, but it must be

dealt with in a very careful way, and hearings like this are incredibly important for it.

Thank you, Mr. Chairman.

Chairman ARCHER. If I may, and I know you are here to represent your groups, but I just am curious to ask each of you individually what it would be worth to you each year not to have to deal with the IRS in your individual lives. Can you quantify that and place an economic value on it? Mr. Huard.

Mr. HUARD. I don't know. If I had to place an economic value on it, I would probably be willing to pay, certainly, several thousand dollars to avoid the aggravation. I prepare my own tax return. I have a master's degree in tax law, and it is a matter of personal pride with me not to pay a preparer to do it.

But I can tell you that the amount of aggravation—and I am using a polite society word—that I have to put up with to deal with the kiddie tax, to deal with form 8606 because I happen to be too rich to take deductible contributions to an IRA, but I used to be able to, so now I have a mixed IRA with some deductible and some nondeductible contributions, schedules A, B, C, D, SE, all of which require multitiered calculations because nothing is ever simple anymore. On your self-employment income now you used to be able to pay at one rate, but now they took the cap off on the Medicare tax so you get to do two—and it just drives you crazy. I regard it as hugely intrusive, and totally unnecessary and largely the result of revenue scrounging because now they have got to get a little more here and they have got to get a little more there, and so you build little boxes and fences around deductions and credits. It is despicable, in my judgment. I would pay a lot to get rid of it.

Chairman ARCHER. Mr. Kearns, what, in your judgment, would be the value to you, personally, to not have to deal with the IRS each year?

Mr. KEARNS. I would like to answer the question on two levels. I don't own a business, but I run one, U.S. Business & Industrial Council. It is a not-for-profit business, but it is still a business, and we have to have our audits, file our tax returns, and so forth. The IRS last year audited us twice, once on our pension accounts because many nonprofits were not in compliance. We were. And they were going to audit the general business. They rescheduled that audit three times. Three times we prepared for it. Each time they canceled. We have not been audited to this date. I don't want to spend the time on the audit, but certainly our books are in order.

So that means, personally, in my business, there were maybe 100 to 200 hours, somewhere, spent complying with IRS audits, and so forth, that I could use to get my message to more people, to write more letters to the Hill, more testimony, and so forth.

On the personal side, I, also, do my income taxes for myself and my wife. I look simply at that as the number of hours I spend doing that is a number of hours that I should be spending with three young girls who are deprived of so many hours while their father is off trying to comply with government regulations, and that should not be.

Chairman ARCHER. Would you value that? For the Committee, would you put a value on it?

Mr. KEARNS. Put a value on it?

Chairman ARCHER. Annually.

Mr. KEARNS. I don't know. In the business aspect, it is probably tens of thousands of dollars, and it is maybe $10,000 on the personal side.

Chairman ARCHER. I intend to ask every witness that comes before this Committee this question. I have done it in the past. In the last panel before this Committee, the minimum response was what I pay my tax preparer I would pay not to have to deal with an income tax every year. The maximum response was a middle-income woman from Connecticut who said she would give her first-born child. [Laughter.]

But I do think it is very important that we get beyond just the economic impact on the interest that we represent and we, also, begin to try to quantify individual freedom and privacy and look at that as a factor in whatever we end up with as a product because it most certainly is worth something and to different people worth differing amounts.

Thank you very much for your testimony.

Mr. Gibbons.

Mr. GIBBONS. I listened with great interest to each of you and what you had to say. Mr. Faris, I want to sit down with you and your folks one day and talk with you seriously about changing the tax system. I offer that request to each of you there at the table because I think that we have made some fundamental errors in our system. First, is that we have tried to do economic engineering and social engineering in the revenue system. Second, we have picked out the wrong measurement of how you collect revenue for the Federal Government. By going to a system of income, as vague as that is, has caused all kinds of distortions in the system and, having participated in it longer than anybody on the Committee here today, I feel guilty for what has been done.

I might remind you that I participated in the 1986 tax activity and got unceremoniously and roundly booted off the conference because I disagreed so strenuously with the conferees in that 1986 committee legislation. So I don't feel any guilt at all about 1986. Yes, Mr. Huard, you got screwed. You knew it was going to happen, and it did.

I have come to the conclusion that what we need is a simple measure of what we pay taxes on, and I think consumption is the easiest tax to pay it on. Mr. Faris, your constituents would not pay any tax as a business, but they would have to collect the tax. Somebody has got to collect the tax, and they would remit it. Simply, they would just have a set of books like you would have it in, say, a small upholstery shop, a one- or two-person upholstery shop. Let's take that as an illustration.

They sell a service. They put covers on chairs, and furniture, and things of that sort. At the end of the taxpaying period, they would simply add up all of their vouchers as to what they had charged people. They do that anyway in order to keep track of whether there is any money in the bank that they can draw out.

They would then add up all of their purchases of all of the materials, supplies, and rent, and everything else that they purchased to run their business, and they would subtract their purchases from their sales, and then they would multiply what was left over

by the tax rate. If the purchases happened to exceed their sales during that taxpaying period, they would get a check back from the government. That is the way all other countries on Earth, except the United States and Australia, already work with a value-added tax.

If their sales exceeded their purchases, they would merely send in a check for their tax, and they would have collected the tax in the sale of their product.

There is no particular tax upon them, and they would have subtracted out all of the taxes that other people had paid on the same products as they come through the whole chain. It is probably the simplest system and the fairest system, and you would have one simple rate for all people, regardless of the kind of business they were involved in, and one simple rate, the same rate, which would be paid by all of the consumers.

So I would like to spend some time with you. I don't want to impose this on top of the payroll tax system or the income tax system that we now have. I would like to repeal all of those and replace it with a simple value-added tax. So that is what I am about doing. I would simply like to have the time to sit down and talk about it freely with you and any staffers that you have, and the same applies to Mr. Kearns and Mr. Huard.

So thank you for this opportunity. If you would like to respond, I would be happy to hear from you.

Mr. FARIS. Congressman, we would love to sit down and talk with you about tax reform. It is near and dear to our hearts. It has been at the top of our members' concerns for a number of years. So we would very much like to do that.

My counterparts from around the world who have a value-added tax tell me some things that put fear in my heart. So I look forward to talking to you about what it does to labor-intensive businesses.

Mr. GIBBONS. I can understand the fear in their hearts because I know the Europeans came about this system in a very awkward manner, and they had all different kinds of rates for different kinds of products and everything else, and they have finally begun to straighten their system out. The more modern systems exist in Japan, New Zealand, in places like that, not in Canada. The Canadian system is a mess. Even the people who put it in place know that they made a hell of a mistake.

But you can have a simple system of taxation based upon consumption, not upon income. It would make you much more competitive in the domestic, as well as the international, marketplace.

Mr. HUARD. I would say to you, Mr. Gibbons, that we certainly have an open mind on the design of any replacement tax system and, indeed, properly measured, value-added tax is a variation of taxing income. You add up what you spent, and you add up what you took in, and hopefully the second figure is bigger than the first. We, certainly, would be very pleased to discuss with you any simple systems that meet the tests we outlined of simplicity, fairness, and stability.

On a personal note, I want to assure you that I remember quite clearly your principled stand in 1986, and I personally absolve you for any blame for what happened.

Mr. GIBBONS. Well, thank you. I appreciate the absolution.

Chairman ARCHER. Are there any further inquiries?

Mr. McCrery and then Mr. Rangel.

Mr. MCCRERY. Mr. Faris, just a quick question. You said that your organization was flatly opposed to a value-added tax, but I think you said that they were open to a national sales tax. Did I understand that correctly?

Mr. FARIS. Yes, you did. Yes, sir.

Mr. MCCRERY. Thank you.

Mr. FARIS. I want to, if I could, Mr. Chairman, thank the Congressman for leadership in trying to abolish a death tax. It may be an inheritance and estate tax to some. To our members, it is a death tax set up to keep the Rockefellers and the Kennedys from passing along their wealth, and what it is doing has killed small businesses and their families trying to liquidate the assets of the business on the death of the owner who spent a lifetime building the worth of the family. I thank you and applaud you for your leadership, Congressman. I look forward to the death tax dying.

Mr. MCCRERY. Thank you, Mr. Faris. I appreciate the assistance of your members, too, in crafting that proposal that Senator Dole and I managed to, with the help of our colleagues on this Committee, get into the bill that the President vetoed. If he had signed that bill, small businesses, family-owned businesses, would have a much better time of it today.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you. Let me thank all of you for your testimony because I think that more and more, as the Nation moves toward high-tech jobs, it is going to be very, very important that we do encourage our small businesses that provide most of the jobs in America to be very, very supportive as we try to streamline everything.

Mr. Faris had indicated that my friend, the Chairman, had 100 percent voting record for small business. Well, I don't know what mine is, but I do hope that it would be 100 percent in terms of the things that just make a lot of sense that causes so many people to leave the system because of the complexity, and we know that the greatest thing going for an income tax system is that it is voluntarily done.

So I want to work with you on that. This idea of pulling things up by the roots and changing the Constitution I am not up to that speed yet. So I hope that, while you are considering these alternatives, that we would do like Mr. Huard did, and that is that he felt the pain with each and every problem that he had in dealing with the tax system. If we could find someone like you to pull out that pain and help us to try to see whether or not that complexity is necessary to have a fair system.

There is nothing that any of you have said, in my opinion, just based on your testimony, that we cannot change without pulling out the system. And if we could find out exactly where that pain is being caused, we can review that, as you look over the other options, whether or not a small business is 50 employees, as Mr. Faris says, or 500, as someone else said, or includes the Fortune 500s, we have to deal with that. If you are looking at a small business, you have to tell us, you have to have pensions there. Should

we give any incentives for the pension plans? You have to have health plans. Should there be incentives for the health plans? In order for us to help, there should be things that you would want us to do. But you can't have fairness all of the time and simplicity, and we just have to find out how we can do it on balance to encourage small businesses to still be the oasis for opportunity for young people in the community that get their start.

I want to be working with you, and I hope that, as you have pointed out your legitimate complaints, and as you review the offer that has been made to you by Mr. Gibbons, that you not forget that we do have this system, and this system is not going to be changed any time soon. So spend some time seeing how we can make it easier now, and then you don't have to forfeit the amendment of the Constitution or pay taxes. Or how much would you pay to kill the tax collector or how much does it cost you emotionally if you paid no taxes? Those are things that we can deal with later. But right now I hope that you can get together with your accountants, but we can work with the part that caused you to spend so much time and so much money for something that is unproductive. So I want to work more closely with you, too.

And, if you have my record with you, Mr. Faris, if it is good, you can say it aloud. If it is not, we will talk privately.

Mr. FARIS. Congressman, I am pleased to note your record. You do have a 100-percent record, but it is the wrong direction. [Laughter.]

I don't know how you did this, but you came up with an absolute zero. Mr. Gibbons got 10 percent, so he was multiple thousandths percent better than you last time. We look forward to working with you because, if we can get you just up to Mr. Gibbons' record of 10 percent, that will be greatly helpful.

Mr. RANGEL. Well, I have always found it is how you pick the questions in terms of what you count for percentages, and so I would say this, if the question still would give me a zero or less than zero, I would feel comfortable if I could work on those areas that make it easier for small businesses to fill out the returns, to make it more simple, and it won't be the percentages. It is knowing that I will be working with you no matter what's there because I don't care what district you are from, it is small businesses that we will be depending on to give the hope for those people to have jobs and dignity with it. So I look forward to working with you.

Mr. FARIS. Congressman, if I could respond to two things you said. I grew up in a service station, and I think you may be old enough to remember what a service station used to be. I grew up in one of those in Pensacola, Florida—Mr. Gibbons' good State—and my dad sometimes would tell me, when a car came in to be repaired, "Son, this is one we need to save the accelerator pedal and move in everything else new." I would suggest to you that our Tax Code is in that bad of shape. We need to keep the fact that we are going to have to have Federal taxes. We need to have people employed to collect those, and we need to have a system to do it. But we need to start with a clean sheet of paper and not try to find out how to fix all of the maladies with the present vehicle. We need to start out and build a clean vehicle from scratch and then figure out how to transition to get there, which will be more complicated

than we have now, but at least we will have an end game that makes sense.

There are things we can do right now, and they are not just doing away with things. Some of the things that we are for in small business will add things. They help create new jobs, which would solve a lot of problems coming before the Congress today.

I know, in our visit with the Kemp Commission to your district, we had some people testify that was some of the most impressive testimony, with all due respect to the Chair and others who testified in this room, as a matter for the Kemp Commission, eloquent testimony on the need for a brandnew system. So we do look forward to working with you, Congressman, and to do what we can to help the small businesses in your district and all around the country.

Mr. KEARNS. If I may just add to that, Mr. Chairman. I agree with everything Mr. Faris just said. However, if there is a weigh station on the road to total reform, I would again come back to estate taxation of small businesses. If we were trying to design a system to make sure that small businesses don't survive from one generation to the next, it is the current estate taxation regime. So, Mr. Rangel, if we want to take at least some small steps, make a downpayment on reform, I would recommend the abolition of estate taxation in the case of small businesses.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. Mr. Faris, I would just like to make a very quick comment. I wish your father had said, "Let's save the brake pedal," rather than the accelerator pedal because we have accelerated our whole tax system, and we should have been braking it all of these years. Thank you.

Mr. FARIS. We will miss you, Congressman.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Faris, until we get to a reformed Tax Code by pulling it out by the roots and eliminating the 16th amendment, we are taking small steps to try to reform the Tax Code and make it more small-business friendly. One of those areas is independent contractor legislation that you all three have been so intimately involved with.

I would like you to just touch on what is happening out there with small business owners, independent contractors and the nightmare that we are experiencing with the IRS and what some of your members have told you about that area and what we are trying to do to reform it.

Mr. FARIS. It is so good to have an NFIB member who has signed the front of the paycheck and knows that responsibility serving on this Committee as a new member. We appreciate your leadership on the Independent Contractor bill that you are bringing forward and are taking the point on.

In the meeting with the Commissioner of the IRS the other day I asked her to get a couple of people from Treasury down, and maybe we could get you over to her office and spend a day coming up with a bill we could all agree on because everybody agrees we need to clear up the independent contractor status.

So, after that meeting, the Commissioner sent me over their new guidelines for their agents on handling independent expenditures.

There are many cities in America whose telephone book is smaller than this. This was over an inch thick just to help the agents figure out what to do about independent contractor status. So for small business, this is a huge issue. It doesn't have to do with paying taxes. It just doesn't make sense to keep changing the rules on us, have an independent contractor OK one day, and the next day they are called employee or they are called an independent contractor and 3 years later they come back and say, "Well, we disagree with that person, so you owe all of this money."

It is a big issue for us, and we appreciate your leadership. We look forward to the administration and everyone getting behind passage of that bill.

Mr. CHRISTENSEN. It is a small step, and it is a step in the right direction until we are able to reform the Tax Code entirely. But, Mr. Chairman, I would just applaud NFIB and everyone out there that is working hard on this issue to take this small step and to help 4½ million small business owners out there get out from under tyrannous-type effects of the IRS and what they have done to hurt small business in America, and I think it would be the right step if this Congress, known as a small business Congress, could put this legislation into effect and see it put on the President's desk for probably a veto, since he has sold out to the big labor union bosses anyway.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman. I want to thank all of the witnesses, too. Your input is extremely valuable, and especially in this town.

There was a quotation from Benjamin Franklin once, "A good example is the best sermon." And I remember growing up my dad counseling us as kids, "You don't live beyond your means. You don't squander your paycheck on instant gratification at the end of the week. You put it away for the proverbial rainy day. You work and try and leave it better for your kids than you found it for yourself." My dad grew up hard scrabble, and he insisted we all work and save. We did follow all of those guidelines, and so I was trying to impart that to my son when he got his first paycheck. I said, "Now, don't blow it on instant gratification. Put something away for that proverbial rainy day," and he said, "That is nuts, Daddy."

I said, "Nuts, George? What are you talking about?"

He said, "If I blow it on instant gratification, they only get at it once."

Now you save your money, put it into Motorola stock, and when they get taxed, a second hit, dividend distribution, a third hit, sell your stock and enjoy a capital gain, a fourth hit, and the ultimate obscenity in the Code is when you have the audacity to die and leave them, and they come in and bash your loved ones.

No, our Tax Code does violence to all of the values that we were brought up with and all of the values which we still try and impart in our kids. Yet, my son was picking up from his experience in this world, notwithstanding my efforts at counsel and guidance, and what he said makes sense. Why do you want to let them get at it more than once? Have a good time.

But I think we are on the slide to paying for that and paying heavily in terms of retarding the kind of economic growth that you people are promoting. That means more opportunities, but it means going back, I think, to basic values, and I commend you for all you have been doing.

I thank you, Mr. Huard, for your support and input on H.R. 2911. But, ideally, I would eliminate any taxes on business whatsoever.

Chairman ARCHER. Mr. Kearns.

Mr. KEARNS. May I just add one thing, Mr. Chairman, and that is that a businessman who is in a small business and facing this estate tax or this death tax has very little incentive to continue to plow those profits into the business. At a certain point, he is going to say, "The more I put into the business, the more the government gets. Why don't I consume it now?" So we couldn't agree more, and the estate tax is a very pernicious example of exactly what you are talking about, Congressman.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. Gentlemen, it is great to hear you talk to us about the needs and the efforts of small business, and particularly your talk about estate taxes. This bill that I worked on, along with Senator Dole, Mr. McCrery, and others on this Committee is a very important first step for a lot of us who want to get to, as Mr. Crane says, the zero line. It is a way to begin to ratchet on behalf of small business and family-owned, closely held businesses toward that goal.

It doesn't take us very far, not nearly far enough, but I think it is very important, as a first step, and I guess the problem I have with all of this is that I have seen it happen so many times in my own district east of Seattle, Washington, and particularly in the rural areas, where, for example, owners of small timber farms, upon the death of the owner, are forced to harvest old growth timber to pay the costs of the burden of estate taxes, and that is in nobody's best interest, and it is a onerous tax. It results in that sort of catastrophic action.

I don't understand the voluntary nature of this whole thing, by the way, gentlemen. I wish somebody would explain to me why we are saying that any kind of a tax is voluntary. I think people go to jail if they don't pay taxes. So, to me, that is not voluntary.

But my big concern here is with the constant obstacle that we face in the White House right now, and that is the veto of the estate tax. I guess I would like your guidance on what do we do to make the President understand the worth and the value of continuing small business in communities, the greatest producers of jobs, for example? How do we get the message across to him that this is the kind of tax relief that we need to move forward with and not stop? What are your suggestions?

Mr. FARIS. It seems that this President, and I am sure it was true of many others before him, can read and understand what the polls tell him and about the phone calls, letters, and cards that come in. What we found across the country, including in your district, and we, again, appreciate your leadership with Congressman McCrery on helping us do something about death taxes, we have to get the grassroots, people on Main Street have to get involved.

We have a saying that if you run a business, you better get involved in politics or politics will run your business. Right now more small business owners got a wakeup call on health care. The labor union is saying they are going to spend $35 million, approximately $570,000 per congressional district in 75 of them is another new wakeup call. We better let the President know that the leadership of 10 percent of the private work force, 40 percent of those voted for small business candidates last time, is not the answer. We are going to have to bring pressure.

So we ask each of you and your districts to get your people to call, write, to let the President and his staff know, whether you are a Democrat or Republican, this is not fair to the family farm, ranch, and business around this country, and it is less than $1 billion, Congressman Rangel, in costs that we have to find, and we do have to find the money. But it is one of the smallest amounts of dollars that has the biggest impact long term for preserving the family farm, ranch, and business than anything. But it is grassroots. It is cards. It is calling. It is going to the local office of the Congressman. It is being sure this President knows.

I would suggest—we tell our members, and we ask everyone to—when you see the President supporting something you like, let him know that, too, because, if you do that, maybe he will listen to you better when you disagree. This, to us, is just a no-brainer, as we say in Tennessee. But, for some reason, it is not getting through.

Mr. HUARD. Let me add two thoughts. First, since the topic of the hearing is replacing the income tax, my testimony did not include any comments on the estate tax. I am pleased to say that NAM has a longstanding policy position of at least 40 or 50 years' duration in favor of total repeal of the Federal estate and gift tax. So I want to congratulate you, and Mr. McCrery, and the others who have labored so valiantly to at least get some partial movement in this direction.

On the other issue, I suppose, I am prone to be pragmatic. I would think that probably the only effective technique is to elect a sufficient number of like-minded Members to override a veto.

Mr. KEARNS. I agree with my colleagues' remarks. I would just add that all too often, unfortunately, there is an antibusiness bias in this country. We see it in the press. We see it in the executive branch in terms of regulators, not simply in the tax area, but in health, safety, environmental regulations.

Our members want to pay taxes. They don't want to avoid taxes. They don't want to pollute the environment and the atmosphere. They want safe workplaces, and I think part of our job, and perhaps you can help us, is to get the message out that our entrepreneurs want to create jobs. They want to create stable communities, and to do so we have to get the government off their backs. There is no other way to do that.

Chairman ARCHER. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. Thank you all for being here today.

I want to address something that has come up in several of the townhall meetings that I had on this issue just before tax day. We held three townhall meetings on replacing our current income tax system with a new system, and I have talked to different people

from different retail associations, various people on the national sales tax, and that is some people feel that it would have a dramatic impact that first year.

If you could start today, if this was the eighth day of creation, and we started with a new system, a national sales tax or a flat tax or any of these taxes, anybody would love to start with a brandnew system. The problem is that transition period. What do you think would be that first-year impact. Would there be that sticker shock where it would hurt their purchasing that first year until they got used to no longer having an income tax, but now they have a national sales tax?

Mr. KEARNS. My feeling is that a good deal of education of the American public is necessary. But when they understand and they see that first pay stub without the Federal withholding and they see prices start to come down as businesses—I mean, corporate income tax in effect is paid by consumers. It is simply written into the price of the product and the consumers pay it. So you are going to see more money in paychecks and you are going to see lower prices as businesses do not have to pass on those costs to consumers.

I think if there is enough education that that is what is happening—I mean, in any transition there are going to be difficulties anywhere in human life. But I think an appropriate campaign of public education is going to make Members realize, taxpayers realize, consumers realize that they are going to be much better off. And understanding the dynamic effects of a new system of taxation like that on the economy, freeing entrepreneurs to create jobs, and so forth, I think it is going to be clear in very short order what a benefit a national sales tax would be to our economy and to our people.

Mr. HUARD. I would think that if the system is done properly, the transition would be relatively brief. I think the reason for that is that cash is a fungible commodity and consumers, like many small businesses, are on a cash basis. So that if they have to spend more to purchase goods and services but they have more to spend on it because there is no more withholding on their wage income or their interest and dividend earnings are not taxed, I think it will wash out relatively briefly.

Mr. FARIS. What we heard in the Kemp Commission going around the country, whether it was the pig farmers in Iowa or the people dealing pig futures in Wall Street, we heard the same kinds of things. And that is, how do we get from here to there. A very big concern. What we have seen around the world is every time a new tax is added, the other one never disappears.

The part that we have talked with the Chairman about is the repealing of the 16th amendment that Congressman Johnson talked with us about earlier in the morning, that unless the American people feel that that is absolutely going to be done away with and we will not have an income tax, our members will not want a new tax, even in transition, for fear that the old one will never go away. There is this distrust right at the heart of our problems with our taxes and the IRS Code. The distrust is severe, and they absolutely do not trust anything. Nothing stays the same. Whatever you told us changes. There is distrust.

I have also found my friends in Canada with the Canadian Federation that everybody there had to buy a new cash register. Everything had to be changed. It cost them a tremendous amount of money and problems. Because there are problems is not a reason not to go to the system on a sales tax. Our members are very open to that. We want a thorough debate and discussion to say, what will the transition be, and what is the end game going to look like, and will I be able to survive?

Everything will work out over a period of time, but if over that period of time I go out of business—the sticker shock at first, we will get over it fairly soon. But while we are getting over it I am afraid another election cycle will turn around and then we will have another new system 2 years later.

Mr. ENSIGN. The other comment that I would like to make is that I see a problem with going to any tax system. If we do not get Federal spending under control, the rate has to be too high no matter what system that we have. Once again we get back to the underground economy. The higher the rate is, the more incentive there is under a national sales tax to barter, for example.

Currently, we hide and do cash transactions to avoid the income tax. I think that that is a fundamental problem that this Congress has to continue to address. And that is, getting Federal spending under control to a level that we do not have to have the tax rates approaching 30 percent.

Mr. FARIS. If we are not careful we will be spending so much time, effort, and energy finding the most comfortable chair on the Titanic we can find. The problem we have is, Senator Kerrey's commission came back and said, In the year 2012 we go out of business. Now, if you are in business and you own it and somebody tells you for sure you are going out of business in a few years, you start right now changing and correcting so you do not go out of business.

Our bottom line problem is not that we tax too much. We spend too much. So just rearranging the chairs is not what this is about. Congressman, thank you for your comment. We 110 percent agree with what you just said.

Mr. ENSIGN. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Before I recognize Congressman Portman who will be the last inquirer before we go to vote, let me just jump in for 1 second to make sure that the world knows that these hearings today will never be for the purpose of finding an additional tax system to put on top of the current tax system. I do not think there is anybody on this Committee on either side of the aisle that is attempting to pursue that course. So I would advise any of your members, Mr. Faris, to rest very easy that that will not be the result of whatever this Committee does.

Mr. FARIS. We know you, and your people in your district obviously know by the vote results you get every time, and there is a lot of trust and confidence in the Chairman. But the problem on Main Street is that this whole thing inside the beltway they do not trust. So it is something we deal with every day with our membership. But we hear what you say. We agree with you, and that is the reason we are glad you are the Chair in this transition time.

Chairman ARCHER. Thank you.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. I think that was an endorsement for President Archer. [Laughter.]

I want to thank all three of you for being here and for your involvement in this issue from the start. Mr. Faris, your work on the Kemp Commission was very important, and I think it is crucial that you keep your members focused and that you do it in a responsible way. Some of the questions here today, I think, get to that issue; that it needs to be a constructive debate.

No one wants to pay taxes, particularly not small business people. It is my view that they have the most pernicious impact on small business. So it is important that we work together and come up with a system that does get the revenue we need so we can keep the deficit under control.

At the same time, I want to thank you for what you do on entitlement spending because, as you mentioned a moment ago, Mr. Faris, and Mr. Ensign referred to it, if we do not get our spending under control, particularly on the entitlement side, we are going to have to raise rates so high that none of this tax reform will matter.

It seems to me that it would be very helpful for this Committee to force the small business community to think more seriously about the various options that are out there. I think all your principles are right on and I think you have pretty much of a consensus among your members on that. So I am going to ask you a couple of tougher questions. It may be that this is premature for you to take a position, but I think from what I am hearing, either a national sales tax or some kind of a flat tax is what your members think would be best for the economy and small business people.

I would say that it would be helpful for us to understand that you would become tax collectors of the national sales tax. All of the collection of tax would fall on you at the retail level. How do your members feel about that, and what responsibility do you think business should have for collecting taxes?

Before you answer that, let me just throw one more out, and that is the whole deductibility question. With many of the flat taxes you lose all the deductions. Others you can keep at the individual or corporate level. The deductions that I am most concerned about are ones relating to fringe benefits; in particular, pensions and health insurance. I do not think we have focused very much on that yet in the national debate. We need to know what impact that would have on small businesses in particular who are looked to more and more to provide that kind of help to uninsured Americans or to Americans who are not saving for their retirement and know that Social Security is not going to be there.

So if you could answer, Mr. Faris, maybe first what the implications would be of one system and whether you can get to a point where you can give us some more specific direction in terms of the national sales tax or flat tax.

Mr. FARIS. Congressman, based on the questions you just asked, it sounds like we need the afternoon because you covered a lot of ground. We thank you very much for your leadership on the simplified pension plan for small business. We think that will be greatly helpful and thank you for that.

I think in terms of contrasting sales and income tax, approximately 40 percent of businesses currently collect taxes on the State basis, and every State, all States have different laws about what is exempt, what is not exempt. If you go to Fulton, Kentucky, you will find a lot of grocery stores. If you go to South Fulton, Tennessee, you will not find any grocery stores. It has to do with the State sales tax and the difference.

So even though there are retailers collecting State sales tax, having a Federal tax—because again, everybody buys a new cash register to start with. That is what they are doing in Canada right now. It becomes an issue that is different when only 40 percent currently collect those taxes, if you have another 60 percent sitting out here that have not been collecting them.

The second thing our members tell us about is that they do not believe that the Federal Government will just accept whatever the State decides to send them as their share. So we are not going to get away from having people, the Federal Government, come out to check the State people and then coming back into our place of business to make sure that what we are paying the State and Federal is accurate. We see no relief from intrusion.

In terms of a flat tax, in terms of different deductibilities, our members have said they want a flatter, fairer, simpler tax. They do not want to be penalized. If they are able to do better in the future why should they pay a higher percentage. If anything, they should pay a lower percentage to favor their own production. But they are sensitive about home mortgage deduction. It is the American dream of having your own home. They are sensitive about charitable deductions because if in fact we want problems solved on Main Street, we need to get every advantage we can to people to solve it with their own money.

We have looked at those issues and we want a simpler, flatter tax. But, Congressman, we say flat tax. It is like Secretary Reich saying workers. When he says workers, he means 10 percent of the people that are unionized and not all the small business owners and their employees and their families and everybody else that works every day. So when you say flat tax, everybody has a different definition of what that means. So the surveys that talk about who is for and against a flat tax, how in the world can you go by that survey when nobody knows what the flat tax is that you are talking about? It is complex. That is the reason these hearings are very important to us.

Mr. PORTMAN. So you are kicking it back to us to give you a little more direction in terms of what you can go to your members with, and that is fair.

Mr. FARIS. It would be very helpful.

Mr. HERGER [presiding]. I want to thank this panel and excuse you. Thank you very much for your testimony. This Committee will stand in recess until following the vote.

Thank you very much.

[Recess.]

Chairman ARCHER [presiding]. The Committee will come to order. Are the members of our next panel—Mr. Thayer, Mr. Padgett, and Mr. Martin—still with us? If so, would you approach the witness table and take seats.

In accordance with the custom of the Committee, if you have written statements that you would like to enter into the record in full, without objection, that will occur. I would like, again, to ask you, if you can, to hold your oral testimony to within 5 minutes.

Mr. Padgett, we will recognize you first. If you will identify yourself for the record, you may proceed.

STATEMENT OF WINFIELD PADGETT, CHAIRMAN, PADGETT PRINTING, DALLAS, TEXAS; AND VICE CHAIRMAN OF THE BOARD OF DIRECTORS, PRINTING INDUSTRIES OF AMERICA, ALEXANDRIA, VIRGINIA

Mr. PADGETT. Thank you very much, Mr. Chairman. It is a great pleasure to be here. Thank you so much for inviting us. And it is particularly nice to be among friends from Texas.

I want to thank you, Mr. Chairman, and the other Members on the Committee, for allowing the Printing Industries of America to express its views on tax reform. We have submitted prior testimony. My remarks are a slightly modified and abbreviated version of that.

Chairman ARCHER. OK, if you will, just identify yourself for the record.

Mr. PADGETT. Surely. My name is Winfield Padgett. I am chairman of Padgett Printing of Dallas, Texas. Our company is a commercial printing company with approximately 100 employees.

I appear before you today as vice chairman of the board of directors of PIA, the Printing Industries of America, the trade association of the commercial printing industry. Our industry is represented by approximately 50,000 companies, with over 1 million employees, and annual sales exceeding $100 billion. We are the largest manufacturer in the United States, in terms of the numbers of companies, and we are the third largest, in terms of annual sales. However, as evident from the figures, our average company has fewer than 20 employees.

We would be pleased to provide information describing the scope of the industry and its size in each State for your consideration, if you so desire.

The timing of this hearing coincides with the completion of a major study by the Printing Industries of America on the effect of fundamental tax reform on our industry. We decided to conduct this study in November, based on surveys of our industry which determined that taxation was the No. 1 concern of printers in the United States. And if you wish a copy of the study, we will be happy to provide that, as well.

Also, we believe that many of the concerns of the industry with regard to the Tax Code——

Chairman ARCHER. We would, by the way, appreciate having a copy of it. So if you would see that it came to our staff, we would appreciate it.

Mr. PADGETT. Absolutely, Mr. Chairman. We just completed the study last week, and we will make it available to you in final form as soon as we have it completely in hand.

[The following was subsequently received:]

Printing Industries of America, Inc.

1996 Tax-Impact Study

How the major tax-reform proposals will affect printing companies

Introduction and Background

At its meeting in October 1995, the Board of Directors of the Printing Industries of America, Inc. decided to commission a study of fundamental tax reform. This decision was based on membership surveys which showed that taxation was the number one concern of printers in the United States. Also, we believed that many of the industry's concerns about the tax code could best be addressed through fundamental tax reform.

Our tax-impact study relied upon 75 years of data from the PIA Ratio Studies. These are annual benchmark surveys of the financial activities of printing companies. When aggregated, the results enable printers of all sizes to compare themselves with their peers to determine what portion of their costs should go for labor benefits, materials, investments etc., using data submitted from similar companies throughout the country. This is time-tested information that enabled us to develop accurate assessments of the effects of the major tax-reform proposals.

We analyzed three proposals:

- **Freedom and Fairness Restoration Bill of 1995** introduced by Rep. Richard K. Armey (R-TX) and Sen. Richard C. Shelby (R-AL);
- **USA Tax Act of 1995** introduced by Sens. Sam Nunn (D-GA), Pete Domenici (R-NM) and Bob Kerry (D-NE);
- **National Retail Sales Tax Act of 1996** introduced by Rep. Dan Schaefer (R-CO) and others.

We intended to include the Modified Income Tax proposal by House Minority Leader Richard Gephardt (D-MO). However, we could not obtain enough information to analyze it as fully as we had hoped.

The Need for Reform: Bringing the Tax Code Into the 21st Century

Before addressing the specific conclusions of the study, we should make some important general observations:

- Tax reform of the type discussed in the three major proposals will result in an apparent increase in taxes to printing businesses.
- Relative tax increases will be greater on small businesses than on large ones.
- Fundamental tax reform will require a major shift in the business view of taxation —from paying taxes on profits to charging taxes to customers as jobs are produced.
- The concepts in the major tax proposals would allow high-technology industries such as printing to modernize much more rapidly to compete in the global marketplace—with the tax code as a partner rather than a competitor.
- Fundamental tax reform is essential.

We were surprised at the size of the tax increases under all three proposals. As we see so often, however, figures alone do not tell the entire story.

The tax code has become almost irrelevant to the process of modernizing or, worse, an inhibiting factor.

We believe that tax reform is essential for several reasons—not least because the current code discourages investment in new technologies. In 1996, the printing industry will spend an estimated $1 billion on computer-related equipment. It is almost trite to mention that the explosion of technology is forcing all companies to update their technologies constantly. Unfortunately, the tax code has become our enemy. Printers must turn over computer technology every 14 to 24 months, but the current depreciation schedule provides for a five-year write-off. While it is true that companies can use the modified accelerated depreciation schedule, use of that option by capital-intensive industries such as printing may result in a triggering of alternative minimum taxes even on small firms. As a result, the tax code has become almost irrelevant to the process of modernizing or, worse, an inhibiting factor.

The three tax proposals are consumption-based and would eliminate business income taxes. Two would eliminate individual income taxes. The plans would tax consumption in various ways, either through value-added taxes or through a national sales tax. It is important to emphasize that the proposed taxes codes are not taxes on profits; they are added costs to manufacturing or taxes imposed on the sale of printed products. Comparing these proposals to the existing corporate tax is not valid. The basic theory of the consumption tax is that the business entity operates and computes income without taxes, and that the remainder is then available for investment in the entity. The value-added tax becomes part of the cost of production. The sales tax is added to the selling price.

Results of the Study: Assumptions and Analyses

The study compared the effect on "C" corporations, "S" corporations and individual executives at various income levels.

The PIA Ratio Studies examine companies in two categories: "Profit Leaders" (i.e. companies in the top 25 percent of the industry) and "All Firms" (all companies participating in the survey). For the purposes of this study we assumed a standard contribution to a qualified retirement plan at 3 percent of wages. We assumed capital asset purchases at various levels: 100 percent, 125 percent, 150 percent, 175 percent and 200 percent of current depreciation. Depreciation was 3.95 percent of sales for All Firms and 3.86 percent for Profit Leaders. Taxable income was based on sales of $1 million, $2 million, $3 million, $5 million, $8 million and $10 million. We also compared the effect on "C" corporations, "S" corporations and individual executives at various income levels. In total about 1,000 firms participated in the Ratios Survey.

Freedom and Fairness Restoration Bill of 1995

A tax on value added, less compensation to employees and expenditures on capital assets (machinery, land and buildings).

Also called the Armey-Shelby Flat Tax, this is a tax on value added, less compensation to employees and expenditures on capital assets (machinery, land and buildings). The bill calls for a tax rate of 20 percent of the taxable amount for the first two years and 17 percent thereafter. Gross income includes all sources of revenues, including gross proceeds from the sale of fixed assets but excluding investment income. Deductions from gross income to arrive at the taxable amount include materials (paper, other chargeable materials and outside services), wages (factory, administrative, selling wages and contributions to a qualified retirement plan) and purchases of fixed assets (the gross amount paid for the purchase of equipment, machinery, land and buildings). Our assumptions are based on the bill as introduced, but we do not believe that the bill contains all the necessary details.

Conclusions

- The flat tax applied to a printing business is obviously higher than the current corporate income tax.
- There is not a significant difference between the flat tax for All Firms, whose profit is 3.3% of sales, and Profit Leaders, whose operating profit is 9.55% of sales. The flat tax is slightly higher for Profit Leaders, because their materials and payroll costs are lower than those for All Firms.
- One can expect, although there are no available statistics, that Profit Leaders will have a higher deduction for capital asset expenditures than All Firms. This is because the Profit Leaders have stronger balance sheets and thus greater financial ability to expand and purchase new capital assets. (In our examples, we do not differentiate this factor.)
- For the final conclusion, one must go beyond the initial numbers. Although the basic tax of 20 percent or 17 percent of value added, less payroll costs and capital expenditures, exceeds current corporate income taxes, the following factors affect that conclusion:

The flat tax has to be considered a cost of the jobs being manufactured. If that is the conclusion, the corporation has no income tax.

1. The flat tax has to be considered a cost of the jobs being manufactured. If that is the conclusion, the corporation has no income tax.
2. The further reduction of the flat tax for capital expenditures should not be looked at as a reduction of the tax but should be viewed as a reduction in the cost of the asset.
3. What is most important is a financial and operating strategy in which the value-added tax is included in the cost of each job and not as an expense to be absorbed after subtracting operating profit.
4. Further, Armey-Shelby does not tax investment, and all wages are taxed at 20 percent or 17 percent. These rates are lower than current individual tax rates.

One key feature for printing businesses under this plan is that Subchapter S, partnership or sole proprietor income is not included in personal taxable income, since these income categories will be taxed under the flat business tax. These changes are significant for printing since there are more than 20,000 S corporations in the industry.

USA Tax Act of 1995

This proposal would also eliminate the current tax structure and replace it with a system of consumption taxes levied on both individuals and businesses. But there are major differences between the Armey-Shelby Flat Tax and the USA Tax. The business portion of the tax would operate similarly to the flat tax method computing income, but the USA Tax does not allow employers to deduct wages. Instead, employers would take tax credits for Social Security taxes paid on behalf of employees.

The individual tax is different in that it would have progressive rates, rather than one flat rate. The USA Tax would include deductions for mortgage interest, charitable contributions and state and local taxes. Employees would also receive tax credits for Social Security taxes paid. The heart of the USA Tax is its allowance of deductions for increased savings. This mechanism is intended to tax people who spend their income as opposed to those who save.

A subtraction-method value-added tax. Such a tax computes its base on the difference between business receipts and purchases from other business.

The USA Tax is a subtraction-method value-added tax. Such a tax computes its base on the difference between business receipts and purchases from other business. There is no deduction for wages paid. There are also additional deductions for capital costs. The tax is assessed at 11% of the taxable base. Gross income is defined as sales of goods and services, including the gross proceeds from the sale of fixed assets. Export sales are excluded.

The deductions from gross income to arrive at the taxable income are as follows:

- **Materials**—including paper, other chargeable materials and outside services. There is no requirement to maintain inventories. All inventory is expensed as purchased.
- **Purchase of fixed assets**—the gross amount paid for the purchase of equipment, machinery, land and buildings.

The proposal contains transitional rules to allow deductions for inventories on hand at the date of enactment. Likewise, transitional rules are provided for the phased-in deduction for the undepreciated basis of fixed assets at the date of enactment.

Conclusions

The USA Tax applied to a printing business results in higher taxes than the current corporate income tax. There is not a significant difference between the USA Tax for the All Firms, whose average operating profit is 3.30% of sales, and Profit Leaders, whose average operating profit of 9.55% of sales. The USA Tax is slightly higher for Profit Leaders, because their material costs are lower than those for All Firms. Taxes under the USA Tax are slightly less those for Armey-Shelby but still represent an increase for labor intensive businesses such as commercial printing and related industries.

There are no available statistics, but one would expect Profit Leaders to have higher deductions for capital asset expenditures than All Firms. This is because the Profit Leaders have stronger balance sheets and thus greater opportunity to expand and purchase new capital assets; but in our examples we do not differentiate this factor.

Even though the USA Tax would result in higher tax payments than under current law, a direct comparison of the systems is misleading for two reasons:

- **The USA Tax** has to be considered a cost of manufacturing, not a tax on profits. If that is the conclusion, then the corporation has no income tax.
- **The further reduction of the flat tax** for capital expenditures should not be seen as a reduction of the tax but as a reduction in the cost of the asset.

The USA Tax is in almost all cases higher than the existing individual income tax.

This would require a fundamental shift in financial and operating strategies, since a value-added tax is part of the cost of each job, not an expense to be deducted from profits.

The USA Tax for individuals is a consumption-based tax. Gross income under the USA Tax would be very similar to adjusted gross income under current law. Investment income would continue to be taxed (unlike the Armey-Shelby Flat Tax, which exempts investment income). The cornerstone of the USA Tax is its deduction for increased savings. This deduction gives the proposal its name— the USA stands for Unlimited Savings Allowance. But the deduction only creates a tax deferral. The full amount is taxed when savings are later withdrawn and spent on non-investment items.

Gross income includes wages, salaries, interest, dividends, profit from proprietorships, distributions from partnerships, pension benefits, proceeds form life insurance contracts and, with some exceptions, the gross proceeds of asset sales. Deductions from income include the Family Living Allowance, dependency exemptions, mortgage interest, charitable contributions, education and training education deduction and unlimited savings allowance.

The USA Tax is in almost all cases higher than the existing individual income tax. This is attributable to its steeply progressive rates, even though it retains many of the deductions under current tax law. Parity is reached at the upper end of the income levels, since both the USA Tax and current law have a top rate of approximately 40%.

National Retail Sales Tax of 1996

This legislation aims to promote "freedom, fairness and economic opportunity for families" by repealing the income tax, abolishing the Internal Revenue Service and enacting a 15% national retail sales tax to be administered primarily by the States. The act would also repeal the estate and gift tax and certain excise taxes.

The national sales tax would apply to gross payments for the use, consumption or enjoyment in the United States of any taxable property or service, whether produced or rendered in the United States or abroad. The act defines gross payments to include all taxes and charges, except customs duties, the national sales tax and state sales taxes.

Would apply to gross payments for the use, consumption or enjoyment in the United States of any taxable property or service, whether produced or rendered in the United States or abroad.

Exemptions from the gross payment of taxable property or services are as follows:

- **Purchases for resale.** A property or service is a purchase for resale if it is purchased by an active trade or business for the purpose of reselling the property or service in the ordinary course of business.
- **Purchases to produce taxable property or services.** A property or service is purchased to produce a taxable property or service if it used in the production of other products or services for subsequent sales.
- **Research, experimentation and development.** Taxable property or services used for the purposes of research, experimentation and development shall be treated as purchased to produce taxable property or services.
- **Exports from the United States for use outside the country.**

Although the particulars of National Retail Sales Tax are undeveloped, the general

concept is clear. In place of all other Federal taxes, printers would collect a 15% tax on all sales, except those to buyers who will resell the goods, use them in further manufacture or use them in research and development. Export sales would also be excluded.

The wording of the definition of "Purchases to Produce Taxable Property or Services" is somewhat vague. Although the definition states, "...such property or services in the production or sale of other taxable property or service...," we believe it follows the path of state sales taxes and applies to goods and services used in subsequent manufacture.

Printers are exempt from payment of Sales Tax as follows:

- **Purchased for Resale**—goods already manufactured which will be subsequently sold as already finished
- **Purchases to produce taxable property or services**—chargeable materials (paper, ink film, plates) and outside services
- **Purchases used in research and development**

As in the collection of sales tax, the act is unclear about whether the printer is allowed exemption beyond goods used in manufacture and capital assets.

It appears, although it is not clearly delineated, that the purchase of capital assets used to produce taxable property and services is exempt from the sales tax.

Again, as in the collection of sales tax, the act is unclear about whether the printer is allowed exemption beyond goods used in manufacture and capital assets. In the application of state sales tax, expenses are taxable unless specifically exempt.

Essentially, the 15% sales tax applies to all purchases including residences. Like the Armey-Shelby Flat Tax and the USA Tax Act, this proposal places the tax into the cost of the product. Consequently, this proposal would more clearly relate the tax to the cost of the product. The tax does not become part of the cost of the materials but is imposed upon the final buyer of the goods. There would be an increase in the cost of taxable expenses and services.

With the Armey-Shelby Flat Tax and the USA Tax the taxes are part of the cost of the jobs produced and are imposed at each step of the manufacturing process. The National Retail Sales Tax, by contrast, is paid only by the end user.

Conclusions

The National Retail Sales Tax, like Armey-Shelby and the USA Tax, eliminates the Federal Corporate Income Tax, but only the National Retail Sales Tax also eliminates the Federal Individual Income Tax. Armey-Shelby and the USA Tax create a flat tax on the adjusted value added, which becomes part of the cost of manufacturing. Therefore, the tax becomes part of the cost and selling price of the product. The National Retail Sales Tax simplifies the concept in that taxes are not considered until the job is invoiced. Also like Armey-Shelby and the USA Tax, the National Retail Sales Tax does not tax profits.

While it is premature to determine which tax is best for the printing industry, it seems obvious that the sales tax approach is beneficial from the pure simplicity of it.

Summary

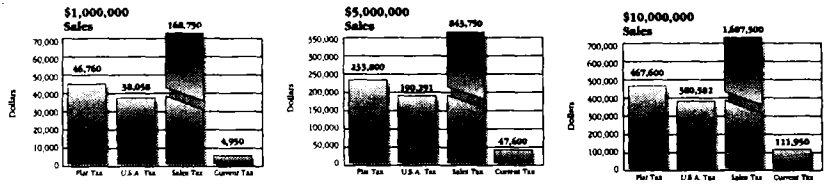
As is evident, these three proposals are similar, particularly in their provisions for business taxes. While it is premature to determine which tax is best for the printing industry, it seems obvious that the sales tax approach is beneficial from the pure simplicity of it. The Flat Tax appeals, because it is fair. Of the three, the USA Tax seems to be the least desirable due to the sharply progressive rates and the tendency of the tax to hurt labor-intensive industries such as printing.

This analysis was prepared by the H.R. Margolis Company under the direction of Printing Industries of America, Inc.

The analysis is based on 1995 PIA Ratios survey data.

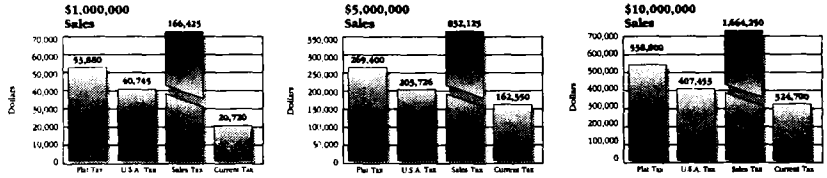
Impact of Tax Reform on All Firms, Profit Leaders and Individuals

All Firms



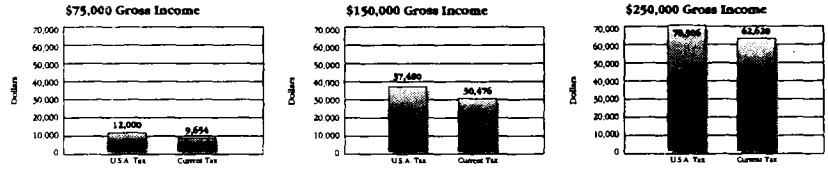
Tax Impact on All Firms: Estimated payments for companies in the All Firms category of the PIA Ratios, assuming sales of $1 million, $5 million and $10 million. In this example, capital expenditures were assumed to be 150% of depreciation for the Armey-Shelby and USA Tax proposals. Current taxes do not include Social Security payments.

Profit Leaders



Tax Impact on Profit Leaders: Estimated tax payments for the most profitable companies in the PIA Ratios—again with sales of $1 million, $5 million and $10 million and capital expenditures of 150% of depreciation. Social Security payments are not included in the current tax figures.

Individuals



Personal income taxes: A comparison of individual levies under the USA Tax proposal and current law for married executives with two children at salaries of $75,000, $150,000 and $250,000. The examples assume 10% savings deductions and $2,000 education deductions under the USA Tax.

Mr. PADGETT. We believe that many of the concerns of the industry with regard to the Tax Code could best be addressed through fundamental tax reform. Our surveys told us that printers were concerned about capital gains taxes, depreciation schedules which do not reflect modern equipment's useful lives, the lack of investment incentives in the Tax Code, and the need to address the burden of taxes on the States and small businesses.

In order to address these issues in the traditional manner, the printing industry would have to equip itself to do something we have never done before: That is, lobby the Ways and Means Committee for changes in the Tax Code. We have concluded that we must do two things at once: Ask you to change the basic structure of the Nation's tax system, while looking at the need for short-term fixes in the event that full reform is delayed.

The tax reform study we conducted relied upon data we had collected for 75 years, as part of the PIA ratio studies. The studies are benchmark studies about the financial activities of printing companies which in the aggregate enable printers of all sizes to compare themselves to other printers. The concept of the studies is that a printer can determine what portion of his costs should go for labor benefits, materials, investments, and so forth, based on data submitted from similar companies throughout the country. This is time-tested data.

Because of our years of experience in collecting this data, we were able to apply the concepts outlined in the major tax reform proposals to the PIA ratios, to develop a fairly accurate assessment of the effect of these proposals.

The proposals we analyzed included the Freedom and Fairness Restoration Bill of 1995 introduced by Representative Armey and Senator Shelby, the USA Tax Act of 1995 introduced by Senators Nunn and Domenici, and the National Retail Sales Tax Act of 1996 introduced by Representatives Tauzin, Schaefer, and others. We also intended to analyze the modified income tax proposal by House Minority Leader Gephardt. However, we could not obtain enough information to analyze the bill.

From the information we obtained in our study, we wish to make several general observations. First, major tax reform is essential. The concern is arguably as much one of simplicity as it is of cost.

Second, the concepts in the major tax proposals would allow high-tech industries such as printing to modernize much more rapidly to compete in the global marketplace with the Tax Code as a partner, rather than as a competitor.

Third, fundamental tax reform will require a major shift in the business view of taxation in our industry, from paying taxes on profits to charging taxes to customers as the job is produced.

Fourth, tax reform of the type discussed in the three major proposals will result in an apparent increase in taxes to printing businesses.

Fifth, the relative increase in taxes will be greater on a smaller printing business than a larger printing business. We were, frankly, surprised to see the significant increases in taxes under the proposals. However, as we often also see, so very often figures alone do not tell the entire story.

Among the issues which led us to the conclusion that tax reform is essential is the current tax treatment of concern to the printing industry. In 1996, we estimate that purchases of computer-related equipment in the industry will exceed $1 billion. It is almost trite to mention that the explosion of technology is forcing companies in all industries to update their technology constantly.

Unfortunately, our current Tax Code has become our enemy. While printers are turning over computer technology in a period of 14 to 24 months, the depreciation schedule provides for a 5-year writeoff. While it is true the companies can use the modified acceleration depreciation schedule, use of that option by capital-intensive industries such as printing may result in a triggering of the AMT, even on small firms. As a result, the Tax Code has become almost irrelevant in the process of modernizing our businesses; or, at worst, it is an inhibiting factor.

In defense, we will ask the Ways and Means Committee to consider a change in the current depreciation scheduling to recognize the realities of the modern world by providing a 2-year high-tech writeoff of computer-related equipment. While tax reform will address this issue, the congressional clock may not run fast enough to keep up with our own needs.

The three consumption-based tax proposals would eliminate business income taxes and the individual income tax. The basic theory of the tax is that the business entity operates and computes income without taxes on income, and that the remainder after operations is then available for investment in the business. The adjusted value-added tax becomes part of the cost, and the sales tax is added to the selling price.

As is evidenced, these three proposals are similar, particularly with regard to the business tax. While it is premature to determine which tax is best for the printing industry, it seems obvious that the sales tax approach is beneficial from the pure simplicity of it.

With a national sales tax, there remain some questions about the shifting of the collection function to business, with a possible corresponding share from cash to credit, ultimately resulting in yet another form of value-added tax. Additional anticipated exemptions for basic commodities, food, clothing, and State sales taxes pose concerns about the promised simplicity of the tax.

The flat tax appeals because it is fair. Although the flat tax approach exceeds current corporate income taxes, the Armey-Shelby flat tax allows most reasonable expenses to be deducted, does not tax investment, and all wages are taxed at 20 or 17 percent—rates substantially lower than the current individual rates.

Of the three, the USA tax seems to be the least desirable, due to the sharply progressive rates and the tendency of the tax to hurt labor-intensive industries such as printing.

At least we know that these proposed systems are better than what we currently have. And it is hard to imagine, Mr. Chairman, what this hearing would be like if we were considering legislation to implement the current system.

Thank you very much for your time and attention.

[The prepared statement follows:]

STATEMENT OF WINFIELD PADGETT, CHAIRMAN
PADGETT PRINTING, AND VICE CHAIRMAN OF THE BOARD OF DIRECTORS
PRINTING INDUSTRIES OF AMERICA

Mr. Chairman and members of the Committee on Ways and Means, I want to thank you for allowing the Printing Industries of America to express its views on tax reform. My name is Winfield Padgett. I am Chairman of Padgett Printing of Dallas, Texas. Our company is a commercial printing company with 125 employees. I appear before you today as Vice Chairman of the Board of Directors of the Printing Industries of America, the trade association of the commercial printing industry. The industry we represent is comprised of more than 50,000 companies with over one million employees and annual sales exceeding $100 billion. This industry is the largest manufacturer in the United States in terms of numbers of companies and third in terms of annual sales. As is evident from the figures, our average company has fewer than 20 employees. For your information, I have included in the attachments to the testimony information describing the scope of the industry and its size in each state.

The timing of this hearing coincides with the completion of a major study by the Printing Industries of America on the effect of fundamental tax reform on our industry. We decided to conduct this study in November based on surveys of our industry which determined that taxation was the number one concern of printers in the United States. Also, we believed that many of the concerns of the industry with regard to the tax code could best be addressed through fundamental tax reform.

Our surveys told us that printers were concerned about capital gains taxes, depreciation schedules which do not reflect modern equipment useful lives, the lack of investment incentives in the tax code, and the need to address the burden of taxes on estates and small businesses. In order to address these issues in the traditional manner, the printing industry would have to equip itself to do something we have never done -- lobby the Ways and Means Committee for changes in the tax code. We have concluded that we must do two things at once--ask you to change the basic structure of the nation's tax system while looking at the need for short term fixes in the event that full reform is delayed.

The tax reform study we conducted relied upon data we have collected for seventy five years as part of the PIA Ratio Studies. The Ratio Studies are benchmark studies about the financial activities of printing companies which when aggregated enable printers of all sizes to compare themselves to other printers. The concept of the Ratio Studies is that a printer can determine what portion of his cost should go for labor benefits, materials, investments etc. based on data submitted from similar companies throughout the country. This is time-tested data.

Because of our years of experience in collecting this data, we were able to apply the concepts outlined in the major tax reform proposals to the PIA Ratios to develop a fairly accurate assessment of the effect of the these proposals.

The proposals we analyzed included the Freedom and Fairness Restoration Bill of 1995 introduced by Rep. Armey and Senator Shelby; the USA Tax Act of 1995 introduced by Senators Nunn and Domenici; and the National Retail Sales Tax Act of 1996 introduced by Reps. Tauzin, Schaefer and others. We also intended to analyze the Modified Income Tax proposal by House Minority Leader Gephardt; however, we could not obtain enough information to analyze this bill.

Before addressing the specific conclusions of our study, we wish to make several general observations.

1. Tax reform of the type discussed in the three major proposals will result in an apparent increase in taxes to printing businesses.

2. The relative increase in taxes will be greater on a small printing business than a large printing business.

3. Fundamental tax reform will require a major shift in the business view of taxation in our industry from paying taxes on profits to charging taxes to customers as the job is produced.

4. The concepts in the major tax proposals would allow high technology industries such as printing to modernize much more rapidly to compete in the global marketplace with the tax code as a partner rather than a competitor.

5. Tax reform is essential.

We were frankly surprised to see the significant increases in taxes under the proposals. However, as we see so often, figures alone do not tell the entire story.

Among the issues which lead us to the conclusion that tax reform is essential is a current tax issue of concern to the printing industry. In 1996, we estimate that purchases of computer related equipment in the industry will exceed one billion dollars. It is almost trite to mention that the explosion of technology is forcing companies in all industries to update their technology constantly. Unfortunately, our current tax code has become our enemy. While printers are turning over computer technology in a period of fourteen to twenty four months, the depreciation schedule provides for a five year write-off. While it is true that companies can use the modified accelerated depreciation schedule, use of that option by capital intensive industries such as printing may result in a triggering of alternative minimum tax even on small firms. As a result, the tax code has become almost irrelevant to the process of modernizing or, at worst, an inhibiting factor. In defense, we will ask the Ways and Means Committee to consider a change in the current schedule to recognize the realities of the modern world by providing a two year high technology write-off of computer related equipment. While tax reform will address this issue, the Congressional clock may not run fast enough to keep up with our needs.

The three consumption based tax proposals would eliminate business income taxes and the individual income tax. These tax plans propose various derivations of the flat tax on an adjusted value added or a sales tax. What is important to emphasize in our analysis is that these proposed taxes are not an income tax on the printing operation but a tax to be included in the cost of manufacturing or as a tax imposed on the sale of printed products. Comparing these proposals to the existing corporate tax is not valid. The basic theory of the consumption tax is that the business entity operates and computes income without taxes on income and that the remainder is then available for investment in the entity. The adjusted value added tax becomes part of the cost and the sales tax is added to the selling price.

The PIA Ratio Studies examine two basic types of companies. "Profit Leaders" are those companies which are in the top 25 percent quartile of the industry and "all firms" which are 100 percent of companies included in the survey. For the purposes of this study we assumed a standard contribution to a qualified retirement plan at 3 percent of wages. We assumed capital asset purchases at various levels. These levels are 100 percent, 125 percent, 150 percent, 175 percent and 200 percent of current depreciation. Depreciation for a "all firms" is 3.95 percent of sales and 3.86 percent for "profit leaders." Taxable income was based on sales of $1 million, $2 million, $3 million, $5 million, $8 million, and $10 million. We also compared the effect on "C" corporations, "S" corporations and individual executives at various income levels. In total about 1000 firms participate in the Ratio Survey.

Results of the PIA Study

I. FREEDOM AND FAIRNESS RESTORATION BILL OF 1995

(The Armey- Shelby Flat Tax)

The Armey-Shelby Flat tax for business is a tax on value added less compensation to employees and the amount expended on capital assets (machinery, land, and buildings). For the first two years, the tax is at a rate of 20 percent followed by a tax rate of 17 percent of the taxable amount. Gross income is all sources of income and revenue other than investment income and it includes the gross proceeds from the sale of fixed assets. Deductions from gross income to arrive at the taxable amount include materials (paper, other chargeable materials and outside services), wages (factory, administrative, selling wages, and contributions to a qualified retirement plan), and purchases of fixed assets (the gross amount paid for the purchase of equipment, machinery, land, and buildings). Our assumptions are based on the bill as introduced but we do not believe the bill contains all the necessary details.

Conclusions

- As a preliminary conclusion, it is obvious that the flat tax applied to a printing business is higher than the current corporate income tax.
- There is not a significant difference between the flat tax for the "all firms" whose profit is 3.3% of sales and the "profit leaders" whose operating profit is 9.55% of sales. The flat tax is slightly higher for the "profit leaders" because the "profit leaders" materials and payroll costs are lower than the "all firms" costs.
- Also, one can expect, although there is no available statistics, that the "profit leaders" will have a higher deduction for capital asset expenditures as compared to the "all firms." This is because the "profit leaders" have stronger balance sheets affording them the finical opportunity to expand and purchase new capital assets. (In our examples, we do not differentiate this factor.)
- For the final conclusion, one must go beyond the initial numbers. Although the basic tax of 20% or 17% of value added less payroll costs and capital expenditures exceeds current corporate income taxes, the following factors affect that conclusion:
    1. The flat tax has to be considered a cost of the jobs being manufactured. If that is the conclusion, the corporation has no corporate income tax.
    2. The further reduction of the flat tax for capital expenditures should not be looked at as a reduction of the tax, but should be viewed as a reduction in the cost of the asset.
    3. What is most important is a financial and operating strategy in which the value added tax is included in the cost of each job and not as an expense to be absorbed after subtracting operating profit.
    4. Further, the Armey Flat Tax does not tax investment and all wages are taxed at 20 % or 17% and these rates are lower than current individual tax rates.

From a personal standpoint, the key feature for printing businesses under this plan is that Subchapter S, partnership or sole proprietor income is not included in personal taxable income since these income categories will be taxed under the flat business tax. These changes are significant for printing since there are more than 20,000 S corporations in the industry.

II USA TAX ACT OF 1995

Proposed by Senators Sam Nunn (D-GA), Pete Domenici (R-NM), and Bob Kerrey (D-NE)

The USA Tax Act of 1995 would also eliminate the current tax structure and replace it with a system of consumption taxes levied on both individuals and businesses. There are major differences between the Armey/Shelby Flat Tax and the USA Tax. The business portion of the tax would operate similarly to the flat tax method computing income, but the USA Tax does not allow employers to deduct wages. Instead, employers could take tax credits for social security taxes paid on behalf of employees.

The individual tax is different in that it would have progressive rates not one flat rate. The USA Tax would include deductions for mortgage interest, charitable contributions and state and local taxes. Employees would also receive tax credits for social security taxes paid. The heart of the USA tax is to allow deductions for increased savings. This mechanism is intended to tax people who spend their income as opposed to those who save.

The USA Tax is a subtraction method Value Added Tax. A subtraction method value added tax computes its base on the difference between business receipts and purchases from other business. There is no deduction for wages paid. There are also additional deductions for capital costs. The tax is assessed at 11% of the taxable base. Gross income is sales of goods and services including the gross proceeds from the sale of fixed assets. Export sales are excluded from the taxable base.

The deductions from gross income to arrive at the taxable income are as follows:

- Materials -material deductions are paper, other chargeable materials and outside services. There is no requirement to maintain inventories. Therefore all inventory is expensed as purchased.

- Purchase of fixed assets - the gross amount paid for the purchase of equipment, machinery, land and building is deductible at the taxable base.

- There are transitional rules to allow deductions for inventories on hand at the date of enactment. Likewise, transitional rules are provided for the phased-in deduction for the undepreciated basis of fixed assets at the date of enactment.

Summary

The "all firms" with an industry average operating profit of 3.30% of sales incurs a higher USA Tax than under existing corporate tax structure. The tax under the USA Tax is slightly less than the flat tax but still represents a tax increase for labor intensive businesses such as commercial printing and related industries. The "profit leaders" with an industry average operating profit of 9.55% of sales also incurs a higher USA Tax than under corporate tax structure; but the USA tax is not as distorted as the "all firms."

Conclusion

As a preliminary conclusion, the USA Tax applied to a printing business results in higher taxes than the current corporate income tax. There is not a significant difference between the USA Tax for the "all firms" whose operating profit is 3.30% of sales and the "profit leaders" whose operating profit is 9.55% of sales. The USA Tax is slightly higher for the "profit leaders" because the "profit leaders" material costs are lower than the "all firms."

Also one can expect, although there is no available statistics, that the "profit leaders" will have a higher deduction for capital assets expenditure as compared to the "all firms." This is because the "profit leaders" have stronger balance sheets affording them the financial opportunity to expand and purchase new capital assets; but in our examples we do not differentiate this factor.

Again, a comparison of the USA Tax for the current tax scheme in misleading. The business tax is 11% of sales less materials and capital expenditures and exceeds current corporate income taxes. This is misleading because of the following:

- The USA Flat Tax has to be considered a cost of the jobs being manufactured. If that is the conclusion, then the corporation has no corporate income tax.
- The further reduction of the flat tax for capital expenditures should not be looked at as a reduction of the tax, but should be reasoned as a reduction in the cost of the asset.

What is most important is a financial and operating strategy which the value added tax is included to the cost of each job and not an expense to be absorbed after operating profit.

The USA Tax for individuals is a consumption based tax. Gross income under the USA Tax would be very similar to adjusted gross income under current law. Investment income would continue to be taxed unlike the flat tax that exempts investment income. The cornerstone of the USA Tax is the deductions for increased savings. This deduction is the namesake of the USA Tax - Unlimited Savings Allowance. This deduction only creates a tax deferral. When savings are later withdrawn and spent on non-investment items, then the amount is taxed at that time.

Gross income includes wages, salaries, interest, dividends, profit from proprietorships, distributions from partnerships, pension benefits, proceeds form life insurance contracts and, with some exceptions, the gross proceeds of asset sales. The reductions from income include the Family Living Allowance, dependency exemption, mortgage interest, charitable contributions, education and training education deduction and unlimited savings allowance.

Summary

The USA Tax is in almost all cases higher than the existing individual income tax. This is attributable to its steeply progressive rates, even though it retains many of the deductions under current tax law. Tax parity is reached at the upper end of the income levels since both the USA Tax and current law have a top rate approximately 40%.

III. NATIONAL RETAIL SALES TAX OF 1996

Proposed by Representatives Schaefer, Tauzin and others

The National Retail Sales Tax Act of 1996 is legislation to promote "freedom fairness, and economic opportunity for families" by repealing the income tax, abolishing the Internal Revenue Service and enacting a national retail sales tax to be administered primarily by the States. It is the intent of The National Retail Sales Tax Act of 1996 to enact a 15% sales tax and repeal the income tax, the estate and gift tax, and certain excise taxes.

The National Retail Sales Tax Act of 1996 imposes a tax off 15% on the gross payments for the use, consumption or enjoyment in the United States of any taxable property or service, whether produced or rendered within or without the United States.

The gross payment of taxable property or service is inclusive of all taxes and charges, excluding custom duties, and also excluding the Federal sales tax imposed by this act and State sales taxes in conformity with this act.

Exemptions from the gross payment of taxable property or services is as follows:

- **purchases for resale** - a property or service is a purchase for resale if such property or service is purchased in an active trade or business for the purpose of reselling the taxable property or service in the ordinary course of that active trade or business.

- **purchases to produce taxable property or services** - a property or service is purchased to produce a taxable property or service if such property or service is purchased by an active trade or business for the purpose of employing or using such property or service in the ordinary course of that active trade or business.

- **research, experimentation and development** - taxable property or services used in an active trade or business for the purpose of research, experimentation and development shall be treated as purchased to produce taxable property or services.

- **exports** from the United State for use, consumption or enjoyment outside the United States

Summary

Although the particulars of National Retail Sales Tax are undeveloped, the general concept is clear. In place of all other Federal taxes the printer will collect a 15% tax on sales. The printer will not collect sales tax from a purchaser who will resell the goods, use the goods in further manufacture, use the goods in research and development, and export sales.

The wording of the definition of "Purchases to Produce Taxable Property or Services" is somewhat vague. Although the definition states, "...such property or services in the production or sale of other taxable property or service...", I believe it follows the path of State sales taxes and applies to goods services used in subsequent manufacture.

Printers are exempt from payment of Sales Tax as follows:

- Purchased for Resale - goods already manufactured which will be subsequently sold as already finished.

- Purchases to produce taxable property or services - chargeable materials (paper, ink film, plates) and outside services.

- Purchases used in research and development

- It appears, although it is not clearly delineated, the purchase of capital assets used to produce taxable property and services is exempt from sales tax.

- Again, as in the collection of sales tax, the act is vague and undeveloped as whether the printer is allowed exemption beyond goods used in manufacture and capital assets. In the application of State sales tax, expenses are taxable unless specifically exempt.

Essentially, the 15% Sales Tax applies to all purchases including residence. Like the Armey - Shelby Flat Tax and the USA Tax Act of 1995, it places the tax into the cost of the product. Consequently, this proposal would more clearly relate the tax into the cost of the product. The tax does not become part of the cost of the materials purchased, but is imposed upon the purchaser of the goods. There would be an increase in the cost of taxable expenses and services.

In the Armey - Shelby Flat Tax and the USA Tax it was necessary to emphasize the tax imposed is part of the cost of the jobs produced; but in the National Retail Sales Tax the concept that the tax is absorbed by the purchase of the goods and is a function of the tax process.

Conclusion

The National Retail Sales Tax like the Armey - Shelby Flat Tax and the USA Tax Act of 1995 eliminates the Federal Corporate Income Tax, but only the National Retail Sales Tax also eliminates the Federal Individual Income Tax. The Armey and the USA Tax creates a flat tax on the adjusted value added which becomes part of the cost of the product manufactured. Therefore, the tax becomes part of the cost and selling price of the product. The National Retail Sales Tax simplifies the concept and the tax on the product is not considered until the job is invoiced.

The National Retail Sales Tax like the Armey and the USA Tax proposals provides the business entity profits without Corporate Income Tax.

As is evident , these three proposals are similar, particularly with regard to the business tax. While it is too premature to determine which tax is best for the printing industry, it seems obvious that the sales tax approach is beneficial from the pure simplicity of it. The Flat Tax appeals because it is fair. Of the three, the USA Tax seems to be the least desirable due to the sharply progressive rates and the tendency of the tax to hurt labor intensive industries such as printing.

At least we know that these proposed systems are better than what we have. It is hard to imagine what this hearing would be like if we were considering legislation to implement the current system.

Chairman ARCHER. Thank you, Mr. Padgett. Let me enter very briefly a comment relative to these percentages of taxation. I personally believe that whatever we do in structural tax reform should result in revenue that is equal to what we currently produce. The concept that, "Oh, well, my proposal will create growth; therefore, we do not have to be concerned about what the percentage is going to be and what it generates currently," to me is not the appropriate way to judge proposals.

Different proposals will create different economic growths for the long term, which may permit the reduction in rates, provided we keep spending under control. But initially, every proposal should have to be judged on a level playingfield which is generating the same revenue as the current system in the first year.

What is a little bit deceptive about some of the flat tax proposals is that a 17-percent rate does not do that. And I am not being critical of what you said, because you are taking from the presentation of the proponents what they say. But the Forbes tax, for example, at 17 percent, leaves an additional $150 billion deficit in the first year, compared to the current revenues produced by our current system.

I personally think that we ought to have a complete exposure, as it were, of what the rate ought to be. It would be about 21 percent, under that proposal, to duplicate current revenues. And so I just throw that in, since you had referred to that. And I want to make that clear for the record in this Committee's hearings.

Mr. Thayer, you are our next witness, and if you would identify yourself, please, for the record and then proceed, we are pleased to have you here.

STATEMENT OF BENNIE L. THAYER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

Mr. THAYER. Thank you, Mr. Chairman. I am Bennie L. Thayer, president of NASE, the National Association for the Self-Employed. It is indeed a pleasure for me to be here today. And I, too, would like to commend you on your consistent support on behalf of small business. I would also commend the Committee on the strong support for the Taxpayer Bill of Rights that was just passed out last week.

If you ask the average NASE member, any member, Mr. Chairman, which Federal agency creates the greatest number of administrative headaches for their business, the answer will invariably be the IRS. We surveyed about 500 of our 320,000 members, Mr. Chairman. I would have to say that we represent moms or pops; because two-thirds of our members tend to be truly self-employed, with the other one-third having less than five employees.

When we asked those 500 members in the survey that was released in April 1996 just what they thought about comprehensive tax reform, it was clear from the survey results that the NASE membership would be quick to agree with the media's portrayal of IRS as a man-eating, 2,000-pound gorilla; and the only way to tame the gorilla is to pass comprehensive tax reform.

About 84.5 percent of the survey participants called for scrapping the Federal tax system. Only 6.6 percent of the respondents called

for maintaining the current system. And while the NASE membership strongly supports changes in the Federal tax system, their perspective as to the type of change that should occur, I have to say today, is anything but uniform.

Of the survey participants who called for abolishment of the current tax system, 57 percent stated that they would favor a flat tax. Of the survey respondents who support scrapping the current tax system, 29 percent believe that the current system should be replaced with a national sales tax. Only about 6.2 percent that favored the abolishment of the present tax law also called for implementation of a value-added tax. So, as you see, that was not very high for our members.

Let us look at business deductions, in terms of the survey. The NASE members are very divided on the issue of giving up most or all of their business tax deductions as a tradeoff for implementation of a tax reform initiative. Just over 40 percent of the survey respondents stated that they are willing to trade off business deductions in this fashion. On the other hand, 36.7 percent of the survey participants are not willing to give up most or all of their deductions for the flat tax. Only 22 percent of the respondents are undecided on the issue.

According to 1993 IRS statistics of income, the self-employed filed 15.8 million nonfarm sole-proprietorship tax returns that year, with total gross receipts of $757 billion; and of that amount, 76.4 percent of those persons were operating businesses in the areas of service, retail, or construction trades.

The self-employed are found in businesses which are very labor-intensive, and thus bear a pronounced payroll tax burden. And therein lies the concern for giving up, if you will, the deductions that they presently enjoy.

This particular point is borne out by the NASE's survey results on tax reform. When asked whether businesses should retain as part of a flat tax system a full deduction for wages and Social Security, 77-plus percent of the survey participants favored retention of a deduction for wage and payroll related expenses. Many survey respondents emphasize that these expenses represent a cost of doing business, and therefore should continue to be fully deductible.

A self-employed individual pays a combined Social Security and payroll tax of 15.3 percent. This means that a self-employed person pays both the individual and the employer's share of the Social Security. We view this as a form of double taxation for self-employed individuals and a clear disincentive toward entrepreneurship.

The self-employed also find the recordkeeping required in Social Security and payroll taxes to be a major headache and a drain of scarce resources. For these reasons, the NASE strongly urges that Congress review the burden Federal payroll taxes place on smaller firms, both from a financial and a recordkeeping perspective. And we ask that you do this as you seriously consider any final tax initiative.

The legacy of the Tax Reform Act of 1986 has already been referred to, Mr. Chairman, so I will not belabor that point. Obviously, we would, within the NASE, say to you that we do not want to see that replicated as we once again undertake this whole issue of tax reform.

Finally, I would simply say to you that, as you grapple with this issue of comprehensive tax reform, we within the NASE will be more than happy to not only offer you the survey of our membership, but any and all research that we intend to do and that we have done on this particular issue.

Thank you so much for allowing me to be present.

[The prepared statement follows:]

STATEMENT OF BENNIE L. THAYER
PRESIDENT AND CEO
NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

On behalf of the National Association for the Self-Employed, I appreciate the opportunity to testify before the House Ways and Means Committee. My name is Bennie L. Thayer, the NASE's President; and I am please to testify today on the impact on small business of replacing the federal income tax.

I wish to commend Chairman Bill Archer and the other Committee members for holding this very important topic of concern to small business community. Comprehensive tax reform is important to the over 320,000 members of the NASE, individuals who operate businesses throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership represents a very wide range of businesses, notably in the consulting and retail fields.

The concept of tax reform is very important to small business for one very fundamental reason. That is -- if you ask the average NASE member which federal agency creates the greatest number of administrative headaches for their business, the answer will invariably be the IRS.

According to tax reform survey results released by the NASE in the April 1996 issue of *"Capital Connection Update"*, not one person among the 438 survey respondents stated that the IRS was a well run agency or that its authority should be enhanced. Instead, 100 percent of the respondents believe that the IRS' powers should be curbed -- or that the agency should be eliminated altogether. About 45 percent of the persons responding stated that the IRS should be abolished as an agency.

It is clear from the survey results that the NASE membership would probably be quick to agree with the media's portrayal of the IRS as a man-eating, 2,000 pound gorilla -- and for this reason, the only way to "tame" the gorilla is to pass comprehensive tax reform. Of major significance, however, when asked questions about specific aspects of tax reform, it's clear that there is no uniform response or answer from NASE members regarding the best way to achieve comprehensive tax reform.

Taxpayer Bill of Rights

The NASE applauds the Ways and Means Committee for its long-standing support for taxpayer rights legislation, as evidenced last week by House passage of (H.R. 2337) the Taxpayer Bill of Rights 2 by a vote of 425-0. This bill should help contribute to a leveling of the "playing field" between the IRS and America's taxpayers. In this context, we wish to particular commend Subcommittee Chairman Nancy Johnson and the other members of the Subcommittee on Oversight for the panel's work this year on taxpayer rights legislation.

Among other provisions, H.R. 2337 will: (1) increase the authority of a taxpayer advocate within the IRS, (2) broaden the agency's authority to abate interest, (3) improve taxpayer protections with respect to tax liens and levies, (4) provide relief from retroactive tax regulations, and (5) shift the burden of proof to the IRS with respect to a taxpayer's claim for reimbursement of attorney's fees in a tax controversy case. Each of these provisions should prove to be very positive, pro-taxpayer initiatives.

We applaud the Committee's work in the area of taxpayer rights for one very important reason. While tax reform may truly benefit a very large number of individual taxpayers as an end result, the NASE believes it is probably going to be very difficult to eliminate the need for IRS Revenue Agents in terms of monitoring and occasionally auditing a business tax return. From a business person's perspective -- there will be a need to retain certain legitimate business deductions as part of any tax system.

Replacement Tax Systems and Add-On Taxes

Should legislation be enacted to simplify or replace the Internal Revenue Code, it is imperative that any new tax system be considered a replacement tax system for the current "tax regime." The net taxes raised by any new tax system should be no more than that raised under the old system. Moreover, the new system should also avoid increasing the overall

burden of taxes now paid by self-employed individuals. To the extent the new system ends up being designed to raise more taxes than the prior system, the business community will label the new tax regime" as an "add-on tax" and as a result, will likely oppose such a proposal.

The Self-Employed and Tax Reform Initiatives

The NASE fully appreciates the trials and tribulations of the legislative process. The NASE has watched many Congressional bills move from the initial hearing stage through committee markup; and then on to House and Senate passage; and finally, on to the House-Senate conference report stage. Throughout the process, a bill undergoes significant technical and substantive changes. The initial legislation often looks very different from what the President may sign into law. Based on this understanding of how the legislative process works, the NASE presents these observations on what our organization believes should be included in any final tax reform initiative. Further, these comments have also be crafted to reflect the tax reform survey results which we have released in this month's edition of "Capitol Connection *Update.*"

As stated above, 100 percent of the survey respondents believe that the IRS' powers should be curbed -- or that the agency should be eliminated altogether. The vigor with which the NASE membership dislikes the federal tax laws appears to be only somewhat less strident than their universal hatred for the IRS. About 84.5 percent of the survey participants called for scrapping the federal tax system. Only 6.6 percent of the respondents called for maintaining the current system.

While the NASE membership strongly supports change in the federal tax system, their perspective as to the type of change that should occur is anything but uniform. Of the survey participants who called for abolishment of the current tax system, 57 percent stated that they favor a flat tax. A flat tax can be defined as a tax system under which taxpayers agree to give up most or all of their tax deduction or credits as a trade-off for obtaining one low tax rate on income. In theory, this type of system would greatly simplify the Tax Code. Flat tax proponents also contend that a flat tax is a better method of measuring economic income than the current tax system.

Of the survey respondents who support scrapping the current tax system, 29 percent believe that the current system should be replaced with a national sales tax analogous to a sales tax currently imposed by many state and local governments. Only about 6.2 of the persons favoring abolishment of the present tax law also call for implementation of a value added tax. Both a national sales tax and a value added tax system are considered a tax on consumption as opposed to an income-based tax system.

Business Deductions

NASE members are very divided on the issue of giving up most or all of their business tax deductions as a trade-off for implementation of a tax reform initiative, such as a flat tax on income. Just over 40 percent of the survey respondents stated that they are willing to trade-off business deductions in this fashion. On the other hand, while 36.7 percent of the survey participants are not willing to give up most or all of their deductions for a flat tax, 22.4 percent of the respondents are undecided on the issue.

In order to understand the types of expenses which the self-employed community believes should be deductible as legitimate business expenses, the Ways and Means Committee must understand the profile of the types of individuals who consider themselves self-employed. Based on those persons who reported nonfarm sole proprietorship activity on their federal tax returns in 1993[1], the self-employed reported the following information to the IRS that year:

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[1]IRS Statistics of Income Bulletin, Publication 1136, Fall 1995, page 34.

1) 15.8 million tax returns claimed nonfarm sole proprietorship status;

2) Total gross receipts nationwide of $757.2 billion;

3) Total deductions nationwide of $600.8 billion; and

4) Total net income nationwide of $156.5 billion.

The self-employed are concentrated in the following industries (computed as a percentage of total gross receipts reported to the IRS in 1993):

Services	34.4 Percent
Retail Trade	27.2 Percent
Construction	14.2 Percent
Finance, Insurance, and Real Estate	7.0 Percent
Wholesale Trade	5.1 Percent
Transportation and Public Utilities	4.7 Percent
Manufacturing	3.6 Percent
All other Industries	3.8 Percent[2]
Total	100 Percent

According to the above profile, 76.4 percent of the self-employed operate businesses in the services, retail, or construction trades. These are industries which are very labor intensive and thus, bear a pronounced payroll tax burden. This particular point is borne out by the NASE's survey results on tax reform. When asked whether business should retain -- as part of a flat tax system -- a full deduction for wages, Social Security, etc. -- 77.2 percent of the survey participants favored retention of a deduction for wage and payroll related expenses. Many survey respondents emphasized that these expenses represent a cost of doing business, and therefore, should continue to be fully deductible.

While the NASE membership appears to strongly supports retention of a deduction for payroll related costs as part of any new tax system, the support for retention of other business related deductions is not as broad-based. For example, only the home mortgage deduction and direct expensing allowance for equipment pulled clear majority support. That is, 66 percent of the respondents support retention of the direct expensing allowance, and 53.9 percent state that they support retention of the home mortgage deduction.

Therefore, whatever new tax system Congress should pass -- it should strive to include legitimate business deductions which reflect the ways small service and retail businesses operate. Such deductions should not solely focus on the needs of manufacturers and other capital intensive businesses; but instead, should strive to take into account the needs of the labor-intensive sectors of the economy. This means that any new tax system should include (among other deductions) full deductibility of all wages, Social Security tax, and other payroll and employee benefit expenses incurred by owners on behalf of their employees and themselves.

Without taking into account the self-employed's income tax bracket, a self-employed individual pays a combined Social Security and payroll tax rate of 15.3 percent. In specific, this means that a self-employed person pays both the individual's and the employer's share of the Social Security. We view this as a form of double taxation for a self-employed individual and a clear disincentive towards entrepreneurship. As a percentage of federal tax revenues, Social Security taxes amount to about 30 percent of all federal tax revenues.

The reason why small business find payroll taxes particularly onerous is due to the fact their firms are predominantly labor-intensive -- as described in more detail above. These businesses also find the recordkeeping required in reporting Social Security and payroll taxes

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[2]This figure has been adjusted to reflect rounding errors to ensure that the Total for all categories adds up to 100 percent.

to be a major headache and drain of scarce resources. For these reasons, the NASE strongly urges that Congress review the burden federal payroll taxes place on smaller firms -- both from a financial and a recordkeeping perspective -- when seriously considering any final tax reform initiative.

The Legacy of the Tax Reform Act of 1986

In closing, the NASE strongly urges Congress to learn from the mistakes made with respect to the enactment of the Tax Reform Act of 1986. The 1986 Act was also billed by proponents as a dramatic simplification of the Internal Revenue Code coupled with a steep reduction in tax rates. The trade-off in 1996 for tax simplification and lower rates involved cutbacks in various tax deductions, such as the meals and entertainment deduction. Ironically, as a result of various tax law changes enacted in the years after 1986, effective tax rates have climbed steeply -- and the various deductions lost in 1986 were never restored.

Since 1986, Congressional tax legislation has become nearly an annual event. In addition, to the increase in tax levies over the time period, these continuous changes in the tax law have made "planning" difficult for the average small businessman. The NASE is not suggesting -- by any means -- that the status quo with respect to the current Internal Revenue Code be maintained. However, we are suggesting that Congress take into account the needs of the small business person whenever it develops a tax reform initiative. Once a tax reform initiative is passed, it is critical that Congress avoid (except under excruciating circumstances) constant changes in the tax law thereafter. A moratorium on tax law changes (for a reasonable time period thereafter) could do much to reduce regulatory burdens on taxpayers, as well as improve business planning.

Chairman ARCHER. Mr. Thayer, thank you for your testimony. I can assure you that Mr. Crane and I, who are sitting here today, who were very much involved in the 1986 tax reform exercise—Mr. English was not here at that time, although I think he probably would associate himself with my comments—do not want to see that replicated, either.

Mr. THAYER. Thank you.

Chairman ARCHER. In fact, Mr. Crane and I spent many days on the floor of the House trying to inform the American people of what was coming as a result of that act, because it is very complicated. I think all of what we said has proved to be true, and the odium that has been involved in that act has been put upon the producers of this country, in a very negative way. But again, the important thing is that we not revisit history and that we not fall into that trap again.

Mr. THAYER. Thank you so much, Mr. Chairman.

Chairman ARCHER. Mr. Martin, if you will identify yourself for the record, you may proceed.

STATEMENT OF MICHAEL L. MARTIN, ENROLLED AGENT; ON BEHALF OF NATIONAL ASSOCIATION OF ENROLLED AGENTS, GAITHERSBURG, MARYLAND

Mr. MARTIN. Thank you, Mr. Chairman. My name is Michael Martin. I am an enrolled agent in private practice in Washington, DC. I am testifying today on behalf of the 9,100 members of the National Association of Enrolled Agents.

Enrolled agents are the only tax professionals who are licensed by the Federal Government to represent taxpayers before the IRS; thus, we are intimately familiar with the problems that taxpayers face—also, possibly an endangered species.

Over 90 percent of our members are also small businesspersons. They own their own business, their practice. They serve their clients as tax advisors, tax planners, accountants, and financial counselors.

We have submitted written comments which you will have in the record, and let me just elaborate on some of the things that we said in the written comments. One of the things that this Committee has to grapple with is the balance between fairness and simplicity: Where does one stop, and the other start? And that is probably going to be your biggest challenge, reaching that balance.

There is this historic tension in the tax reform movement that if you make the law simple, it seems not fair. There is a myth. The myth is that if the tax law is simple, you will have greater compliance. I do not know that that myth is true. I know that a lot of taxpayers will try to minimize their taxes, whatever tax system this Committee comes up with. It is just the nature of the American business.

It has been widely testified to here and reported in a number of studies that small business is the engine that is growing, providing jobs. A lot of those jobs right now, as people are laid off, as government downsizes, as industry downsizes, are small business—true sole proprietors.

These people may be hurt. The service sector, as opposed to the manufacturing or retail sector, I think would be the ones who may

be hurt most by either the flat tax or the sales tax. The flat tax could have an effect of forcing small businesses to lay off workers and downsize their businesses, because payroll taxes will not be deductible.

A major expense in my practice is rent. Where is rent deductible? Well, as a creative accountant, I would advise my clients, "Well, what you have to do is go into some kind of system of cost accounting so this becomes a cost of goods sold." This is something that is not done in the service industry, but why not?

Well, what is the cost, then, to the taxpayer of buying new computers, new accounting systems, completely redoing their accounting systems, to come up with a cost of goods sold for every client that they service? And of course, the question that they are going to ask me is, "Is my time in setting up these systems going to be deductible under the new system?"

We are concerned about the inability of businesses to offset other taxable income with losses from a business. Many startup businesses get off the ground while the owner is still employed, or while a spouse is employed elsewhere. The business loss is a true economic loss, and reduces the total income of the individual. Under current law, less tax is paid. Under most of the proposals we have seen, a higher tax would be paid, as the loss would not be allowed. This might be enough to make the difference between a business succeeding or failing.

The current proposals also do not address what happens to those losses if they are disallowed. Will they be carried forward to be used when the business makes a profit, or carried back against previous profits such as the current law for net operating losses? If so, for how many years? What happens if the business never shows a profit? Under current law, that economic loss is recognized for tax purposes in several sections of the Code. Under the proposal, there is nothing to deal with this. Simplicity will suffer in order to deal with this complexity.

We worry about the reported effect on the real estate value. Many small businesses tap the equity in their homes as startup capital for their business. If, as projected, real estate values could decrease by up to 20 percent under a flat tax scenario, that equity is gone.

I have looked at a number of my clients, and I remember participating in the White House small business conferences. Small businesses were asked to rank the most onerous taxes in terms of compliance. The first one was payroll taxes. The second was sales tax, dealing with sales tax: What is exempt sale, what is not an exempt sale? And the third was the income tax.

If one looks at the current Internal Revenue Code, only a very few chapters are devoted to itemized deductions. A few more are devoted to administration, collection, and penalties. Most of that volume deals with what is income. What is income? What is excluded from income? And what is an ordinary and necessary business expense in determining the income of a business?

Some of the myths of tax reform are, "Have a flat tax, and abolish the IRS." Well, if we have a flat tax where it is gross income times the percentage, and that is your tax, I would suggest to you that the IRS will spend a great deal of time—or you will want the

IRS to spend a great deal of time—verifying that line one is correct.

Another myth is that tax accountants and attorneys will go away. I do not think that myth is going to happen, because a good business is going to have accounting. How else are they going to know if their profit margin is correct? How else are they going to know if they are actually making a profit? They have to have that accounting. And my experience is, no matter how simple or low the tax rate is, people are going to try to minimize the taxes they pay.

The idea that a national sales tax would minimize the intrusion of the IRS in a business' life I think is also a myth. Some of the most difficult cases that the IRS and I as a practitioner deal with are businesses who are experiencing cash flow crunches and use the trust fund taxes, the taxes they withhold from their employees' wages, and do not remit those to the IRS on time.

I can almost guarantee you that in a national sales tax we would be faced with the same problem; that those taxes collected by the business in a cash flow crunch would be used to pay a vendor, to keep the business open, before they would be sent to the government. I see the IRS having to hire, literally, 10,000 additional revenue officers to handle collections.

I understand your guarantee that the Tax Reform Act of 1986 will not happen again; but small business is concerned because small business looks at Congress over the long haul. And we saw what happened when the deductions for rental property, for example, were given up in the reform act, and now we are back with five rates, the maximum being the 39.6-percent rate.

Small business owners are first attracted to the idea of a flat tax, but then the next question out of their mouth is, "But, well, Michael, can I deduct my home office?" I think these are the questions that you are going to have to grapple with. Taxpayers, small businesses, have gotten used to deducting a lot of things under the current system. They want to be able to deduct those things against their business income. And if you tell them, "We are taking those things away in order to give you fairness," their question is, "What is my guarantee?"

If you truly believe that small business is the backbone of the American economy, and if you believe that one of the answers to unemployment caused by government and industry downsizing is self-employment, and if you believe the statistics that show the small business providing the bulk of new jobs created in this country, if you believe these things, then any tax law change that you contemplate must be of a nature that it will help these businesses to grow and to flourish.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF MICHAEL L. MARTIN
ENROLLED AGENT
ON BEHALF OF NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. Chairman and Members of the Committee, my name is Michael L. Martin. I am an Enrolled Agent in private practice here in Washington, D.C. I would like to thank you for your invitation to testify on tax reform and its impact on small business, entrepreneurs and start-up companies.

I am testifying today on behalf of the more than 9,100 members of the National Association of Enrolled Agents (NAEA). As members of the Committee know, Enrolled Agents are the only tax professionals possessing a Federal license to represent taxpayers before the Internal Revenue Service. Our members represent more than four million (4,000,000) individual and small business taxpayers annually. Over 90% of our members own and operate their own tax representation practices. As a result, NAEA members, who serve their clients as tax advisors, tax planners, accountants and financial counselors, have a thorough understanding of the special concerns of small business, entrepreneurs and start-up companies.

The NAEA has not taken an official position with respect to any of the individual proposals that have been publicized in the press of late. We are waiting to see the legislation that actually gets introduced so that we may analyze specific proposals rather than speculating on "pie in the sky" scenarios. We also want the Committee to recognize that tax practitioners are not of one mind when considering the question of tax system reform. We have over 9,100 members and are certain we could find some members willing to take any side in the debate over the best way to achieve true tax simplification and fairness. As taxpayer representatives, however, we feel quite comfortable presenting for your consideration the issues raised by these proposals and the impact on small business entrepreneurs. We trust this input will aid you in your deliberations.

Key Issues for Consideration in Tax Reform Legislation

Simplicity vs. Fairness

There is an historic tension in the tax code between simplicity and fairness. In fact, as the authors of the current code, the members of Ways and Means probably realize more than most, that its complexity is in large measure caused by an effort to instill fairness. As we have often said before this committee, our system of voluntary compliance depends upon taxpayers self-assessing themselves. If taxpayers perceive the system as fair, they will voluntarily comply. If they believe it favors some over others, they will find ways not to fully comply. Most of the proposed flat tax suggestions make a clear distinction between income earned by labor and income earned by investment. Our caution to the committee is that perception of fairness is paramount to acceptance by taxpayers of any change in the current system.

Correct Balance

It is critical in any system of taxation to achieve the correct balance between providing the incentive for people to accept the necessity of taxes on their efforts while not defeating their motivation to better themselves and their financial situation. At one time, when we had top tax rates in this country of 90%, we were denying the need to leave some incentive there for people to engage in productive work. Presidents and Congresses across the political spectrum from Kennedy to Reagan recognized the tremendous economic boom that would result from unleashing the competitive zeal of the American entrepreneur. The rising tide does lift all boats.

Environment Encouraging Business Entrepreneurs

The formula for enhancing and nurturing the climate for business entrepreneurship is fairly simple to derive and much more difficult to achieve. It consists of restricting governmental regulation of business to the absolute minimum degree needed to insure public safety and welfare; insuring our educational system trains our children for the jobs of tomorrow; providing assistance and information about developing markets; and creating an economic incentive for people to excel.

It has been widely reported that studies of the net job growth in the US over the past decade have concluded that small business was responsible for almost all of the new jobs created. Given

today's climate of large corporate layoffs and reorganizations - this is not difficult to believe. It is perhaps the ultimate irony for the baby-boom generation to have been urged by their Depression-era parents to seek employment where they were guaranteed a life-long job and a good pension, such as government, AT&T or IBM, only to find that only those who are self-employed today are really certain where they will be working next month.

In a tax system structured to maximize opportunities for citizens to excel, several features must be present:

* formation of capital for business investment must be present
* taxation must be so ordered as to not benefit any business form over another, i.e., corporation vs. sole-proprietorship
* entrepreneurs must be rewarded for the additional risk they shoulder in striking out on their own.

Specific Concerns About the Flat Tax Proposals

Double Taxation

Many of our members report that most small business owners conceptually are attracted to the idea of a flat tax. But when they start to examine the practical aspects of a true flat tax and find out that they will, in effect, be paying twice on the same income, then they are almost unanimously opposed.

Why do we say they will be paying twice on the same income? Because that is the reality of the current proposals for small business owners. In every specific proposal advanced thus far in the debate over this issue, every business entity will be required to file a separate tax return. The deductions permitted allow for wages paid to employees but generally do not permit any deduction for compensation paid to the business owner or their family members for salaries drawn, health benefits paid or pension contributions earned.

These same earnings are then taxed again when the individual business owners file their own personal income tax returns. In fact, very preliminary findings from a survey still being conducted by one of our state affiliates indicate that a pure flat tax would significantly raise the tax burden on small business owners. When one considers the limitations on business deductions and the double-taxation of income - any possible savings derived from a tax rate reduction is generally lost. This is especially true for small business enterprises with under 50 employees which are generally service businesses. The flat tax decidedly favors capital intensive enterprises such as manufacturing as opposed to service businesses.

Since the small business sector is one of our most vibrant economic sectors, caution is needed before launching any drastic change to the tax structure that underlies traditional business decision making. We feel that too much emphasis is placed on the tax consequences of business decisions currently and long for the day that decisions can be reached based on their true economic viability. However, reality compels us to warn of any precipitous change out of concern for the effect on the economy. We believe that a large measure of blame for the savings and loan crisis we have just concluded can be laid on the doorstep of the 1986 Tax Reform Act. When retroactive measures were passed concerning real estate investments there were immediate and devastating consequences to the valuation of the properties affected.

Business Capitalization and Equity Formation

The lifeblood of small business entrepreneurs is access to adequate capital. In many instances the primary motivating factor for those who invest their resources in the venture capital market is to achieve a greater after-tax return on their investments. Some of the current flat tax proposals specifically exempt from taxation any income derived from interest, dividends and capital gains. Aside from the essential question of the fairness about providing such a huge tax break to the top 5% of the taxpaying public, there are real concerns about the potential for evaporation of venture capital funds given an environment where there is no tax on returns from relatively risk-free

investments. We have seen studies predicting both a dearth of and an excess of venture capital funds should the flat tax proposals be enacted. We urge the Committee to hold hearings specifically focusing on this question of capital formation during its deliberations on tax system reform.

Equity Protection

The average family's greatest asset is the equity in their home. Small business entrepreneurs often tap this equity for start-up capital. We have seen projections all over the economic landscape on the effect that flat tax implementation would have on real estate values. Fortune magazine estimated that American homeowners would lose $1.2 trillion in equity in year one of a flat tax. We don't know if that is accurate or not - but the question deserves intensive scrutiny before any change is contemplated in the deductibility of home mortgage interest and property taxes.

Specific Issues Concerning the Value Added Tax or National Sales Tax

Underground Economy

The single best argument in favor of the VAT or National Sales Tax is that it would snag tax revenues currently not being reported and paid. The underground economy is expanding despite all efforts by the Internal Revenue Service to reverse the trend. The question to be considered: Is this salutary effect worth the risk of a major change in legitimate consumer consumption habits because of perceptions about the cost of goods and services? That is the impact the creation of a VAT or National Sales Tax would have, especially if the rate were anywhere near the 21% to 25% figure that is being bandied about in the press.

Regressive Nature of Sales Taxes

The undeniably regressive nature of sales taxes would have to be addressed in any contemplated legislation. This could easily be remedied through the creation of specific exemptions on food, clothing, prescription drugs, etc. or through the creation of a refundable credit for certain low-income taxpayers.

Administrative Feasibility

We have grave concerns about the administrative feasibility of the VAT or National Sales Tax proposals. The most troublesome taxpayers the IRS has to deal with -- and we have to represent -- are those business taxpayers who fall behind in their payroll tax deposits and run up trust fund tax liabilities. These occur because the vast majority of these business enterprises have never been adequately capitalized and find themselves using the trust funds they hold for the government as their operating capital. The problem is significant under the current tax system where we are only talking about the employees' Federal Income Tax withholdings and the employees' share of the FICA tax liabilities. We shudder to think what dimensions the problem will take on when we institute a VAT or National Sales Tax and now expect these same small businesses to collect, account for and pay over in a timely fashion not just 20% or 30% of their gross payroll but 20+% of their gross sales!

The Mythology of Tax Reform

There are some myths about tax reform we believe need debunking. No flat tax proposal we have seen to date would eliminate the Internal Revenue Service. To believe otherwise is not to confront reality. Much has been made of the ten line tax form. We submit that even if the form were reduced to three lines:

Line 1.	Gross Income
Line 2	Times Flat Tax Rate
Line 3.	Send this Amount

all it would mean is that there would be a great deal of IRS interest into what was included in Line One! Under such a system, the IRS could eliminate tens of thousands of clerks laboring away in their Service Centers keeping track of the hundreds of tax forms and publications and replace them with legions of new auditors trained to perform income probe examinations to insure taxpayers were truly including all their income on line one.

A VAT or National Sales Tax would necessitate that thousands more Collection employees be assigned to the task of tracking and collecting all those new trust fund revenues the nation's businesses would now be responsible for collecting. In addition, the accounting requirements imposed on businesses would far exceed anything near what they now are required to maintain. For one thing, given the anticipated amounts involved and the need to provide for a steady stream of government revenues to replace the wage withholding stream, one could anticipate that business would be required to file much more often then quarterly.

Faced with these new and troublesome challenges, we have no doubt that the bureaucracy could easily redefine its mission to stay in business. We live in a complex world. There are no easy solutions to these complexities, despite our wish that there would be. The best we can do is provide a system that is comprehensible, predictable and fair as possible. And preferably one that does not change every year. One of the best things Congress could do for American small business and the American economy is impose a moratorium on tax law changes for five years.

Summary

We appreciate this opportunity to come before the Committee and share our views about this critical issue. We pledge our willingness to continue to support the Committee in its deliberations and will be happy to respond to any questions members may have concerning our remarks.

Chairman ARCHER. Thank you, Mr. Martin.

Mr. Crane.

Mr. CRANE. I just wanted to make one comment referring to the Chairman's comments about that 1986 tax law. And this also addresses the point that you raised, Mr. Chairman, about determining what the percentage of a flat tax would be. That is under what is called static analysis.

I remember the time we took the maximum capital gains rate from—what was it?—40 down to 28 percent, in 1978. All the experts were called before our Committee to assess the revenue impact, and they all, universally, scored it as a revenue loser. It turned out producing big increases in revenue, but, more importantly, explosive increases in venture capital upon which new business startups are dependent. And that means more taxpayers.

We went through the identical procedure again in 1981 when we took it down to 20 percent. And even some of President Reagan's people from Treasury were concerned when asked to score that. They thought it would have minimal impact, but it produced an even bigger increase in revenues and an even bigger increase in venture capital.

I remember when we were in an executive session over in H–137 on the markup of that 1986 tax bill. I was sitting next to this guy from Treasury, and I was looking over his paper that he had provided to inform us. They had listed that increase in the maximum capital gains rate as a $25 billion revenue raiser over 5 years, as I recall.

I asked him at the time, "How could you do that, when we know the experience of taking that capital gains rate down, both in 1978 and 1981?" He said to me, cynically, "Congressman, this bill does not become law until January 1, 1987, but the fiscal year starts on October 1, 1986, and we anticipate raising $20 of that $25 billion between October 1 and December 31." And they were right on target, sad to say.

But at any rate, I throw that out only because I have respect for our Chairman's guidelines and the discipline necessary. And if it turned out that, by some of these simplifications, you increased revenues, you can go back and revisit and start ratcheting it down even further. But I have never heard of any economist who ever tried to advance the argument that raising taxes promotes economic growth. Quite the contrary.

Do you want to get a word in edgewise?

Chairman ARCHER. No.

Mr. CRANE. Oh. Yes, and I agree with our Chairman that there are benefits under consumption taxes that a flat tax approach would not address.

But something with regard to Mr. Martin's comments: I have been promoting a flat tax for 25 years, and Chairman Rostenkowski when he was in charge just laughed me out of the room when I tried to get him to hold hearings on it. But mine does not tax business at all, on the grounds that businesses do not pay taxes, they gather taxes. That is a cost, like plant and equipment and labor, and the regulatory burdens that have to be passed on and still get a fair return on investment or you are out of business. And

the only people who pay, taxpayers, are individuals. They pay it either with their taxpayer hat on or their consumer hat on.

To eliminate some of those extraneous burdens to me would be highly desirable on another count, as well, so as to eliminate some of the heated rhetoric we have had over the past 1½ years on, "You malefactors of great wealth out there ripping us off with your extortionate profits." I think the class warfare would be muted and diminished considerably if we could get rid of the imposition of that burden on the business community and go back to leveling a tax one time, at the time you earn it, and it is forever after home free if you save it or invest it.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Gentlemen, important objectives, and I think you would likely agree, one of the most important objectives of tax reform is to move toward a tax system that dramatically increases the national savings rate.

I noticed in your testimony some references specifically to the fact that a lot of small businesses are started up out of the savings of the owners, and that is a principal source of capital for business starts.

I would like each of you to explore that a little bit. And specifically, Mr. Martin, you were critical of the idea of, in an income tax system, removing the home mortgage deduction because it would specifically impact on access individuals have to a major source of capital. Would you like to elaborate on that? Then, if each of you would, generally comment on where increasing the national savings rate is as an objective of tax reform.

Mr. MARTIN. Well, Mr. English, I do not think my role is to be critical, but to just point out some pitfalls that we see. If we believe the statistics that we see coming out from learned articles, if I believe what I see when my clients come in and say, "Can I afford to buy this house?"—and they normally buy a 20- to 30-percent more expensive house than they can afford because of the tax savings that they receive—so that leads me to believe that these learned articles which project a 20- to 30-percent decrease in real estate values, if the mortgage interest and real estate tax deduction goes away, are probably correct.

Now, if I have a house that I bought 5 years ago and I put the minimum 10 percent down, and now 5 years later I want to go into business but the house has decreased in value by 20 percent, I have no ability to borrow against that house. I have no ability to take an equity loan. That is our concern.

Mr. ENGLISH. So you feel that the loss of a mortgage interest deduction by moving to a flat tax, relative to the current regime, would actually reduce access to capital for small business starts?

Mr. MARTIN. I think it could happen, yes, sir.

Mr. ENGLISH. OK. Before I move on to the others, I wanted to ask you a specific question about one of your comments in your written testimony. And that is, you express concern that there would be a dramatic increase in accounting requirements in all of the tax reform proposals that are before us.

I wonder, as a practitioner, do you feel that a subtraction method value-added tax with, say, an expensing regime, or a cash flow regime for expensing capital investments, need be more complex than the current tax system?

Mr. MARTIN. The only value-added tax system I am familiar with and have had any real dealing with is that in Great Britain, and I find that system to be terribly complex. It takes a great deal of accounting to handle.

Mr. ENGLISH. Could there not be a much simpler system, though, that would be essentially subtraction method value-added tax?

Mr. MARTIN. Well, the simplest system is going to be the national sales tax. I mean, that is simplicity in itself.

Mr. ENGLISH. Yes.

Mr. MARTIN. But then, what is the rub? Is it fair?

Mr. ENGLISH. OK.

Mr. MARTIN. I mean, a national sales tax, most people feel—and I think it is true—is the most regressive taxation there is.

Mr. ENGLISH. Yes, I was just trying to address the complexity. Thank you for your comments.

Mr. Padgett, do you want to elaborate on the question?

Mr. PADGETT. Well, just to your comment about savings, Mr. English, I think all of us think of it, perhaps, in different ways at different times. You know, it could be as simple as stuffing the money in the mattress. It could be investing in CDs.

In my case, we are fairly capital intensive, with rapid technological change, so the first thing I think about when I think about simplifying the Tax Code is the less time, effort, and expense that I have to spend on performing those services to satisfy the government, as opposed to using that money productively in the growth of my business and serving my clients. If that expands—which I hope it would do, with the reinvestment of that money—then, naturally, I would have more tax to pay.

Mr. ENGLISH. Yes, and also elaborating on your testimony—I see my time has run out, but if I could ask one more very quick question—you say that you are concerned about the USA tax, and you specifically reference the sharply progressive rates.

If we were to adjust those rates and stick with a consumed income tax, but have it much flatter with lower marginal rates, would you be more comfortable with that approach?

Mr. PADGETT. Well, I would say we would certainly be willing to look at it. One of the premises behind our approach to the whole issue is to reduce the rhetoric down to specific examples. So the real challenge and the enjoyment that we have had in working through this process has been to actually apply the information in each proposed bill to current industry practice. So we would be interested very much. Certainly, the simpler it is, the better. I know that is hedging a little bit.

Mr. ENGLISH. My time is up. Thank you very much, gentlemen. I apologize, Mr. Thayer, that we did not have more of a chance to interact.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. Just a quick question, Mr. Chairman. To follow up on Mr. English's question on the tax deductibility of mortgage interest, what would happen to mortgage interest rates if mortgage

interest was no longer tax deductible? Do you think they would stay the same?

Mr. PADGETT. Well, it is an interesting exercise, if I can comment. First, my overall impression is that they would drop. My guess is it would probably be in the area of about 25 or 30 percent. I am not an economist, and I have no practical experience with it, but my guess is that because of the reinvestment in the economy, the growth of business, the growth of employment, people are going to have more money to spend and are going to be looking at other avenues to invest and, certainly, home ownership and equity would be part of that.

Now, part of the problem in looking at this, from anybody's viewpoint, I think is the tampering that is involved. And whether it happens overnight, Mr. Hancock, or whether it happens in 2 or 3 years, I cannot begin to tell you; although I would suggest a longer timeframe than we are probably comfortable discussing at this point.

Mr. HANCOCK. In other words, what you are saying is, at least temporarily, that it very well could be that the homeowner could end up, if he did not deduct it—paying basically the same thing, if his rates went down?

Mr. PADGETT. For the near term. But ultimately, I think it is going to be a much better situation.

Mr. HANCOCK. Would that possibly redirect savings into stocks, bonds, and business, and redirect the money available for expansion of business and what-have-you, rather than into residential real estate?

Mr. THAYER. That is, indeed, very possible, Mr. Hancock. I, too, think that the result would be that they would go down. The smaller businesses certainly would have more disposable income to redirect into some other forms of investment. But I think the key there would be whether or not there was an incentive from the Federal Government in some way for them to, indeed, do that.

You have got a panel coming subsequent to this panel, talking about pension reform. And here, I think, you would want to somehow annex the two, and we can talk about dollars that could be redirected into that specific area as a result of that decrease.

Mr. HANCOCK. It is an interesting exercise. You know, the Japanese, basically, following World War II said, "Look, save your money; invest it in business." We, following World War II, said, "Buy a house." And sometimes you kind of wonder if maybe the Japanese were not smarter than we were in that particular area. Anyway, thank you, gentlemen.

Chairman ARCHER. Gentlemen, I am going to make one brief insertion here, and then we will excuse you and we will go vote. And then we will take our next panel.

I am terribly concerned about any tax reform effort that will revisit what we did in 1986. Every group that testifies before this Committee will say, "But if you will only correct this, then it will be a much better code for us." And then the next group comes in and they say, "Well, correct this over here, but we do not care if you do anything massive or really restructuring, because we are kind of comfortable with this, but you just need to fix this one little

part of it." And I will submit to you that we will end up with another 1986, without a doubt.

The other thing, I would say, Mr. Martin, to you is that deductions are wonderful, but the more deductions you have, the higher the rate is going to be. And the higher the rate goes, the more demand there is going to be for more deductions. Unless we change our frame of mind as we approach taxation and stop thinking in terms of deductions and start thinking in other terms, I do not believe we are going to end up with any truly rational, beneficial tax reform.

It is a very difficult challenge for me, who believes we should scrap income as the base for taxation, to be able to begin to talk to people and they say, "Well, what about a deduction?" I say, "Hey, you do not have anything to deduct against. You are getting your whole paycheck. You are getting all of your income. There is nothing to deduct against." You have got to think very differently if, in fact, we have a complete replacement and no longer use income as a base of taxation. That is a big educational job that I hope we can get done, because I think the benefits will be enormous.

I think the more that we can release unnecessary expenditures for compliance—and I do my own income tax, and it takes me about 2 days every year to do it—that work effort is worth something that could be used doing something else. Some of the brightest minds in this country spend full time dealing with this Tax Code. They are not producing wealth. They are reshuffling dollars. What if those brightest minds in this country were spending full time producing wealth, instead of reshuffling dollars? Would we not all be better off?

Then there is the savings issue, which is vital because every economist tells us that if we do not have more savings we are not going to have the job creation, we are not going to have the growth, we are not going to have lower interest rates, we are not going to have the things that we want in this country, and our Tax Code should be shifted in a way where it develops savings and it is not a barrier to savings.

If we do not tax income, we have a zero tax on savings. We have got to start thinking in a different frame of mind. I could go on and on, but when we do use income as the base and we begin to talk about, "Well, how can we refine this and make it really something that we like?" I do not think we will ever get there. It will be like chasing the end of the rainbow because, perhaps one of you testified, the big complexity in the Code is, "How do you define income?" And that will continue to be a problem.

As long as income is the base, the question of how you define income, and the timing, and whether you are an independent contractor or not an independent contractor—which we are struggling with today as a great complexity—will continue to be in the Code. We will never get rid of that.

I simply submit that, if we think this thing through, we will say that as long as we use income as the base, we will always end up where we are now, and we will continue tinkering and tinkering and tinkering as we run into problems.

Thank you for coming, and thank you for listening to my closing comments. I have to go vote. We welcome your input as we move

along. This is just the beginning of the process. We are not ready to do anything immediately, but we do want to get all of the information in hand so that when we—hopefully, in the next Congress—will be able to look at some specific alternatives and work on them, maybe we will have you back again.

But in the meantime, any ideas that you have, we welcome them, and we thank you for coming today.

Mr. PADGETT. Thank you, sir.

Mr. THAYER. Thank you.

Mr. MARTIN. Thank you, Mr. Chairman.

[Recess.]

Chairman ARCHER. The Committee will come to order.

The Chair apologizes to our last panel for keeping you waiting. And at long last now, we are pleased to hear your testimony, so if you would take seats there at the witness table. At least two members of your panel understand these disruptions, because they have had to accommodate the demands of the bills before in their careers. So we are happy to have you with us.

Congressman Zion, if you would lead off, identify yourself and the people that you represent. And without objection, each of your printed statements or written statements will be inserted in the record in full. If you will attempt to limit your oral presentation to 5 minutes, the Chair would be grateful.

Mr. Zion.

STATEMENT OF HON. ROGER H. ZION, HONORARY CHAIRMAN, 60 PLUS ASSOCIATION, WASHINGTON, DC; AND FORMER MEMBER OF CONGRESS

Mr. ZION. My name is Roger Zion. I represent the 425,000 senior citizens calling ourselves 60 Plus. Mr. Chairman, first, I want to congratulate you, Senator Lugar, and others who have introduced a consumption tax. The Council on National Policy had a meeting about 1 month ago, and Nancy Mitchell, an economist, said that it costs about $200 billion for individuals and corporations to comply—well, first to understand, and to comply with the provisions of the Revenue Code. I spoke to her. I said, "That is not nearly enough." She said, "Well, I probably understated it."

My wife and I spent 2 days just accumulating materials to send to the accountant. It cost him $6 just to send the materials back to us. As you know, Mobil Oil has testified that it took them 50 man-years, $100 million, and 109 pounds of paper, just trying to comply with the provisions. So if you extrapolate our individual experience and that of Mobil Oil, times the number of companies that have to do this, that $200 billion figure is minimal.

I believe, Mr. Chairman, you have suggested that there is about $200 billion that is not reported by the prostitute, the drug dealer, the self-employed, and others. I would like to submit, sir, that that is considerably minimal, too. It has got to be many times that.

Now, the big argument that I hear in discussing this with lots of people is that your consumption tax is not progressive. Baloney. The guy that buys a yacht spends many, many times the tax money than the fellow that buys the rowboat spends; the guy that buys a Maseratti, a lot more tax money than the guy that buys a

used Chevrolet. So I would like to say that it is a voluntary tax on the rich.

I would further suggest, though, that you might exempt food and medicine, for a couple of reasons. One, exempting medicine would help research and pharmaceuticals save billions of dollars in hospitalization, surgery, and so forth. And then, most importantly for our members, is that it would eliminate the "death tax."

Our 425,000 senior citizens are from all around America. The seniors are struggling against the onset of government intervention in their lives. Operators of small business are not concerned only about their lives, but the future lives of their children and their grandchildren.

There is nothing more meaningful to American seniors or the American economy than tax relief for small business. Without it, economic security, economic expansion, and job creation will be lost.

Of all the taxes that negatively affect small business, the Federal estate and gift tax is perhaps most killing of all. It has been singled out again and again as one of the most job-killing taxes in America. Even the President's White House conference on small business listed this tax as a high priority for elimination. If the Congress and the administration truly want to send a positive message to small business, they have to repeal this "death tax."

In the Gallup Poll taken this last year of over 1,000 small businesses, in 61 percent of these businesses they said that payment of estate taxes will limit their potential business growth. Sixty-four percent report that payment of estate taxes will impact their ability to sustain their family business. Of those expecting to liquidate all or part of their businesses, 50 percent expect to eliminate 30 or more jobs; 20 percent, to eliminate 100 or more jobs. Sixty percent of businessowners say that if the estate tax were eliminated, they would hire additional workers for the coming year.

[The prepared statement follows:]

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Roger H. Zion (R-IN., 1967-'75)
Honorary Chairman

James L. Martin
President

Testimony by The Honorable Roger H. Zion, (R-IN, 1967-'75)
Honorary Chairman of the 60 Plus Association
before the
House Ways and Means Committee
Rep. Bill Archer (R-TX), Chairman
Reform the Tax Code
Wednesday, April 24, 1996
10 a.m.
Room 1100 Longworth House Office Building

Good Morning, I want to begin by thanking you Mr. Chairman, and the other members of this committee for giving me and 60 Plus the opportunity today to testify on this very important issue.

60 Plus is a three year old organization of more than 425,000 senior citizen lobbyists from all around America. These seniors are struggling against the onset of government intervention in their lives. They are operators of small businesses, and they are concerned not only about their lives, but about the future lives of their children and their grandchildren. There can be nothing more meaningful to America's seniors or to the American economy than tax relief to small businesses. Without it, economic security, economic expansion and job creation will be lost.

The importance of what we are discussing here today has been documented over and over again, to the point where I believe no thinking person could possibility deny that small business tax relief is the key to renewed economic opportunity and hope to our entire nation.

I want to point out Mr. Chairman, that of all the taxes that negatively effect small business, the Federal Estate and Gift Tax is perhaps the most killing of all. This tax has been singled out again and again as one of the most job killing taxes in America today. Even the President's own White House Conference on Small Business listed this tax as a high priority for elimination in order to get government out of the way of all small business' hope, growth and opportunity. If the Congress and the Administration truly want to send a positive message to small business in America, then together they must repeal the Estate Tax...or as many refer to it, "THE DEATH TAX!"

The evidence that elimination of this tax would help the economy is overwhelming Mr. Chairman, as I know you know.

For example, according to a Gallup Poll taken last year of over 1000 small businesses:

- Sixty-one percent of business owners said that payment of Estate Taxes will limit their potential business growth;

- Sixty-four percent of business owners report payment of Estate Taxes will impact

their ability to sustain their family business;

- Of those expecting to liquidate all or part of their business, 50 percent expect to eliminate 30 or more jobs and 20 percent expect to eliminate 100 or more jobs, and

- Sixty percent of business owners said that if Estate Taxes were eliminated, they would hire additional workers in the coming year.

Mr. Chairman, I can go on and on with intellectual argument after intellectual argument and statistical argument after statistical argument with numbers ad infinitum, but Mr. Chairman, I want to address another aspect of this tax on small business that doesn't get much attention and yet is the most compelling reason for action to eliminate this tax now...the moral issue.

As you know Mr. Chairman, the only action by an American citizen that triggers this tax is either a desire to give to the next generation economic opportunity or DEATH. In other words, in most cases, DEATH is the only thing that causes this taxation. Therefore, due to the unpredictability of when we will be called to meet our maker, when and on whom this tax will be enforced is likewise unpredictable. The longer we wait to end this obnoxious tax, the more people and families we will unknowingly sentence to suffer this tax. We don't know who will lose jobs because of delay, we don't know which families will be further devastated by government because of delay, we can't know which enterprising mother will be unable to pass on to her daughter economic independence because we hesitated, we can't predict which inner-city business will be lost to future generations thereby condemning, unnecessarily, more children to lost hope for a better future due to "timing".

Repealing the Federal Estate and Gift Tax immediately not only makes real economic sense, and good government policy, but it makes moral sense as well.

However Mr. Chairman, let me be very clear about what I am about to say.

As you know this unconscionable tax has been repealed several times in the past only to find its way back into the IRS tax code. According to the Tax Foundation, the first transfer tax was imposed in 1797, and was repealed in 1802. Due to the Civil War, transfer taxes were adopted again in the 1860's and the Congress of 1870 repealed it once again. In 1898 the nation once again passed a transfer tax only to have it repealed for a third time in 1902. So we have clear evidence, Mr. Chairman, that to merely repeal for yet another time this "GRAVE ROBBERS'" tax is no guarantee American taxpayers will truly rest in peace.

Therefore, we at 60 Plus realize that to repeal the DEATH TAX is leaving the job undone. In order to insure small businesses and all Seniors that this tax will not rise from its grave yet again to haunt American prosperity, we must see to it that the IRS is unable to breath life back into it. It will be necessary to drive a stake through the heart of the government's ability to resurrect this anti-family, anti-job tax.

We have no alternative -- no choice but to complete the job by eliminating the present system which, if we fail to do so, will surely give rise to the Death Tax again.

We must be diligent in our commitment by supporting changes in our tax system that guarantee that the DEATH TAX IS DEAD once and for all.

Thank you Mr. Chairman and the rest of the Committee again for this opportunity.

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60 Plus is a nonpartisan seniors advocacy group with a free enterprise, less government, less taxes approach to seniors' issues. 60 Plus is one of the fastest growing seniors groups in the country with over 425,000 citizen lobbyists. 60 Plus publishes a newsletter, Senior Voice, and a Congressional ratings system, bestowing a GUARDIAN OF SENIORS' RIGHTS award on Members of Congress in both political parties who vote "pro-senior" on major issues.

Mr. ZION. Mr. Chairman, if I could defer to my associate here, Jim Martin, a long-time "Hillite," formerly associated with some of our colleagues in the House, I will defer to Jim for a moment.

Chairman ARCHER. All right. Mr. Martin.

STATEMENT OF JAMES L. MARTIN, PRESIDENT, 60 PLUS ASSOCIATION

Mr. MARTIN. Thank you, Mr. Chairman.

Chairman ARCHER. You also are here representing the 60 Plus Association?

Mr. MARTIN. Yes, I am. I am president of the 60 Plus Association. We are a senior citizens' advocacy group.

Chairman ARCHER. OK.

Mr. MARTIN. This is the No. 1 issue with seniors.

Chairman ARCHER. You may proceed.

Mr. MARTIN. Thank you, Mr. Chairman. This is what we call the most confiscatory of all taxes, perhaps the most unnatural of all taxes. It is applied uniquely to that which has already been taxed. We call attention to this.

We know that this tax is very well known to your panel. Many people have spoken eloquently here already today about the social consequences of this loathsome tax. Suffice it to say that 70 percent of family businesses do not survive a second generation because of it; 87 percent do not make it through a third.

You are even going to hear from one prominent tax attorney, maybe the preeminent attorney in the country on this tax. It is hard to believe, he is trying to put his own firm out of business; he loathes this tax so much.

In testimony before your Committee last year, Mr. Chairman, from a Mississippi tree farmer, Chester Thigpen, whose son is here today, he painted a poignant reminder of this tax's impact on a small business operation. Mr. Thigpen's plight belies the key reasons this tax was enacted in the first place: One, to break up concentrations of wealth; two, to raise revenues.

On part one, the amassers of great wealth have the lawyers and accountants to avoid this grave robbers' tax; but not Mr. Thigpen, who worked so long and hard to accumulate his small tree farm, but now finds he cannot pass it along to his children and grandchildren without being socked by a massive tax on his aftertax savings.

On part two, it is simply not a revenue raiser, grossing 1 percent of receipts year in and year out, as you well know. It is probably a revenue loser. And in the words of the well-known economics professor who testified last year on the other side, the Senate Finance Committee, he said this tax is not doing what progressives, as he put it, thought it would do. In fact, he said at the outset of his testimony, "I am an unrequited liberal. I now believe that the gift and estate tax is a bad tax, even, and perhaps especially, on liberal grounds, and serious thought should be given to repealing it."

Mr. Chairman, your Committee took significant action last year when you voted an increase in the estate tax exemption from $600,000 to $750,000. Unfortunately, it never became law. And while this was a step forward, the ultimate solution, we feel, is total repeal—the approach advocated by about 100 House Members

to date. They support H.R. 784 introduced by Representative Chris Cox of California. And it is supported, I might add, by many members of this panel.

Let me just conclude by saying, Mr. Chairman, that there are two certainties in life: taxes and death. And now, you can add a third certainty: taxes after death, because of this so-called inheritance or death tax.

Another economist, Milton Friedman, says it sends a bad message to savers: That it is better to spend your money on, perhaps, wine, women, and song, than it is to save it. Mr. Crane referred earlier to his son saying, "Hey, I may as well spend it. Uncle Sam is going to take it."

Worse yet, perhaps spending it on politics. I refer to Ross Perot. Someone trying to figure out what makes Mr. Perot tick points out that in the 1992 Presidential election he was very proud to say that he spent $60 million on his campaign, all his own money. Well, that is not so, if you look at the top estate tax right now of 55 percent. Actually, 33 millions of those dollars would be tax dollars, under the current system.

So, I will make an interesting proposition to this Committee. Since polls show that Mr. Perot apparently is not hurting either President Clinton this time around or Senator Dole, let us go ahead and repeal this tax, and perhaps he will get out of this race.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow. A copy of Edward J. McCaffery's testimony before the Senate Committee on Finance, dated June 7, 1995, is being retained in the Committee's files.]

The 60 Plus Association

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*Tax Fairness for Seniors * Repeal Unfair Inheritance Taxes!*
*Guardian of Seniors' Rights Award * Senior Voice Newsletter*

Roger Zion (R-IN, 1967-1975)
Honorary Chairman

James L. Martin
President

Testimony by James L. Martin
House Ways and Means Committee, Rep. Bill Archer (R-TX), Chairman
Reform the Tax Code
Wednesday, April 24, 1996, 10:00 a.m.
Room 1100 Longworth House Office Building

Good morning, Mr. Chairman and Members of the Committee, my name is Jim Martin and I'm President of the 60 Plus Association. It's an honor to speak with you about tax reform and how today's tax system impacts on small businesses and particularly on senior citizens, their children and grand-children.

There's no question that the income tax system as we know it should be ripped out by its roots and replaced with a fairer, simpler system.

Mr. Chairman, let me say that as young reporter covering Capitol Hill in 1962-63-64 and then as an Administrative Assistant for six years to Representative, later Senator Edward J. Gurney (R-FL), I know the hard work and long hours that go into these hearings.

60 Plus is a three-year-old anti-tax advocacy group that has dedicated itself to repealing the Federal Estate and Gift Tax, the most unfair and confiscatory of all taxes placed upon Senior Citizens. The 60 Plus Association has for three years been in the forefront of efforts to repeal what is gruesomely called the death tax, or the grave robber's tax, this most confiscatory of all taxes, from writing to House and Senate members, testifying about its burdensome effect on small mom and pop operations, to holding a seminar on repeal, to drafting letters to Members of Congress co-signed by 35 national organizations, a copy of which we will submit for the record.

We also submit the testimony of a well-known liberal economics professor who testified last year before the Senate Finance Committee and whose testimony rebuts the argument that this tax helps working men and women.

Also, I would remind the Committee of one of its best witnesses last year, Chester Thigpen, the 83-year-old tree farmer from Mississippi, the grandson of slaves, a hard-working African-American small businessman who faces an overwhelming tax burden trying to pass along his estate to his five children. 60 Plus submits an editorial from the *Washington Times* regarding Mr. Thigpen's plight.

Also a *USA Today* column by Grover Norquist on the effects of the Estate Tax on small businesses is submitted for the record.

Submitted, too, are remarks culled from hundreds of letters from American working men and women who oppose this most burdensome tax. And following are remarks from literature generated by Rep. Chris Cox (R-CA) author of H.R. 784, to repeal this tax. As Mr. Cox said earlier in a Dear Colleague letter, "When the National Review published its "New Year's Resolutions" wish list for 1996, they asked 10 key conservative groups for legislation that is "simple...widely supported, and would yield great political dividends."

Mr. Cox went on to say: "I am proud to say that the H.R. 784 was included among this list. From the National Federation of Independent Businesses who labeled the estate tax the single greatest government burden imposed upon small family businesses, to the Small Business Survival Committee, to the 60 Plus Association, taxpayer groups around the nation (at least 35 such groups signed a letter endorsing H.R. 784) urge that we act now to repeal the most destructive tax on the books."

Mr. Cox further states:

One of the most powerful reasons that people work is to make life better for their children and loved ones. That's why families will go to great lengths to circumvent this most unnatural of all taxes, which seeks to repeal human nature.

60 Plus is a nonpartisan seniors advocacy group with a free enterprise, less government, less taxes approach to seniors' issues. 60 Plus is one of the fastest growing seniors groups in the country with over 425,000 citizen lobbyists. 60 Plus publishes a newsletter, Senior Voice, and a Congressional ratings system, bestowing a GUARDIAN OF SENIORS' RIGHTS award on Members of Congress in both political parties who vote "pro-senior" on major issues.

The Estate Tax was first instituted as a temporary emergency measure designed to raise revenue during war time. The first Federal Estate Tax was enacted in 1797 as a way for our nation to build a navy to police our shore. The tax was repealed in 1802. It was brought back during war time-during the Civil War and the Spanish-American War, for instance. The Estate Tax became a permanent feature of the tax code in 1916. Its basic structure has remained largely unchanged since the 1930s.

Aside from being a source of revenue, another express purpose of the Estate Tax was to break up large concentrations of wealth. (Of course, this principle is altogether inconsistent with a free-enterprise system and a competitive world economy.) 75 years of experience however, suggests that-rather than being an important means for promoting equal economic opportunity-Estate Taxes are in fact a barrier to economic advancement for people of all economic circumstances.

In 1995, these taxes raised less than 1% of total federal receipts. At the same time, the estate tax is one of the costliest taxes for the IRS to administer. The transfer tax provisions take up 82 pages of the Internal Revenue Code and 289 page of Regulations issues by the IRS. Estate Tax planning has gotten so complicated that the IRS now maintains a separate estate and gift tax unit in each of its field offices.

Many disputes between the IRS and estates end up in court. There are more than 10,247 transfer cases now pending before federal courts. Compliance and enforcement costs alone eat up about 65 cents for every $1 collected, according to one estimate.

70% of family business don't survive through the second generation. 87% don't make it through the third.

On April 5, 1995, the House approved (as part of the Contract With America) a boost in the Estate Tax exemption, from $600,000 to $750,000. This bill also indexes the exemption so that it can keep pace with inflation in future years.

Mr. Chairman, you have expressed a keen interest in reforming the current tax code with an eye toward moving to a more fair and equitable system of taxation. The House Small Business Committee, and your Committee, have held hearings on the adverse impact which the Estate Tax has on family-owned businesses. Given how wasteful and destructive the Estate Tax is, however, policymakers shouldn't be satisfied simply with raising the exemption-but should seek to repeal the Estate Tax altogether.

Those who support Estate Tax repeal should proceed on a two-track process, then: both to move free-standing legislation (such as H.R. 784), and also to seek the repeal of the estate tax as part of a comprehensive overhaul of the entire Federal tax code, as proposed by your Committee.

Given that the Estate and Gift Taxes are among the strongest sources of the tax code's current bias against savings and capital formation, the best chances for repeal of the Federal Estate and Gift taxes may lie in the context of completely overhauling the Federal tax code.

In addition to working directly with members of Congress, participants of the 1995 Estate Repeal Summit, sponsored by the 60 Plus Association, should be encouraged to work with the many national grass-roots organizations interested in this subject to publicize the need for Estate Tax repeal and to galvanize support across the country for the Family Heritage Preservation Act.

Consider the wisdom of economist Milton Friedman, who said of this most discouraging of all taxes, a tax applied uniquely to that which has already been taxed, that it sends a bad message to savers, to wit: that it is o.k. to spend your money on wine, women and song, but don't try to save it for your kids.

In conclusion, Estate taxes **discourage saving, discourage entrepreneurship, and penalize families.** Estate taxes are **anti-family.**

Estate taxes cause **business closures, increased unemployment,** and they generally restrain businesses from operating and competing in an open marketplace.

For every "Rockefeller" or other "wealthy" individual who some feel should have to "pay" this extra tax, we at 60 Plus say two things:
1. These individuals have already paid their taxes duly and properly.
2. For every "Rockefeller" being hit by this double tax there are thousands of mom and pop businesses and small farms in the 50 states who are literally "run out of business" by this unjust tax.

Thank you, Mr. Chairman.

USA TODAY

THURSDAY, JANUARY 18, 1996

Abolish estate tax

GOP plan would save family farms, small businesses

By Grover G. Norquist

Ben Franklin reminded us that "Nothing is certain but death and taxes," but for too many family farms and small businesses, the federal government's inheritance tax is a death sentence.

More than 70% of all family businesses do not survive through the second generation. Fully 87% don't make it to a third generation.

Karen Kerrigan, the president of the Small Business Survival Committee, says that while individuals die of many causes, 90% of small businesses that fail shortly after the death of their founder are literally torn apart because the inheritance tax burden falls at a difficult transition period. "Estate taxes are nothing less than a hostile government takeover of family businesses," Kerrigan says.

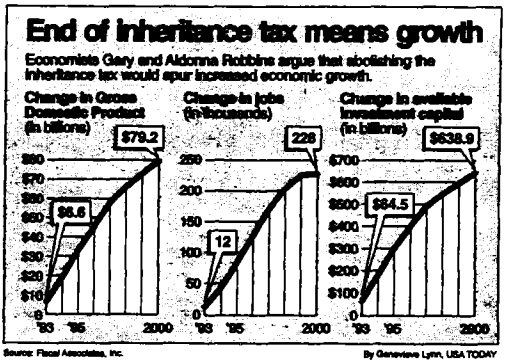
The present federal inheritance tax ranges from 37% to 55% of estates of more than $600,000. Since the $600,000 exemption, passed in 1981, was not indexed for inflation, it is now worth only $377,000 in 1981 dollars. Every year, inflation brings more and more Americans' estates into the grip of the federal tax.

The Democrats were even pushing to tax more Americans at death. As early as 1992, Democratic leader Dick Gephardt and then-Senate majority leader George Mitchell introduced legislation to increase the number of estates subject to federal tax by lowering the exemption from $600,000 to $200,000. For many Americans, their family house and insurance policy would push them into the claws of the Democrats' tax collectors waiting outside the funeral home. Fortunately, the bill died in committee and hasn't been reintroduced.

At a time of a declining savings rate in America, this tax raises only 1% of federal revenue but consumes 8% of each year's savings. That's $15 billion that could have been invested in expanding the economy.

If the estate tax had been abolished in 1971, economists Gary and Aldonna Robbins calculate, our national stock of savings would have been $399 billion larger in 1991, the gross domestic product would be $46 billion higher and we'd have 262,000 more jobs.

While the Democrats have argued for increasing taxes on Americans who die, the Republicans have called for protecting family businesses and farms by raising the exemption from $600,000 to $750,000 and adding protections that stop family businesses and farms from being broken up by the Internal Revenue Service at death.



This estate-tax reform was part of the Contract with America and was in the balanced-budget plan passed by the House and Senate and vetoed by Bill Clinton.

Rep. Chris Cox, R-Calif., with 81 co-sponsors, introduced the Family Preservation Act to completely abolish the federal inheritance tax. Sen. John Kyle, R-Ariz., introduced its counterpart in the Senate with eight co-sponsors.

Jim Martin, president of 60 Plus, a grass-roots lobby for older Americans, says that because of the confiscatory inheritance tax, a third certainty can be added to Franklin's maxim: "Death is no refuge from taxes."

Abolishing the inheritance tax would have many benefits. The Robbinses found that over the next seven years, the capital stock of America would increase by $639 billion, the gross domestic product would increase by more than $79 billion and 228,000 jobs would be created.

We also could toss 82 pages of the Internal Revenue code and 289 pages of its regulations into the trash can. And millions of Americans would not be at the mercy of the IRS and lawyers to protect their families.

The fight between Democrats, who want more Americans to pay the inheritance tax of up to half their life savings, and the Republicans, who are fighting to reduce or eliminate this tax, highlights the differences between the parties. Clinton wishes to maintain a tax that makes lawyers rich, keeps the IRS busy, kills small businesses and plays to the worst instincts of envy.

Clinton knows there are more self-employed Americans than there are union members. And self-employed business people are not dependent on the government.

They are class enemies of Clinton and his party. His 1993 tax increase — two-thirds of which fell on small business — was designed to weaken them. Remember that Stalin, in the same way, viewed independent farmers, or kulaks, as class enemies who needed to be wiped out. Republicans value small businesses as allies that create jobs and reduce the demand for welfare.

But the estate tax's days are numbered.

The flat tax proposed by Sen. Richard Shelby, R-Ala., and Rep. Dick Armey, R-Texas, would abolish the inheritance tax. The Kemp Commission Wednesday called for reform of this destructive tax. As soon as a Republican is elected president, death taxes will be abolished, and the sword of Damocles hanging over millions of small businesses and farms will be removed.

Grover G. Norquist is president of Americans for Tax Reform in Washington, D.C.

The 60 Plus Association

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Roger Zion (R-IN, 1967-1975)
Honorary Chairman

James L. Martin
President

March 11, 1996

Dear Congressman:

Enclosed is a letter urging your co-sponsorship of Congressman Cox's H.R. 784, a bill to abolish what is perhaps the most hated tax in America today. "The Family Heritage Preservation Act" has unified a cross-section of America as exemplified by the broad based interests of the 32 organizations which have signed this letter to you.

These groups represent millions of American voters as well as thousands upon thousands of small businesses which provide new jobs. To support repeal of the "Death Tax," is to support increased revenue, increased jobs and small business opportunity for Americans.

Philosophy should play no role in repeal, but should it, please remember the words of USC economics professor Edward J. McCaffery, who testified before the Senate Finance Committee last fall:

"I begin with a few confessions. I am an unrequited liberal, in both the classical and contemporary political senses of that word, whose views on social and distributive justice might best be described as progressive. I used to believe in the gift and estate tax as a vehicle for obtaining justice. As to the latter belief, only, I am now prepared to confess that I 'was blind, but now can see.' I now believe that the gift and estate tax is a bad tax, even and perhaps especially on liberal grounds, and serious thought should be given to repealing it."

Yours truly,

Roger H. Zion

James L. Martin

60 Plus is a nonpartisan seniors advocacy group with a free enterprise, less government, less taxes approach to seniors' issues. 60 Plus is one of the fastest growing seniors groups in the country with over 425,000 citizen lobbyists. 60 Plus publishes a newsletter, Senior Voice, and a Congressional ratings system, bestowing a GUARDIAN OF SENIORS' RIGHTS award on Members of Congress in both political parties who vote "pro-senior" on major issues.

Dear Congressman:

Your colleague, Christopher Cox (R-CA), has introduced a bill called the Family Heritage Preservation Act (H. R. 784).

The Family Heritage Preservation Act completely eliminates the Estate and Gift Tax placed upon the lifetime of savings which seniors give to their children and grandchildren.

We strongly believe that one of the most unfair of many unfair taxes -- the most confiscatory of all, is the Estate and Gift Tax. It's a dangerous tax. It is also anti-family because it breaks up homes, families, family businesses, and assets generation after generation due to the need to pay these second, third and fourth taxes. It is not a revenue raiser, producing only 1% of gross taxes, rather, it is a revenue loser in that it is a disincentive to job creation, thus shrinking the potential tax base.

To that end, we the undersigned, strongly encourage you to immediately add your name as co-sponsor of (H.R. 784) "The Family Heritage Preservation Act" and to support its passage. Your staff can contact Bradford Campbell in Congressman Cox's office at 225-5611.

(Signature)	GO Plus Assoc. (Organization)
(Signature)	AMERICANS FOR TAX R. (Organization)
(Signature)	SMALL BUSINESS SURVIVAL COMM. (Organization)
(Signature)	[illegible] (Organization)
(Signature)	Assn. of Concerned Taxpayers (Organization)

(Signature)	Conserved Women for America (Organization)
(Signature)	Capitol Hill Prayer Hat (Organization)
(Signature)	CONSERVATIVE CAMPAIGN FUND (Organization)
Amy Moritz (Signature)	The National Center for Public Pol. Res. (Organization)
(Signature)	The Conservative Caucus, Inc. (Organization)
Marton C. Blackwell (Signature)	Conservative Leadership PAC (Organization)
(Signature)	Small Business Council of America (Organization)
(Signature)	Conservative Victory Fund (Organization)
Edmund Peterson (Signature)	Project 21 (Organization)
(Signature)	COALITION FOR AMERICA (Organization)
(Signature)	PRINTING INDUSTRIES of America (Organization)
(Signature)	National Cattlemen's Beef Assoc. (Organization)
Martin Mawyer (Signature)	Christian Action Network (Organization)
(Signature)	National Tax Limitation Com. (Organization)
Stan Hoyman (Signature)	E.S.T.A.T.C. (Organization) and Seven times against the Estate

Tom Schatz (Signature)	Council for Citizens Against Government Waste (Organization)
Lloyd Wood III (Signature)	U.S. Business & Industrial Council (Organization)
[illegible] (Signature)	Am. Conserv. Union. (Organization)
Mike Korberg (Signature)	United Seniors Assoc. (Organization)
[illegible] (Signature)	Arizona Thoroughbred Breeders Association (Organization)
Robert M. Gerard (Signature)	United Dairymen of Arizona (Organization)
[illegible] (Signature)	Arizona Wholesale Beer and Liquor Association (Organization)
[illegible] (Signature)	USA owned / USA made (Organization)
Lewis P. Sheldon	Traditional Values Coalition (Organization)
Nancy Mitchell (Signature)	Citizens for a Sound Economy (Organization)
[illegible] (Signature)	U.S. Chamber (Organization)
Tim Wildmon (Signature)	American Family Association (Organization)
(Signature)	(Organization)
(Signature)	(Organization)
(Signature)	(Organization)

KILL THE GRAVE ROBBERS TAX
List of Organizations Urging Co-Sponsorship of Rep. Cox's (R-CA) (H.R. 784), & Sen. Kyl's (R-AZ) (S. 628) legislation, *The Family Heritage Preservation Act*

1. 60 Plus Association	Jim Martin/Roger Zion
2. Americans for Tax Reform	Grover Norquist
3. Small Business Survival Committee	Karen Kerrigan
4. Competitive Enterprise Institute	Marlo Lewis, Jr.
5. Associated Concerned Taxpayers	Gordon Jones
6. Concerned Women for America	Jim Woodall
7. Capitol Hill Prayer Alert	Harry Valentine
8. Conservative Campaign Fund	Pat Flarety
9. The National Center for Public Policy Research	Amy Moritz
10. The Conservative Caucus	Howard Phillips
11. The Conservative Leadership PAC	Morton Blackwell
12. Small Business Council of America	Paula Calimafde
13. The Conservative Victory Fund	Ron Pearson
14. Project 21	Edmund Peterson
15. Printing Industries of America	Ben Cooper
16. National Cattleman's & Beef Association	Alan Sobba
17. United States Business and Industry Council	Lloyd Wood III
18. United Seniors of America	Mike Korbey
19. The National Tax Limitation Committee	Louis K. Uhler
20. Coalition for America	Paul Weyrich
21. End Severe Taxes Against the Estate	Stan Harper
22. Christian Action Coalition	Martin Mawyer
23. American Conservative Union	David Keene
24. USA Owned/USA Made	Rick Muth
25. Council for Citizens Against Government Waste	Tom Schatz
26. Citizens for a Sound Economy	Nancy Mitchell
27. Arizona Wholesale Beer and Liquor Association	Philip MacDonnell
28. Traditional Values Coalition	Louis Sheldon
29. United Dairymen of Arizona	Robert M. Girard
30. Arizona Thoroughbred Breeders Association	James S. Skelly
31. U.S. Chamber of Commerce	R. Bruce Josten
32. American Family Association	Tim Wildmon
33. National Small Business United	John P. Galles
34. National Beer Wholesalers Association	Ronald A. Sarasin

Support for Rep. Chris Cox's (R-CA) Family Heritage Preservation Act (H. R. 784) from 60 Plus Association Members

I am delighted to learn that there is a group pressing the interests of conservative senior citizens — those people (AARP) are anathema to my political ideology.

- Theodore J., Alexandria, VA

I am enclosing a check to help your continued fight against unfair inheritance taxes. I applaud your trying to increase the exemption from $600,000 to $750,000.

- Bill M., Waycross, GA

I, like you, detest the inheritance tax. Your cause is fine, but I want a total revision of the tax system.

- Jack M., Lakeland, FL

The more successful a citizen is in this great country, the more he is penalized. Americans work hard for themselves and their children and due to these unfair Estate Taxes, the children will suffer. Thank you for helping repeal the Federal Estate and Gift Tax laws. We appreciate your efforts.

- Mr. Ronald B., Chattanooga, TN

Please, with God's help, try to make Congress let us of the middle class die in peace, knowing that our estates will go to our heirs, without heavy inheritance taxes hanging on the back of these heirs.

- Roy B., Sioux Falls, SD

My token aid I hope will help to put a crimp in the IRS's plundering of estates.

- Fred O., Nebraska City, NE

I want to thank you for your conservative bills and the work involved on inheritance taxes and social security. We don't need more social-spending.

- Mrs. Josephine, Evanston, IL

I certainly do endorse the legislation you are behind, to eliminate Federal Inheritance tax, a cruel and unfair tax. It is a tax on estates which have already been taxed through the years.

- Mrs. F. M., Indianapolis, IN

I did not know of your organization until I received the mailer recently. I have been aware and opposed to the efforts to reduce the estate tax exemption, and I'm glad that an organized group is not only fighting the reduction, but going for ABOLITION of the tax.

- Mr. John L., Rancho Palos Verdes, CA

Of all the bad tax laws, I believe the Federal Estate and Gift tax law to be one of the most unfair. I am 73 years of age. I would like to expand my business (and thereby make more jobs), but I will not do so because I feel I must remain liquid in preparation for the big Vulture who will attack my estate upon my death, forcing my estate to make fire sales of property in order to satisfy the Vulture's cash appetite.

- Mr. Wilton E., Marion, SC

I hope you keep up the effort to get the inheritance tax exemption raised. My wife died of cancer at an early age before I knew about making out the funny little paper known as the 'living trust' which gives the $1.2 million exemption instead of $600,000. So my children will be stuck with a big inheritance tax, mainly due to the appreciation of my 1995 house purchase.

- Mr. John S., Manhattan Beach, CA

My estate has been acquired by me with honest Sweat, Blood, and Tears, and it gripes me that these S.O.B's try to get it away from my heirs. I hope I am the fireman of the special place for them in hell!

- Mr. John H., Wilmington, CA

I am glad to know someone is willing to fight one of the most demeaning taxes I know. My parents worked really hard to make a few extra dollars to be able to pass on to their children and grandchildren. What happened? The government ended up as being the heirs, not the ones it was intended for.

- Mr. Robert S., Gainsville, FL

Milton Friedman has pointed out that the Estate Tax sends a bad message to savers, to wit: that it is O.K. to spend your money on wine, women and song, but don't try to save it for your kids. The moral absurdity of the tax is surpassed only by its economic irrationality.

- Institute for Research on the Economics of Taxation, June 3, 1994

I begin with a few confessions. I am an unrequited liberal, in both the classical and contemporary political senses of the word, whose views on social and distributive justice might best be described as progressive. I used to believe in the gift and estate tax as a vehicle for

Support for Rep. Chris Cox's (R-CA) Family Heritage Preservation Act (H. R. 784) from 60 Plus Association Members

obtaining justice. As to the latter belief, only, I am now prepared to confess that I 'was blind, but now can see.' I now believe that the gift and estate tax is a bad tax, even perhaps especially on liberal grounds, and serious thought should be given to repealing it.

- Edward J. M., Professor of Law, USC

Excerpt from Senate Finance Committee testimony, June 1995

We owe a special debt to 60 Plus for getting the tax free amount raised from $600,000 to $750,000.

- Harold I. A., prominent Estate Tax attorney, Birmingham, Alabama, September, 1995

There are two certainties in life: Taxes and Death. Now because of the Inheritance Tax, we can add a third: Taxes after Death.

- Jim Martin, Chairman The 60 Plus Association

I've spent most of my adult life in tax — as an IRS Agent. I've always disagreed with an estate or Inheritance Tax. It discourages saving and encourages wasting.

- B.C. — CA

I regard the Inheritance Tax as a (expletive deleted) rip-off, the confiscated revenue being little more than robbery.

- F.H.O. — NE

The onerous death tax is akin to stealing the very gold out of a dead man's teeth while he lies stone cold and defenseless. It is no less evil than stealing a dead man's wallet and credit cards while he lies dead in the street after a fatal car accident unable to resist.

- R.E.D. — CA

The inheritance tax is morally wrong. Why should such a tax be added to the grief already suffered by a wife and children?

- A.R.O. — CA

Now consider the seniors' plight — inheritance tax structure on which we have already paid three tiers of taxes.

- B.Mc G. — TX

I want to be a part of the movement to repeal the Estate Taxes.

- K.M.O. — IL

I'm in strong support of Sen. Kyl's bill in the Senate and Rep. Cox's bill in the House to abolish these taxes.

- D.H.W. — MI

Having recently destroyed my AARP card and resigned from that organization which did not represent my views, I noted, with interest, an article about your organization in the April 7th issue of 'Human Events.'

- Richard G. W., Shillington, PA

I am nearly 64 years old, and once thought the American Association of Retired Persons was a good organization for older Americans. I joined around 10 years ago, but resigned after the leadership endorsed the President's monster health care plan last year. The group never consulted me on this, or any other, issue. Many friends say the same.

- Ed B., Richmond

I am delighted to learn that there is a group pressing the interests of conservative senior citizens.

- T.A. J., Alexandria, VA

I recently read about your grou in 'Human Events' and was interested in the fact that you are providing an alternative to AARP.

- Jack R. S., Palm Springs, CA

I belong to AARP but because of their Left Wing leaning I have no intentions of renewing my membership when it is due.

- Mrs. Lenore M. F., Middletown, NY

I am 72 years old and we need an alternative to AARP. Thank God for you. I read about you in 'Human Events.' What a wonderfi paper."

- Martin L., Colbert, WA

I'm over 60 and fed up with AARP. Please send information about 60 Plus to me.

- Joyce S., Orem, UT

Special thanks to all of you who have written your Members of Congress — we especially thank you fc forwarding your letters to us, they are very encouraging!

Please keep your letters coming! Every letter is read. We need the feedback from our members. Here at 60 Plus, we listen to our members and we learn from our members. We especially need to hear about your Inheritance Tax "horror" stories. It's the exchange of information that keep us a vital organization and helps sprea the word about the "silent plague" of Inheritance Taxes. ♦

Support for Rep. Chris Cox's (R-CA) Family Heritage Preservation Act (H. R. 784) from 60 Plus Association Members

Thank you for [the 1995 Estate Tax Summit]. Your speakers and panelists were more varied than the usual run by far and I enjoyed hearing their views.

- Florence R., Washington, DC

A few days ago I watched you on NET [television] and would like more information on your organization. If possible I would like to have you include information about the funding of AARP and NCSC by the taxpayers.

- Richard B., Tillamook, OR

I heard a representative of your organization on the local talk radio station in Philadelphia (WWOB). I was impressed by what I heard, compared to what I hear from AARP.

- Val C., Bryn Mawr, PA

Your letter was sent [to a person who no longer resides at this address], therefore I am answering and returning the petition because I am very interested in abolishing and lowering taxes. In 1992 my fathers estate was settled, and the inheritance taxes for the state of Ohio was twice as much as the federal inheritance tax. This became a great concern to me, and I wanted a way to protest this unfair, confiscating tax....send me at least five more petitions and I'll distribute them to my friends...

- Russell S., New Albany, OH

My husband and I have been members of 60 Plus for nearly a year now, and although we are unable financially to support the organization in the manner we would like, we are very pleased to be part of a true voice for senior citizens.

- Arlene and Ken W., Fountain Hills, AZ

I definitely agree with the Family Heritage Preservation Act (the Cox-Kyl bills). You were right when you said we work hard to make life better for our children, grandchildren and loved ones.

- James M., Oskaloosa, KS

Keep fighting, we'll keep praying and responding as best as we can. This is a fight we can win. And a fight we must win!

- Sarah B., Flushing, NY

I strongly support your efforts to abolish the estate tax. It's a cruel tax on those upstanding citizens who are doing the best they can to scrimp and save and put a little away for their families.

- Richard O., Tampa, FL

I believe whole heartedly in what your organization is doing to pass inheritance tax legislation.

- Elinor E., Penn Yan, NY

Hope that you will continue the fight and be successful. I am in my eighties and still healthy.

- Florence F., Newton, NJ

Dear Rep. Chris Cox (R-CA): My wife and I were very pleased to receive your letter concerning the efforts by The 60/Plus Association to reduce or do away with the federal estate tax. As an attorney I have seen the great injustice which this tax has done to many people and the effect it has had upon their life's work and I feel that it is essential that the federal estate tax be eliminated as soon as possible, as we did in California.

- George A., Jr., Paramount, CA

I am writing for your support of HR 660. It is difficult, if not impossible in some cases, for older, existing senior housing to comply with the Fair Housing Amendment Act of 1988. I am pleased that HUD's revised rules will make it easier for a community to qualify as senior. However, I feel strongly that Congress should act to guarantee that the law will authorize existing and future senior communities to function in that capacity. Seniors are not anti-children. However, the lifestyles of young families and seniors are vastly different. Their vast energy depletes ours.

- Jay and Mary Lou A., Hemet, CA

[Editors note: 60 Plus worked hard on this issue. Rep. Cliff Stearns (R-FL) and Rep. Dan Miller (R-FL) and others were successful in getting HUD to revise its rules.]

I have long thought that the Federal Inheritance tax is the most unfair tax there is. I am tired of the government trying to control our entire lives and then go so far as to rob our children after we are dead. I can't think of anything more disgusting than having those wealthy fat cats in Washington rob from the dead and their children

Support for Rep. Chris Cox's (R-CA) Family Heritage Preservation Act (H. R. 784) from 60 Plus Association Members

> finance their unreasonable etirement purses. My husband nd I are both veterans of WW II. Ay husband served six years in the JS Marine Corps and is a Pearl Harbor Survivor. I served in the Navy. Having been at Pearl Harbor on Dec. 7, 1941, my husband well knows what it is to e in battle without the needed lefenses.
>
> - *Rachel T., Canifria, CA*

Count me in favor of HR 784. Estate taxes have cost me thousands of **$$$$**.

- *Virginia L., Dallas, TX*

Special thanks to all of you who have written your Members of Congress — we especially thank you for forwarding your letters to us, they are very encouraging!

Please keep your letters coming! Every letter is read. We need the feedback from our members. Here at 60 Plus, we listen to our members and we learn from our members. We especially need to hear about your Inheritance Tax "horror" stories. It's the exchange of information that keeps us a vital organization and helps spread the word about the "silent plague" of Inheritance Taxes. ◀

"I just wanted you to know that I fully support you in regard to doing away with Estate Taxes. The more successful a citizen is in this great country, the more he is penalized. Americans work very hard for themselves and their children and due to the unfair Estate Taxes, the children will suffer."

- *Ronald T., Chattanooga, TN*

"I've spent most of my adult life in tax -- as an IRS Agent...I've always disagreed with an estate or Inheritance Tax. It discourages saving and encourages wasting."

- *Bob C., Menlo Park, CA*

"I hope you succeed in stopping the tax on estates."

- *Elaine P., Ossineng, NY*

"You are the first person who seemed to understand that most of us seniors can't keep up with our fast changing society. Keep enlightening your public. Many thanks for your newsletters!"

- *Virginia B., Riverdale, CA*

"I can't think of anything more disgusting than having those wealthy fat cats in Washington rob from the dead and their children."

- *Rachel T., Canifria, CA*

Please keep your letters coming! Every letter is read. We need the feedback from our members. Here at 60/Plus, we listen to our members and we learn from our members. We especially need to hear about your Inheritance Tax "horror" stories. It's the exchange of information that keeps us a vital organization and helps spread the word about the "silent plague" of Inheritance Taxes. ♦

DEATH AND TAXES

Tax his cow,
tax his goat,
Tax his pants,
tax his coat,
Tax his crops,
tax his work,
Tax his tie,
tax his shirt,
Tax his tractor,
tax his mule,
Teach him taxes
are a rule,
Tax his oil,
tax his gas,
Tax his notes,
tax his cash;
Tax him good
and let him know—
After taxes
he has no dough.
If he hollers,
tax him more;
Tax him 'til
he's good and sore.
Tax his coffin,
tax his grave,
Tax the sod
in which he lays.
Put these words
upon his tomb:
"Taxes drove me
to my doom."
And after he's gone
he can't relax;
They'll soon be after
his Inheritance Tax!

Anonymous

Chairman ARCHER. Thank you, Mr. Martin.

Congressman Sarasin, we would be pleased to hear from you, and if you would officially identify yourself before you proceed.

STATEMENT OF HON. RONALD A. SARASIN, PRESIDENT, NATIONAL BEER WHOLESALERS ASSOCIATION, ALEXANDRIA, VIRGINIA; AND FORMER MEMBER OF CONGRESS

Mr. SARASIN. Thank you very much, Mr. Chairman. I am Ron Sarasin. I am the president of the National Beer Wholesalers Association. We represent the middle tier of a very heavily regulated three-tier system of beer distribution, in our case consisting of 2,900 licensed malt beverage distributorships, most of which are family owned and operated. I can very proudly say that there is a beer wholesaler in every single congressional district in this country.

First, I would like to give you a little economic background of the industry, and wholesalers in particular, and then talk about State taxes. The entire beer industry generates $175 billion, employs 2.6 million people, and provides over $14 billion in revenue to local, State, and Federal Governments. Wholesalers alone provide 92,600 jobs, pay over $3 billion in wages, and over $1.5 billion in taxes. In addition, we add value to the tune of about $7.4 billion.

The average or typical beer distributorship, if there was such a thing, would have 32 employees, with an average worker earning $33,700. Approximately 54 percent of a typical beer distributor's operational cost is for payroll. So estate taxes hit our members hard, because the vast majority of our operations are family owned and operated.

We certainly believe that such taxes are confiscatory, and they impact very, very dramatically on the value of years of savings that the decedent had already paid taxes on one, two, or even three or more times. On death, the decedent's heirs are then socked with an estate tax of up to 55 percent.

For example, if we had a beer distributorship which was valued at $10 million, which is larger than average for our distributorships, at the decedent's death the family would owe approximately $4.9 million in estate taxes. If the family attempted to keep the business, they would have to take out a loan to pay the taxes, and then they pay that back over time.

So, over a 10-year period, at an interest rate of one-half over prime, the family is liable for about $1 million a year, with no deduction for the interest that is paid. In addition, obviously, those dollars are paid with aftertax dollars. So, in order to keep the business in the family, that family has to leverage the business dramatically, or they sell or shut down the operation.

If a family in our business tries to sell—and since only the strong survive—in our business the typical purchaser would be another beer distributor, a larger beer distributor. And our data indicate that when a firm is purchased, the existing facilities are usually closed, and the brands it previously handled are moved to an already existing warehouse. The 32 jobs that are average for our operations are therefore lost from that community.

I think the question that has been asked here today and that we certainly want to ask again is, do we want to help people who work

hard prosper and in turn give back to their community? And there is no question, every Member of Congress could go back to their district and find that their local beer distributor is active in many civic and community functions. These are the people, along with other entrepreneurial types in the community, who are the fabric of the community. They are the people who serve on boards of education, zoning boards, and so forth.

So, what message are we sending? We are sending the message that the more your business grows, the more jobs you create, the more you give back to your community, the more the government can take from you when you die.

Many of our members' families started in this business right after Prohibition. That was a time in American history when we were taught that if we worked hard and built a business, our children and our children's children would be better off.

An estate tax is contrary to every message we should be sending to small business and entrepreneurship. Hard work should be rewarded; not penalized. Giving to the community and spurring economic growth should be encouraged by the Federal Government; not discouraged. We also know that this is one of the most complicated and costly taxes that we could possibly impose on everyone.

Now, it has been called a voluntary tax by some economists, because you can figure out ways to avoid it. The problem with that is, our people tell us it costs from $10,000 to $250,000 to get the proper estate planning advice to try and keep that tax as low as possible. These are dollars that could have been spent on job creation, additions to facilities, or brand promotion.

The taxes are unfair. They are counterproductive to every tenet we should be ascribing to. As you consider fundamental tax reform in the coming months, we would urge you to consider the total elimination of the estate taxes as they are currently applied in our society.

Thank you, Mr. Chairman.

[The prepared statement follows:]

The Honorable Ronald A. Sarasin
National Beer Wholesalers Association

Good morning Mr. Chairman and members of the Ways and Means Committee. My name is Ron Sarasin and I am president of the National Beer Wholesalers Association (NBWA). NBWA represents the middle tier of a heavily regulated three tier system of beer distribution, consisting of over 2,900 licensed malt beverage distributorships, most of which are family-owned and operated. I can proudly say that there are beer wholesalers in every congressional district in the country.

I understand we are here today to discuss tax reform and the impact reform would have on small business. Although NBWA does not support any particular tax reform proposal at this time because our members are still analyzing the various options, I can state that we believe when Congress is addressing fundamental tax reform that total and complete repeal of estate and gift taxes should be included in any final plan adopted. In addition, we hope that you also eliminate a tax which unfairly discriminates against one sector of industry and is regressive by nature -- excise taxes. That issue, however, I will leave for discussion for another day.

First, I wanted to give you some economic background information on the beer industry and beer wholesalers in particular, and then get into the importance of repeal of estate taxes to our members.

The beer industry, which includes the three tiers of brewers, wholesalers and retailers, is a major player in the U.S. economy. The United States ranks number one in the world in beer production -- far ahead of the second and third place countries, England and Germany, combined. Today over 84 million working Americans responsibly consume and enjoy a nice cold beer, with beer representing

88 percent of the volume of all licensed beverages sold in America.

Each year, the entire beer industry generates $174.9 billion, employs 2.6 million and provides over $14 billion in revenue to local, state and federal governments through excise, sales and other taxes and fees.

According to data prepared by Dr. Steve Barsby & Associates, an economic consulting firm, beer wholesalers themselves provide 92,600 jobs, pay over $3 billion in wages and over $1.5 billion in taxes. Further, beer wholesalers create $7.4 billion in value added to the product, which is just the starting point for economic activity created by our members.

Beer wholesalers add value to the three tier system in the following ways:

- they purchase and finance inventory, reducing the producers' capital requirements and assume the risk of non-payment from retailers;

- they provide a local warehouse facility for quick delivery to the retailers, insuring product freshness and reducing retailers' required inventory;
- they sell the product to retailers, aiding smaller producers who cannot afford exorbitant advertising and marketing expenses or large sales forces; and
- they provide sales support services such as advertising, promotion, merchandising, and market intelligence.

The typical beer distributorship has 32 employees, with the average worker earning $33,700. As large corporations continue downsizing, beer wholesalers truly rely on

their employees since approximately 54 percent of the typical operation's costs are for the annual payroll.

Estate taxes hit our members hard because the vast majority of beer wholesale businesses are family-owned and operated. In fact, we believe estate laws are paramount to **confiscation** for privately held companies such as the typical beer distributorship. The value of one's estate is the result of years of savings that the decedent has already paid taxes on one, two, three or more times already. After a lifetime of taxes and more taxes; upon death, the decedent's heirs are then socked with an estate tax of up to 55 percent.

For example, if a beer distributorship is valued at $10 million at the decedent's death, the family would owe approximately $4.9 million in estate taxes. If the family chooses to keep the business, they must take out a loan to pay the estate taxes, and pay back the borrowed amount over time. Over a ten year time period, at an interest rate of one-half over prime, the family is liable for close to $1 million a year with no deduction for the interest paid. In addition, the money must be paid with after tax dollars. Therefore, in order to keep the business in the family, the heirs must totally leverage the distributorship, sell or shut down the operation.

If the family chooses to sell, they must find a buyer. Generally, in business only the strong survive. The beer wholesale business is no exception and, therefore, the only business that might afford to buy a beer wholesale business is a larger beer distributor. Our data indicate that when a firm is purchased, the existing facilities are usually closed and the brands it previously handled are moved to an already existing warehouse. Obviously, the average 32 jobs are lost from that community.

My question to this committee is, do we want to help people who work hard, prosper and in turn give back to the community? I believe almost every member here could go back to their district and find that their local beer distributor has been active in many civic and community functions. What message are we sending? The more your business grows, the more jobs you help create, and the more you give back to your community, then the more government can **take** from you when you die.

Prohibition was repealed in 1933 and the industry was totally restructured. The second tier of the licensed beverage industry was established to insure that there were no longer corruptive ties between the producer and retailer. Many of our members' families started in the beer wholesale business right after prohibition -- a time in American history when we were taught that if we worked hard and built a business, our children and our children's children would be better off. The estate tax is contrary to every message that we should be sending to small business and entrepreneurship. Hard work should be rewarded, not penalized. Giving to the community and spurring economic growth should be encouraged by the federal government, not discouraged.

Further evidence against the estate tax is that it is one of the most complicated and costliest taxes for the IRS to administer. I have seen numbers that demonstrate compliance and enforcement costs can take up approximately 65 cents for every dollar collected. In addition, the federal government only collected about $15 billion last year from estate, gift and generation-skipping transfers -- this is less than one percent of total federal receipts.

It is also interesting to note that one estate planning scholar from Harvard Law refers to the estate tax as a "voluntary tax," because a business owner can arrange his or her affairs in such a manner as to essentially pay whatever amount of taxes he or she wishes.

The beer industry, particularly the individual brewers and NBWA, works hard through education efforts to enourage beer wholesalers to have an estate plan in place so that the business can be passed down from generation to generation. The cost, however, is high. One wholesaler has estimated that each individual beer distributorship spends anywhere from $10,000 to a quarter of a million dollars in estate planning costs. This costly estate tax advice dilutes money which could be spent on job creation, additions to facilities, and brand promotion.

Estate taxes are unfair, costly and counterproductive to all of America, but particularly to small business owners. Small business is the foundation of the American free enterprise system, and this Congress should strive to encourage small business growth and expansion. When considering fundamental tax reform in the upcoming months, please give careful consideration to the elimination of estate taxes.

Chairman ARCHER. Thank you, Mr. Sarasin.

Mr. Thigpen, if you would identify yourself for the record and whom you represent, you may proceed.

STATEMENT OF LONNIE THIGPEN, AMERICAN TREE FARM SYSTEM, FOREST INDUSTRIES COUNCIL ON TAXATION, AND AMERICAN FOREST & PAPER ASSOCIATION

Mr. THIGPEN. My name is Lonnie Thigpen, and last year my 83-year-old father, Chester Thigpen, spoke to you about the importance of estate tax reform in our family and the tree farm he has in Montrose, Mississippi. Today, it is still an important issue to our family.

Chairman ARCHER. Mr. Thigpen, if you will identify yourself and the people that you represent. Do you represent anyone other than yourself today?

Mr. THIGPEN. No.

Chairman ARCHER. You do not? OK. Good. Well, you may proceed, then. Because I had here that you were potentially representing the American Tree Farm System, the Forest Industries Council on Taxation, and the American Forest & Paper Association. Is that not correct?

Mr. THIGPEN. Yes, I am here on behalf of them, too.

Chairman ARCHER. OK. Well, good, as long as we get that on the record. That is good. You may proceed.

Mr. THIGPEN. OK. Mr. Chairman, I appreciate the opportunity to appear before your Committee. Today you are seeking information on an issue that is very important to more than 9.9 million people who own most of the Nation's productive timberland. Most of us have been in this business for a long time.

As my father reminded you, Professor Larry Doolittle of Mississippi State University published a paper in 1992 that suggested that one-half of the tree farmers in the Midsouth were 62 years old or over. This pattern holds true in other parts of the country, as well. So it should come as no surprise to the Committee that when tree farmers gather, one of the things that we talk about is estate tax planning.

Estate taxes matter not just to lawyers, doctors, and businessmen, but to people like me, extension agents, educators, civil servants, and farmers. My parents were both born on the land that is now part of their tree farm. Last year, my father told you how he plowed behind a mule for his great uncle who owned it before him. His dream then was to own land, and in 1940 that dream became a reality.

In that year, he bought a little piece of land, and inherited some from his family's estate in 1946. Then he saved and bought some more. Back when dad started, the estate tax applied to only 1 in 60. Today, it applies to 1 in 20, including my father's farm. I wonder if I would be able to achieve a dream like he has had, if I started out today.

Our family first got started in forestry in 1960, and at age 10 I was right there working in the forest with my father. I took what I learned in 4–H Club and brought it home and applied it in the woods. At that time, much of our land was played-out old cotton and row-crop fields, so early on we spent about 90 percent of our

time trying to keep it from washing away. We developed a management plan and started growing trees. Today, we manage our property for timber, wildlife habitat, water quality, and recreation. We have built ponds for erosion control and for wildlife. Deer and turkey have come back to our farm, and we invite our neighbors and friends to come hunt with us.

It took my father and mother half a century, but they have managed to turn our land into a working tree farm that has been a source of pride and income for our entire family. Our tree farm made it possible to put my four brothers and sisters and me through college. It made it possible for our parents to share their love of the outdoors and commitment to good forestry with our neighbors. And finally, it made it possible for them to leave a legacy that makes us very proud: Beautiful forests and ponds that can live on for many, many years after my father and mother pass on. They both wanted to leave the land in better condition than when they first found it, and we believe they have.

They want to leave the tree farm in our family, also. But no matter how hard we work, leaving the legacy in our family depends on people like you.

My father tells the story of how in 1960 it was almost impossible for him to find someone who would lend him $10,000 to buy what at that time was played-out cotton fields. Today, because of his sweat and forethought, the same piece of land is valued at more than $1 million, many seem to think. All of that value is tied up in land and trees.

We are not rich people, either. My father and I do most all of the work on the farm ourselves. So under current law, as heirs, we may have to break up the tree farm and sell off the timber before its time, to pay estate taxes. Giving up the tree farm that my family has worked for 50 years to create would break our hearts, and it would discourage me from being a tree farmer, and also my children and grandchildren.

If the tree farm had to be sold or the timber cut before its time, what would happen to the erosion control programs that we put in place, and the wildlife habitat? Who would make certain that the lands stayed open for the neighbors? If we had this chance to inherit this land, we are sure that we would.

My father says, too often people focus on just the cost of estate tax reform, and not the benefits. I mentioned earlier that 9.9 million forest landowners in this country are close to retirement age—or, like my father, well past it. Without estate tax reform, many of these properties would be broken up in smaller tracts, or harvested prematurely. Some may no longer be economical to operate as tree farms, and will perhaps be converted to other uses, or back into marginal agriculture. Other properties will become too small, or generate too little cash flow to support the kind of multiple use management we have practiced on our property.

A healthy, growing forest with abundant wildlife provides benefits to everyone. Without estate tax reform, it will become harder and harder for people like us to remain excellent stewards of our family-owned forests.

Mr. Chairman, last year my father and mother were named the national outstanding tree farmers of the United States of America.

Our family was greatly honored to be selected to be the best of over 70,000 other members of the American Tree Farm System. One reason they were selected was because they had been speaking out on behalf of good forestry for almost four decades, and at a time when it was not very popular to do so.

That is why my father felt it was so important as to leave his home in Montrose, Mississippi, and travel to Washington, DC, last year, at age 83, and that is why I am here today: To remind the Committee that estate tax reform is important to preserve family enterprises like ours. It is important for our healthy forests.

My father and I planted some more trees here recently. He knows that he will probably not be around to see them mature, but he hopes his grandkids will be here to watch them grow on the Thigpen farm. And I know millions of forest landowners feel the same way about their tree farms.

We would applaud any efforts you can make to reform estate taxes. We ask you to please help us, and we thank you.

Chairman ARCHER. Mr. Thigpen, thank you very much, and we did enjoy having your father as a witness last year. I hope you will carry back to him our best wishes and our congratulations for what he has accomplished through hard work, thrift, and perseverance in his lifetime. We are very, very pleased to have you with us today.

Mr. THIGPEN. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF LONNIE THIGPEN
AMERICAN TREE FARM SYSTEM, FOREST INDUSTRIES COUNCIL ON TAXATION AND AMERICAN FOREST AND PAPER ASSOCIATION

My name is Lonnie Thigpen. Last year, my 83 year-old father, Chester Thigpen, spoke to you about how important estate tax reform is to our family and our Tree Farm in Montrose, Mississippi. Today, it is still as important as ever.

Mr. Chairman, I appreciate the opportunity to appear before this Committee. Today, you are seeking information on an issue that is very important to more than 9.9 million people who own most of the nation's productive timberland. Most of us have been at it for a long time. As my father reminded you, Professor Larry Doolittle of Mississippi State University published a paper in 1992 that suggested half of the Tree Farmers in the Mid-South were 62 years old or over. This pattern holds true in other parts of the country as well. So it should come as no surprise to the Committee that, when Tree Farmers gather, one of the things we discuss is estate taxes.

Estate taxes matter not just to lawyers, doctors and business men, but to people like us: extension agents, educators, civil servants and farmers. My parents were both born on land that is now part of our Tree Farm. Last year my father told you how he plowed behind a mule for my great uncle who owned it before him. His dream then was to own land. And in 1940 that dream began to become reality. In that year he bought a little piece of land and inherited some from my family's estate in 1946. Then he saved and bought some more. Back when Dad started, the estate tax applied to only one estate in 60. Today it applies to one in 20 -- including my father's. I wonder if I would be able to achieve a dream like his if I were just starting out today.

Mr. Chairman, you have heard many witnesses talk about the technical details of estate tax reform. They know far more about it than I do. With your permission, I'd like to take a few minutes to talk about what I do know; what estate tax reform will mean in places like Montrose, Mississippi and to Tree Farmers like me and the rest of our family.

Our family first got started in forestry in 1960, and at 10 years old, I was right there working in the forest with my father. I took what I learned in 4-H and brought it home to apply in our woods. At that time much of our land was played out cotton and row-crop fields, so early on we spent 90 percent of our time trying to keep it from washing away. We developed a management plan and started growing trees. Today, we manage our property for timber, wildlife habitat, water quality and recreation. We have built ponds for erosion control and for wildlife. Deer and turkey have come back, and we invite our neighbors to hunt on our land.

It took my father and mother a half century, but they have managed to turn our land into a working Tree Farm that has been a source of pride <u>and</u> income for the entire family.

Our Tree Farm made it possible to put my four brothers and sisters and me through college. It made it possible for our parents to share their love of the outdoors and commitment to good forestry with our neighbors. And finally, it made it possible for them to leave a legacy that makes us very proud; beautiful forests and ponds that can live on for many, many years after my father and mother pass on. They both wanted to leave the land in better condition than when they first started working it. And they have.

They want to leave the Tree Farm in our family. But no matter how hard we all work, leaving this legacy with our family depends on you.

My father tells the story of how in 1960 it was almost impossible for him to find someone who would lend him $10,000 to buy what at the time was played-out cotton fields. Today, because of his sweat and forethought, that same piece of land is valued at more than one million dollars. All that value is tied up in land and trees. We're not rich people. My father and I do almost all the work on our land ourselves. So, under current law, as heirs, we may have to break

up the Tree Farm or sell off timber before its time to pay the estate taxes.

Giving up the Tree Farm that my family has worked for fifty years to create would break our hearts. I don't think it would be good for the public either. If the Tree Farm had to be sold or the timber cut before its time, what would happen to the erosion control programs we put in place, or the wildlife habitat? Who would make certain that the lands stayed open for our neighbors to visit and enjoy? I know that as heirs we would do this. And I hope our children will have the same opportunity.

My father says that too often people just focus on just the costs of estate tax reform and not the benefits. I mentioned earlier that most of the 9.9 million forest landowners in this country are close to retirement age, or like my father, well past it. Without estate tax reform, many of their properties will be broken up into smaller tracts or harvested prematurely. Some may no longer be economical to operate as Tree Farms and will perhaps be converted to other uses or back into marginal agriculture. Other properties may become too small or generate too little cash flow to support the kind of multiple use management we practice on our property. Healthy, growing forests with abundant wildlife provide benefits to everybody. Without estate tax reform, it will become harder and harder for people like us to remain excellent stewards of our family-owned forests.

Mr. Chairman, last year my father and mother were named the National Outstanding Tree Farmers of the Year. Our family was greatly honored to be selected the best from over 70,000 other members of the American Tree Farm System. One of the reasons they were selected was because they have been speaking out on behalf of good forestry for almost four decades -- at a time when it wasn't always wise to speak out.

That's why my father felt it so important as to leave his home in Mississippi and travel to Washington last year. And that is why I am here today -- to remind the Committee that estate tax reform is important to preserve family enterprises like ours. It is also important for healthy forests. My father and I planted some more trees not long ago. He knows he will not likely be here to see them mature. But he hopes that his grandchildren and great-grandchildren will be able to watch those trees grow on the Thigpen Tree Farm -- and I know millions of forest landowners feel the same way about their own Tree Farms.

We would applaud estate tax reforms that would make this all possible.

Thank you.

Chairman ARCHER. Mr. Nelson, if you would identify yourself and what group, if any, that you represent for the record, you may proceed.

STATEMENT OF WAYNE NELSON, PRESIDENT, COMMUNICATING FOR AGRICULTURE, FERGUS FALLS, MINNESOTA

Mr. NELSON. Certainly, Mr. Chairman. My name is Wayne Nelson. I am a farmer from southwestern South Dakota, and I am the president of Communicating for Agriculture, which is an association representing farmers, ranchers, and rural business people in all of our 50 States.

For years, Communicating for Agriculture has considered estate tax reform one of our highest priorities. Heirs wanting to carry on family businesses all too often have had to sell land or other assets to pay for Federal estate and State inheritance taxes. As a result, many long-established farms and small businesses have not been passed on to the next generation.

Mr. Chairman, I farmed with my father until his death in 1993. My father thought he had an adequate estate plan, but because of a chronic illness that he had, everyone had expected him to die before my mother. When my mother died unexpectedly, it negated part of his plans to keep the farm operating and lower our estate taxes after his death. Consequently, the estate owed a great deal more tax than what we had expected. The estate had to sell over 700 acres in 1993 to pay Federal estate and State inheritance taxes.

As most other farmers, my father had existing debt against this land, which meant that more land had to be sold in order to come up with enough cash for the estate to pay the estate taxes. In addition, I had to go out and borrow further money myself to buy out my sister and brother, who were also part of the inheritance. As you can see, I am fortunate enough that I can still continue to farm in a little smaller manner, but I am one of the lucky ones that can do that.

Mr. Chairman, many farmers and small business people are not as lucky, and have had to sell so much of their assets that continued operation is impossible. The loss of businesses puts added strain on our rural areas that are already suffering from the flight of their young people because they cannot find enough work at home.

The average age of farmers today is almost 60 years old. What happens when this generation is gone? It seems so unfair for a farmer or a small businessperson to work their entire life building a business and paying taxes, only to have the operation severely downsized, or in some cases even forced out of business, because of estate taxes that quickly reach 55 percent. In most areas of the country, many medium-sized and even some small farms have equity exceeding the $600,000 exemption that is now in the law.

The old saying, "Farmers live poor and die rich," speaks to the large amount of value that is held in their land. The only way to get cash from this asset is to borrow against the land. This lack of cash is one reason so many assets of farms and family businesses have to be sold to pay the estate taxes. Normally, there is little cash available, because it is all concentrated in the business.

Congress last made estate tax changes in 1981, creating a tax exemption for the first $600,000 of an estate's value. Since then, inflation has eroded the dollar value of this exemption. Estate tax planning can help to limit the amount of taxes owed, but the planning itself can be very costly and complicated, as well. In all instances, the estate tax represents the second or even third time these family assets have been taxed.

My father thought he had a plan that would help, but he did not allow for the early death of my mother. Many times, plans are not easy to change, even if circumstances warrant that change. This added expense of planning diverts money that could be spent on capital improvements and more employment for family-owned businesses.

Life insurance is one of the most used planning tools, but it, too, can be expensive. One study shows that more planning money is spent within our national economy to prevent family businesses from being destroyed by estate taxes than is being collected under the law.

Mr. Chairman, we at Communicating for Agriculture urge Congress to reform the estate tax laws so family farms and businesses may survive the death of a principal. Please do not let our government put them out of business following a lifetime of work and paying income taxes. Placing their burdensome taxes on their children is contrary to the American tradition which built this country. We feel that hard work must be rewarded.

Thank you very much.

[The prepared statement follows:]

TESTIMONY

Wayne Nelson, President
Communicating for Agriculture
Committee On Ways & Means
April 24, 1996
Estate Tax Reform

Mr. Chairman and members of the Committee. Thank you for asking me to testify today about this important tax issue. My name is Wayne Nelson and I am President of Communicating for Agriculture, a membership association representing farmers, ranchers and rural business people in all 50 states. For years, Communicating for Agriculture has considered estate tax reform one of our highest priorities. Heirs wanting to carry on family businesses all too often have to sell land or assets to pay for Federal estate and state inheritance taxes. As a result, many long-established farms and small businesses have not been passed on to the next generation.

Mr. Chairman, I am a grain farmer from Winner, South Dakota. I farmed with my father until his death in 1993. My father thought he had an adequate estate plan but because of a chronic illness, had expected to die before my mother . When she died unexpectedly, it negated his estate plan to keep the farm operating and lower estate taxes after his death. Consequently, the estate owed a great deal more tax than expected. The estate had to sell over 700 acres in 1993 to pay Federal estate and state inheritance taxes. As most other farmers, my father had existing debt against his land which meant that more land had to be sold to generate enough cash before the estate could be settled, adding to the problem. In addition, I had to go further in debt to buy out my sister and brother's shares of the inheritance who are not in farming. As you can see, I am very fortunate to be able to continue to farm, even if it is in a more limited manner.

Many farmers and small business people are not as lucky and have to sell so much of their assets that continued operation is impossible. This loss of businesses puts added strain on rural areas already suffering the flight of their young people because they can't find work at home. The average age of farmers today is almost 60 years. What happens when this generation is gone? It seems so unfair for a farmer or small business person to work their entire life building a business and paying taxes only to have the operation severely downsized or even forced out of business because of estate taxes that quickly reach 55%. In most areas of the country, many medium size and even some small farms have equity exceeding the $600,000 exemption now in the law.

The old saying - "farmers live poor and die rich" - speaks to the large amount of value that is held in the land. The only way to get cash from this asset is borrow against the land. This debt is one reason that so many assets of farms and family businesses have to be sold to pay estate taxes. Normally, there is little cash available, it is concentrated in the business.

Congress last made estate tax changes in 1981, creating a tax exemption for the first $600,000 of an estate's value. Since then, inflation has eroded the real dollar value of this exemption. Estate tax planning can help to limit the amount of taxes owed but the planning itself can be very costly and complicated as well. In all instances, the estate tax represents the second or even third time these family assets have been taxed. My father thought he had a plan that would help but he did not allow for the early death of my mother. Many times, plans are not easy to change even if circumstances warrant change. This added expense of planning diverts money that could be spent on capital improvements and more employment for family-owned businesses. Life insurance is one of the most used planning tools and it too, is expensive. One study shows that more planning money is being spent within our national economy to prevent family businesses from being destroyed by estate tax obligations than is being collected under the law.

Mr. Chairman , we in Communicating for Agriculture urge Congress to reform the estate tax laws so family farms and businesses may survive the death of a principal. Please don't let our government put them out of business following a lifetime of work and paying income taxes. Placing these burdensome taxes on their children is contrary to the American tradition which built this country. Hard work must be rewarded.

Thank you.

Chairman ARCHER. Mr. Nelson, thank you for your comments. I am sure you are aware that in the Balanced Budget Act of 1995, we significantly improved the provisions relative to the estate tax, particularly for family farms and family businesses. Unfortunately, the President elected to veto that act when it hit his desk. But we have shown our commitment, even if we have to keep this tax system that we have today, to try to improve it in that regard. And that commitment will continue.

Mr. Eacho, if you will identify yourself and whatever group you might represent, you may proceed.

STATEMENT OF WILLIAM C. EACHO III, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ATLANTIC FOOD SERVICES, INC., MANASSAS, VIRGINIA; AND MEMBER OF THE BOARD OF GOVERNORS, FOOD DISTRIBUTORS INTERNATIONAL, FALLS CHURCH, VIRGINIA

Mr. EACHO. Thank you, Mr. Chairman. Good afternoon. I am William C. Eacho III. I am a member of the board of governors of Food Distributors International, and I am president and chief executive officer of Atlantic Food Services, Inc., the largest privately owned distributor of food service products in the mid-Atlantic region. We are based in Manassas, Virginia.

At the request of the Committee, I will limit my testimony to a few short minutes. Food Distributors International has provided the Committee with my written comments, which we would like to appear in the official record of this hearing.

Mr. Chairman, I am very pleased to have this opportunity to appear before you today to discuss an issue that is very near and dear to my heart, one which has long been of significance to the food distribution industry, and that is Federal estate taxes.

I commend you for holding these hearings and for including a panel on the estate tax issue early in the process. In my opinion, no tax reform initiative can meet the objectives of simplification, lowering the cost of capital, increasing savings and investment, and instilling fairness in the Tax Code, without addressing what I consider to be the cruelest Federal tax, the estate tax.

The Federal estate tax must be repealed, for the reasons stated in my testimony, as part of any sweeping tax reform effort. My company, founded 80 years ago by my grandfather, has been family owned for three generations. Indeed, two previous generations were in the food business in a different company.

Starting off as a seafood stand on the District of Columbia waterfront, we have grown to become a broad-line distributor offering over 10,000 products, employing over 300 associates, with revenues over $150 million. We hope to keep the business family owned for generations to come. However, the current Federal estate tax is a serious threat to that continuity of ownership, not only for my company and the food distribution industry, but for thousands of other companies throughout all industries.

Our company has grown and developed in recent years to a level at which our future may be in jeopardy if changes in the estate tax provisions of the IRS Code are not adopted. Should my wife and I, for example, meet an untimely death, my heirs would have to sell the business to pay the estate taxes.

To mitigate this risk through the purchase of insurance is cost prohibitive. The traditions and culture that we have worked so hard to build would be lost. Lacking sufficient liquid assets to pay the estate tax leaves my business and others like it vulnerable to being bought out by a much larger multibillion-dollar, publicly owned competitor. When that happens, jobs are lost and lives are forever changed.

Many family-owned businesses are a fixture of their community. In relinquishing control of the local business to a large and often remotely managed corporation, the community loses a valuable ally. Fortune 500 companies are by no means the enemy; however, we must recognize that businesses owned and operated by members of a local community are far more likely to become involved in the betterment of that community.

Family-owned businesses are our Nation's leading source of innovation and economic growth. They comprise 99 percent of the companies in the private sector, 60 percent of all working Americans, 50 percent of the gross domestic product, and 30 percent of U.S. exports. These businesses are responsible for employing nearly one-half of all American workers, and they are where two-thirds of all new American jobs are currently being created.

In today's ever-increasing global marketplace, the pressures on businesses to remain competitive are enormous. The estate tax only further compounds these pressures. Moreover, the most recent statistics show that revenue raised by the estate and gift tax is only nominal. For a tax that raises a nominal amount of revenue for the government, the costs are great: Lost jobs, stifling of work and investment, damage to communities and family livelihoods, and devastation for the heirs of a family run business who are left with this huge tax burden.

Unfortunately, there is a myth that estate taxes affect only the wealthy. Well, I can tell you, the heads of family-owned food distribution companies are not all wealthy individuals; nor are our customers, the restaurant owners, or the owners of grocery stores. In fact, the profit margin for distributors, full-service restaurants, and food retailers, is extremely low, amounting to a few pennies on the dollar. Most small businesses depend on the reinvestment of profits. Therefore, the majority of these operations are simply not liquid enough to pay this burdensome estate tax.

The estate tax is a tax on capital, penalizing the accumulation of savings and wealth that is necessary for capital formation and business growth. Therefore, it acts as a disincentive to save and invest. Individuals have the incentive to dispose of their wealth through any number of personal consumptions, rather than to be forced to pay Uncle Sam.

I take great pride in the thriving enterprise that we have created at Atlantic, and in the culture and values that drive us to greater success. It is very discouraging to know that my business would be unlikely to survive me. If my goals in life were to amass a great fortune or to live like a king, I would sell my business, I would have sold it a long time ago, to enjoy the proceeds. But what drives an entrepreneur is his vision of the enterprise and what the enterprise can become. It is the reward that comes from creating fulfilling jobs for the people that you work with.

It is disheartening to know that so many of these jobs would be lost if I died unexpectedly and had not planned accordingly. Frankly, the planning is simply cost-prohibitive at this point. I have purchased—I am digressing a little bit here, but I have purchased life insurance, for example; but the amount of life insurance that would be necessary to pay the estate taxes would consume my entire salary, practically. It is absurd to think of it.

I appreciate the fact that the Ways and Means Committee has devoted a panel within this hearing on tax reform to address the impact that estate taxes have on family-owned businesses. Additionally, I would like to commend Representatives Jim McCrery, Jennifer Dunn, Bill Brewster, Wally Herger, Lewis Payne, Jim Bunning, and others in the U.S. House of Representatives for their support of H.R. 2190, the Family Business Protection Act of 1995, which would increase the estate tax exemption and lower the estate tax rate.

We also appreciate the earlier testimony today of Chairwoman Meyers, where she, too, recognized the need to eliminate estate taxes. In fact, bipartisan support for estate tax relief was so strong, it was included in the conference report on the Balanced Budget Act.

The food distribution industry believes that this is a positive first step toward addressing a problem that has been permitted to go unanswered for far too long, and would like to see some form of estate tax relief enacted during this session of Congress. However, the ultimate goal of our industry is for the elimination of estate taxes, which we hope will occur under tax reform.

Elimination of estate taxes will allow family-owned businesses the opportunity to invest in their future and expand with an eye toward the next century. Our heirs should not be forced to forfeit to the government the businesses we have worked a lifetime to build. Instead, they should have the opportunity to continue to grow into the next generation, providing meaningful employment and cultivating future growth for our local communities and the Nation's economy.

The American people rely on Atlantic Food Services and the other 260-plus members of Food Distributors International, and the hundreds of thousands of family-owned grocery and convenience stores and restaurants across the country that we supply, for the food they eat every day. Please join us in ensuring that the spirit of free enterprise and the incentives to own and build a business will be strengthened for future generations. It is un-American and immoral to punish success. Therefore, I ask you and your colleagues in Congress to abolish the estate tax once and for all.

Thank you for inviting me today. I look forward to answering your questions.

[The prepared statement follows:]

TESTIMONY OF WILLIAM C. EACHO, III

BOARD OF GOVERNORS
FOOD DISTRIBUTORS INTERNATIONAL[1]

PRESIDENT AND CHIEF EXECUTIVE OFFICER
ATLANTIC FOOD SERVICES, INC.[2]

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

APRIL 24, 1996

Introduction

Good morning, Mr. Chairman and members of the Committee. I am William C. Eacho, III, member of the Board of Governors of Food Distributors International, and President and Chief Executive Officer of Atlantic Food Services, Inc. I am very pleased to have the opportunity to appear before you today to discuss an issue that is very near and dear to my heart, and one which has long been of significance to the food distribution industry -- federal estate taxes.

I commend you, Mr. Chairman, for holding these hearings, and including a panel on the estate tax issue early on in the process. In my opinion, no tax reform initiative can meet the objectives of simplification, lowering the cost of capital, increasing savings and investment, and instilling fairness in the tax code without addressing the cruelest federal tax -- the federal estate tax. The federal estate tax should be repealed, for reasons stated in my testimony, as part of any sweeping tax reform effort. Short of "tax reform," the system should be substantially modified from its current form.

By way of background, Food Distributors International, the umbrella name for the National-American Wholesale Grocers' Association -- and its foodservice partner organization, the International Foodservice Distributors Association (IFDA) -- is an international trade association comprised of food distribution companies which primarily supply and service independent grocers and foodservice operators throughout the United States, Canada and more than 20 other countries. Food Distributors International's 265 member companies operate over 900 distribution centers with a combined annual sales volume of $126 billion. NAWGA members employ a work force of over 350,000 and in combination with their independently-owned customer firms, provide employment for several million people. IFDA represents member firms that annually sell over $33 billion in food and related products to restaurants, hospitals, and other institutional foodservice operations.

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(703) 532-9400

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Background on Atlantic Food Services, Inc.

Atlantic Food Services, Inc., is the largest privately-owned distributor of foodservice products in the mid-Atlantic region. Our company, founded eighty years ago by my grandfather, has been family-owned for three generations. Starting off as a seafood stand on the Washington, D.C. waterfront, we have grown to become a broadline distributor offering over 10,000 products, employing over 300 associates, with revenues over $150 million. We hope to keep the business family-owned for generations to come. However, there is a serious threat to that continuity of ownership -- not only for my company and the food distribution industry, but for thousands of companies throughout all industries. That threat is known as estate taxes -- or more aptly put -- death taxes.

Mr. Chairman, my company has repeatedly been recognized for excellence and innovation in our industry. In 1989, Atlantic was selected the "Innovator of the Year" by *ID Magazine*, a national publication for the foodservice distribution industry. In 1994, Atlantic received the "Great Distributor Organization" award from the same publication. Long recognized as an industry innovator, we have continued to introduce change through development of new technologies, marketing strategies, and constant improvements of our systems. Our greatest strength, without a doubt, flows from our people.

The corporate culture we have developed at Atlantic has contributed significantly to the leadership position we currently hold in our industry. Our associates are highly motivated and entrepreneurial. Each day, these associates see the many benefits of working for a family-owned company, and work hard to ensure our success. We care about our people and invest in their development. From professional training to family counseling, we constantly look for ways to help them improve and achieve their goals. Recently, we have seen many top performers from our larger public-owned competitors join our company seeking the type of culture that a family-owned business offers. From sales and transportation associates to executives, we continue to attract the top talent in our industry. Our people feel like members of a broader family -- one we call Team Atlantic -- and share feelings of job security and dedication, which are uncommon in many companies today.

All of this could change in an instant. Our company has grown and developed in recent years to a level at which our future may be in jeopardy if changes in the estate tax provisions of the Internal Revenue Service Code are not adopted. Not too long ago, when we were smaller and the value of the business was a few million dollars at best, we could afford to buy life insurance to pay estate taxes. Indeed, I have a couple of million dollars of life insurance for that purpose, and fortunately I am young enough that such insurance is affordable. Yet more recently, the market value of our business has grown dramatically, to such a level that, should I meet an untimely death, my wife would have to sell the business just to pay the estate taxes. To mitigate this risk through the purchase of insurance would be cost prohibitive. The traditions and culture that we have worked so hard to build would be lost.

The Need for Estate Tax Reform

Lacking sufficient liquid assets to pay the estate tax leaves my business and others vulnerable to being bought out by a much larger, multi-billion dollar competitor. When that happens, jobs are lost and lives are forever changed. Many family-owned businesses are a fixture of their community. The dissolution of family-owned and operated farms and small businesses impact the community at large. In relinquishing control of the local businesses to large and often remotely-managed corporations, the community loses a valuable ally. Fortune 500 companies are by no means the enemy. However, it should be noted that businesses owned and operated by members of the local community are more likely to become involved in the betterment of that community.

Small businesses -- which are family-owned for the most part -- comprise 99 percent of the private sector, 60 percent of all working Americans, 50 percent of gross domestic product, and 30 percent of U.S. exports. Again, these small businesses are responsible for employing nearly one-half of all American workers, and they are where two-thirds of all new American jobs are currently being created. As a result, a tax that discourages the livelihood of family-owned business in essence undercuts American competitiveness and job growth. In today's ever increasing global marketplace, the pressures on businesses to remain competitive are enormous. The estate tax only further compounds these pressures.

It is estimated that within the next two decades, over $6 trillion in wealth will be transferred to the next generation.[3] Recently, it was predicted by the Coleman Foundation Chair of Entrepreneurship at St. Louis University, that during the next decade, $1 trillion in small family businesses will pass to the next generation. Research shows that less than two-thirds of the family businesses succeeded into the next generation, and less than 15 percent make it into the third generation.

In 1993, a comprehensive study sponsored by the Small Business Council of America and National Life of Vermont found that the major reason cited for small business failures was lack of adequate capital -- following the death or retirement of the principal owner. Lack of capital (primarily needed to pay estate taxes) has been cited as the largest obstacle to passing on the family business in over 70 percent of the failed businesses following the death of the owner.

Privately-held, independent businesses are the backbone of our free enterprise system. We are our nation's leading source of innovation and economic growth, as the statistics cited earlier demonstrate. Moreover, most recent statistics show that the revenue raised by the estate and gift tax is only nominal. In 1995, the U.S. Government collected approximately $15 billion in transfer taxes, representing just over 1 percent of total federal revenue. A June 2, 1994, study of the Tax Foundation concluded that estate tax laws can have roughly the same disincentive effects on entrepreneurial activity as a doubling of income tax rates.

For a tax that raises a nominal amount of revenue for the government, the costs are great -- lost jobs, stifling of work and investment, damage to communities and family livelihoods, and devastation for the heirs of a family-run business who are left with this huge tax burden.

According to a recent Gallup Poll, one-third of all small-business owners will have to sell outright or liquidate a part of their firm to pay estate taxes. Of those who have to liquidate to pay the Internal Revenue Service, half expect they will have to eliminate 30 or more jobs. Another 20 percent of those firms put the number of employees they will have to let go as high as 100 or more.

Impact of the Estate Tax on Small Businesses

Mr. Chairman, the food distribution industry has a long-standing record supporting the elimination of federal estate taxes. Roughly 25 percent of Food Distributors International's members are family-owned and operated. They provide employment for over 22,000 people, and have a combined annual sales volume of over $7.5 billion. However, all of the member companies of Food Distributors International supply food and related products to family-owned "Mom and Pop" food stores, independent food retailers, grocery and convenience stores, and restaurants.

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[3] *Forbes* (December 1993) at p. 140

Unfortunately, there is a myth that estate taxes affect only the wealthy. Well, let me tell you, the heads of family-owned food distribution companies are not all wealthy individuals. Nor are the restaurant owners or food store owners. In fact, in 1994, profits before tax as a percent of sales for foodservice distributors was a mere 1.4 percent -- the highest level since 1987. This measure for wholesale grocers was 1.6 percent.[4] The median pre-tax income for full service restaurants was 3.1 percent of total sales in 1994,[5] and the net profit after tax for food retailers between April 1994 and March 1995 was 1.14 percent.[6]

Most small businesses depend on the reinvestment of profits. Therefore, the majority of these operations are not liquid enough to pay this burdensome estate tax. The high income tax rates, which partially account for the low profit margin, coupled with a steep graduated estate tax rate up to 55 percent, effectively make the Government a 50-50 partner in a family business.

Options for Small Businesses

The looming reality of the estate tax can affect the present day planning of the business. Business owners may decide that they do not want to invest their capital in an entity that will soon be liquidated. Moreover, if small businesses need to borrow capital, in order to meet operating demands or expand, lenders often inquire about succession plans -- for they are aware of the risks to continuing operation of the business that could arise following the death of an owner. Often they require high rates to take the risk, or added security, raising the cost for a business. Armed with this knowledge, the business owner may discourage his or her children from participating in the business.

Even if the business owner opts to pass the business to his own family members, the gamble is great. The business owner who undertakes the prudent planning for his or her own death may drain their limited profits on estate planning costs. Unfortunately, even the best laid plans will not alleviate the burden on heirs, who will have to struggle to survive under the debt of the estate tax.

The Disincentive Effects of the Estate Tax

The estate tax is a tax on capital, penalizing the accumulation of savings and wealth that is necessary for capital formation and business growth. Therefore, it acts as a disincentive to save and invest. Individuals have the incentive to dispose of their wealth through any number of personal consumptions rather than be forced to pay Uncle Sam. Such behavior has a dramatic impact on our low national savings rate.

Not only does the estate tax discourage saving, it also has the effect of discouraging hard work. The old American adage that hard work will be rewarded is deflated by the prospects of the federal government sweeping up more than half of the estate's value. As a result, the tax can act as a deterrent for those most likely to pursue entrepreneurial activities, that in turn create new jobs for others. Accordingly, any plan to alter the current federal tax system to increase savings and investment must include repeal of this burdensome tax to be effective.

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[4] *1995 Distributor Productivity Financial Report*
Falls Church, VA: NAWGA/IFDA (Food Distributors International), 1995

[5] *Annual Operations Ratio Survey*
Washington, DC: National Restaurant Association, 1995

[6] *Annual Financial Review*
Washington, DC: Food Marketing Institute, 1995

I take great pride in the thriving enterprise we have created at Atlantic, and in the culture and values that drive us to greater success. It is very discouraging to know that my business would be unlikely to survive me. If my goals in life were to amass a great fortune or to live like a king, I would have sold my business to enjoy the proceeds a long time ago. But what drives an entrepreneur is his or her vision of the enterprise, and the reward comes from creating fulfilling jobs. It is disheartening to know that so many of these jobs would be lost if I died.

What Others in Our Industry Have to Say

In preparation for testifying before this committee, I communicated with various family-owned business leaders within the food distribution industry about estate taxes. I received from a foodservice distributor a letter particularly relevant to this debate. Following is the text of that letter:

> This memo is an update on both the status of -- and the futility associated with -- the exercise of estate and management succession planning. This is an exercise which consumes a fair amount of time, and resources, in order to satisfy constantly changing compliance requirements.
>
> Before we take up the subject of estate planning and taxation, some company background is necessary to gain an appreciation of our business, and our family circumstances.
>
> Our company is a small foodservice distribution company and we employ 98 people. The company is profitable, and we are growing our business. In order to finance the growth of our business, our family reinvests all of the after-tax profits in facilities, equipment, and working capital. During the past two years, we have more than doubled the volume of our business; however, in order to accomplish this growth, we invested approximately $3.8 million of additional capital to sustain the growth of the business. In the process of growing our business, we added 56 full-time employees to our payroll.
>
> In addition, I am limiting my compensation in order to support the growth of the business. I am the highest paid employee, and my total annual compensation is limited to $100,000. Clearly, our motivation is to grow our business through reinvested earnings. Our motivation is more than self-serving. If we do not grow our business, we do not survive in our competitive marketplace.
>
> As you know, I have an illness that mandates constant planning for both the managerial succession of our business, and the financial security of my family after my death. Our planning is focused on keeping our business independent, and permitting my four children to obtain their education, and giving my wife the ability to enjoy a financially secure future.
>
> I find the entire estate planning process to be a time consuming and non productive process, which is also very expensive. Changes in the tax code, or the rulings associated with the code, require changes in estate planning.
>
> Since we are organized as a subchapter S corporation under the tax code, we have already paid substantial federal and state taxes on the income produced by our corporation. At current federal and state tax rates, we reinvest approximately 58% of the corporation's annual income. Upon my death, federal and state estate taxes on the proceeds of the sale of my stock in the corporation further reduce the value to approximately 24% of the value of the stock.
>
> The entire income and estate tax structure is a terrible financial burden, and a frustrating disincentive to the social and economic objectives of the nation. Creation of jobs and generation of revenue are cited as the primary motivations in the free enterprise system. Yet, the tax code seems to deliberately frustrate those motivations.
>
> If you have any questions, please call me. Regards.

Conclusion

Again, I appreciate the fact that the Ways and Means Committee has devoted a panel, within this hearing on tax reform, to address the impact that estate taxes have on family-owned businesses. Additionally, I would like to commend Congressmen Jim McCrery, Bill

Brewster, Wally Herger, Lewis Payne, Jim Bunning, Congresswoman Jennifer Dunn, and others in the U.S. House of Representatives for their support of H.R.2190 -- the Family Business Protection Act of 1995 -- which would increase the estate tax exemption and lower the estate tax rate. In fact, bipartisan support for estate tax relief was so strong that it was included in the conference report on the Balanced Budget Act.

The food distribution industry believes that this is a positive first-step toward addressing a problem that has been permitted to go unanswered for far too long, and would like to see some form of estate tax relief enacted during this session of Congress. However, the ultimate goal of the food distribution industry is for the elimination of estate taxes, which we hope will occur under tax reform. Elimination of estate taxes will allow family-owned businesses the opportunity to invest in their future and expand with an eye toward the next century.

Our heirs should not be forced to forfeit to the government the businesses we have worked a lifetime to build. Instead, they should have the opportunity to continue to grow into the next generation, providing meaningful employment and cultivating future growth for our local communities and the Nation's economy. The American people rely on Atlantic Food Services and the other 260+ members of Food Distributors International, and the hundreds of thousands of family-owned grocery and convenience stores, and restaurants across the country that we supply, for the food that they eat everyday.

Please join the food distribution industry in ensuring that the spirit of free enterprise and the incentives to own and build a business will be strengthened for future generations. It is un-American and immoral to punish success. Therefore, I ask you and your colleagues in Congress to abolish the estate tax once and for all.

Thank you for inviting me. I look forward to answering your questions.

Chairman ARCHER. Thank you, Mr. Eacho.

And our last witness of this panel is Mr. Apolinsky. And if you will identify yourself and whatever group you might be representing today, you may proceed.

STATEMENT OF HAROLD I. APOLINSKY, SIROTE & PERMUTT, P.C., BIRMINGHAM, ALABAMA; AND VICE PRESIDENT, LEGISLATION, SMALL BUSINESS COUNCIL OF AMERICA

Mr. APOLINSKY. Thank you, Mr. Chairman. I am Harold Apolinsky. I am an estate tax lawyer from Birmingham, Alabama, with the firm of Sirote & Permutt. I am here on behalf of the Small Business Council of America. And I feel privileged, not only to be before you in this wonderful room, but to be on this distinguished panel. I have never before heard such eloquent arguments from bright, hard-working people for repeal of the estate taxes.

I am the guy that Jim Martin said is sort of the nutty estate tax lawyer who has been doing it for 30 years, and teaching estate planning at both the University of Alabama School of Law and Cumberland School of law for 20 years. I teach as a hobby. It also helps me recruit the brightest in the class to come to work for my 100-lawyer firm. But this panel has just made, to my way of thinking, marvelous and telling arguments.

In my few minutes, I want to share with you a little bit about the Small Business Council, about your overall objective of tax improvement, and then finish up with a little footnote on the estate and gift tax, particularly.

The Small Business Council of America—I am proud to have been their chairman. I am now vice president of legislation. It is a unique organization. We have 20,000 family business, small business entrepreneurs, startup. But we also have a number of tax lawyer members, and our board consists of 35 tax lawyers.

Last May, after a 1½ hour debate, we voted, without dissent, to urge the complete repeal of the estate, gift, and generation-skipping taxes. Certainly, it scares me. It scares me when I hear former Congressman Sarasin's reference to $10,000 to $250,000 fees that we earn for estate planning, to think about, "Well, what is my practice going to be when that is not there any longer?" I have quantified that over a 3-year period, something like $12½ billion is being spent on estate planning.

But I come back, just like my board did, to the concept that repeal is so great for family businesses, family farms, and families. That is what we have to focus on: What is best for our clients, not what may be best for our practice.

Another thing that would be best for our clients is what you are focusing on now: The overall remodeling, simplification of the tax laws. As you know, since 1981, there have been 11 major tax law changes, which is sort of remarkable in a 15-year period. These laws have changed some 9,500 Code subsections.

I started an organization in 1982 called the American College of Tax Counsel. Membership is now over 600 senior tax lawyers, those practicing 15 years or longer. We publish The American Journal of Tax Policy. I had the staff early on begin to count code subsections. It is just startling to me the number of code subsections.

I contrast it in my mind to what life was like under Wilbur Mills. He insisted that there be 15 years between major tax changes: The 1939 Code, the 1954 Code, the 1969 law. I have come to the conclusion that probably Fanny Foxe had more of an adverse effect on the Tax Code than any other single individual. [Laughter.]

Well, this tremendous change, constant change, has been wonderful for my business. I have educated three of the most glorious children a father and mother could possibly have, explaining these changes. But small businesses, for sure, family businesses who cannot employ large tax staffs internally are overwhelmed.

I know several of you—and I am impressed—do your own tax returns. I do not. Twenty years ago, the IRS announced a special program to indict and imprison lawyers whose tax returns were incorrect. Now, I know some businessmen would applaud that as a good thing for the country. My return was OK, but that scared the devil out of me. I employed an accountant 20 years ago to do my tax return. I would love a system that would be simple, where we all could go back to doing our return or no returns were necessary.

I think the whole system would have collapsed, but for two large computers in this country that are programmed to do tax returns. I think CCH owns one, and H&R Block.

I think that we must have a change to get back to simplicity. The 1986 law was supposed to be fairness, growth, and simplicity, and as you said this morning, it did not work. I urge three steps. One step: pension simplification. Paula Calimafde, the chair of our Small Business Council of America, is a much more knowledgeable pension lawyer than I am. She has and will share some thoughts with you.

It seems like almost everyone agrees to the proposed pension changes. The pension system has stalled in this country. My clients want to shut their plans down because of legal fees and complexity. This would help restart it.

The second step would be to repeal the estate and gift tax, for all the arguments everyone has made. How deadly this tax is.

The third would be this overall change of the system, because that is the permanent cure to keeping the estate tax repealed. If we get rid of it, we have got to keep it out by this overall change in the system.

I have given some examples of the harm to families, jobs, and communities from death taxes. These were actual client examples of major clients having been sold. Also, one client spending so much money for life insurance, he has quit expanding.

I hope we will simply follow the example of Australia. Australia repealed the estate tax in 1977 completely, because they felt death taxes were an inhibitor on the growth of family farms, family businesses, and family capital. They wanted larger farms, larger businesses. They wanted more jobs. It seems to me, more jobs just help so very many. I hope, because it is a death tax, we would simply hurry with repeal. People die unexpectedly and the problem hits.

Thanks so much for the opportunity to share some thoughts with you.

[The prepared statement and attachments follow:]

STATEMENT OF HAROLD I. APOLINSKY ON BEHALF OF
THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE COMMITTEE WAYS AND MEANS

IMPACT ON SMALL BUSINESS OF REPLACING THE FEDERAL INCOME TAX
(FOCUS ON REPEALING ESTATE AND GIFT TAXES)

April 24, 1996

Mr. Chairman and Members of the Committee, I am Harold I. Apolinsky, Past Chair of the Small Business Council of America (SBCA) and currently Vice President - Legislation. I am also a practicing tax attorney (over 30 years) who specializes in estate planning and probate. For also 20 years, I have taught estate planning and estate, gift and generation-skipping taxation as my avocation to law school seniors at both the University of Alabama School of Law in Tuscaloosa, Alabama and the Cumberland School of Law in Birmingham, Alabama. I am here to present our views on replacing estate, gift and generation-skipping taxes.

SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans, and employ over 1,500,000 employees.

The time has come for Congress to simplify our tax system. As a first step, replacing the estate, gift and generation-skipping taxes would save and strengthen family businesses and family farms and save jobs. Many are at risk today.

Since 1981, there have been 11 major tax laws changing 9,455 Internal Revenue Code subsections.

	NO. OF CODE SUBSECTIONS CHANGED
1981-Economic Recovery Tax Act (ERTA)	483
1982-Tax Equity and Fiscal Responsibility Act (TEFRA)	530
1984-Deficit Reduction Act (DEFRA)	2,245
1984-Retirement Equity Act (REACT)	44
1986-Internal Revenue Code (FGSA)	2,704
1987-Omnibus Budget Reconciliation Act (OBRA)	231
1988-Technical and Miscellaneous Revenue Act (TAMRA)	1,588
1989-Omnibus Budget Reconciliation Act	462
1990-Omnibus Budget Reconciliation Act (OBRA)	300
1993-Revenue Reconciliation Act	784
1994-General Agreement on Tariffs and Trade (GATT)	84
(Total changes in 13 years)	9,455

1913: income tax law was 14 pages.
1954: 984 pages.
1985: 3,979 pages.
1992: 8,600 pages.

Commerce Clearing House published its first volume of 400 pages in 1913. It currently publishes 22 volumes of its tax service containing almost 40,000 pages.

(1939 Code + 15 years = 1954 Code + 15 years = 1969 law)

Understanding these changes plus intelligent tax planning has become impossible for owners of small businesses, entrepreneurs, and start-up companies. A simple tax system would allow them to focus their financial resources and energies on competition and growth and jobs.

The most devastating and harmful tax the successful business and farm owners face is the estate tax.

An estate tax is due nine months after death. It is imposed on the transfer to children or other heirs of the taxable estate of every decedent who is a citizen or resident of the United States ($600,000 of assets are exempt). The graduated estate tax rates begin effectively at 37% and increase to a maximum rate of 55% (see Exhibit "A" for how the tax is calculated). Taxes on bequests to spouses may be deferred until the last-to-die of husband and wife.

A gift tax is levied on taxable gifts (excluding $10,000 per donee per year) as a back-stop to the estate taxes. The graduate rates are the same. Taxable gifts are added at death in the estate tax return to determine total transfers to children and other heirs, both during life and at death. (The $600,000 exempt amount may be used during life for gifts or at death.)

An extra, flat 55% generation-skipping tax is imposed on gifts or bequests to grandchildren ($1,000,000 is exempt).

The 1995 White House Conference on Small Business recommended as its 4th of 60 priorities eliminating estate and gift taxes.

1. Only 30% of family business make it through the second generation. Seventy percent (70%) do not. Only 13% make it through the third generation. Eighty-Seven (87%) do not. The primary cause of the demise of family businesses, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)

2. A recent study by Prince and Associates (research company) for National Life of Vermont reviewed the history of 749 family businesses which failed within three years after the death of the founder. The Prince study reinforced and supported the conclusion of the deadly effect of estate taxes. The businesses could not continue as a result of the tax drain on working capital needed to effectively compete and cover errors in judgment made by new and younger management. Jobs were lost in the communities.

3. The estate and gift tax took its present form primarily in the early 30's. The express purpose was to "break-up family wealth". Is this consistent with a free enterprise economic system and a very competitive world economy?

4. In 1994, the estate, gift and generation-skipping taxes accounted for only 1.2% of revenue. If you factor the significant expense in collecting these taxes, the income tax when assets are sold, and income taxes from jobs saved and provided, the repeal would be revenue neutral or revenue positive.

5. The transfer tax provisions represent 82 pages of the Internal Revenue Code and 289 pages of Regulations issued by the Internal Revenue. The transfer tax system forces many estates, the Internal Revenue Service, and the Department of Justice to expend funds in court. The number of transfer tax cases now total over 10,000 representing over 13,000 pages of the Commerce Clearing House Tax Publication. Litigation consumes, in legal, accounting, and appraisal fees, approximately $100,000 per case.

6. Independent analyses reveal that, were these transfer taxes repealed, the Nation's GDP level of employment and capital formations would increase substantially. According to one study, repealing these taxes would increase GDP from 1993 to the year 2000 by over $79 billion, create 228,000 new jobs and increase capital by $639 billion. (Fiscal Associates, Inc. -- Federal Transfer Taxation: A Study in Social Cost).

7. Combined income and estate taxes frequently consume 75% or better of retirement plan accounts at death. (Exhibit B).

8. Combined income and estate taxes often consume more than 80% of a family's resources. A very few of our most wealthy citizens have elected to give up their citizenship, become citizens of foreign countries, and avoid the 55% transfer taxes. The cover story of Forbes, November 21, 1994, was devoted to "Expatriation -- As the Ultimate Estate Planning Technique." What a loss of available capital! These are the people who give the most to charity and have the resources to seed new businesses.

This should be a wake-up call that this tax is no longer appropriate. We have the highest transfer taxes in the world. Congress should step back, study the issue, and then repeal these taxes to promote jobs and the growth of family capital.

9. Attached are the facing page and conclusion of a 1995 study of the estate tax impact on family business by the Family Enterprise Center, Marietta, Georgia. Their conclusion is chilling.

10. Australia repealed their estate and gift tax laws in 1977. It was felt that these transfer taxes were an inhibitor on the growth of family businesses. The legislative body of Australia sought more jobs which they believed would come if family businesses grew larger and were not caused to be sold, downsized, or liquidated at the death of the founder to pay estate taxes.

11. It is estimated that individuals spend over $12.5 billion in legal and accounting fees alone for estate planning over a three year period.

12. It is contrary to the best interest of my tax practice, my teaching, and my firm (we have 8 out of 100 lawyers doing estate planning, administration and probate) to urge repeal of these transfer taxes. It is the right thing to do to help grow family businesses, farms, and capital provide jobs and investment and encourage the entrepreneurial spirit needed for small businesses to become large businesses and family businesses of all sizes and family capital to survive death.

13. H.R. 784 was introduced by Representative Christopher Cox of Newport Beach, California on February 1, 1995 to repeal these taxes with 20 co-sponsors. **As of March 19, 1996, there were 94 Co-Sponsors.** A listing of co-sponsors is attached. **H.R. 1039, introduced by Representative Philip Crane of Illinois on February 24, 1995, has 8 Co-Sponsors.**

14. Senate bill 628 was introduced on March 27, 1995 to repeal these taxes by Senators Jon Kyl of Arizona and Jessie Helms of North Carolina. **As of March 19, 1996, there were 8 Co-Sponsors.** A listing of co-sponsors is attached.

15. Examples from my practice of the negative impact of estate tax on families and jobs are attached as Exhibits "C", "D", "E" and "F".

A REPORT ON THE *IMPACT* OF THE FEDERAL ESTATE TAX:

A STUDY OF TWO INDUSTRY GROUPS

Prepared By: **Joseph H. Astrachan and Craig E. Aronoff**
Family Enterprise Center
Coles School of Business
Kennesaw State College
Marietta, Georgia
July 24, 1995

CONCLUSION

Family-owned and small businesses throughout our history have helped the country grow and prosper. The close ties which exist between members of these organizations and their relationship to the larger community around them have helped build self-sufficiency and have provided important moral role models and local leaders.

In the last decade small businesses like these have accounted for nearly half of this nation's GDP. Indeed, most of our new job creation is attributable to their efforts.

Yet we have made the accumulation of capital essential for long term, generational business operations increasingly difficult by this counterproductive tax. Our estate tax laws is preventing, or significantly hindering, all families, including minorities, from gathering and keeping the wealth necessary for the continuance of these important institutions. We are damaging our nation's ability to create new jobs, new opportunities and new wealth. The results of the surveys are a tragic commentary on a national policy directed at redistribution rather than at the development of economic strength.

A rough idea of the amount of funds which potentially could be used for business and employment growth can be obtained by an easy, but significant, extrapolation to all businesses in the country. If only 50,000 businesses in the U.S. employing an average of 100 people[3] respond to the problems of the estate tax as the AED survey participants have done, then $2.1 billion has been spent nationally on estate tax planning advice and $1.3 billion annually on insurance premiums for policies whose sole purpose is to pay the estate tax. If the figures obtained in the minority entrepreneur survey are used, $400 million is spent on life insurance premiums annually and one half a billion dollars on planning.

This constitutes an extraordinary percentage of funds used in anticipation of the payment of a tax which in 1993 brought in $880 million from closely-held corporations and $2.65 billion from other corporate holdings. If the amount of money expended under the AED projection were invested in the form of employment growth and the average salary and benefits were estimated to be approximately $35,000, then we project that nearly 86,000 new jobs would be added to the economy through the elimination of estate tax.

[3]The U.S. Bureau of the Census, in its *County Business Patterns, 1991 Annual*, estimates that there are 6.2 million business establishments in the U.S.; 5.4 million employ under 20 employees, 674,000 employ between 20 and 99, and 134,000 employ over 100.

CURRENT CO-SPONSORS OF THE FAMILY HERITAGE PRESERVATION ACT

H.R. 784; 95 (89R, 6D)

Robert Andrews (D-NJ)
Dick Armey (R-TX)
Spencer Bachus (R-AL)
Richard Baker (R-LA)
Bill Baker (R-CA)
Bob Barr (R-GA)
Roscoe Bartlett (R-MD)
Brian Bilbray (R-CA)
Tom Bliley (R-VA)
Peter Blute (R-MA)
Ed Bryant (R-TN)
Henry Bonilla (R-TX)
Sonny Bono (R-CA)
Jim Bunn (R-OR)
Jim Bunning (R-KY)*
Dan Burton (R-IN)
Ken Calvert (R-CA)
Charles Canady (R-FL)
Dick Chrysler (R-MI)
Tom Coburn (R-OK)
Wes Cooley (R-OR)
Chris Cox (R-CA)
Bud Cramer (D-AL)
Philip Crane (R-IL)*
Mike Crapo (R-ID)
John Doolittle (R-CA)
Bob Dornan (R-CA)
David Dreier (R-CA)
Jimmy Duncan (R-TN)
Robert Ehrlich (R-MD)
Bill Emerson (R-MO)
Jack Fields (R-TX)
Michael Forbes (R-NY)
Jon Fox (R-PA)
David Funderburk (R-NC)
Elton Gallegly (R-CA)
Ralph Hall (D-TX)
Mel Hancock (R-MO)*
Richard 'Doc' Hastings (R-WA)
J. D. Hayworth (R-AZ)
Joel Hefley (R-CO)
Wally Herger (R-CA)*
Stephen Horn (R-CA)
John Hostettler (R-IN)
Duncan Hunter (R-CA)
Tim Hutchinson (R-AR)
Bob Inglis (R-SC)
Sam Johnson (R-TX)*
Walter Jones (R-NC)
Sue Kelly (R-NY)
Peter King (R-NY)
Jack Kingston (R-GA)
Jim Kolbe (R-AZ)
Steve LaTourette (R-OH)
Steve Largent (R-OK)
John Linder (R-GA)
Bob Livingston (R-LA)
Bill McCollum (R-FL)
Jim McCrery (R-LA)*
David McIntosh (R-IN)
Buck McKeon (R-CA)
Don Manzullo (R-IL)
Susan Molinari (R-NY)
Sonny Montgomery (D-MS)
Carlos Moorhead (R-CA)
Sue Myrick (R-NC)
Charlie Norwood (R-GA)
Ron Packard (R-CA)
Mike Parker (D-MS)
Bill Paxon (R-NY)
Richard Pombo (R-CA)
Nick Rahall (D-WV)
Frank Riggs (R-CA)
Pat Roberts (R-KS)
Dana Rohrabacher (R-CA)
Toby Roth (R-WI)
Ed Royce (R-CA)
Jim Saxton (R-NJ)
Joe Scarborough (R-FL)
Jim Sensenbrenner (R-WI)
John Shadegg (R-AZ)
Joe Skeen (R-NM)
Lamar Smith (R-TX)
Nick Smith (R-MI)
Jerry Solomon (R-NY)
Steve Stockman (R-TX)
Bob Stump (R-AZ)
Jim Talent (R-MO)
Randy Tate (R-WA)
Charles Taylor (R-NC)
Mac Thornberry (R-TX)
Barbara Vucanovich (R-NV)
Dave Weldon (R-FL)
Don Young (R-AK)
Dick Zimmer (R-NJ)*

S. 628; 9R

Lauch Faircloth (R-NC)
Rod Grams (R-MN)
Jesse Helms (R-NC)
Kay Hutchison (R-TX)
Jim Inhofe (R-OK)
Jon Kyl (R-AZ)
Richard Lugar (R-IN)
Richard Shelby (R-AL)
Bob Smith (R-NH)

*** denotes members of the House Ways and Means Committee**

EXHIBIT "A"

CALCULATION OF ESTATE TAXES

A. Gross Estate (fair market value at death of all assets, including real estate, stock, cash, life insurance, retirement accounts, etc.).

B. Deductions:

1. Debts and expenses.
2. Marital (assets left to spouse if citizen).
3. Charitable.

C. Taxable Estate.

D. Add Prior Taxable Gifts.

E. Total transfer to heirs (life and death).

F. Apply Rates: 18% to 55%.

G. Less credit ($192,800*)

H. Net tax (effective 37% to 55% [plus 5% for larger estates] due 9 months after death.

I. Extra 55% tax for bequests to grandchildren in excess of $1 million.

* This is tax on $600,000 taxable estate.

The complexity for filing the estate tax return is demonstrated by the 35 hours and 83 minutes estimated pursuant to the Paperwork Reduction Act Notice (Instructions attached).

Department of the Treasury
Internal Revenue Service

Instructions for Form 706
(Revised August 1993)

United States Estate (and Generation-Skipping Transfer) Tax Return

For decedents dying after October 8, 1990.

Section references are to the Internal Revenue Code unless otherwise noted.

Paperwork Reduction Act Notice.—We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form and related schedules will vary depending on individual circumstances. The estimated average times are:

Form	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS
706	2 hr., 11 min.	1 hr., 9 min.	3 hr., 26 min.	49 min.
Sch. A	20 min.	16 min.	10 min.	20 min.
A-1	46 min.	25 min.	59 min.	49 min.
B	20 min.	10 min.	11 min.	20 min.
C	13 min.	2 min.	8 min.	20 min.
D	7 min.	6 min.	8 min.	20 min.
E	40 min.	7 min.	24 min.	20 min.
F	33 min.	6 min.	21 min.	20 min.
G	26 min.	18 min.	11 min.	14 min.
H	26 min.	6 min.	10 min.	14 min.
I	26 min.	25 min.	11 min.	20 min.
J	26 min.	5 min.	16 min.	20 min.
K	26 min.	9 min.	10 min.	20 min.
L	13 min.	5 min.	10 min.	20 min.
M	13 min.	31 min.	24 min.	20 min.
O	20 min.	9 min.	18 min.	17 min.
P	7 min.	14 min.	18 min.	14 min.
Q	7 min.	10 min.	11 min.	14 min.
Q Wksht	7 min.	10 min.	59 min.	20 min.
R	20 min.	34 min.	1 hr., 1 min.	49 min.
R-1	7 min.	29 min.	24 min.	20 min.
S	26 min.	22 min.	37 min.	25 min.
Contin.	20 min.	3 min.	7 min.	20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the **Internal Revenue Service**, Attention: Reports Clearance Officer, T:FP, Washington, DC 20224; and the **Office of Management and Budget**, Paperwork Reduction Project (1545-0015), Washington, DC 20503. **DO NOT** send the tax form to either of these offices. Instead, see **Where To File** on page 2.

Change To Note

- The Omnibus Budget Reconciliation Act of 1993 increased the maximum estate tax rate to 53% for taxable estates in excess of $2.5 million and 55% for taxable estates in excess of $3 million. This increase is permanent and applies to the estates of decedents dying after December 31, 1992. Because the February 1993 revision of Form 706 is based on a maximum estate tax rate of 50%, it should not be used.

For Decedents Dying After	and Before	Use Revision of Form 706 Dated
----------	January 1, 1982	November, 1981
December 31, 1981	October 23, 1986	November, 1987
October 22, 1986	January 1, 1990	October, 1988
December 31, 1989	October 9, 1990	July, 1990
October 8, 1990	January 1, 1993	October, 1991
October 8, 1990	----------	August, 1993

General Instructions

Purpose of Form

The executor of a decedent's estate uses Form 706 to figure the estate tax imposed by Chapter 11 of the Internal Revenue Code. This tax is levied on the entire taxable estate, not just on the share received by a particular beneficiary. Form 706 is also used to compute the generation-skipping transfer (GST) tax imposed by Chapter 13 on direct skips (transfers to skip persons of interests in property included in the decedent's gross estate).

Which Estates Must File

Form 706 must be filed by the executor for the estate of every U.S. citizen or resident whose gross estate, plus adjusted taxable gifts and specific exemption, is more than certain limits.

To determine whether you must file a return for the estate, add:

1. The adjusted taxable gifts (under section 2001(b)) made by the decedent after December 31, 1976;

2. The total specific exemption allowed under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) for gifts made by the decedent after September 8, 1976; and

3. The decedent's gross estate valued at the date of death.

You must file a return for the estate if the total of 1, 2, and 3 above is more than $600,000 for decedents dying after 1986. For filing requirements for decedents dying after 1981 and before 1986, see the November 1987 Revision of Form 706.

Gross Estate

The gross estate includes all property in which the decedent had an interest (including real property outside the United States). It also includes:

- Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth;
- Annuities;
- Joint estates with right of survivorship;
- Tenancies by the entirety;
- Life insurance proceeds (even though payable to beneficiaries other than the estate);
- Property over which the decedent possessed a general power of appointment;
- Dower or curtesy (or statutory estate) of the surviving spouse;
- Community property to the extent of the decedent's interest as defined by applicable law.

For more specific information, see the instructions for Schedules A through I

Cat. No. 16779E

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EXHIBIT "B"

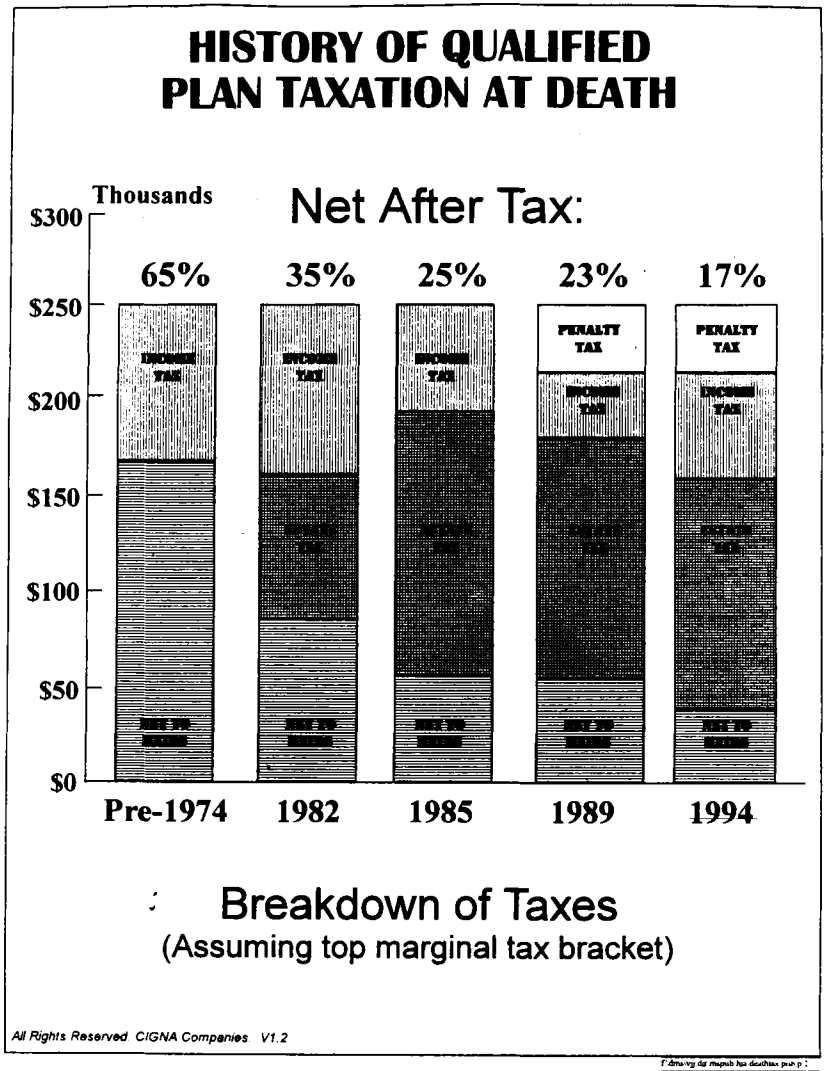

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EXHIBIT "E"

FAMILY FARM

1. Farm land currently appraised at $2,000,000, net of mortgage, after reduction for possible 2032A election.

2. Husband and wife own a home adjacent to the farm (value $400,000), equipment (value $600,000), and tax-exempt bonds (value $200,000) for a total of $1,200,000.

3. At the last-to-die of the husband and wife, estate taxes will be $886,000.

4. With only $200,000 liquid investments, land will need to be sold to pay estate taxes. The family will lose the farm.

EXHIBIT "F"

Mr. H

1. In 1991, at age 69, he was diagnosed with cancer.

2. He took stock of his mortality and first became aware of the 55% estate taxes.

3. Added capital gains taxes and estate taxes to equal more than 80%.

4. Said: "I quit." If hit, on new business ventures, family keeps 20%. If miss on venture, family loses 100%.

5. He stopped staying up at night agonizing over new multi-million dollar ventures.

6. Began to downsize. Went from 50,000 employees in 1991 to 1,000 at his death four years later.

7. Why turn-off those who can take risks and provide jobs?

EXHIBIT "C"

X COMPANY

1. Founded in 1940 in Texas with one store.

2. Sold because of death taxes in 1994. It had grown to 150 stores with sales of almost $2 Billion (1994) and had 9,000 full-time employees and 11,000 part-time employees (1994).

3. In 1989, the president and CEO died in a plane crash.

4. The company redeemed $30 million of stock. Funds were used to make partial payment of estate taxes.

5. The 28 year old son of the deceased CEO took the reins as president. He struggled for five years. His working capital had been severely depleted. Without appropriate resources, it became impossible to maintain or improve earnings through expansion or innovations.

6. The company was publicly traded, but that did not help. The value of the stock dropped.

7. The then 33 year old CEO realized that with combined income and estate taxes, the total left for the family was less than 20%. It was not worth it.

8. X Company was sold to a Dutch Company in 1994. It continues to run the stores. It will not nearly be the outstanding corporate citizen of Dallas, Texas that X Company was. What a loss because of estate taxes.

EXHIBIT "D"

SOFT DRINK COMPANY

1. Largest family-owned soft drink bottler.

2. Second generation owners and managers.

3. To try and fund estate taxes and avoid having to sell the business -- purchased life insurance.

4. Annual premiums: $1,500,000 after tax.

5. The company has stopped acquiring, growing and providing more jobs. Expansion capital is being used to pay insurance premiums.

6. What a waste of capital to expand!

Chairman ARCHER. Mr. Apolinsky, thank you so much for your thoughtful presentation. And I must say, I join Mr. Martin in telling you that you are a rarity, indeed——

Mr. APOLINSKY. Thank you.

Chairman ARCHER [continuing]. Of someone who will effectively propose the elimination of what is their primary source of income.

I reflect back to when, during the Reagan years, there was a member of his administration who told me that he had never been so excited in his entire life as getting up every day and going to work and making an effort to abolish his own job. Those type of people in our society are extremely rare, but are, in my opinion, true Americans.

All of you gentlemen have presented outstanding testimony in recognition of what is a basic premise in a free society, and that is that capital savings are essential to economic growth and job creation. The more the government reaches out and takes away capital savings, the more they undermine the ability of Americans who want to work to be able to get a job to work to support their families.

Not all of us can be employers, but it takes an employer to create a position for an employee, and it takes capital accumulation to be able to do that. Many of my colleagues who disagree with me continue to pit the rich against the poor, rhetorically, over and over again in this country, while we know that it takes $280,000 of capital invested, on average, to produce one job in the United States of America. That is the average.

Now, you are orienting to family businesses, and that, of course, tugs more at our heartstrings than the capital spent by big corporations, but the result is the same. It is that it produces beneficial economic results.

We must win this battle of education with the American people; that if they destroy your family business, or destroy your family farm, at the time of death, that they have taken away the assets that are necessary to create jobs and economic growth for future Americans, and they have arrogated that into the public treasury to be spent on consumption which will never be seen again, in one way or another.

And so I am entirely sympathetic to the position that you have presented to this Committee today. And yet, I know—and I wish this room were covered with television sets for ABC and CBS and NBC and CNN, to carry what you have presented to the people of this country—that when we leave this room, we will go right back to the rhetoric of those on the other side who, if they can find somebody who has $280,000 necessary to create one job, they will characterize that person as rich, and want to take at least one-half of it away from them.

So, there is great sympathy with the majority of this Committee today to the position that you have articulated, and I am exceedingly grateful to you for coming and taking time out of your busy lives to make your presentations.

Mr. Hancock, do you have an inquiry?

Mr. HANCOCK. Thank you, Mr. Chairman. I appreciate the testimony. There are a couple of questions that I think are very essential that we need especially to ask the business community and the

people that would like to do something about the estate tax that I think maybe we have overlooked.

I would like to ask Mr. Apolinsky—is that the way you pronounce your name?

Mr. APOLINSKY. Yes.

Mr. HANCOCK. I would like to ask you, how many of your clients took an active part politically before they got concerned about their estates?

Mr. APOLINSKY. That is an interesting question. I do not know. I guess I do not ask them, as a matter of routine. I see them in the community. I see them on host committees. I see them giving money into the political process. I try to encourage them to write letters. I have seen them get very excited—very excited—about the possibility of repealing the estate tax.

Mr. HANCOCK. Well, I can understand that, but my question is, how many of them were active politically before they became successful and had an estate to tax? The reason I ask is I think this is our biggest problem. You know, it is a moving target. When I go back home and we talk about the estate tax, people say, "If I had $1 million, or $5 million, I would not mind giving the government $1½ million of it, you know." That is the socialistic concept.

In fact, quite frankly, I asked Ross Perot, when he got involved in what was happening, how come he did not do it before he was 60 years old. To me, this is the biggest problem we have. And I can speak to this. You know, I am 67. I have been talking about this for 20, 25, 30 years. Most of the people my age would not talk to me back 30 years ago. They were not concerned about it.

Now, how do we educate a society that we have, a society that gives people an opportunity to earn and save and develop an estate, and try to get them involved in the political process before that happens? Because I mean, that is where we have got to go. We have got to educate somebody.

So that is why I am asking you the question. And I have been asking a lot of people this. Because they are coming now to Washington saying, "We have got to do something about the estate tax," and I am saying, "Well, where were you 30 years ago?"

Mr. APOLINSKY. I think you have put your finger on what is a critical question. There is no doubt about it. I have asked myself the same question. Why has this tax lasted this long? Because I agree with you. I think it is socialistic to break up wealth. That did not work in some of the Eastern European countries, and it does not make any sense to me.

And I have come to the conclusion—there is an executive in Birmingham who made reference to the fact once that "denial" was not a river in Egypt. [Laughter.]

It is just that death is something that—I do not mind talking about death, but, if you are the "deathee," it is scary. People do not focus—they do not focus on that. You would be amazed as to how many clients I sit down who are in their sixties, who are startled that there is an estate tax. They have never heard of it. They do not know it exists. Oh, the insurance guy has been trying to get to them, but they sort of hear, "I want to sell you a policy," and so they do not listen to that.

They understand income taxes, because they get a dose of that every April, but they do not understand estate taxes. They are startled. I think John Harber, who was one of our leading industrialists, who had 50,000 jobs, is a wonderful story. He came up with me last year because he got interested in this at age 73.

He said when he was 69 years old the doctor told him he had cancer and he had 6 months to live. The doctor was wrong. He lived 5 more years after that, thank goodness. But he said, "I paused for the first time and I listened, and I became aware there was an estate tax." He said, "I could not believe it." He said, "I just could not believe that."

Now, here was just a tremendous industrialist. He said, "I could not believe that there was a 55-percent tax." He said, "I figured that when I had income tax and estate tax together, that was a little more than 80 percent." He said, "I decided, I am going to quit." He said, "I had been putting together . . ." He and Boone Pickens were good friends, and they would put together new business ventures, put millions of dollars in them to start up new businesses.

He said, "I decided it was not worth staying up all night agonizing over some new business, to keep 20 cents on the dollar for my family if I hit, and to lose 100 cents on the dollar." So, he said, "Harold, I quit. And at that time, I had 50,000 employees." Five years later, when he died, he had 1,000 employees.

So, I think it is just crazy to turn off these—and I have had two other clients tell me they have quit when they found out about the estate tax. It just was not worth it. I think it is crazy to turn off people who can build business and create jobs. I could not. I can represent them. That is fine. But it takes a certain spirit to take a risk and be willing to lose.

That is what is happening as a result of this death tax, no question about it. So, you are right. It is a question of trying to educate people that it does exist. You are doing a wonderful job. Just having these hearings, bringing the focus to estate tax, is to make people aware that it is there, and it is very deadly.

Mr. HANCOCK. One final comment. I do not know how many people have thought about this. But you know, maybe what we ought to do is to get Internal Revenue next year to send a copy of the estate tax form to people and say, "Hey, you know, ultimately you are going to have to fill this thing out, too." Because, what is it? Forty-some-odd pages of it? Very few people have ever seen it.

I have been carrying it in my briefcase for 30 years, and I show it to people and say, "Look, you are going to have to fill this thing out one of these days. Now, you had better start arranging your records." You would be surprised at how many people say, "Hey," you know, when they look at that.

But anyway, maybe we ought to ask Internal Revenue to send that out. Do you think that might get some people's attention?

Mr. APOLINSKY. Oh, I think that is wonderful. Maybe when people write in and say, "How much do I have when I retire?" Social Security could respond with information regarding estate taxes. I think that is a terrific idea.

Mr. HANCOCK. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you.

Thank you, gentlemen. We truly are grateful for your presentation today.

Mr. APOLINSKY. Thank you, Mr. Chairman.

Chairman ARCHER. The Committee will stand adjourned.

[Whereupon, at 2:32 p.m., the hearing was adjourned.]

[Submissions for the record may be found on page 376.]

IMPACT ON STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ENTITIES OF REPLACING THE FEDERAL INCOME TAX

WEDNESDAY, MAY 1, 1996

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

The Committee met, pursuant to notice, at 12:10 p.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
April 15, 1996
No. FC-14

CONTACT: (202) 225-1721

Archer Announces Hearing on the Impact on State and Local Governments and Tax-Exempt Entities of Replacing the Federal Income Tax

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing to examine the effect of some of the proposed replacement tax systems on State and local governments and tax-exempt entities. **The hearing will take place on Wednesday, May 1, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

BACKGROUND:

As part of its hearings on replacing the Federal income tax, the Committee on Ways and Means has begun to examine how the proposed replacement systems would affect specific segments of society and the economy. Witnesses will be asked to focus on the advantages and disadvantages of some of the proposed replacement tax systems using the following guidelines:

1. The basic alternatives are: an income tax (with one or more rates); a flat tax (such as the one introduced by House Majority Leader Dick Armey); a national sales tax (such as the one introduced by Reps. Schaefer and Tauzin); a value added tax (both invoice-credit and subtraction methods); and an income tax system with an unlimited savings deduction (such as the USA tax system introduced by Senators Domenici and Nunn).

2. The alternatives, whenever possible, should be considered in their pure, conceptual form (i.e., witnesses are discouraged from focusing exclusively on all the permutations of a so-called "flat tax" or on which items should (or should not) be exempted from a tax).

3. Any new tax system would replace the individual income tax, the corporate income tax, and estate and gift taxes. Witnesses could also consider replacement of payroll taxes and excise taxes, as long as they consistently considered such replacement for all proposed tax systems.

4. Replacement must be deficit-neutral, both in the short-term and the long-term.

Following this hearing, the Committee will continue to examine the impact of the proposed alternatives, including the effects on: individuals and families; employee benefits and retirement and personal savings incentives; international trade; home ownership and real estate generally; agriculture; domestic manufacturing; energy and natural resources; retail sales; financial services; service industries; and health care. Dates for hearings on these topics will be announced in one or more future press releases.

FOCUS:

The focus of this hearing will be limited to the impact of fundamental tax reform on State and local governments and tax-exempt entities.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business Tuesday, April 23, 1996. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff at (202) 225-1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Committee office, 1102 Longworth House Office Building, no later than 10:00 a.m. on Monday, April 29, 1996.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Wednesday, May 15, 1996, to Phillip D. Moseley, 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 deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least one hour before the hearing begins.

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 typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

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, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. 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 now available over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

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Chairman ARCHER. The Committee will come to order. The Chair apologizes to our witnesses for being 10 minutes late in beginning this hearing.

Today, we continue our series of hearings on the issues raised by proposals to replace the Federal income tax. Last week, we heard from small businesses. Today, we will hear from State and local government representatives and from tax-exempt organizations.

The views of State and local governments are very important. Fundamental changes in our tax system may have significant impacts on State and local tax systems, financing, and activities. We need and we want State and local government input and expertise as we go about examining the various alternatives for replacing our outdated and counterproductive Federal tax system.

We also must consider the impact of fundamental tax reform on tax-exempt organizations, and in particular on charities who do so much good for so many. We must consider whether and how current tax-exempt organizations should, under a new tax system, be exempt from tax on their activities. We must also decide whether and how there should be tax incentives for charitable giving within the new tax system.

Certainly, I think none of today's witnesses would argue that we should keep all of the worst aspects of our current tax system. In fact, I will just digress momentarily to say, so far, no one has appeared at that witness table nor up here in the chair of a Member to defend the current tax system. We should not keep the worst aspects, including the income tax and the estate tax, merely because those taxes allow a deduction for charitable gifts.

Moreover, any reexamination of tax incentives for charitable giving should include consideration of whether current tax incentives are appropriately targeted and whether organizations receiving charitable contributions are devoting a large enough share of those contributions to charitable purposes.

Accordingly, I look forward to and welcome the testimony of today's witnesses and the continued input of State and local governments and tax-exempt organizations about this process.

[The opening statement of Mr. Ramstad follows:]

STATEMENT OF REP. JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON REPLACING THE FEDERAL INCOME TAX
May 1, 1996

Mr. Chairman, thank you for giving this committee another opportunity to examine the impact of reforming our tax system.

Clearly, today's tax system fails the critical tests of efficiency, simplicity, flexibility, political responsibility and fairness.

It is also clear that some of the complexities built into our current system benefit entities that most Americans believe deserve help. For example, preferential tax treatment for governmental bonds helps state and local governments finance needed infrastructure and development in our communities. And the deduction for charitable contributions encourages Americans to donate to organizations that meet critical human needs.

Replacing our current system with one that encourages work, savings and investment will result in a rising tide of economic growth that will lift all boats. But at a time when the federal government is devolving power to state and local governments and asking more of the private sector, we must remain mindful of the impact of fundamental tax reform on those entities.

That is why this hearing is so crucial. State and local governments and charitable organizations must be our partners in this effort to reform our flawed tax system. I look forward to a continued dialogue with them throughout this massive undertaking.

Thank you, Mr. Chairman.

Chairman ARCHER. Without objection, Mr. Hancock is recognized for a statement.

Mr. HANCOCK. Thank you, Mr. Chairman.

I just want to welcome this group to this Committee. I specifically want to welcome my friend, Bob Holden, who is the treasurer from the State of Missouri. There are some questions that I would like to ask Mr. Holden that have nothing to do with the situation here at the Federal level but at the State level, but I will defer on those for private conversation.

Thank you very much. This is Mr. Holden's first term representing the State of Missouri. He has done what I consider a good job for the State of Missouri.

Thank you very much, Mr. Chairman.

Chairman ARCHER. The Chair would like to ask each witness subsequent to their being recognized to identify themselves and the entity that they represent. The Chair recognizes Mr. Portman to introduce the first witness.

Mr. PORTMAN. I thank the Chairman.

It is my pleasure to introduce a fellow Cincinnatian, Ken Blackwell, treasurer of the State of Ohio.

He brings, Mr. Chairman, a rich and varied background to this important discussion on tax reform. Ken Blackwell is a former mayor of Cincinnati, a member of the city council in Cincinnati, a former U.S. Ambassador to the U.N. Human Rights Commission, currently treasurer of the State of Ohio, but also importantly was one of the two State elected officials who was on the so-called Kemp Commission, the tax reform commission which issued its report earlier this year.

It is a pleasure to have you, Ken, before the Committee. I look forward to your testimony.

Chairman ARCHER. Mr. Blackwell, you are recognized.

Mr. BLACKWELL. Thank you, Mr. Chairman.

Chairman ARCHER. Let me also suggest to the witnesses that we would appreciate it if you would hold your oral testimony to within 5 minutes. Your entire written statement, without objection, will be inserted into the record.

Thank you.

STATEMENT OF HON. J. KENNETH BLACKWELL, TREASURER, STATE OF OHIO

Mr. BLACKWELL. Thank you, Chairman Archer. Good afternoon to the Members of the Committee, and in particular, my fellow Cincinnatian, Representative Rob Portman, who is a longtime friend and colleague.

For too long, the whole economy, including the State and local government sector, has been restrained by a Federal Tax Code that favors one type of State or local taxation over another. This philosophical discrimination runs contrary to the principle devolution of power to the States. The current Federal tax system also makes State and local governments coconspirators with the Federal Government in a system that violates the principle of horizontal equity. Horizontal equity says people of similar economic circumstances should pay similar taxes.

Consider two otherwise identical families, both making $75,000 in income, one living in New York and the other in Texas or Florida. The New York family probably pays $4,000 or more in State and local income taxes while the Floridian or Texan pays nothing. Because of Federal tax deductibility, the New York family will probably pay close to $1,000 less in Federal income taxes. This unfairly coerces State and local governments into one form of taxation over another.

Particularly alarming is the fact that the Federal Government favors tax policies that often obstruct economic growth. My service on the tax reform commission made one thing very clear. Real tax reform eliminates the bias against savings and investment and real tax reform will increase economic growth.

This thesis is supported by empirical data in a recent report by Professor Richard Vedder of Ohio University for the Joint Economic Committee of Congress. He found that, first, relatively low-tax States grew nearly one-third faster than high-tax States. Second, income taxes have a particular adverse impact on income growth. Third, Federal flat rate income taxes are significantly more favorable to economic growth than progressive taxes. Fourth, personal income and flat rate tax States grew about 25 percent faster than did personal income in States with a progressive tax rate structure.

The attached charts to the submitted testimony, derived from Professor Vedder's report, show that tax policy impacts State spending and personal income growth. Given this evidence, the Federal Government's support for proconsumption, antisaving tax schemes at the State and local level is clearly antigrowth.

As treasurer of the State of Ohio, my professional interest lies very significantly with municipal bond issuance. Currently, State and local issuers enjoy a tax-exempt status in the capital markets. Losing this tax exemption frightens some issuers and the average Wall Street investment banker, but the benefits of that change become clear in light of prosavings tax reform at the Federal level. Increased emphasis on savings and decreased emphasis on consumption will expand capital markets. An increase in savings means an increase in available capital. As the supply of capital outstrips the demand for capital, the cost of capital, the interest rate, falls.

An increase in savings will also increase the demand for savings vehicles, local, State, or Federal securities. Again, rising demand for government securities drives down interest rates. The bottom line is that greater economic growth for the people means greater economic stability for the people's government at all levels.

The way to economic growth in this country is obstructed by a high-tax system that punishes savings. Replace that system with one that unleashes the power of the private sector and thereby you strengthen the public sector.

Mr. Chairman, in addition to the remarks I just made, I am submitting an addendum to and an expansion of my remarks for inclusion in the official transcript.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF J. KENNETH BLACKWELL, TREASURER
STATE OF OHIO

Thank you, Chairman Archer. Good morning Ways and Means Committee members, and in particular my fellow Cincinnatian, Representative Rob Portman and our Kentucky neighbor, Representative Jim Bunning.

For too long, the whole economy, including the state and local government sector, has been restrained by a federal tax code that favors one type of state or local taxation over another. This philosophical discrimination runs contrary to the principle of devolution of power to the states.

The current federal tax system also makes state and local governments co-conspirators with the federal government in a system that violates the principle of horizontal equity. Horizontal equity says people of similar economic circumstances should pay similar taxes. Consider two otherwise identical families, both making $75,000 in income, one living in New York and the other in either Texas or Florida. The New York family probably pays $4,000 or more in state and local income taxes, while the Floridan or Texan pays nothing. Because of federal tax deductibility, the New York family will probably pay close to $1,000 less in federal income taxes. This unfairly coerces state and local governments into one form of taxation over another.

Particularly alarming is the fact that the federal government favors tax policies that often obstruct economic growth.

My service on the National Commission on Economic Growth and Tax Reform made one thing very clear. Real tax reform that eliminates the bias against saving and investment will increase economic growth.

This thesis is supported by empirical evidence in a recent report by Professor Richard Vedder of Ohio University for the Joint Economic Committee of Congress. He found that:

1. Relatively low-tax states grew nearly one-third faster than high-tax states.
2. Income taxes have a particularly adverse impact on income growth.
3. Flat-rate income taxes are significantly more favorable to economic growth than progressive taxes.
4. Personal income in flat-rate income tax states grew about 25 percent faster than did personal income in states with a progressive rate structure.

Given this evidence, the federal government's support for pro-consumption, anti-savings tax schemes at the state and local levels, is clearly anti-growth.[1]

As Treasurer of State of Ohio, my professional interest lies very specifically with municipal bond issuance.

Currently, state and local issuers enjoy tax-exempt status in the capital markets. Losing this tax-exemption frightens some issuers and the average Wall Street investment banker. But the benefits of that change become clear in light of pro-savings tax reform at the federal level.

Increased emphasis on savings and decreased emphasis on consumption will expand capital markets.

Increase in savings means an increase in available capital. As supply of capital outstrips the demand for capital, the cost of capital -- the interest rate -- falls.

An increase in savings will also increase the demand for savings vehicles -- local, state, or federal securities. Again, rising demand for government securities drives down interest rates.

The bottom line is that greater economic growth of the people means greater economic stability

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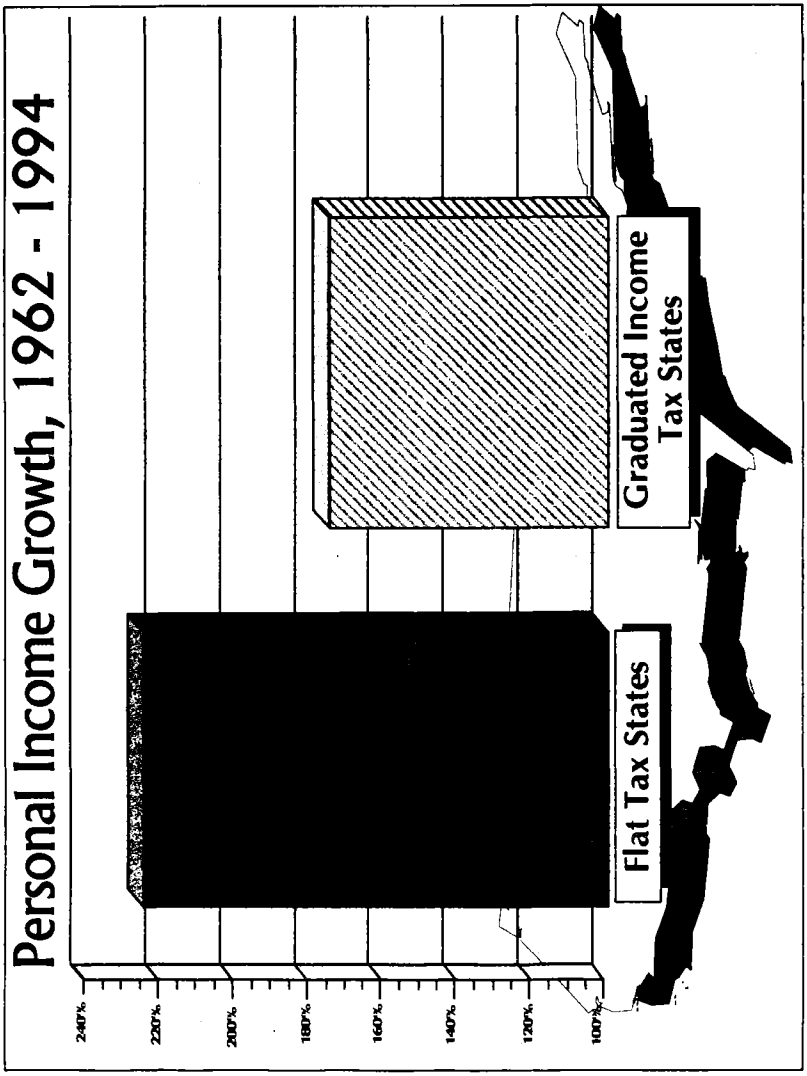
[1]Alternatively, deduction of state and local taxes can be maintained so long as all state and local taxes are deductible. In order to maintain a low tax rate and high exempt amount, the cost of this deduction would have to be paid for elsewhere.

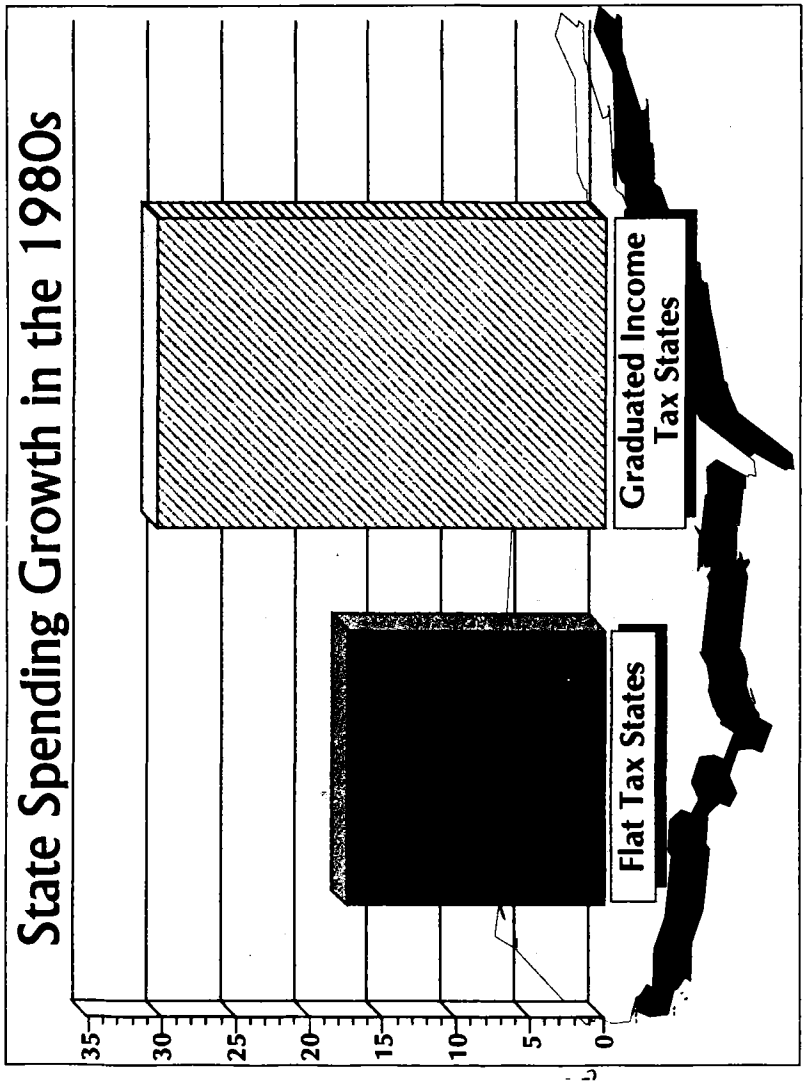
for the people's government -- at all levels.

The way to economic growth in this country is obstructed by a high-tax system that punishes savings. Replace that system with one that unleashes the power of the private sector, and thereby strengthens the public sector. Growth is key to our success in the twenty first century. The tax code should reflect this reality.

Please place this official testimony in the Congressional Record.

Thank you.


Personal Income Growth, 1962 - 1994
240%
220%
200%
180%
160%
140%
120%
100%
Flat Tax States
Graduated Income Tax States


State Spending Growth in the 1980s
35
30
25
20
15
10
5
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Graduated Income Tax States
Flat Tax States

Joint Economic Committee Staff Report

STATE AND LOCAL TAXATION AND ECONOMIC GROWTH:

LESSONS FOR FEDERAL TAX REFORM

December 1995

EXECUTIVE SUMMARY

The experience of the states over the past third of a century provides a unique laboratory for investigating the effects of tax policy on economic growth. States vary widely in the method and magnitude by which they raise revenues, and this paper examines the resulting effects on economic well-being within states.

Through a comprehensive statistical analysis, this study concludes that higher state and local taxes had a distinct and significant negative effect on personal income growth over the period extending from 1960 to 1993. That is, when state and local taxes were raised, personal income growth slowed markedly. By the same token, states with lower taxes enjoyed substantially higher personal income growth.

Key findings include:

- Relatively low-tax states grew nearly one-third faster than high-tax states. This difference in growth rates translates into higher income of about $2,300 per person or $9,000 for a family of four for people living in low-tax states compared to those living in high-tax states.

- On average, an increase in state and local tax burdens equal to one percent of personal income lowered income growth by over three and a half percent. Since states raised tax burdens by an average of nearly two percent of personal income over this period, an average family of four lost almost $2,900 in income.

- Income taxes have a particularly adverse impact on income growth. Had a representative state kept its level of income taxation at the same share of personal income over the course of this study, personal income in that state would be over 30 percent greater today.

- Flat-rate income taxes are significantly more favorable to economic growth than progressive taxes. Personal income in flat-rate income tax states grew about 25 percent faster than did personal income in states with a progressive rate structure.

Prepared by: Richard K. Vedder, Ohio University and the Center for the Study of American Business at Washington University

Available on the Internet:
http://www.senate.gov/~jec/sta&loc.html

ADDENDUM

TO

TESTIMONY OF

J. KENNETH BLACKWELL,

TREASURER OF STATE OF OHIO

BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

May 1, 1996

Tax reform is something America's state and local governments and tax-exempt entities can and should welcome. My service on the National Commission on Economic Growth and Tax Reform has led me to conclude that meaningful tax reform will not only serve to clarify the proper roles of the private, public and tax exempt sectors in America's economy but that an economic growth driven tax reform will significantly ease the burden of service on each of these sectors.

For too long, the whole economy, including the state and local government sector, has been held back by a federal tax code that has discouraged saving and investment, retarded the growth of productivity, wages and employment, and placed more of a strain on the social safety net. State and local governments must also confront very costly problems involving compliance with and enforcement of the current tax system that results in hundreds of billions of dollars of wasted resources that could be put to better use. That is why we need tax restructuring.

States and local governments are forced to deal with a tax code that says, in effect, "Washington knows best." States that have high income taxes are considered good, progressive jurisdictions, so Washington rewards their citizens with lower federal taxes. States that raise revenues more by sales taxes, excise taxes or user fees are punished relative to states that use high income or

property levies. Rather than being neutral on state fiscal policy, Washington is trying to use financial incentives to dictate the nature of state taxation. This is inconsistent with empowering state and local governments to do what they feel is best for their citizens. State and local governments should demand that the existing federal tax bias towards property and income taxes end. One alternative that has been suggested to end this federal bias is to make all state and local taxes - not just property and income taxes - deductible. However, in order to maintain the desired low tax rate and high exempt amount, the cost of ending the federal bias in this deduction would have to be paid for elsewhere.

What is particularly wrong about the type of taxation that Washington is compelling states to adopt is that it has a particularly adverse impact on growth. Washington is telling the states: "tax production of goods or the resources used to produce goods, rather than consumption." The federal income tax is anti-growth because it double or triple taxes income used for savings and investment, while taxing income used for consumption only once. The reason savings-deferred income taxes or sales taxes are not anti-growth is that each taxes income used for saving and investment no more heavily than income used for consumption. State and local governments should not be compelled to adopt anti-growth tax systems simply because the federal government has chosen to do so.

For some time I have believed that state and local governments have been cut by the double edged sword that is taxes and taxation. Taxes choke job creation, personal income growth and free enterprise. Prof. Richard Vedder of Ohio University has recently concluded in his report prepared for the Joint Economic Committee of Congress that 1.) relatively low-tax states grew nearly one-third faster than high-tax states, 2.)Income taxes have a particularly adverse impact on income growth, 3.)Flat-rate income taxes are significantly more favorable to economic growth than progressive taxes, and 4.) Personal income in flat-rate income tax states grew about 25 percent faster than did personal income in states with a progressive rate structure.

The current federal tax system makes state and local governments co-conspirators with the federal government in a system that violates the principle of horizontal equity, a principle that says that people of similar economic circumstances should pay similar taxes. Consider two otherwise identical families, both making $75,000 in income, one living in New York and the other in either Texas or Florida. The New York family probably pays $4,000 or more in state and local income taxes, while the Floridan or Texan counterpart pays nothing. Because of federal tax deductibility, the New York family will probably pay close to $1,000 less in federal income taxes. This is unfair and coerces state and local governments determine their basis of taxation from federal and not

state policy.

This bias is not a "benefit" to taxpayers in high income tax states. The taxpayers of those states are simply being taxed more heavily than others to pay for more income transfers to, for example, the poor or students. These taxpayers are not gaining as a result of federal and state tax policies tied to high income taxes. These taxpayers are just suffering less than if there were no deduction. I would suggest that the existing federal income tax code includes an exempt amount so that the poor might get some income free of tax. If that is the case, why should America "punish" state income taxpayers who are being forced to give their money to the poor via the state income tax and transfer system for doing what the exempt amount and the existing charitable deduction on the federal level render praiseworthy. The existing tax system promotes contradictory objectives and inconsistent policies as between states and the federal government.

As treasurer of state of Ohio, these facts and others compel me to support meaningful tax reform. Permit me to briefly explain why.

Property values and property tax receipts

Contrary to the opinion of some policy makers, property values and tax receipts of local governments should remain strong under tax

reform, whether or not the mortgage interest deduction is retained. If the deduction were eliminated, along with taxation of interest received by the lender, interest rates would decline to compensate. The Commission has suggested however retention of the mortgage interest deduction, provided that lenders continue to be taxed on the interest as under current law. Whichever method is chosen, economic growth due to reduced taxation of saving and investment would boost incomes and demand for housing, and would increase other types of real estate investment and the property tax base. Professor Dale Jorgenson of Harvard told the Commission that the economy would grow by an additional 9% over a decade, with an approximately 16% increase in business fixed income investment if the biases in the tax system were eliminated. Consequently, such a tax overhaul would raise state and local government income from property taxes, income taxes and sales taxes, and reduce state and local government outlays for welfare, Medicaid and unemployment compensation.

Deduction of state and local taxes

Taxes are the price we pay for government services and products. It is possible that the loss of the deduction for state and local taxes would reduce citizens' desire for the goods and services provided by state and local governments by exposing their full cost, now partly concealed. In the case of consumption services

received by taxpayers, this is not necessarily a bad thing. However, many of the activities of state and local governments are explicit or implicit transfer payments (welfare, education, etc.) that would be deductible if provided through private charities, or if education spending were considered "investment" in human capital. Services provided business (security, water, trash pick up, etc.) are certainly costs of doing business, and are generally of a type that would be deductible if purchased from a private vendor. These deductions could be retained in exchange for a lower exempt amount or a higher tax rate.

Demand for tax-exempt municipal bonds

Tax restructuring will not take away any advantage enjoyed by municipal bonds, nor will it raise borrowing costs for state and local governments. Indeed, by strengthening the economy and the state and local tax base, and reducing unemployment and poverty, it will improve state and local government revenues and reduce need for welfare related outlays. In particular, tax exempt securities will not fall in price. This concern is based on a misunderstanding of the relationship between taxable and non-taxable securities and the functioning of the credit markets, and is without merit. Interest rates consist of a basic rate of return demanded by lenders, plus rate premiums reflecting differences in risk among various securities, expected inflation and taxes. Tax exempt bonds

do not have the tax premium. Taxable bonds do. Under the flat tax, the tax premium in currently taxable bonds would fall to current tax exempt levels. There would be no change in the tax treatment of tax exempt bonds. Their prices and interest rates would be largely unchanged.

Change in Federal Definition of Taxable Income

The states that use federal definitions need to make adjustments in their taxes whenever federal taxes change. The types of tax changes the Commission contemplates would not be difficult for the states to adapt to, however. States would only have major difficulties if the federal government abandoned income taxation entirely in favor of a sales tax. Then there would be no federal definition of income for state law to refer to or data gathering to share with state income tax enforcement agencies.

In conclusion, I favor an American tax system that unleashes the potential of the private rather than the public sector to confront the twenty first century. Growth is key to the success of both the public and the private sectors in the twenty first century. The tax code should reflect this reality.

Chairman ARCHER. Thank you, Mr. Blackwell, and thank you for your contribution on the tax commission.

The Chair recognizes Mr. Crane to introduce our next witness.

Mr. CRANE. First of all, I want to express appreciation to all the witnesses for being here today in this important discussion, but I want to pay a special tribute to the most gorgeous member out there on the dais, Loleta Didrickson, who is our comptroller in the State of Illinois.

Thank you for coming today, Loleta.

Ms. DIDRICKSON. Thank you, Congressman.

Chairman ARCHER. Ms. Didrickson, you are recognized. You may proceed.

STATEMENT OF HON. LOLETA A. DIDRICKSON, COMPTROLLER, STATE OF ILLINOIS; ON BEHALF OF NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND TREASURERS

Ms. DIDRICKSON. Thank you, Mr. Chairman and Members of the Committee. I am Loleta Didrickson, the Illinois State comptroller. I am pleased to be here. I am representing NASACT, the National Association of State Auditors, Comptrollers and Treasurers, for the first part of my presentation.

On behalf of my colleagues in the other individual States, I would like to raise a couple points for consideration. The various Federal tax reform initiatives that you have under discussion are all of significant interest to the States. They all will, first, definitely impact State revenues and costs; second, will definitely impact individual State economies; and the third point is that they will impact the administrative efficiency, methods of compliance and enforcement, possibly the fundamental assumptions, revenue productivity, and taxpayer equity associated with State tax policies and practices. These impacts will vary in nature and importance State by State.

Given the above generalities, there are two messages I wish to represent on behalf of NASACT. First, as any of the Federal reform initiatives are considered, in specific, we would respectfully suggest that State fiscal officials be provided the opportunity to participate and contribute to the quality and comprehensiveness of the debate. Through NASACT, State fiscal officers, such as myself, are willing to make that contribution.

A second point that I would like to make, and the final points with regards to NASACT, is at least because of the administrative impacts, if not the economic impacts, States will need time to adjust and implement changes in their own tax policies and practices as a result of any reform measurements that you pass. Such State government adjustments may need to take the form of amendments to State tax law, revised forms and schedules, taxpayer assistance information, and new methods of tax compliance, enforcement, and audit.

So the two points here with regards to the NASACT messages, first, we appreciate the opportunity for participation in the policy discussion, and second, time will be needed to implement any such State adjustments.

I now would like to talk about the Illinois impact with regards to some of the proposals that you are talking about or considering. In specific, I would like to talk about the fact that Illinois is a flat tax State, has been since 1969, and as you are beginning your discussions on comprehensive tax reform, the Federal flat tax proposal that most of us are familiar with with regards to the Armey plan, the tax rate of 20 percent dropping to 17 percent thereafter, with interest, dividends, and capital gains exempt and other loopholes closed.

It has appeal because of its simplicity. It does not require changes in the Constitution. The current Federal graduated income tax for us in Illinois is a loser because it takes our most powerful economic impact dollars out of the State.

Illinois has had that flat income tax rate that I mentioned since 1969. It currently sits at 3 percent. We have only three exemptions. The first is retirement income. Second is a 5-percent property income tax credit. Third is the income tax exemption for the blind and elderly of $1,000.

Let me explain our experience with that flat tax system. We see it as having several advantages. First, it is broad based. It allows us to maintain very low rates and still achieve productive revenue yield. Second, it is simple to enforce and administer. In fact, our easy 1040 form can actually be in a postcard format. Third, it encourages voluntary compliance because it is very easy. Fourth, it has, as Ken Blackwell mentioned, the horizontal and vertical equity, meaning that taxpayers with comparable adjusted gross incomes actually are taxed similarly. Finally, the Illinois flat tax rate introduces minimum economic distortions. Actually, taxpayers make the decision for economic reasons, not for tax reasons.

I could go on. There are a couple points that I would like to make, though, with regards to highlights. Finally, I would like to say that we will need to understand what the determining point is for the base for determining the liability at the State level. For nonfilers who would not have Federal liability, we would ask you to consider that they report also, even though they have no tax liability, so that we can run the match against the Federal and the State so we can see who would need to be in compliance.

Excluding all unearned income does raise some concerns. There probably are some unexpected consequences of such a change with regards to higher financing costs for State and local governments.

Finally, I see this as a win-win with regards to any kind of changes you make to make a simpler, flatter, fairer Tax Code work. We have found that in Illinois, it does work. We have actually done in the Office of the Comptroller some simple modeling that shows that if you were to pay us the talked about, discussed flat tax proposal, that would mean to the State of Illinois about $1.2 billion straight cash to our State treasury if we use a very conservative multiplier based on an assumed 8 billion dollars' worth of tax dollars that would be able to stay in our taxpayers' pockets.

Thank you very much for the opportunity to give you the Illinois perspective, but more importantly, the NASACT perspective with regards to our ability to participate and recognizing the States' need to implement with regards to time.

[The prepared statement follows:]

Testimony of Loleta A. Didrickson
Illinois State Comptroller
before the
House Ways and Means Committee Testimony
May 1, 1996

Good Morning Mr. Chairman, and Honorable members of the Committee. Thank you for the opportunity to discuss tax reform with you. I am Loleta Didrickson, Comptroller of the State of Illinois. As State Comptroller, I am the State's Chief Fiscal Officer, a Constitutional Office elected by the voters of Illinois every four years.

I am pleased to be here representing the National Association of State Auditors, Comptrollers and Treasurers (NASACT), and on the behalf of NASACT and my colleagues in the individual states, provide the committee with our perspectives and interests in the issues you are considering.

The various federal tax reform initiatives you have under discussion are all of significant interest to the states. They all:

- will definitely impact state revenues and costs;
- will definitely impact individual state economies;
- will impact the administrative efficiency, methods of compliance and enforcement, and possibly the fundamental assumptions, revenue productivity and taxpayer equity associated with state tax policies and practices. These impacts will vary in nature and importance state by state.

Given the above generalities, there are two messages I wish to present on behalf of the NASACT membership.

First - as any of the federal reform initiatives are considered, in specific, we would respectfully suggest that state fiscal officials be provided the opportunity to participate and contribute to the quality and comprehensiveness of the debate. Through NASACT, state fiscal officers, such as myself, are willing to offer such participation and contribution.

Second - at least because of the administrative impacts, if not the economic impacts, states will need time to adjust to and implement changes in their own tax policies and practices as a result of reform of federal policies and practices. Such state government adjustments may need to take the form of amendments to state tax law, revised forms and schedules, new taxpayer assistance information, and new methods of tax compliance enforcement and audit.

My intention is to expand on the NASACT messages of:

- Participation in the policy discussion, and
- Time to implement state adjustments,

by discussing some of the specific proposals before the Committee, by referencing Illinois' experience with some of the proposed reforms, and by suggesting the nature of the impacts the federal reform initiatives would have on the Illinois experience.

As the federal government discusses comprehensive tax reform, one of the reforms being considered is the federal flat tax proposal, which claims to be simple, straightforward and fair. The particular version that I will be referring to starts at a tax rate of 20% dropping to 17% thereafter, with interest, dividends, and capital gains exempt and other loopholes closed. This flat tax proposal has appeal because of its simplicity and does not require changes in the constitution. The current federal graduated income tax is a loser for Illinois, because it takes our most powerful economic impact dollars out of the state.

In the states, we have been looking for ways to do things smarter, smaller, more effective and efficient. There is no example more out of concert with that approach than the current federal tax structure and the operations of the IRS...100,000 employees at a $10 billion cost annually. One of the more interesting aspects of the flat tax proposal is that it would do away with the IRS as we know it. The federal tax system has spiraled out of control. Americans devote 5.1 billion hours per year to federal tax reporting paperwork. The higher the tax rate the more it encourages people to avoid taxes. There is no constituency for all of this! It has been frequently noted about progressive tax rates, that the higher the marginal rate, the more it will induce people to evade taxes.

Illinois has had a flat income tax since it's inception in 1969, originally 2 ½%, currently at a 3% flat rate. Our Illinois Tax Code does not distort Illinois tax decisions - if you earn it, we tax it, at a lower, fairer tax rate. Our only exemptions are: retirement income; 5% property income tax credit; and, $1,000 for the blind and elderly.

Our experience is that our state's flat tax system has several advantages:

- It is broad based, allowing us to maintain low rates and still achieve a productive revenue yield;

- Simple to enforce and administer;

- Encourages voluntary compliance;

- Has horizonal and vertical equity. This means that taxpayers with comparable adjusted gross incomes are taxed similarly;

- The Illinois flat tax rate introduces minimum economic distortions because taxpayers make decisions for economic reasons, not for tax reasons.

While the flat tax policy has had a very positive reaction within our Illinois economy, changes at the federal level will have impacts on our system in Illinois. Illinois is one of seven states that has a flat tax rate and one of four that uses the federally adjusted gross income (AGI), as its base.

I would like to raise several questions and concerns regarding the above impact issues.

1. What will be the staring point or base for determining state tax liability?

2. The current federal proposals would exclude unearned income, such as interest, dividends and capital gains, from the federal taxable base. For many states, including Illinois, this is currently part of our taxable base. Either state law would have to be changed, or we would have to construct entirely new reporting and compliance tools.

3. The federal flat tax proposal raises the minimum taxable income level. Such a change in minimum federal AGI for reporting would be higher than the levels at which states tax. Once again, requiring revision of state law or, the creation of entirely new separate state reporting and compliance mechanisms.

4. We request consideration under this proposal to provide for required reporting, even though there is no tax liability, so that we in Illinois can continue to run a match of state taxpayers and federal taxpayers to ensure compliance.

5. States, like the federal government, have created a variety of tax expenditures or tax breaks. Change to a federal flat tax will require an analysis of the justification and return on investment on all such tax expenditure programs.

6. Excluding all unearned income, removes the market interest rate differential between states and local tax exempt debt instruments, and those that are taxable. An expected consequence of such a change would be higher financing costs for state and local governments.

My comments have referenced the need for working with the states through NASACT to smooth out the impact of federal tax code changes. I have also shared Illinois' experience with the flat tax at the state level. In closing, let me share with you the positive impact of the federal flat tax proposal in the state of Illinois. The Illinois Office of the Comptroller calculates the initial savings form the federal flat tax proposal to be $8 billion annually to Illinois taxpayers. Leaving that money in the hands of Illinois taxpayers would produce an impact on the economy of $16 billion, using a multiplier of two. Taxed at our current flat income tax rate of 3% and our 5% sales tax, this spending has the potential to generate $1.28 billion in new revenue to the Illinois State Treasury.

As Illinois' Comptroller, our office reported in our FY 1995 GAAP Financial Report, a $1.2 billion dollar operating deficit primarily due to past due Medicaid bills. Illinois has been unable to implement a rainy day fund or set aside a reserve due to this fiscal constraint. We overly rely on property taxes to fund our schools. In fact, our Governor and our legislative leadership have proposed various plans for increasing education funding at the state level.

As a government fiscal officer and as an elected politician, I am always in favor of solutions to problems that don't require asking more of state taxpayers. A federal flat tax that could put approximately $1.3 billion of additional revenue in the state treasury to solve our problems in Illinois with Medicaid bills and school funding...looks like a winner to me.

I strongly encourage you to make those fundamental changes to our federal tax code, leaving more money in the pockets of the individual taxpayer. If Illinois' experience is any guide, a simpler, flatter, fairer tax code works.

Chairman ARCHER. Thank you, Ms. Didrickson.

The Chair recognizes Mr. Rangel to welcome and introduce the next witness.

Mr. RANGEL. It is my pleasure to introduce the first deputy mayor of the city of New York, who is living proof that you do not have to come from the political arena in order to be an effective public servant, as he is. He does not come here just politically but he comes here as a very experienced tax lawyer who truly understands the value of the contributions as made by the great city of New York.

As you know, Mr. Chairman, I do not talk too often about my city, but the fact that it is the cultural center of the world, produces more taxes and provides more entertainment to the entire country, with its trade center and financial district, I am glad to have someone that understands it not only politically but certainly from a tax perspective and I welcome him in joining this panel.

Mr. Powers, we anxiously wait to hear your testimony.

Mr. POWERS. Thank you very much.

Chairman ARCHER. Mr. Powers, you may proceed.

STATEMENT OF PETER J. POWERS, FIRST DEPUTY MAYOR, CITY OF NEW YORK

Mr. POWERS. Thank you, Mr. Chairman, and thank you very much, Congressman Rangel.

As the Congressman mentioned, I am a CPA and a tax lawyer and I spent 25 years of my career before entering government practicing tax law. Believe me, there is nobody in this room who is more in favor of reform of the Federal tax laws than myself. I have seen too many times where the tail wagged the dog, where a tax law that was so complex that business deals that should have gone on in a very sensible way got reconstructed, redone, and were in the end done in a very unsensible way because of the tax laws.

So I am very much in favor of any kind of substantive reform, as is the mayor, on behalf of the city of New York. But we have to be careful when we do reform. We do not want to throw out the baby with the bathwater.

New York City has the fourth largest budget in the country, counting the Federal Government's budget. In order, it is the Federal Government first, then California, New York State, New York City, and last, the State of Texas. We are a high-tax city and a high-tax State. We have lowered taxes. Mayor Giuliani has lowered taxes since he has been in office, but we do rely in large part on an income tax, a city income tax as well as a State income tax, to fund the resources that we need to take care of the city.

The fact of the matter is, though, although people talk about the money that flows to New York City, New York City sends $9 billion more to the Federal Government than it gets back and the State of New York sends about $14 billion more in tax revenue to the Federal Government than it gets back.

The concern that we have, if there is elimination of State and local taxes as a deduction, a lot of the businesses that are in New York and a lot of the people who live there are going to leave because it is going to become that much more expensive. Under cur-

rent rates, if we took away the State and local tax deduction, it would be like a 40-percent increase in our taxes.

When people leave New York, it is not so simple to say they will go to New Jersey or Westchester or Connecticut. Large businesses will leave the country. I have spoken to leaders in the securities industry and they have told me they do not have to be in New York, they do not have to be in America anymore to do their business.

We have a wonderful generator of wealth in the city and State of New York. Before we do something that could hurt that generator of wealth and cause those businesses to leave the State and the city and possibly the country and dissipate in a way that could be harmful to the Federal Government's fiscal interest, as well as the city and State's fiscal interest, I think we should be very careful to analyze the effects. We should be sure that we know it is not going to hurt the city, and also to be sure that the city's balance of payments does not get worse under a new tax system, and the city does not wind up spending more than the annual $9 billion that goes to the Federal Government. We love to help, we love to share, but we need to save a little bit for ourselves.

We are very concerned about the possible disallowance of the exemption for municipal bond interest. Like many cities in the Northeast and many cities throughout the city that are older cities, we have an aging infrastructure. We have in New York City a $4 billion annual capital budget that we spend. Most of that is on infrastructure repair, bridges, rail, subways.

We get a benefit from being able to have municipal bonds and lower interest rates that come from that. That also creates a lot of jobs and also enables our economy to thrive in the city. When the city's economy thrives, it has a great impact on the national economy. We would not like to lose the municipal bond interest exemption because we believe that would force us to pay higher interest rates and not enable us to do the repairs to infrastructure that we have had to do in the past.

As far as charitable deductions are concerned, we are extremely concerned that at a time when the Federal Government is asking States and cities to do more—and we support that, we support a lot of the block grant concepts that have been proposed—that if you take away the tax benefits for charitable contribution, it could be very harmful and limit charitable deductions.

I have to go back to my experience as a tax lawyer for many years. Many times, charitable deductions happen because of the tax benefits that they had. We could create ways where taxpayers could save a lot of dollars and still give a lot of dollars to charity. Everybody seemed to benefit and the Federal Government did not have to pay the full cost of the dollars that went to charity.

This time when we are trying to do things in New York with less government help, such as welfare reform—which we have achieved in New York. We have 125,000 fewer people on welfare than 1 year ago. We have the largest workfare program in the country today. As we speak, 20,000 people who receive welfare benefits are working for the city of New York. They are helping to clean the city. They are working in offices. We give them the dignity of a job.

At a time like this, when we are very often a partner with charities to get benefits to people, to help them out of tough situations, to take away the benefit for charitable contributions, it would be very detrimental.

We also employ thousands and thousands of people in the city of New York, 400,000 people, one way or another affiliated with our charitable institutions, and the institutions have budgets of over $30 billion. A lot of that money is spent not just in the city of New York but also nationwide. We think it would be very harmful to us if we lost the charitable deduction.

Last, I might say that certainly, since we want to make sure that people save money and not consume, I would like to defend the home interest mortgage deduction. When you think of it, for your average person, the only way they create wealth in many people's lives is by buying a home and spending the money in a mortgage every month and seeing the value of that home grow.

Also, in the city of New York, home ownership is one of the major housing programs that we are pushing because we believe that brings back neighborhoods, it gives people a stake in their neighborhoods, and also creates a better economy and better jobs for people when we do that. So we would not like to lose the home interest deduction.

In conclusion, I would like to say we support tax reform, but before we do certain things, we should be very careful that we are not, as I said earlier, throwing the baby out with the bathwater, because we have a terrific economic engine in the city of New York that creates a lot of wealth in this country. I would hate to see a change in the tax law dissipate that wealth in a way where not only New York loses it, but perhaps the country loses it.

I thank you very much for the opportunity to speak here today, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF PETER J. POWERS, FIRST DEPUTY MAYOR CITY OF NEW YORK

Good morning. Mr. Chairman and members of the Committee. I am Peter Powers, First Deputy Mayor of the City of New York, serving under the leadership of Mayor Rudolph Giuliani. I am a CPA, have a masters degree in tax law, and practiced tax law for 25 years before assuming my current position. I appreciate the opportunity to appear before the Committee to present the views and concerns of the City of New York regarding the impact of the proposed "flat tax" and other reform proposals on state and local governments.
I applaud efforts to reform the Federal tax system in order to simplify the system and promote national economic growth.

In fact, Mayor Giuliani is also in the midst of reforming New York City's tax system and reducing taxes in order to make the City more competitive with surrounding jurisdictions. The Giuliani Administration has already reduced City taxes by hundreds of millions of dollars by, among other things, taking major steps to eliminate the City's commercial rent tax and reducing the Hotel Tax. In addition, the Mayor is proposing major reforms in City business income taxes in order to simplify and improve the City's tax system.

Of course, there are many views as to the best way to reform the Federal tax system. It is important that the new policies being proposed not create new problems for major cities such as New York and reduce its attractiveness as a place to do business for national and international firms, as well as local businesses.

Any negative effects that these tax proposals might have on New York City would ultimately have negative effects on the national economy as well. New York City is the major generator of wealth in this country. The City is the financial capital of the world and the nation's gateway to international markets. Over $3 trillion worth of global trading takes place on New York City's exchanges, or more than a quarter of the global equity market. Ninety-three of the world's top 100 banks have offices in New York. The City is a leading destination of international travelers with more than 5.5 million foreign tourists annually, who then visit other parts of the U.S. If New York's economy declines as a result of these tax changes, our ability to attract business from other parts of the world declines. This would in turn affect the U.S. economy as well.

New York City residents and businesses, which already send $9 billion more to the Federal government than they receive in Federal aid, could be particularly hurt by some of the specific changes being discussed. The elimination of the state and local tax deduction, in particular, would result in an automatic increase of 30 percent to 40 percent in the tax burden of New York City businesses and individuals. In effect, the loss of this deduction results in a substantial increase in the New York City and State effective tax rates. Faced with a choice of continuing to do business in New York or relocating to more favorable tax climates, I have little doubt what that decision would be.

Moreover, many businesses in the financial or service sectors with significant investments in new technology and communications networks could decide to leave the United States and relocate abroad. As evidence that this could occur, consider that 75 percent of the financial assets that foreign banks manage in the United States are located in New York City. These assets could easily be moved to London or Tokyo.

At the same time, these proposals could increase the tax burden of small businesses. Those just starting out in the business world would see an increase in tax rates and the elimination of deductions which help such firms in these most vulnerable years. In addition, the proposed elimination of the mortgage interest deduction could be particularly harmful to the New York real estate industry.

In addition to the impact on businesses, we must also not ignore the potential impact of Federal tax reform on the City's residents. Our preliminary analysis of Congressman Dick Armey's flat tax proposal indicates that the total tax for a middle class married couple in New

York City earning between $30,000 and $50,000 with two children and employer provided health insurance would increase on average by $1,736. This must not be the result of reform. New York City's middle class which contributes substantially to the stability and economy of our region should be protected instead of penalized in the process.

In addition, the proposed elimination of the earned income tax credit would be detrimental to low income families. Our analysis indicates that taxes for a married couple earning $20,000 with two children would increase by more than $800 due to the loss of the EITC.

Moreover, the elimination of the mortgage interest deduction must be carefully weighed against the dreams of families to buy a home. This is especially true in New York City where housing values are above the national average.

Turning to some of the other concepts underlying reform, the proposal to eliminate the Federal tax on interest income, dividends and capital gains has a both positive and negative impact for New York City. On the plus side, it does away with the double taxation of income and would increase investment which is good for Wall Street. However, the elimination of the Federal tax on interest income would be very detrimental to New York City government as it is the largest issuer of tax-exempt debt in the nation. The funds raised through the sale of the City's bonds are vital in our efforts to repair the City's aging infrastructure and must not be jeopardized. After all, the condition of our roads, bridges and highways has a direct impact on the rest of the nation.

Moreover, even if tax reform were to achieve its long-term economic objective of lowering interest rates, City debt service costs would almost certainly rise in the short-term. In addition, the value of the exemption for current bondholders would disappear.

As to the elimination of the deduction for charitable contributions, I do not need to tell this Committee of the significant impact this proposal would have on New York City's non-profit sector at a time when government aid is declining and we are looking to this sector to increase its efforts. The non-profit sector provides charitable, social and educational services to millions of people. It also helps maintain the vitality of our arts and cultural institutions which are an important component of the local tourist industry.

New York City has the largest concentration of non-profit organizations in the country, employing more than 400,000 individuals locally and with budgets exceeding $30 billion a year. New York is also one of the largest centers for fundraising in the nation. In 1994, 19 New York City foundations contributed over $1 billion in grants, representing nearly 30 percent of the total giving among the top 100 U.S. foundations.

All of the tax proposals under consideration would directly affect state and local tax policy and tax administration and, in addition, the budgets of state and local governments. Of the 42 states with a personal income tax, all but five conform to a Federal income definition in computing state income taxes. In addition, many jurisdictions have come to rely on IRS enforcement and compliance programs as well as Federal information reporting requirements.

In New York City, the proposed changes in the Federal tax base would automatically flow through to New York City's taxes. Realistically, the City could not decouple from the Federal system without incurring significant costs and jeopardizing compliance.

Various proposals have been made to convert the Federal income tax system to a more consumption-oriented tax scheme.

Of these, the "flat tax" sponsored by Congressman Dick Armey and the Domenici-Nunn Unlimited Savings Allowance (USA) tax would eliminate the double taxation of income,

exempt investment earnings and broaden the tax base. In addition, business would be allowed to deduct capital expenditures fully in the year of the outlay rather than through current depreciation methods. What remains is a simplified tax system with one or more tax rates applied to a completely new tax base.

The positive aspect of these proposals is that current administrative structures would continue, albeit in a more simplified environment. In other words, the IRS would still be in business. This allows the City to continue to "piggyback" on the Federal system with little administrative disruption.

However, there is no guarantee that the flow through of proposed Federal tax law changes to New York City's tax system would produce a revenue neutral result for the City budget. We have estimated that conformity to a Federal flat tax could result in a net reduction in our personal income tax revenues of hundreds of millions of dollars. While on the Federal level this loss is expected to be completely offset by an increase in business taxes, this may not occur at the local level. Given the particular mix of business and individual taxpayers in New York City, there is no certain way of predicting whether the proposed reforms would hold the City harmless revenue-wise.

Moreover, the redistribution of tax burden among individuals and businesses could very well redistribute the burden among various regions in the nation. This shift in tax burden could increase the Federal balance of payments deficit with New York City beyond the current $9 billion level.

As another Federal tax reform option, Representatives Schaefer and Tauzin have proposed a national sales tax, which would eliminate the IRS and rely on state administrative structures to implement and enforce the national tax. Rather than simplifying the tax system, this proposal raises complex policy issues regarding such matters as the definition of the base to be taxed. In order to raise enough revenues to replace the income tax system, the new Federal sales tax would have to apply to a much broader array of transactions than is currently subject to sales taxation in most states. It would also require a dramatic expansion of state administrative structures in order to monitor and collect taxable interstate and international sales.

In order to maintain revenue neutrality, the rate for a national sales tax would need to be in the 15 to 20 percent range. However, the rate jumps to the 30 to 40 percent range after including state and local sales taxes. Consider the consequences of paying a 40 percent tax on goods and services. A national sales tax would increase tax evasion and heighten the competition between states and localities with different tax rates. Furthermore, this type of system would be highly unfair to lower income families.

In summary, the City of New York agrees that the Federal tax system needs reform. The major objectives should be to broaden the tax base and lower rates in a fair and equitable manner. In addition, any Federal reform must also include an adequate transition period to allow states and cities to adapt to the new tax environment. The final look of reform should protect against significant shifts in tax burden to areas such as New York which represent an important part of the national economy.

This is an era when the Federal government is rightfully turning back responsibilities to state and local governments. We are eager to shoulder these new responsibilities because they increase our flexibility to govern. However, we cannot absorb new financial burdens as a consequence. I therefore urge the Committee to view any changes in the tax system in this context.

Thank you for the opportunity to address this committee.

Chairman ARCHER. Thank you, Mr. Powers.

Mr. Holden, you have already been welcomed by your representative on this Committee, Mr. Hancock. I also welcome you and we will be pleased to have your testimony. You may proceed.

STATEMENT OF HON. BOB HOLDEN, TREASURER, STATE OF MISSOURI; ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS

Mr. HOLDEN. Thank you, Mr. Chairman, Congressman Hancock, my friend from southwest Missouri, and Members of the Committee. I am Bob Holden, the State treasurer of Missouri and chairman of the Legislative Committee of NAST, the National Association of State Treasurers. I have a written statement that I have submitted for the record that is extensive.

As the chief financial officers within our respective States, State treasurers exercise a broad range of essential fiscal responsibilities, including cash and debt management, the investment of public funds, and the investment and management of public pension funds. Because State treasurers recognize the complexities involved in shaping public fiscal policy, NAST appreciates the opportunity to begin what we hope will be an ongoing dialog about tax reform and tax policy and its impact on our shared enterprise—the Federal, State, and local government partnership—and the citizens we jointly serve.

At the outset, let me make clear that NAST is not here to speak against tax reform. To the contrary, the State treasurers share your concerns about the problems, impediments, and inefficiencies in our existing tax structure, and we are here to say that we are eager to work with you to explore ways in which tax reform can provide an overall benefit to the taxpayers and to the economy.

However, we also wish to offer a precautionary message. The operation of Federal, State, and local government is linked at a fundamental level. We draw our resources from the same taxpayers. Decisions on matters of Federal tax policy will flow downstream from Capitol Hill and have a dramatic and widespread effect on State and local fiscal management, tax policy choices, and the execution of governmental responsibilities. Care needs to be taken that the pursuit of Federal tax reform does not hamper efforts to create a new federalism by impairing State and local solvency and increasing our fiscal dependence on Federal Government.

In this regard, I would like to draw your attention to a few areas of State and local fiscal management which NAST believes will be seriously affected by major Federal tax reform.

First, several of the current tax reform proposals would remove the longstanding tax exemption for income generated by bonds issued by State and local government. This unique tax treatment has served to lower the cost of borrowing for State and local governments and has made it feasible to build schools, hospitals, roads, subways, airports, and other facilities and infrastructure vital to economic development and growth in our States and local communities.

While experts may disagree on the economic effects of removing the tax preference for State and local securities, there is no argument that State and local governments face a backlog of infrastruc-

ture needs and a shortage of capital. When you add to this the responsibilities which will flow to the States from Washington under devolution and the new federalism, it is clear that State and local governments will need more, not less, capacity to finance the government projects and services that will be resting on the shoulders of people in State and local governments in the future.

Accordingly, NAST recommends that Congress exercise great caution when considering any tax reform measure which could potentially jeopardize the ability of State and local governments to access low-cost financing or which hamstring the flexibility of State and local governments to generate capital investment.

Almost all State and local tax systems conform significant portions of their tax law to the existing Federal tax program and system. For example, nearly every State with a personal or corporate income tax begins from a Federal starting point and then utilizes numerous other provisions of Federal law in the calculation of State tax. States also rely extensively on Federal enforcement and compliance programs and Federal information reporting and withholding mechanisms to facilitate the administration of State tax law. By doing this, States make it easier for taxpayers to comply with State tax laws because taxpayers are not required to deal with two widely different sets of tax laws.

Given this linkage between State tax systems and the existing Federal tax system, it is clear that fundamental Federal tax reform will also trigger fundamental changes in State tax policy and law: Federal tax reform will compel the States to choose between continued conformity with the Federal law or the creation and maintenance of an independent tax infrastructure.

Moreover, it is also clear that economic, administrative, legal, and political considerations will put tremendous pressure on the States to remain in conformity with any new Federal law, since the greater the degree of nonconformity, the more complex and burdensome the State taxes would be for taxpayers and the more difficult they would be to enforce.

The principles of federalism and genuine partnering between Federal, State, and local governments require a complete analysis of the issues before implementing such a Federal constraint on tax policy choices made by State and local government. Under the Constitution, a core element of sovereignty is the autonomy to develop a tax policy and design a revenue system which meets the needs and reflects the desires of our taxpayers.

Fundamental Federal tax reform will force the States to choose between simplicity, continuing to conform to Federal tax law, whatever its form, or autonomy, with all of its attendant costs and burdens. Simplicity will effectively pass control of State tax policy and the ability to generate State revenue to Congress. Autonomy will result in the need to go to State legislators to obtain legal authority to employ a non-Federal taxing mechanism, will generate enormous administrative costs and compliance problems, and will challenge the willingness of taxpayers to give State and local government sufficient tax headroom.

If there is to be any real choice in this matter, Congress, State, and local government must work together to fashion changes in tax policy which recognize both the effective reach and the inherent

limits in our intergovernmental relationship with the American taxpayer. Such a dialog should also include consideration of the potential impact on State and local revenue streams and creditworthiness from proposed changes in the mortgage interest deduction and the deduction for property taxes and State and local income taxes.

As you can see, the matters I have been discussing are not merely theoretical issues to be debated on college campuses or in think tanks in Washington, DC. Federal tax reform raises serious questions involving the fundamental relationship between Federal, State, and local government, and the outcome of this debate will have a significant fiscal impact on every State and every community in this country.

Most important, however, we must not forget that the parties most affected by this debate have a human face. They are the citizens of this country. When you push beyond the constitutional theory and political rhetoric, we are talking about shaping the tax burdens which will be imposed on real people who are trying to earn a living, feed and care for a family, and put a roof over their heads. As public officials, it is our responsibility to honor this public trust by working together to fashion an intergovernmental tax structure that is not only simple and fair, but also enhances opportunity and the quality of life for the people who pay the bill, while keeping the tax burden at a minimum.

Accordingly, NAST calls on the National Organization of State and Local Officials to join with us in conducting a coordinated national analysis of the impact of Federal tax reform on State and local governments which can be presented to this Committee and to Congress for use in this debate.

Finally, NAST wants to convey in the strongest terms that whatever decisions you might reach about the specific components of tax reform, it is critical that Congress build in a reasonable transition time for State and local governments to coordinate with any new Federal tax provisions.

As we have illustrated today, fundamental Federal tax reform will have a significant impact on critical aspects of fiscal operations of State and local government, requiring adjustments in tax policy and revenue systems, debt management, and program priority. In many cases, changes will have to be made in State law to accommodate such adjustments. Retooling an intergovernmental tax structure is a project on par with balancing the budget and should not be given short shrift.

Mr. Chairman, a famous Missourian, Mark Twain, has been credited with saying, "Everybody complains about the weather but nobody does anything about it." I think he would be pleased to know that you are doing something about an issue which concerns millions of Americans. It will not be an easy job, but I trust that from my remarks today and the remarks of the other members on the panel that you can see that NAST and all of us want to work with you to meet the goals of a simpler, fairer, and more efficient tax system than we have today.

Thank you very, very much.

[The prepared statement follows:]

STATEMENT OF HON. BOB HOLDEN, TREASURER
STATE OF MISSOURI
ON BEHALF OF NATIONAL ASSOCIATION OF STATE TREASURERS

Mr. Chairman and members of the Committee, I am Bob Holden, the State Treasurer of Missouri and the Legislative Committee Chairman of the National Association of State Treasurers (NAST), which represents the state treasurers in all fifty states and the territories.

As I am sure you know, State Treasurers are the chief financial officers of the states. Within our respective states, State Treasurers exercise a broad range of essential fiscal responsibilities, including cash management, debt management, the investment of public funds, and the investment and management of public pension funds. Accordingly, because State Treasurers recognize the challenges and complexities involved in shaping and implementing fiscal policy, NAST appreciates this opportunity to begin what we hope will be an ongoing dialogue about tax reform and tax policy and its impact on our shared enterprise -- the federal, state and local government partnership -- and the citizens we jointly serve.

Let me make clear at the outset that the State Treasurers share your concerns about the problems, impediments and inefficiencies in our existing tax structure, and that we wholeheartedly support your efforts to simplify the tax structure, to enhance its fairness, to improve its administration, to increase incentives to work, save and invest, and to stimulate economic growth.

In short, the State Treasurers are not here to say "nay" to tax reform in general, or any reform proposal in particular. To the contrary, NAST wants you to know that we are eager to work with you to explore ways in which tax reform can provide an overall benefit to the taxpayer and the economy, and enhance the ability of government at all levels to deliver appropriate services.

In offering this support, however, we must also convey an important precautionary message: The operation of federal, state and local government is inextricably linked and limited by a fundamental fact -- we draw our resources from the same taxpayer. Accordingly, your decisions on matters of federal tax policy will flow "downstream" from Capitol Hill and have a dramatic and widespread effect on state and local fiscal management, the tax policy choices available to state and local governments, and the ability of state and local government to fulfill program responsibilities, including those that Congress is contemplating transferring to the state and local level as part of "devolution."

Thus, your decisions on federal tax policy will have a tremendous effect on the vitality of the "new" federalism -- a concept that we welcome -- and we are here today to bring the cautionary reminder that as Congress pursues the laudable goals of tax reform, you do not inadvertently impair state and local sovereignty and increase fiscal dependence on the federal government at a time when state and local government is striving to achieve greater autonomy.

In sending this message of caution, we also want to reiterate that NAST does not come before you merely as a "special interest" trying to protect favorable treatment under the tax laws. Instead, as I suggested previously, we are here today because under our Constitution, we are partners in the enterprise of governing. Federal tax reform will generate a significant ripple effect on tax policy through all levels of government, and NAST believes that the fundamental linkage between federal, state and local government must stay foremost in your consideration if this important dialogue on tax reform is to yield an overall benefit to the taxpayer, and not simply shift the source of the tax burden from one level of government to another.

In this regard, I would like to draw your attention to several areas where NAST has serious concerns about the potential impact of federal tax reform on state and local fiscal management, the tax policy choices available to state and local governments, and the ability of state and local government to fulfill program responsibilities.

The Ability of State and Local Government to Finance Infrastructure and Other Capital Needs

Since the 16th Amendment ratified a federal tax system in 1913, state and local governments have utilized tax-exempt governmental bonds as an important source of funding to finance infrastructure, capital-intensive public projects and vital programs needs. It does not

overstate the case to say that bonds issued by state and local government have played a major role in building this nation: The proceeds of governmental bonds have built schools, hospitals, roads, bridges, subways, tunnels, airports, housing and numerous other facilities used daily by the American people. In so doing, tax-exempt governmental bonds have provided the lifeblood for economic development and growth in our states and in our local communities.

Some of the current tax reform proposals would directly or indirectly affect the federal tax treatment of state and local government securities. The primary effect of these proposals would be to remove the unique tax-exempt treatment for income generated by such governmental bonds. This longstanding tax exemption has allowed investors to accept a lower interest rate on governmental debt, which in turn, has lowered the cost of borrowing for state and local governments.

Some experts believe that removing the favorable tax treatment for state and local bonds will cause the yield on such bonds to rise and the value of outstanding bonds to fall, with the overall effect of increasing the cost of borrowing by state and local government. Other experts argue, however, that interest rates will fall after tax reform, and state and local borrowing costs will remain the same or be reduced, even without the current preferential tax treatment. Still other experts contend that increased interest rates on state and local bonds will increase the demand for such securities by pension funds and other tax-exempt buyers, thereby expanding the pool of capital available to state and local government.

While the experts may differ on the likely short-term and long-term effects which will result from a change in the tax treatment of state and local government bonds, there is no question that tax considerations alone will not determine the demand for and value of governmental securities and the cost of borrowing to the governmental issuer. Instead, cost and value will be determined by the market based on a combination of tax considerations and broader economic factors. Such factors (e.g., Federal Reserve policies, the size of the federal budget deficit, the rate of inflation, foreign interest rates and the business cycle) could impede any potential benefits of tax reform for the issuers of state and local securities. Moreover, even the slightest increase in the interest rate paid on a governmental bond will result in significantly higher costs of borrowing to the state or local issuer.

NAST believes that this uncertainty regarding the economic effect of removing the preferential tax treatment of state and local bonds must be placed alongside the incontrovertible fact that state and local governments face a backlog of infrastructure needs and a shortage of capital. For example, close to 235,000 miles of American roads are rated poor or mediocre; one out of three bridges in the United States is rated structurally deficient or functionally obsolete; and the cost of repair for aging public schools is estimated at $100 billion. When you add to this the responsibilities which will flow to the states under "devolution" and the "new" federalism, it is clear that state and local governments will need more -- not less -- capacity to finance governmental projects and services.

Accordingly, NAST strongly recommends that Congress exercise great caution when considering any tax reform measures which could potentially jeopardize the ability of state and local government to access low cost financing, or which hamstring the flexibility of state and local governments to generate capital investment.

State Tax Systems, State Tax Policy, And State Sovereignty

To simplify the administration of state tax law and policy, most states presently conform a significant portion of their tax law to the existing federal tax law and system. By so doing, the states make it easier for taxpayers to comply with state tax laws because taxpayers are not required to deal with two separate sets of tax laws, rules and definitions. For example, nearly every state with a personal or corporate income tax begins the calculation of state tax from a federal "starting point" -- often the federal measures of adjusted gross income or taxable income. In addition, state tax laws often conform to numerous other federal definitions and provisions such as personal exemptions, standard allowances, itemized deductions, depreciation schedules, treatment of capital gains, and Individual Retirement Arrangements (IRA).

The states have also found that conformance to federal tax law facilitates the lministration of state tax law by allowing states to rely extensively on federal enforcement and ›mpliance programs and federal information reporting and withholding mechanisms.

Of the states which conform state tax law to the federal tax law, twenty states conform ıtomatically, so that changes in the federal law are incorporated into state law without further ate action. Seventeen other states are tied to the federal law in effect on a particular date, and us state legislation would be necessary to update the reference point and incorporate new ıanges in federal law into state law.

Given this linkage between state tax systems and the existing federal tax law and system, it clear that fundamental federal tax reform, with nothing more, will also trigger fundamental ıanges in state tax law and policy, in that federal tax reform will compel the states to choose :tween continued conformity with the federal law or the creation and maintenance of an dependent tax infrastructure. Moreover, it is also clear that economic, administrative, legal and ›litical considerations will generate tremendous pressure on the states to remain in conformity ith any new federal tax law since the greater the degree of nonconformity, the more complex the ate tax law will be for taxpayers. This also increases the likelihood of noncompliance and the fficulty in enforcing the state tax.

In particular, it should be noted that tax reform proposals which call for the repeal of the deral income tax will also effectively require the repeal of state income tax laws since current ate income tax systems rely heavily on the infrastructure of the existing federal income tax stem, and most states will have a great difficulty maintaining and administering a personal or ›rporate income tax without a federal counterpart.

The fundamental principles of federalism mandate that such federal constraints on the tax ›licy choices of state and local government should occur only after a complete analysis of the ;ues, an effort which goes beyond the proceedings of today's hearing.

Under the Constitution states are sovereign entities, entitled to maximum flexibility to :termine tax policy and design revenue systems which meet the needs and reflect the desires of ır taxpayers. The autonomy of the states in determining tax policy is a core element of ›vereignty in that the power to generate revenue carries with it the independence to set :penditures, and to establish priorities among those expenditures.

Fundamental federal tax reform will force the states to choose between simplicity -- ›ntinuing to conform to federal tax law, whatever its form -- or autonomy -- with all its tendant costs and burdens. Simplicity will effectively cede control of state tax policy and the ›ility to generate state revenue to the Congress. Autonomy will result in the need to go to state gislatures to obtain legal authority to employ a non-federal taxing mechanism, will generate ıormous costs and compliance problems, and will challenge the willingness of the taxpayer to ve state and local government additional tax headroom.

If there is to be any real "choice" in this matter, Congress and state and local government ust work together to fashion changes in tax policy which recognize both the effective reach and e inherent limits in our intergovernmental relationship with America's taxpayers.

In this regard, such a dialogue should also include consideration of the impact on state and cal revenue streams of the proposed changes in the mortgage interest deduction, and the :duction for property taxes and state and local income taxes.

Most local governments rely heavily on property taxes for the generation of revenue to ınd operating costs and to repay debt. Many analysts believe that if the mortgage interest :duction and the property tax deduction are eliminated, property values will fall, and local ·operty tax revenue will be negatively affected. At the very least, such an environment would ake it very difficult to increase property taxes, especially those requiring voter approval.

A comparable conclusion has been reached regarding the proposed elimination of the

deduction for state and local income taxes. These taxes are a significant source of revenue for state and local governments, and assuming such taxes survive the press for conformity with federal taxes, the loss of the deduction would increase the pressure on state and local government to lower existing rates. Again, at a minimum, it would be very difficult to increase such taxes in the future.

Once again, therefore, NAST strongly recommends that before the Congress embarks on the path of tax reform, you seriously consider the ramifications for federalism, the sources and limits of state and local revenue, and the fiscal and tax policy ripple effect which tax reform will have on state and local government.

State and Local Government Responsibilities to Provide Retirement Benefits and Health Care Coverage

State and local governments not only must provide for the retirement income and health care of public employees, but state and local governments are the front line providers of public services and the fall back for public benefit support. As such, changes in the federal tax treatment of retirement benefits and health care coverage will have a potential fiscal impact on state and local governments, both as an employer, and as a provider of governmental services.

Many experts contend that incentives under the current tax law have served as the impetus for the formation of retirement and health plans. Under current law, private sector employers receive favorable tax treatment for providing compensation in the form of such benefits, and the worker receives the tax benefit of an up-front exclusion from income taxation, coupled with the deferral of taxation on accrued investment income until distribution.

Under the principal tax reform proposals, however, employee benefits would receive less favorable tax treatment than under the current law. For example, many proposals would place all savings on a par with amounts deferred under qualified pension plans. Accordingly, under such reforms workers will weigh the relative advantages of continuing to receive compensation in the form of employer-sponsored retirement benefits (deferring income to savings, but with restrictions on access) or receiving compensation directly as income and then controlling the savings themselves. Other tax reform proposals call for including pension or health care contributions in the worker's current taxable income, and removing pension and health care contributions as a deduction by the employer.

Although it is unclear which reforms will ultimately find their way into law, it is reasonable to conclude that the overall effect of the current proposed reforms will be to reduce the incentive to maintain employer-sponsored retirement and health care plans and to create a preference for current income (wages) over deferred income (pension contributions).

While the primary effect of these changes will be experienced in the private sector, there is likely to be spillover to state and local government. First, to attract and retain qualified employees, state and local government may have to adjust benefit packages to provide greater wage compensation. Second, if the value of health care premiums is included in taxable income, the cost of coverage would increase for all employers, who would, in turn, pass such costs on to employees in the form of lower wages or reduced coverage.

Finally, if individuals fail to take advantage of the changes in the tax law to save sufficient amounts for retirement and/or health care, or if employers have less incentive to provide retirement and health care benefits, then there will be increased demands on and increased cost borne by the public benefit programs run by state and local government.

The Responsibilities of State and Local Governments in Carrying Out Tax Reform

As reflected by the foregoing discussion, the impact of federal tax reform on state and local government is not merely a theoretical conundrum to be debated on college campuses or in

hink tanks in Washington, D.C. It is a serious question involving the fundamental relationship etween federal, state and local government. It involves issues which are at the core of overeignty -- the power to set tax policy, and to design revenue and expenditure systems which neet the needs and reflect the desires of our taxpayers. It is a debate which will have far reaching nd significant economic impact in every state and every community in this country.

We must not forget, however, that the parties most affected by this debate have a very uman face -- they are the taxpayers of this country. When you push beyond the constitutional neory and political rhetoric, we are talking about shaping the tax burden which will be imposed n real people, who are trying to earn a living, feed and care for their families, and put a roof over neir heads. As public officials, it is our responsibility to honor this public trust by working ogether to fashion an intergovernmental tax structure that is not only simple and fair, but also nhances opportunity and the quality of life for the people who pay the bill.

Accordingly, NAST calls upon the national organizations of state and local officials to join vith us in conducting a coordinated national analysis of the impact of the federal tax reform on tate and local government. The goal of this effort should be to generate a state-by-state analysis f the impact of the major tax reform proposals which can then be presented to Congress for use n this debate. If we are asking you to heed the concerns of state and local government, then we hould be prepared to step forward and give Congress the information it needs to address those oncerns.

Finally, NAST wants to convey in the strongest terms, that whatever decisions you might each about the specific components of tax reform, it is imperative that Congress build in a easonable transition period for state and local governments to coordinate with any new federal ax provisions. As we have illustrated today, fundamental federal tax reform will have a ignificant impact on critical aspects of the fiscal operation of state and local government. djustments will have to be made in tax policy and revenue systems, debt management, and rogram priorities. In many cases, changes will have to be made in state law to accommodate uch adjustments. Retooling an intergovernmental tax structure is a project on a par with alancing the budget, and should not be given short shrift.

Mr. Chairman, a famous Missourian, Mark Twain, has been credited with saying, Everybody complains about the weather, but nobody does anything about it." I think he would e pleased that you <u>are</u> doing something about an issue which concerns millions of Americans. I vant to commend you and the members of this committee for your resolve to scrutinize and eform our federal tax process. It will not be an easy job, and I hope that through my remarks oday, you can see that NAST wants to work with you to meet the goal of a simpler, more quitable, more efficient system. Thank you.

Chairman ARCHER. Thank you, Mr. Holden.

Mr. Dorso, you do not have a Member on this Committee to warmly welcome you, so I am pleased to insert myself in that capacity and to tell you we are very pleased to have you here. I suspect that you have traveled more miles to get here than the other members of the panel. We will be pleased to have your testimony. You may proceed, if you will please identify yourself for the record.

STATEMENT OF HON. JOHN DORSO, MAJORITY LEADER, NORTH DAKOTA HOUSE OF REPRESENTATIVES; AND MEMBER, EXECUTIVE COMMITTEE, NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. DORSO. Thank you, Chairman Archer, and good afternoon, Members of the Committee. My name is John Dorso. I am the Majority Leader of the North Dakota House of Representatives and a member of the executive committee of NCSL, the National Conference of State Legislatures. I am delighted to be here and thank you for holding this important meeting. By the way, I traveled from Florida. I was on a little vacation.

Basically, I am here today to bring you a State perspective, a little bit, on tax reform. There are four main points that I would like to make and they are these. We are sympathetic to Congress' desire to reform a Federal tax system that is viewed as complicated and unfair. Federal and State tax systems are inextricably linked. Any Federal reform will have serious ramifications on the State. And, State legislators must be involved in the process.

Let me illustrate some of my concerns. In North Dakota, we have a citizen legislature and we only meet for 80 days every 2 years. That is the Constitution in North Dakota. Anything that you would do to change taxes would have a big effect on our State. In fact, I had our Legislative Council people prepare some graphs and some other work for you to peruse later on that I have submitted as part of my testimony.

I think approximately 22 percent of our general fund is generated through personal income taxes and there is another 7 or 8 percent that comes from corporate income taxes. We left the 1995 session of the legislature with an $11 million ending fund balance of a $3 billion budget, and any change that you might make in the tax system, you can see, would have a big effect on the State of North Dakota's budgetary problems. In fact, depending on the timing, it may cause us to go into a special session, which I can tell you that the people of North Dakota do not particularly like, nor do our citizen legislators, most of whom are at home trying to figure out their taxes in April.

I guess my biggest message here, and after listening to the other members of the panel who certainly have studied the issue more than I have as far as the intricacy and the practical effects on their particular constituencies, is that NCSL, and I am sure all of the legislative bodies across this country, wants to be involved in this. I think, as a citizen legislator, I would like to just give you the message that—and I will pass on a conversation I had with a member of our Legislative Council who prepared the other stuff, is he thinks the Federal Tax Codes are a mess. That is a nonpartisan

ıtement because the Legislative Council is nonpartisan, but we ed to do something about it.

North Dakota is simple in the way that we approach income xes. We charge 14 percent of the Federal tax liability. Over the ars, many people have introduced measures in the legislature to ange things, any number of different deductions, and so forth, d they have all been rejected by the people of North Dakota beuse the people of North Dakota have always relished a simple x system. Fourteen-and-a-half percent of the tax liability, you pay countants a lot to get to your Federal tax liability and then you n figure out your State taxes fairly simply.

So I think that North Dakotans, in general, like simple taxes. I not think that any of us are afraid to pay our taxes, but we rely hate paying accountants to have to figure out how to do it. I, as a businessman, just sold a business and I was intrigued by remark that was made here. I sold my truck line on December and it took 2 months for my accountants and CPAs to figure out ıat the best date was to sell the corporation. I think that is a lit- silly. I think that is terrible, when tax policy drives business desions like that.

My final remarks, Mr. Chairman, we would like to be part of this ocess. I think NCSL would like to offer its help in your deliberaıns. Certainly. State legislative bodies have some resources that could put to work in helping you. We are inextricably tied to ıat you do. Certainly, it has a big effect on our budgets and we ıuld just like to have our feet under the table as you go forward th this process.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF HON. JOHN DORSO, MAJORITY LEADER NORTH DAKOTA HOUSE OF REPRESENTATIVES ON BEHALF OF NATIONAL CONFERENCE OF STATE LEGISLATURES

Good morning, Chairman Archer, members of the Committee. My name is John Dorso, I am the Majority Leader of the North Dakota House of Representatives and a member of the Executive Committee of the National Conference of State Legislatures. I am delighted to be here and thank you for holding this important hearing. NCSL is a bipartisan organization representing the more than 7,000 elected state legislators in all 50 states and territories. At NCSL, legislators from both sides of the aisle come together to develop policies on issues of importance to the state-federal relationship. Members who testify on behalf of NCSL are guided by the policies and positions that have been developed over time and adopted by a three-fourths majority, ensuring a bipartisan approach to these vital issues. With that background, on behalf of NCSL, I am pleased to be able to talk with you today about our views of federal tax reform and its potential impact on the states.

There are four main points that I wish to make today:

1. we are sympathetic to Congress' desire to reform a federal tax system that is viewed as complicated and unfair
2. federal and state tax systems are inextricably linked
3. any federal reform will have serious ramifications on the states, and
4. state legislators must be involved from the beginning of the reform process

NCSL understands completely the motivation for reforming the federal tax system in a way that encourages savings and simplifies the process. A strong argument can be made that America's low savings rate is related to slow economic growth over the past twenty years. The complexity and resulting unfairness of the federal tax code, in and of itself, undoubtedly adds economic costs, to say nothing about the way it infuriates the nation's taxpayers. I think it is safe to say that we are all quite sure our predecessors did not envision the type of tax system we have today when the states adopted the Sixteenth Amendment in 1913 and gave Congress the income tax.

While any major restructuring of the federal system will raise complications for the states, NCSL nonetheless commends you for considering the pros and cons of reforms that may simplify the tax code and increase savings. Federal tax reform could have several advantages for the states. If reform led to a faster-growing economy, states would be able to collect more revenue and possibly lower rates. States and the federal government might also be able to cooperatively develop a more closely integrated system of federal and state taxation. Increased cooperation or integration could lower tax rates and increase the efficiency of tax administration, provided that it is approached in a manner that preserves the fiscal autonomy of the states.

NCSL believes that federal tax policy should be fair and simple and should not encroach on the ability of state and local governments to adopt fair and effective tax systems to meet the commitments made to our shared constituencies. To preserve the fiscal viability of state governments, the federal government must consider the impact of changes in federal tax policy on the traditional revenue bases of state and local governments. You have started that process with today's hearing, and we hope that this is just the beginning of the dialogue between us.

Let me illustrate these concerns with an example that hits particularly close to home. In North Dakota, I serve in what is truly a "citizen legislature." We meet for 80 days, once every two years. Our state income tax code is about as simple as it gets. North Dakotans pay fourteen and a half percent of their federal income tax liability in state income tax. Let's get right to the point. If you do away with the federal income tax completely, then we've got issues to deal with. Foremost among them is the mathematical fact that fourteen and a half percent of zero is zero. It may take you at least two complete, very active years, to run through the debate and construction of legislation to restructure the federal tax code here in Washington. Back in Bismark, we'll have to fix our end in much less time, possibly in a special session. The more consultation and involvement we have from the outset, as partners in the reform effort, the easier it is for us to take care of our end when the time comes.

During the course of today's hearing, I know you will also be hearing from some experts in state and local finance, the Federation of Tax Administrators, the Multistate Tax Coalition and the Government Finance Officers Association among them. These are very knowledgeable, experienced professionals who can get into the details and complexities of the other issues, such as collections problems, that I'll touch on later. But let me recommend now, and NCSL endorses this recommendation, that not only should you have elected officials from state and local

governments working with you at the table, but early in the process, we put together a staff level working group to help iron out the technical and transitional issues.

I'll turn now to the remainder of our concerns. Specifically, state legislators are concerned about the following aspects of federal tax reform:

1. transition time,
2. the potential for shifting the overall burden of tax administration to the states,
3. the elimination of state and local income tax deductions,
4. the potential effects on state and local bonds,
5. further intrusion into the excise tax base which is a traditional revenue source for state governments, and of displaced state revenues.
6. the negative impact of retroactivity

You will hear others speak today on most of the above points, but I would like to address the first two items in greater detail. Despite the difficulties you have had here in Washington in getting a comprehensive restructuring plan passed, it seems that there is general consensus on the need to balance the federal budget and shift some responsibilities away from the federal government and back to the states. The details of that devolution obviously are still to come, but it is important that we take this opportunity to remember that state and local governments will need adequate transition time to adapt to the new system. Furthermore, as states begin to take on more decision-making responsibility for domestic programs, they will need added flexibility, not only in programmatic requirements, but in the ability to finance operations through a transition period. Just as block grants are not necessarily positive if the appropriations cuts that accompany them are too severe, tax reform may impose greater restrictive burdens on state and local governments if it is not done carefully. Too often, Washington limits revenue options by preempting state tax authority. During any tax reform effort, do not take further actions that would have the unintended consequences of limiting our options, such as preempting our ability to tax certain revenue sources. Of equal importance is the fact that the states have balanced budget requirements, and can ill-afford to lose revenue through the retroactive application of any tax change. Implementation of a new tax system will require significant transition time on its own, we will need an even greater range of options to manage our operations during any dual transition period of tax restructuring and devolution.

NCSL has not taken a formal position on any of the individual tax reform plans that have been proposed during this session of Congress; however we can address the potential implications of the different models as examples of our overall concerns. A flat tax has significant impacts on state and local government, especially since, in theory, there would be no deductions. NCSL would argue that of any deductions in the current system, the deduction for state and local income and property taxes must be maintained, otherwise, you create the potential for double taxation of our taxpayers. A flat tax, potentially altering the tax advantages of our bonds, also has serious potential effects on our ability to finance a great deal of public infrastructure projects. Furthermore, the loss of data for the federal tax that comes from information about the taxpayers' sources of income would hamper any state's ability to maintain a comprehensive tax system. This becomes even more problematic if, in the course of changing to a flat tax you decide to abolish the Internal Revenue Service altogether without retaining or transferring some of the data management functions, because the problems of data loss are compounded by the loss of a central repository of information.

Speaking of the IRS and the administration of the federal tax system, we know that at least one major proposal on the table includes the idea that the states would collect and remit a national sales tax to the federal government. This is not quite as simple as it sounds, especially for the five states that do not even have a sales tax. Furthermore, in order to avoid an unfunded mandate, adequate federal administrative funds would have to be forthcoming for any effort that involves increased collection responsibilities for the states.

Many of the same data-collection issues apply for states if the federal government were to move toward a consumption-based income tax in that it would be difficult for states to maintain their current systems, and many would be forced to conform to the new federal system or risk losing significant portions of their revenue base. A change to a national sales tax or value-added tax would also pose serious issues for states in the area of displaced revenue. The sales tax and excise taxes have been the most significant traditional revenue source for states. Currently, state

and local sales taxes range from 4.5 percent to 10 percent. A national sales tax rate on the order of 17 percent could raise some jurisdictions' combined rate to over 25 percent. This could create a severe disruption in state revenue from the consumer's negative reaction to such a high rate.

In summary, all of your options create serious issues for states, and will require a considerable amount of planning, and detailed attention. However, as I mentioned at the beginning of my testimony, tax reform would also give us an opportunity to work together to resolve some difficult issues. NCSL supports enactment of legislation to initiate a joint state-federal effort to collect unpaid taxes as well as permitting federal refunds to be offset for state income tax debts. It is my understanding that you recently had a hearing on one such proposal, H.R. 757, which would establish an offset program on a reciprocal basis for legally enforceable, past due state tax obligations. This would further cooperative efforts in joint federal/state tax administration.

In conclusion, any federal restructuring will create administrative complexities for all states, but especially for those states whose tax system is most closely tied to the federal code, like North Dakota. Regardless of the type of reform you undertake, if restructuring is going to take place, it is imperative that we have a place at the table and work with you as partners in that effort. As legislators, that type of consultation and the institution of adequate transition time to implement reform are our top concerns. NCSL will be reviewing our tax reform policies this year, and as you get closer to having some details regarding which direction you will go, we will develop greater details on the specific consequences for states, which will determine in large part our ability to support any particular reform plan.

Again, Mr. Chairman, I appreciate the opportunity to testify at today's hearing. It is vital to our economic prosperity as a nation that we address the problems associated with the complexities of the federal tax system. We at NCSL, as elected leaders or the through a staff working group, are prepared to assist you and look forward to working with you as partners in your effort to undertake this challenge. I would be happy to answer any questions at the appropriate time.

GARY J. NELSON
State Senator
Chairman

JOHN D. OLSRUD
Director

JAY E. BURINGRUD
Assistant Director

CHESTER E. NELSON, Jr.
Legislative Budget
Analyst & Auditor

JOHN WALSTAD
Code Revisor

North Dakota Legislative Council

STATE CAPITOL 600 EAST BOULEVARD BISMARCK 58505-0360 (701) 328-2916 TDD (701) 328-4935

April 26, 1996

Honorable John Dorso
State Representative
P.O. Box 7310
Fargo, ND 58109

Dear Representative Dorso:

This letter is to provide background information you requested on potential effects of federal income tax changes on North Dakota state income tax revenues. Enclosed are six copies of the North Dakota short-form income tax return for your information.

Also enclosed are six copies of a chart illustrating the percentage distribution of general fund estimated revenues for the 1995-97 biennium. This chart indicates that 28.5 percent of estimated general fund revenues will come from individual and corporate income taxes. Broken down, individual income taxes will contribute approximately 22 percent and corporate income taxes will contribute approximately 6.5 percent of 1995-97 general fund revenues. Attached to the copies of the chart is a copy of a table showing estimated general fund revenue receipts from various sources for the 1995-97 biennium.

Individual income tax revenues for the 1995-97 biennium are expected to be $298.7 million and the 1995 Legislative Assembly adjourned anticipating an $11.2 million ending general fund balance for the biennium. It would have taken only a 3.7 percent decrease in individual income tax revenues to wipe out the ending general fund balance for the biennium (However, please note that the current estimation of the ending general fund balance is $29.3 million). Any change in federal income tax laws could necessitate a special legislative session in North Dakota if the timing of the federal action does not allow the North Dakota Legislative Assembly adequate time to react during its normal legislative sessions.

Income tax returns in North Dakota can be filed under the long-form method, using federal adjusted gross income as a starting point, or the short-form method, using federal income tax liability before

credits as a starting point. North Dakota is one of only three states (Vermont and Rhode Island are the others) using federal income tax liability as a starting point for state individual income tax determination. Although North Dakotans have a choice of two filing methods, the short-form return method provides substantially lower liability for the great majority of taxpayers, and 97 percent of 1994 individual income tax returns were filed on the short-form return.

We hope this provides helpful information. Please contact our office if you have further questions.

Sincerely,

John Walstad
Code Revisor

JW/LMM
Encs.

Form 37-S — North Dakota Individual Income Tax Return — 1995

NOTE: If information on label is not correct, please make corrections on label.	Your first name and initial	Last name	Your Social Security Number
	If joint return, spouse's first name and initial	Last name	Spouse's Social Security Number
	Mailing address	Apt. No.	(PH) Daytime Phone ( )
	City, town or post office, State and Zip Code — PLACE LABEL WITHIN BLOCK		Were you required to pay estimated income tax to IRS for 1995? Yes ☐ No ☐

Filing Status - (Check only one) 1. ☐ Single 2. ☐ Married filing joint 3. ☐ Married filing separately - Enter your spouse's name _____ 4. ☐ Head of Household 5. ☐ Surviving spouse with dependent child

Filing Category - (Check only one) 1. ☐ Resident 2. ☐ Nonresident **Note: If you moved into or out of North Dakota during 1995, see page 4 for instructions on which box to check.**

Check either of these boxes **Only If It Applies To You** - See page 3 of instructions: ☐ Amended return ☐ Extension form attached

School District - Enter number from list on page 12 of instructions ____ **Income Source Code** - Enter number from list on page 4 of instructions ____

A Complete Copy Of Your Federal Return Must Be Attached

Form 37-S

A. **Enter your Federal adjusted gross income** (From Line 31, Fed. Form 1040 or Line 16, Fed. Form 1040A or Line 4, Fed. Form 1040EZ or Line D, Fed. Tele File Worksheet) ..... (SX) A

B. **Enter your Federal taxable income** (From Line 37, Fed. Form 1040 or Line 22, Fed. Form 1040A or Line 6, Fed. Form 1040EZ or Line E, Fed. Tele File Worksheet) ..... (SS) B

1. **Federal income tax liability** (See inst. page 5) If you do not need the adjustments provided for on Lines 3 through 5, skip Lines 2 through 8 and enter the amount from Line 1 on Line 9 and complete Lines 10 through 25 ..... (SV)		1	
2. Federal adjusted gross income (From Line A above) ..... (SH)		2	
3. Interest on U.S. obligations (Residents only) (See instructions) ..... (SN)		3	
4. Nonresidents Only: (Attach Schedule NR) (See instructions) ..... (SA)		4	
5. Other (Identify) _____ (See instructions) ..... (ST)		5	
6. Total (Add Lines 3, 4, and 5)		6	
7. North Dakota adjusted gross income (Line 2 less Line 6) ..... (SC)		7	
8. Line 7 divided by Line 2 (Round to nearest whole percentage) ..... %		8	
9. Adjusted Federal income tax liability (Line 1 multiplied by percentage on Line 8) (See instructions) ..... (SI)		9	
10. North Dakota income tax [Line 9 multiplied by .14 (14%)] ..... (SB)		10	
11. Residents enter amount, if any, from Line 7, Schedule 4 (Cr. for income tax paid to another State) (See instr.) ..... (SD)		11	
12. **NET TAX LIABILITY** (Line 10 less Line 11) (CF) ..... (SE)		12	
13. North Dakota income tax withheld (Attach supporting W-2s and 1099s) ..... (SF)		13	
14. 1995 estimated tax payments and amount applied from 1994 return ..... (S&)		14	
15. Total payments (Line 13 plus Line 14)		15	
If Line 15 Is Greater Than Line 12, Complete Lines 16 Through 20. If Line 15 Is Less Than Line 12, Complete Lines 21 Through 24.			
16. **OVERPAYMENT** (Line 15 less Line 12) If less than $5, enter zero ..... (SG)		16	
17. Amount of Line 16 you wish to apply to 1996 estimated tax ..... (SQ)		17	
18. Amount of Line 16 you wish to contribute to Nongame Wildlife Fund ..... (SP)		18	
19. Amount of Line 16 you wish to contribute to Centennial Tree Trust Fund ..... (SW)		19	
20. **REFUND** (Line 16 less Lines 17, 18, and 19) If less than $5, enter zero ..... (SR)		20	
21. **TAX DUE** (Line 12 less Line 15) If less than $5, enter zero ..... (SZ)		21	
22. Voluntary contribution to Nongame Wildlife Fund (Only if tax due on Line 21) ..... (SU)		22	
23. Voluntary contribution to Centennial Tree Trust Fund (Only if tax due on Line 21) ..... (SY)		23	
24. **BALANCE DUE** (Line 21 plus Lines 22, 23 and, if applicable, 25) Pay to **STATE TAX COMMISSIONER**		24	
25. **Total interest from Form 400-UT (See instructions)** ..... (SO)		25	

MAIL TO:
STATE TAX COMMISSIONER
STATE CAPITOL
600 E. BLVD. AVE.
BISMARCK, ND
58505-0550

PLEASE READ INSTRUCTIONS FOR LINES 17, 18, 19, 22, 23 AND 24.

I declare under the penalties of North Dakota Century Code § 12.1-11-02, which provides for a Class A misdemeanor for making a false statement in a governmental matter, that this return, including any accompanying schedules and statements, has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return. **For Privacy Act Information, see inside front cover of instruction booklet.**

Your Signature _____ Date _____

Spouse's Signature (if joint return) _____ Date _____

Signature of Preparer other than Taxpayer _____ Date _____

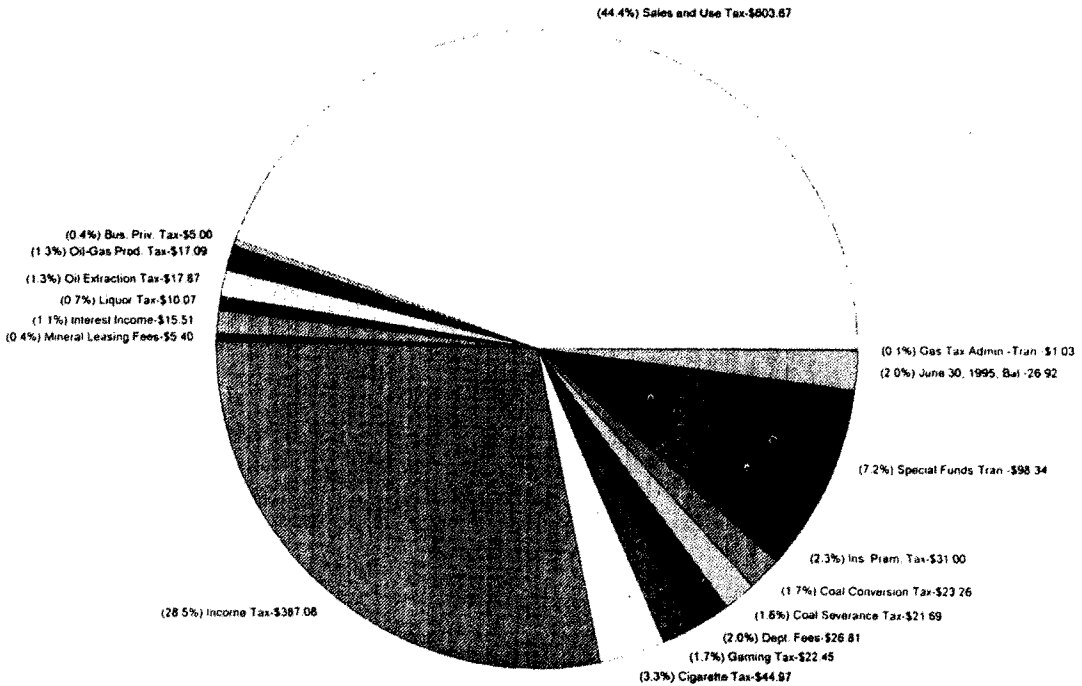
28700

☐ OPR PLEASE DO NOT WRITE IN THIS SPACE

"Buy North Dakota Products"

PERCENTAGE DISTRIBUTION OF GENERAL FUND ESTIMATED REVENUES

FOR THE 1995-97 BIENNIUM



SUMMARY OF MAJOR LEGISLATIVE CHANGES TO GENERAL FUND REVENUES AS RECOMMENDED BY THE EXECUTIVE BUDGET FOR THE 1995-97 BIENNIUM

Estimated Revenue	Original 1995-97 Executive Budget General Fund Revenues	Legislative Changes	Legislative 1995-97 General Fund Revenue Totals
Beginning balance	$ 60,141,000	$(33,223,914)	$ 26,917,086
Sales and use tax	592,396,000	11,280,000	603,676,000
Individual income tax	304,721,000	(5,964,000)	298,757,000
Corporate income tax	86,940,000	1,390,000	88,330,000
Oil and gas production tax	16,505,000	581,000	17,086,000
Oil extraction tax	22,205,000	(4,339,000)	17,866,000
Insurance premium tax	31,000,000		31,000,000
Wholesale liquor tax	9,954,979	116,021	10,071,000
Cigarette and tobacco tax	44,968,000		44,968,000
Coal severance tax	21,686,000		21,686,000
Coal conversion tax	23,257,000		23,257,000
Departmental collections	23,859,442	2,955,059	26,814,501
Gaming tax	25,867,000	(3,414,000)	22,453,000
Interest income	14,434,000	1,074,667	15,508,667
Mineral leasing fees	5,400,000		5,400,000
Business privilege tax	5,000,000		5,000,000
Gas tax administration	1,025,000		1,025,000
Transfer - Bank of North Dakota profits	28,000,000	31,900,000	59,900,000
Transfer - Mill profits	1,000,000		1,000,000
Transfer - State aid fund	35,132,000	312,748	35,444,748
Transfer - Lands and minerals	2,000,000		2,000,000
Total	$1,355,491,421	$ 2,668,581	$1,358,160,002

Chairman ARCHER. My thanks to all of you. You have all made an outstanding contribution. Let me assure you that your point that we should give adequate time for the States to change their process so that it can fit within whatever we do is well noted. I believe all of us would agree that we must have a commitment to that, regardless of what direction we go. We must be aware that your legislatures only meet at a certain time, and sometimes only once every 2 years, and it is difficult to call special sessions. I can assure you that we will be very sensitive to that.

I also would say to you that it is not the intention of this body to do anything this year on structural tax reform, but these hearings are very helpful to us in laying the predicate, in giving us the kind of input that we need to have so that we can do it in a very thoughtful and not precipitous way, because whatever we do, if it is truly structural replacement of the current income tax, is going to represent a major change, and major changes should not be taken lightly.

Mr. Dorso, I was pleased to hear you talk about your own personal experiences because each of us wears two hats in this world. We have certain professional or business entities or associations that we represent, or in your case, State governments, but we also are individuals. We have to deal with this income tax as individuals as well as whatever its impact may be on the entities that we represent. Sometimes, that brings a conflict of interest.

I have asked every witness that has come before our Committee, if I can get you to put your personal hat on for 1 second and then we will get back to the entities that you represent. How many of you prepare his or her own income tax?

[No response.]

Chairman ARCHER. I am not surprised. There are only a few of us in the Congress who prepare our own income tax, and I continue to do it just for the challenge of it and to try to be sure that I have a greater understanding, in detail, of what this Committee is putting on other people. This year, as usual, I had to get an extension, because it is so complex and I could not get all the information together that I needed to prepare my own income tax return.

I am going to ask you another question that I have asked all witnesses. From a personal standpoint, what would it be worth to you individually not to have to file a Federal income tax, and I would like each of you to give me your best judgment response on that.

Mr. Dorso.

Mr. DORSO. Mr. Chairman, I will use another personal anecdote. I have six children and I own two subchapter S corporations and I am involved in some limited partnerships, and so forth, and so forth. I will tell you, when you have six children who are all involved in family businesses, and I did not do my own personal income taxes but I tried to help my children with theirs, are you talking dollars, time, or just frustration?

Chairman ARCHER. No, I am talking about if you could quantify it as to a monetary value, what would it be worth to you—annually, not over a lifetime.

Mr. DORSO. In my own personal instance, between the two subchapter S corporations that I own and the children and everything,

I suppose it would cost me—I have not gotten the bill for this year, but it is going to exceed $7,000.

Chairman ARCHER. So you would voluntarily pay $7,000 not to have to deal with the income tax in your personal life each year, is that a fair statement?

Mr. DORSO. If you replaced the income tax with a check for $7,000, I will be happier than you can imagine. [Laughter.]

Chairman ARCHER. Mr. Blackwell.

Mr. BLACKWELL. About the same.

Chairman ARCHER. About the same? Mr. Holden.

Mr. HOLDEN. I have been a public official as a legislator and now as a treasurer, so my tax return is not very complicated. But there is a tremendous amount of frustration on the part of the citizenry about the process that they go through. So any way that we could simplify it in this process, I think we should take a serious look at it.

Chairman ARCHER. Ms. Didrickson.

Ms. DIDRICKSON. My personal story is going to be my son, who is 25 years old. He happens to be a bond trader and he has great appeal with regards to the simplification of the Tax Code at the Federal level. He does not make that much money. I believe the concept of being able to simplify that and not have to have somebody else preparing it when you are not making a great sum has great appeal, and I think it has appeal to the younger generation in a way that maybe none of us are actually as aware of.

Chairman ARCHER. But could you place, as far as you personally are concerned, could you place a value on how much it would be worth to you not to have to deal with the IRS at all in your personal life?

Ms. DIDRICKSON. I cannot put a monetary value to that, but it has tremendous appeal.

Chairman ARCHER. Mr. Powers.

Mr. POWERS. Mr. Chairman, as long as I work for government, it is worth a couple of thousand dollars. If I go back to the private sector, it will be worth a lot more to me not to have to file an income tax return. I always felt it was disgraceful that people had to spend a lot of money to do a basic civic duty of paying your taxes. So it is worth a lot, I think, to a lot of us.

Chairman ARCHER. I have always believed that it is very difficult to quantify the value of individual liberty and privacy, not to speak of all of the administrative redtape and what you have to pay a preparer and everything else. But the mere fact that there is an entity up here with enormous power over our lives to intrude and to demand records, to demand that you prove your innocence, even from the standpoint of individual liberty and privacy, that is worth something and it is very hard to quantify.

But on one panel that I asked this question, a middle-income lady from Connecticut who was a witness, testified when I got to her, "I would give my first-born child not to have to deal with it." She had had some untoward experiences with the IRS, let me just say that.

I think it is interesting to note that, but let us get back to more basic consideration. Mr. Powers, let me ask you, what was the experience in New York City when we dropped the maximum mar-

ginal rate from 50 percent to 28 percent, insofar as the ability to negotiate your tax-exempt bonds and any other aspects of that change in the Federal law?

Mr. POWERS. I will have to give you my experience as a tax lawyer. I was not with the city government at that time. At a lower rate, the bond market was still favorable, because people adapted to the lower rate very quickly. They had the sense that this is the highest it ever should be, even though it was a tremendous reduction in taxes for mostly the high-income earners.

The municipal bond business was still good and people were still willing to invest. There was, I think, a little bit of hesitancy because the benefit was not as good, but from my practice in advising people on how to avoid—avoid, not evade, Mr. Chairman——

Chairman ARCHER. I understand.

Mr. POWERS [continuing]. Avoid paying the maximum amount of taxes, this was still a very important factor for them.

Chairman ARCHER. I think that everyone should understand that the term "avoidance" is legal. The term "evasion" is illegal.

Would you render an opinion as to what impact it may or may not have on municipal bonds if the rate were reduced from 28 percent—it is not 28 today, it is 39.5 percent today maximum marginal rate—if that were reduced to 20 or 21 percent?

Mr. POWERS. The benefit you get would be less and I would imagine it would have a negative effect, although, believe me, I am not suggesting that we do not go to 21 percent by my answer on that. What I am saying is that is something we need to address, keeping municipal bond interest as exempt income. I think there would still be a market for municipal bonds because people play on the margins and if they could get a better return, they would do it.

Chairman ARCHER. So you think the city of New York would not be disadvantaged by that, as far as the interest rate on municipal bonds?

Mr. POWERS. Not if the Federal tax rates went down. If that is how it happened, I do not believe we would be terribly disadvantaged. There may be some fallout, but I do not think a lot.

Chairman ARCHER. You, I think, mentioned home mortgage interest as a deduction, too. That deduction would be worth less at 20 or 21 percent than it is at 39.5 percent. Would you be concerned about that?

Mr. POWERS. Yes, I would, because I think when you look at your home buyers, especially the young home buyers, those percentages and pennies and dollars mean a lot, mean whether they can buy that house or not buy that house, very often, especially the younger people. It would perhaps more so have an effect on them than many of the people who buy municipal bonds and are dealing with wealth that they have accumulated and bought the bonds.

So I would be very concerned about that, because having represented many young homeowners in purchasing their home, the first home, as a practicing attorney, a lot of them are tight financially. People tend to stretch a little bit. Homes are expensive in my area, and I think it could have a very negative effect, not only on people purchasing homes but in the long run, as I mentioned when I spoke, that if they do not buy the homes, they are not going

to accumulate the wealth. This wealth gets recycled. This is wealth when they sell those homes that gets invested over the years. So that is the negative effect I see happening. It would slow down the reinvestment of wealth.

Chairman ARCHER. If the deduction were retained but the rate was 20 percent instead of 39.5 percent so that the deduction was not worth as much, would you see that as a problem?

Mr. POWERS. No.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. Powers, would you agree that whether or not we pull this tax system up by its roots or whether we remain sensitive to the deduction of local and State taxes may depend on the outcome of the congressional elections next November?

Mr. POWERS. Mr. Rangel, you correctly said I did not come from politics, so I cannot kind of make——

Mr. RANGEL. Do you think it could have an impact which way the elections go?

Mr. POWERS. I am not sure I understand the question. Certainly, the congressional election depends on who wins, who loses, and how they feel on these things.

Mr. RANGEL. Very good. We will discuss it with the mayor before the elections come up. We will talk about it.

Mr. Blackwell, I know clearly what you are against. What type of revenue system do you have in the State of Ohio? How do you raise your taxes?

Mr. BLACKWELL. We have an income tax and we have a sales tax. The income tax is a progressive tax rate system which has——

Mr. RANGEL. If we wiped out the—I am sorry.

Mr. BLACKWELL [continuing]. Which is five rates too many.

Mr. RANGEL. If we wiped out the income tax system, that would wipe it out for Ohio, too, would it not?

Mr. BLACKWELL. It would not. It would change—the transition period. We would have to scramble for a definition of what is income, if, in fact, you do away with the U.S. income tax system, you have no definition. But that——

Mr. RANGEL. That would be a State problem.

Mr. BLACKWELL [continuing]. Would put us on even footing with all the other States. I am sure a State that has placed a now-Senator in space could figure out how to adjust to the situation.

Mr. RANGEL. No, no, I am just saying this. You stated that you are for advocating the wiping out of the Federal income tax system toward a flat tax that would be prosavings and anticonsumption.

Mr. BLACKWELL. No, what I said—I think, if you listened to all of the panelists, in particular, the gentleman from New York, going to a single-rate tax system does not, in fact, do away with the income tax system of the Federal Government. It takes it from a progressive, multirate system to a single-rate system, but it is still income based.

Mr. RANGEL. An income-based Federal flat tax, Federal flat tax, then you would support a flat tax for your State, as well, to piggyback the Federal tax?

Mr. BLACKWELL. Yes, sir. Absolutely.

Mr. RANGEL. You would advocate the preservation of the exemption or deductibility of the mortgage interest?

Mr. BLACKWELL. Right, I would.

Mr. RANGEL. Would you support the deductibility of charitable contributions?

Mr. BLACKWELL. I would.

Mr. RANGEL. Are there any other deductions you would support in this flat tax?

Mr. BLACKWELL. Yes. You have named two. The other one that I would put on the table is the full deductibility for workers in this country of the payroll tax. Since employers can, in fact, write it off as a cost of doing business, I think that the workers of America, and particularly the State of Ohio, should have, in fact, the full deductibility of that very, very regressive tax. More young people in my State pay more in the payroll tax than they do in the income tax. So I think this opportunity that Congress has to radically change the entire tax system is very, very beneficial.

Mr. RANGEL. This contribution to the Social Security pension fund and the contributions to health care, you believe should be written off?

Mr. BLACKWELL. Yes. My belief is that if you look at the demographics, Representative Rangel——

Mr. RANGEL. I am not arguing with you, but you believe it should be written off?

Mr. BLACKWELL. No, no. What I am saying is if you look at the demographics, we are hoodwinking the people of this country to tell them that in 30 years——

Mr. RANGEL. Mr. Blackwell, I am agreeing with you. I am agreeing with you it is a regressive tax. I am just trying to make it clear that you would want it deductible, because by the time I get finished with these deductibles, this flat tax is not going to be that flat, that is all. So I am agreeing with you about the impact.

Mr. BLACKWELL. You hit my three deductibles.

Mr. RANGEL. All right. Do you have a city tax at all?

Mr. BLACKWELL. In charter cities. Some of our charter cities have city taxes.

Mr. RANGEL. Pardon me?

Mr. BLACKWELL. Some of our charter cities have city taxes.

Mr. RANGEL. In those charter cities, would you support allowing the citizens of the charter cities to deduct their city tax from the State tax, or would they have to pay the city and the State tax?

Mr. BLACKWELL. Mr. Rangel, I believe that taxes are the prices we pay for government services. I believe in the principle of——

Mr. RANGEL. I believe in all that you believe in, Mr. Blackwell. I am just asking you whether or not the tax rate—I am for simplicity, you see, so I agree with all those principles. It is just that when they put those lights on for me, it means I cannot talk anymore.

Mr. BLACKWELL. I am terribly delighted to be here to discuss this.

Mr. RANGEL. We will meet again. My time is expired, but you and I are for good government, simplicity of taxes——

Mr. BLACKWELL. Absolutely.

Mr. RANGEL [continuing]. And deductibility where it is favorable to our constituency.

Mr. BLACKWELL. No, I am for what I think is in the interest of the American taxpayer. I am not here telling you that if it is good for the Ohio taxpayer and not good for the American taxpayer, since Ohioans are Americans, also, Mr. Rangel, that I would argue the narrow interest.

I think that what we have to do is to deal with a tax system that is strangling economic growth, is the primary source of economic anxiety that the President and Members of this Congress talk about that is driven by two tracks. One is income stagnation and the sense of job security, and the only way that we are going to get the economy going again is to, in fact, unshackle it from a Federal tax system that is confiscatory, antigrowth, antisavings, and anti-investment, and I——

Mr. RANGEL. And antieducation and antitraining and antijobs and it has more people in jail than most civilized countries. That has some impact, too, does it not, Mr. Blackwell? Would the fact that we have more money invested in our jails than in our educational system have some impact?

Mr. BLACKWELL. What I am saying, Mr. Rangel, is that I think that we should, in fact, unleash the American economy, create jobs, lift incomes, and one of the ways that you can do it is, in fact, by simplifying a system that is suffocating with its complexity.

Chairman ARCHER. The gentleman's time is expired.

Mr. RANGEL. I am agreeing with you. I thought you might want to agree with me.

Mr. BLACKWELL. This is a lovefest.

Chairman ARCHER. Since the gentlemen are in agreement, the gentleman's time is expired.

Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

Loleta, the flat tax that we introduced in Illinois started the same year I came to Congress and I have been a champion of a flat tax all the years I have been here. I am in competition with my distinguished Chairman here——

Ms. DIDRICKSON. I am aware.

Mr. CRANE [continuing]. Who wants to root the IRS out with a consumption tax. I pointed out to him that he has some validity in his arguments, since we went from 2.5 percent to 3 percent. Bill's concern, of course, is that when you create a flat tax, subsequent Congresses can continue to ratchet it up.

However, we do have a consumption tax along with our flat tax in Illinois, I was just explaining to him the worrisome thing about a consumption tax from my perspective is that people are not as painfully aware of what they are paying in taxes when you have a consumption tax as they are when they have to submit their payment based on their earnings. I think we have demonstration of that, in part, in the State of Illinois, since our consumption tax is 5 percent and our flat tax is only 3 percent.

Be that as it may, and I am still open to further input from my distinguished Chairman——

Chairman ARCHER. If the gentleman will yield, I did not intend to get into a debate with the flat tax versus consumption taxes today, but we will get into that at a later time.

Mr. CRANE. That sounds good. But the fact of the matter is, in terms of the issue that Loleta brought up here, and that is the differential when you exclude unearned income, the differential that you have, then, in trying to offer attractive tax-exempt municipals or tax-exempt State bonds, the same principle would apply with regard to imposing a consumption tax.

It is something that raises a valid question to me, in part, except since those authorities have the power to tax, would not an offering of a municipal bond or a State bond still be more attractive at the identical rates that the private sector is offering? Would that not be more attractive than investment because of the fact that they have that endless power to tax and to raise the revenues to cover their outstanding liabilities?

This, to be sure, would increase costs at the local and the State level. But it has always struck me as kind of unfair that with those advantages in an open market, that whether it is a local municipality or a State, that they have that advantage of the tax-exempt status of the bonds they issue. Would it not be a fairer, more level playingfield if everybody is playing on the same terms?

Ms. DIDRICKSON. We have had that discussion in the Office of the Comptroller, and I will limit my comments to the Office of the Comptroller. In fact, there are many of us who believe that that would be a level playingfield and that there is an attractiveness to that discussion. But it also is recognized that it can increase costs with regards to going to the markets for capital projects.

You are absolutely correct, Congressman, with regards to the consumption tax in the State of Illinois, too. I would like to briefly comment on that. We do have the 5-percent consumption tax, but we have been very careful in the Illinois General Assembly and the executive branch to not overburden it because it is a regressive tax, and that discussion and debate goes on repeatedly in the Illinois General Assembly.

Getting back up to our flat tax, which you were talking about, indeed, we have raised it, but it has been at 0.5 percent since 1969 and we have been very careful, very careful. So it has still remained a very broad, very low tax which has had a high yield with regards to revenue.

Mr. CRANE. I thank you all again for your testimony and I appreciate your input. Loleta, I look forward to working with you back home.

Ms. DIDRICKSON. Thank you, Congressman.

Mr. CRANE. Thank you all.

Ms. DIDRICKSON. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Portman.

Mr. PORTMAN. I have a couple of questions for the panel that I would like to get in before our break. First, I thought Mr. Blackwell did a good job in the Ohio versus New York debate earlier with my friend, Mr. Rangel, but I want to give him a chance to talk about one of the issues where I think he may differ with some of the other panelists and that is in the area of tax-exempt bonds.

I guess my question would be to Mr. Blackwell, and then perhaps Mr. Powers or another panelist might want to chime in. What would the effect be, in your view, of a flat tax or, let us say, the

flat tax proposed by the Kemp Commission, on tax-exempt municipal bonds? What would be the effect on the market?

Mr. BLACKWELL. Thank you, Mr. Portman. Tax restructuring, in my opinion, will not take away any of the advantages enjoyed by municipal bonds, nor will it raise borrowing costs for State and local governments. Indeed, by strengthening the economy of the State and local governments, I think revenues will be increased and there will be a reduction in the need for welfare-related outlays.

In particular, tax-exempt securities will not fall in price. This concern is based on a misunderstanding of the relationship between taxable and nontaxable securities and the functioning of the credit markets, and I think it is without merit. Interest rates consist of a basic rate of return demanded by lenders plus premiums reflecting differences in risk among the various securities, plus expected inflation and taxes. Tax-exempt bonds do not have a premium. Taxable bonds do.

Under the single-rate system envisioned by the Commission, the tax premium in currently taxable bonds would fall to the current tax-exempt rates or levels, and I think that will result in no significant change in the tax treatment of tax-exempt bonds. Their prices and interest rates would be largely unchanged.

Mr. PORTMAN. That is interesting. Mr. Powers, do you have a comment, or do any of the other panelists?

Mr. POWERS. Yes, Mr. Portman. I think the key here is to keep the tax exemption for tax-exempt bonds. Tax-exempt bonds have lived through 70 percent tax rates back at one point when we had that on unearned income, and subsequently, 50 percent tax rates, and 28 percent tax rates, and they have thrived.

The issue is that some of the thought is to take away the exemption. That, I think, is dangerous. I think the market will adjust to different tax rates, and though we are talking one tax rate, over the years, tax rates have changed. I think the key here is to give some benefit to municipalities so that they can get a lower cost of funding, especially at a time when they have to fix infrastructure and Congress is giving less money.

Mr. PORTMAN. In effect, I think part of what Mr. Blackwell is saying is that the macroeconomic impact of a flat tax and all the efficiencies you get with that would have benefits that would supersede some of the detriments that you might see to municipalities not having that exempt status. How do you answer that?

Mr. POWERS. I am not sure of that, and I have to say, flat tax is a very broad term, as we are talking here. I am not sure what the benefits would be that would offset losing the exempt status. We rely very heavily on that and spending $4 billion a year, it would have a big impact on New York if the costs went up to us.

Mr. HOLDEN. Congressman, nobody knows the answer to your question. I can bring up studies. We will give you every point of view on that issue. I think what I would hope this Committee would keep in mind, that at a time when more and more responsibility is coming back to the States and local governmental entities through handling public policy issues, it is also at the same time that we have to focus more of our effort on infrastructure, our roads, highways, and bridges.

This is a system that, by and large, has worked pretty well at the State and local level up through the years. Any changes you want to make, I would hope that you would look at them very carefully and look at the long-term impact of what is being discussed before we dramatically change or remove the tax exemption for State and local bonds.

Mr. PORTMAN. Unbelievably, I have the light, also. I think we have time for maybe one more comment.

Mr. Dorso.

Mr. DORSO. Congressman, I have heard the experts here, but I am just giving it my citizen spin. I think interest rates drive decisions about buying houses more than taxes. I have children who are in the process of buying houses, and a 2-percent swing in the mortgage rate is going to make a heck of a lot more difference than what you do in taxes.

I think the bottom line is, municipal and State bonds, it is the same thing. I do not know how far you can go, and I do not know which way you are going to go, but the market will react. But interest rates drive the decision for me as a businessman, not necessarily the tax rate. That is the secondary consideration, and I think it would be for my kids.

Mr. PORTMAN. Ultimately, we get back to fiscal and monetary policy and its interplay with all this. Thank you all very much.

Mr. CRANE [presiding]. Mrs. Johnson.

Mrs. JOHNSON. Thank you. We do have a vote, so I will keep my questions short and maybe one other person can get in.

Ms. Didrickson, it is nice to have you. I enjoyed visiting with you last week.

Ms. DIDRICKSON. Thank you, Congresswoman Johnson. I did, too.

Mrs. JOHNSON. I learned a lot about the example that you were setting and I know there are other State administrators who are setting this example, too, but certainly you and the treasurer in Connecticut have taken a lead in making government more efficient, cutting its costs and improving its performance. I commend you on your success.

Your testimony interested me in this regard. If we go to a flat tax and we define the minimum taxable level differently than it is currently defined, and we define the base differently than it is currently defined, excluding a lot of income that is currently taxable, then the take of any State income tax is going to be diminished.

Ms. DIDRICKSON. That is correct.

Mrs. JOHNSON. Either you will have to tolerate that loss of revenue or you will have to have your own structure, which means that the whole goal of simplicity will be—and not real. That concerns me. It seems, from your testimony and from that of a number of the rest of the witnesses, that if we do not do this in harmony with you—at least now there is a certain harmony. People can figure out what their State taxes are and deduct it. The two systems have become somewhat integrated and simplified.

But if we do this certain ways, we could end up forcing both municipalities and States to have their own tax law so they can define a base that will yield them the revenue that they want and a level of income eligibility that will yield them the base. That concerns me. I had not realized the possibility of this enormously difficult

complexity that could result from "simplification" at the Federal level.

Ms. DIDRICKSON. I do not think that it means necessarily that our tax system in the State of Illinois, our flat tax would become more complicated, but it does mean that—we are one, out of the seven flat tax States, we are one of the four that uses AGI, the adjusted gross income, so we would have to change our baseline to reflect that. That also means we would have to make revisions within our Tax Code and determine what kind of revenue we would be producing. Those are decisions that we would need to make at the State level, but those are decisions that I believe that we very well could answer and make at the State level.

But that gets back to the position that NASACT has requested along with NAST and a number of the others, is that give us enough time to be able to react to it. It does not mean that it is not doable, and I do not believe that it makes it more complicated, but we do have to make adjustments, and one that you have raised there is one that I raised in my testimony with regards to the baseline.

You also mentioned the fact that there are a number of States who are looking to become smarter, smaller, and clearly, I think there probably is not a constituency for maintaining the IRS at 100,000 employees and at a $10 billion annual appropriation. So I think that we need, and I believe that concertedly, together, the Federal Government and the State governments need to be able to look to a system that will provide simplicity, make the taxes flatter, and make them simpler to conform. I think that is a goal that we at the State are certainly looking to do and I am delighted that you, at the Federal level, are doing the same thing.

Mrs. JOHNSON. Mr. Holden.

Mr. HOLDEN. Congresswoman, I believe there are 37 States that are tied directly or in some capacity to the Federal tax system, so you make a major change, you are going to talk about a lot of States having to come in and address this issue.

What the Chairman said a while ago about wanting to work with the States and local communities, I appreciate, because we are all in this together. What you do up here is going to have a very dramatic impact on how we address these issues at the State and local level.

As you come forward with your ideas on what you are seriously taking a look at, I would encourage you to reach out and touch all of our organizations. Give us the specifics that you are wanting. Let us go back and talk individually with our States to come forward so that you have the best information possible, and trying to come forward with a comprehensive, appropriate tax reform bill that I think we all would genuinely like to see happen.

Mrs. JOHNSON. I guess in closing, what I think is very important for you and all your organizations to do is to look at what you think the definition of taxable income ought to be under, say, a flat tax scenario, because if we exclude whole categories of income, that will have a lot of influence, what rates you are obliged to look at.

Then I think it is very important that there be some agreement among the States and the Federal Government as to what is going to be deductible so that we do not get into an erratic pattern where

deductions vary widely across the States and are very different from the Federal pattern. We need, as a society, to decide whether charitable deductions are in or out, whether home mortgage deductions are in or out, whether R&D credits are in or out, and health premium taxes and so on.

So if we should go the flat tax direction and we do not come to some agreement on the definition of the base and the basic deductions, then we have the potential to have an enormous impact.

Thank you.

Chairman ARCHER. The gentlelady's time has expired and our time is about to expire to make this vote.

I want to thank each of you—in fact, I do thank each of you for coming today. I understand there are no further questions, so this panel is excused. After we have voted a couple of times, the Committee will come back. In the meantime, we will be in recess. We will hear our next panel when we do return.

[Recess.]

Chairman ARCHER. The Committee will come to order. The Chair would like for our next panel of Arthur Lynch, Harley Duncan, Dan Bucks, Frank Shafroth, and Deborah Doxtator to take seats at the witness table.

My greetings to each of you as witnesses and thank you for coming to testify before the Ways and Means Committee. As you are recognized, if you will identify yourselves for the record before you commence, and then if you would, please, try to limit your oral testimony to 5 minutes or less. Without objection, your entire written statement will be entered into the record.

Mr. Bucks, would you lead off, please.

STATEMENT OF DAN R. BUCKS, EXECUTIVE DIRECTOR, MULTISTATE TAX COMMISSION

Mr. BUCKS. Thank you, Mr. Chairman and Members of the Committee. My name is Dan Bucks and I am the executive director of the Multistate Tax Commission. The commission is an organization of 40 State governments, an interstate compact agency that works to preserve federalism and ensure fairness in State taxation of interstate commerce.

This committee is to be commended for these hearings on the State and local impacts of Federal tax restructuring. While they have gotten little attention to date, these impacts are likely to prove to be one of the two or three most important issues of all in Federal tax restructuring.

The stakes are very high. If Congress fails to deal properly with the State and local impacts, Congress could centralize governmental power in Washington on a scale never seen before in our Nation's history. It could do serious damage to State and local governments across the Nation and disrupt even the most basic and elementary public services.

In particular, if Federal tax restructuring centralized more power in Washington, it would reverse Congress' recent efforts to transfer responsibilities to State and local governments and its enactment of landmark protections against unfunded mandates. However, Federal tax restructuring could become the "mother of all unfunded mandates" and could end federalism in this Nation, and with it

limit the freedoms and flexibility that are nurtured and supported by federalism.

Are these dire consequences inherent in any major restructuring of Federal taxes? No, certainly not. Are they possible if some of the current proposals are adopted without significant changes that take account of State and local needs? Most certainly, yes. The State and local impacts of each major Federal tax proposal vary and each proposal should be evaluated from the viewpoint of how much choice it leaves the citizens of the States to fashion their own tax policies.

The current system supports a wide range of choice in State and local tax policy, with sales, income, and property taxes being mixed in different proportions across the Nation. A major goal of Federal tax change should be to leave the citizens of the various States with as much freedom of choice in tax policy as possible.

Consider first the proposals for a national sales tax to replace the Federal income tax. As proposed today, these plans to repeal the Federal income tax effectively repeal State and local income taxes, as well, because of constitutional, administrative, and international treaty problems.

The Federal Government provides a legal, administrative, and auditing infrastructure and a set of international tax treaties that are a foundation for State income taxes. It is unclear how States would be able to reconstruct this infrastructure independent of the Federal Government, and even if they could, there appears to be a constitutional barrier to independent State income taxes because the due process clause likely prohibits States from requiring information reporting from certain out-of-State businesses.

Income taxes raise 25 percent of State general fund revenues. Thus, these current proposals for a national sales tax to eliminate the Federal income tax, and therefore the State income tax, would blow a large hole into State budgets and effectively eliminate income taxes as a policy choice at the State and local level.

If States are also mandated to conform their State and local sales tax bases to the base of the new national sales tax, virtually all power over State tax policy will be transferred from State capitals to Congress, while the budgets of States and some local governments would have been decimated.

Further, the burden of most Federal, State, and significant local finance would be stacked upon a single base of sales transactions with the combined rates reaching the stratosphere, as high as 40 percent or more, according to some estimates.

Take the example of two States, Oregon and Montana. The citizens of those States have gone to the ballot box more than once to choose income taxes instead of the sales tax as their primary State revenue source. A national sales tax to replace the Federal income tax without protecting State income taxes would nullify the votes of the citizens of those States. They would no longer be able to levy State income taxes and their States would be forced by congressional edict into a system of sales taxation that they have rejected in free and open elections.

There are solutions to these problems. Congress can take action to enable States to continue to levy income taxes, and it could develop a sales tax in full cooperation with the States. However,

these solutions require a level of cooperation and a partnership between the States and Congress that is rarely seen.

Let us turn now to the flat tax and the USA plan. Plans of these types contain broad-based general business taxes that, in fact, have already been pioneered by the State of Michigan, and Congress could well learn from this State experience. In many ways, these broad-based business taxes provide States with a broad foundation of choice to fashion their own business tax systems. So there are some major federalism pluses to these plans.

However, there are also some federalism minuses. By repealing the individual taxes on dividends, interest, and capital gains, current flat tax plans effectively repeal taxes on the same items for the States. Again, a State fiscal loss would occur and the policy choices available to citizens would be narrowed.

Tennessee, for example, levies an income tax on investment income only, and the flat tax would foreclose the policy choice that Tennessee has made. Again there are solutions, but they require a partnership between Congress and the States.

The USA plan would create incentives for persons to convert deferral of State taxes on saved income into a permanent exemption by moving from one State into another. Both fiscal problems and conflicts among the States will result. And again, Congress and the States need to work together to find solutions.

The Multistate Tax Commission joins with the other organizations who have testified here in calling for the creation of a joint congressional-State staff working group to evaluate the federalism impacts of each major proposal for Federal tax change.

Beyond that modest step, the commission also raises a bold and revolutionary idea for establishing tax policy in this Nation. Because the relationship between Federal and State interests are so great, we propose that those features of any new tax system that overlap Federal and State interests be enacted by an interstate compact between Congress and cooperating States.

A compact is the one vehicle consistent with federalism to establish a true partnership between Congress and the States, and the mechanism is ideally suited to preserving federalism as the Nation moves to a new tax system because a compact would require a full consideration and reconciliation of Federal, State, and local interests involved in a major tax change.

A compact between Congress and the States would also promise an economic dividend. If the base and the intergovernmental features of a new tax system were enacted by compact, the tax system would be more stable and potentially less costly for government, business, and citizens to administer. A base established by compact would be less likely to change, so investors could plan and make investments with the security that they would face fewer surprises from either the Federal Government or the States. Coordinated administrative mechanisms established by compact could cut costs of compliance and administration for the private and public sectors, alike.

If Congress and the States worked together in full and complete partnership, they can both preserve federalism and improve economic growth and efficiency. If Congress does not work with the States, however, the results could dramatically reverse the efforts of this Congress to return power from Washington, DC, to the States and could be extremely disruptive for State and local governments.

Thank you.

[The prepared statement and attachment follow:]

Testimony to the Ways and Means Committee of the
U.S. House of Representatives
May 1, 1996

Federal Tax Restructuring: Perils and Possibilities for the States

By Dan R. Bucks, Executive Director, Multistate Tax Commission

An historic debate is developing over the nature of the federal tax system. Several national leaders are seeking to replace federal income taxes with consumption or other taxes that shift the tax burden away from capital income. Each of these proposals will affect state fiscal systems in fundamental ways.

The central irony of the emerging debate is that while the federal government is transferring expenditure responsibility to the States, most of the major tax changes would effectively reduce the tax policy choices available to States. State officials need to be engaged in this discussion to preserve the vitality of federalism.

This article reviews three major variants of consumption taxes advocated by various Members of Congress:

- the National Retail Sales Tax (NRST) introduced by Representatives Dan Schaefer (R-CO), Billy Tauzin (D-LA) and Dick Chrysler (R-MI). (This bill is H.R. 3039). Senator Richard Lugar (R-IN) has also advocated a national sales, although he has not yet introduced legislation;

- the Flat Tax proposed by Representative Richard Armey (R-TX) and Senator Richard Shelby (R-AL) and a variant thereof introduced by Senator Arlen Specter (R-PA). (These bills are H.R. 2060, S. 1050, and S. 488, respectively); and

- the Unlimited Savings Allowance (USA) Tax introduced by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM). (This bill is S. 722).[1]

A transactional Value-Added Tax (VAT) is also discussed because its impact on States closely parallels the proposed National Retail Sales Tax. However, although proposals for such a VAT have been introduced in the 104th Congress, they are discussed only briefly because they have not been proposed as a substitute for the existing federal personal and corporate income taxes.[2] Finally, a fifth proposal, by Representative Richard Gephardt, is not reviewed here because it does not propose major changes in federal taxation of business.

Each of the plans discussed here is intended to improve the U.S. savings rate by shifting the burden of taxation to consumption and by providing direct or indirect incentives for investment and savings. Because each of the proposals takes a different form, they will affect state tax systems in different ways. Nonetheless, with respect to state taxation, the proposals share a common characteristic: ***compared to current***

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[1] Senator Jeff Bingaman (D-NM) has also advocated substituting the Boren-Danforth Business Activities Tax (BAT), a "subtraction method" value-added tax, for the existing corporate income tax. See: Scrambling to Pay the Bills: Building Allies for America's Working Families, February 28, 1996, pp. 17-19. Most of the observations made here regarding the business-level tax embodied in the Nunn-Domenici USA Plan apply with equal force to the Boren-Danforth BAT. The Boren-Danforth BAT was proposed in the Comprehensive Tax Restructuring and Simplification Act of 1994, S. 2160, 103d Congress.

[2] See the VATs proposed in the Deficit and Debt Reduction and Health Care Financing Act of 1995 introduced as S. 237 by Senator Ernest Hollings (D-SC) and in the National Health Insurance Act introduced as H.R. 16 by Representative John Dingell (D-MI).

circumstances, all of the proposals would leave the States with fewer tax policy choices.

The current structure of federal and state tax systems combines consumption taxes—state sales taxes—with "ability to pay" taxes—federal, state and local income taxes. If the federal government moves to a consumption tax, it will be difficult, if not impossible, for States to maintain "ability to pay" income taxes in their revenue mix. Administering a state individual or corporation income tax without a federal tax would be extremely difficult, if not impossible, for nearly all States. To a large degree, States currently rely on federal income tax definitions of income, expense and other relevant items and begin state tax computations from a federal starting point. In addition, States rely extensively on federal audit and compliance programs for their own purposes and are reliant as well on federal information reporting and withholding rules for their own administration. Without this infrastructure, it is unlikely that States would be able to administer an income tax without substantial additional capacity and without additional complexity to taxpayers. They may also run into Constitutional issues that would prevent effective administration, especially with respect to requiring information reporting by out-of-state corporations. Ultimately, these Constitutional issues may prove to be the greatest barrier to continued State use of income taxes in the absence of a federal income tax. Thus, the proposed federal tax changes will narrow the diversity of tax policies available to the States, and the entire federal/state fiscal system will shift to various forms of consumption taxes.

The Federalism Impacts—Briefly

Space does not allow for a full discussion of the impact of each proposal on our system of federalism. This high-level assessment of the three major plans demonstrates, however, that the impacts are significant and vary somewhat among them.

National Retail Sales Tax. Replacing the federal income tax with a single transactional tax, such as the Schaefer/Tauzin/Chrysler NRST or a Euro-VAT, will also require that States shift in large part to such a tax. As noted above, it seems unlikely in the extreme that a State could effectively maintain and administer an income tax in the absence of a federal counterpart. Thus, a primary federalism impact of these transaction tax proposals is that States would no longer have the option of including ability-to-pay income taxes in their tax mix.

With all income taxes repealed, a single tax base—consumption—would be used to finance the majority of federal and state services and a substantial share of local services. No other major industrialized country relies to such a high degree on transactional consumption taxes; instead they typically mix consumption and ability-to-pay income taxes much as the States do now.[3]

The limits on policy choices would be especially dramatic in the five states that do not now levy a state sales tax: Alaska, Delaware, Montana, New Hampshire and Oregon. Sales taxes are a divisive issue in these States, and indeed Montana and Oregon voters have specifically rejected such taxes in referenda on several occasions. Yet, under a NRST or Euro-VAT, these States would likely have to abandon their traditional reliance on income taxes. The impact on these States highlights in the

[3] This heavy reliance is likely to lead to higher rates than some envision. The 15 percent rate included in the Schaefer/Tauzin/Chrysler NRST does not acknowledge the need of States to find a replacement for their income tax receipts. After accounting for the need to replace state income taxes, plus the likelihood that the final tax base will be narrower than the pure consumption base used to calculate the 15 percent rate, the final combined federal-state-local tax rate necessary to raise revenues equal to federal and state income taxes, plus current state and local sales taxes, would be in the 30 percent to 40 percent range. Similarly, the rate for a Euro-VAT would likely be much higher than its advocates anticipate.

extreme the constraints placed on the policy choices of all States under a shift to a federal transactional consumption tax.

A NRST or Euro-VAT would also raise the key federalism issue of the autonomy allowed States to define the bases (and perhaps rates) of state sales taxes or VATs. Admirably, the Schaefer/Tauzin/Chrysler NRST leaves states free to retain their own sales taxes and opt-out of administering the federal tax. Whether such a dual system would be politically sustainable in the long run is open to question, however. It seems likely that that American business community would apply intense pressure for mandatory consolidation, and it is true that a consolidated federal-state tax would be easier to administer for taxpayers and tax administrators alike.

However, consolidation of the two levels of taxation would mean that Congress would control the structure of state retail sales taxes. And, given that these proposals may compel States to abandon income taxes, the result is congressional control of the major share of the general fund revenues of most States. This control could even theoretically lead over time to congressional earmarking or restraining of the uses of state revenues. ***If the NRST or Euro-VAT leads to States losing the authority to determine tax policy for themselves, the balance of power in our federal system will shift profoundly in favor of the national government.***

Others may argue that the loss of autonomy in tax policy will be outweighed by the efficiency benefits to the national economy arising from a common national tax. Proponents could also argue that States will enjoy the revenue benefits of Congress enacting a tax base that is broader than most States have been able to adopt on their own. Whether the federal base would remain immune over time to the inevitable process of exemptions and special exceptions is yet to be seen, however.[4]

There is also no assurance that Congress, after gaining control of the federal and state tax base, will retain the benefits of national uniformity. Indeed, Congress has prohibited States from taxing certain "government-sponsored enterprises," such as "Fannie-Mae," while continuing to subject such enterprises to federal income taxation.

The stakes in this debate between economic efficiency and political autonomy are very high for the States. The authority to determine tax policy is a core element of sovereignty. With that power comes the independence to set expenditure priorities. Ultimately, the combination of the repeal of federal income taxes and mandated conformity to a federal transactional tax would make States much more dependent on the federal government.

Space does not permit a discussion of all the important issues raised for States in the context of a National Retail Sales Tax. The proposal for states to administer the Schaefer/Tauzin/Chrysler National Retail Sales Tax deserves serious consideration.[5] State administration likely ensures greater attention to details important to States as well as to issues of national importance. State administration might also provide a means of resolving the use tax nexus issue; interstate sales would be taxed under a national sales

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[4] Moreover, it is not certain that a federal NRST base that will (presumably) include most household purchases of services will necessarily be appreciably larger than existing state sales tax bases. States currently tax significant amounts of business inputs, which will be exempted under a national sales tax because taxing them at rates as high as 15-20 percent would lead to significant economic distortions. The expansion of the state sales tax base to include household services may not do much more than compensate States for the loss of the sales tax base comprised of such business inputs.

[5] A member of the California State Board of Equalization (the agency charged with responsibility for administering that State's sales tax) has set forth a detailed proposal for state administration of a national sales tax. See: Ernest J. Dronenburg, Jr., "SAFCT: State Administered Federal Consumption Tax: The Case for State Administration of a Federal Tax," paper prepared for the New York University Annual State and Local Taxation Conference, November 30, 1995.

tax, and it would make little sense to have the States administer a federal tax on such sales while remaining effectively powerless to tax them themselves.

Nunn-Domenici USA Plan. The tax plan proposed by Senators Nunn and Domenici combines a "federalism friendly" operational (Michigan-style) VAT with a consumed income tax that has the potential to divide the States.

At the business tax level, Nunn-Domenici propose a subtraction-method VAT that would be administered like an income tax. Such a tax is "federalism-friendly" because States could readily "piggyback" on what would be a robust, broad-based tax. States could simply transport their current apportionment formulas from the corporate income tax arena to the new operational VAT. Michigan's experience—especially with the U.S. Supreme Court's approval of apportioning an operational VAT in *Trinova*[6]—serves as a model for other States. New Hampshire as well now has several years of experience with administering an operational VAT.

The Nunn-Domenici operational VAT would also benefit States by reducing problems created under the corporate income tax by the artificial shifting of income overseas via transfer pricing. The Nunn-Domenici plan alleviates the transfer pricing problem because export sales are exempt from the tax and import purchases are taxed. (In technical terms, it is a "border-adjusted" VAT).

While the business tax portion of the Nunn-Domenici plan is workable from a federalism perspective, the individual consumed income tax may be a different matter.[7] The "source tax" issue that arose in conjunction with pensions, IRAs and other tax-deferred retirement income would be magnified under the USA plan.[8] A person could add to savings and receive a deduction while a resident of a consumed income tax State, but then retire to a low-rate or non-income tax State.[9] The incentive to retire to such a State would greatly increase relative to the current situation because the exemption (or low rate) would apply not only to pension benefits but to all savings vehicles.

States could de-couple from the USA savings deduction without creating severe administrative complications. However, there would likely be significant political difficulties in eliminating at the state level a federal tax deduction that would be popular with individuals who have significant savings.

A federalism advantage of the USA plan is that it does not interfere with the operation of state sales taxes. A federalism disadvantage is that States may find it difficult to retain a traditional "ability-to-pay" income tax. However, that difficulty appears to be more political than technical or administrative, since interest, dividend, and capital gain income would continue to be reported to and audited by the federal government.

Armey-Shelby and Specter Flat Taxes. These plans aim at the goal of corporate tax integration, whereby all income is theoretically taxed only once. There is no

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[6] *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358 (1991).

[7] Under the proposal, the individual tax base would be equal to income from wages, interest, capital gains, and dividends less net additions to savings.

[8] Congress recently preempted the authority of States to tax, under the source principle, IRS-qualified pension and certain other deferred compensation benefits paid to former residents. See: H.R. 394, Public Law 104-95.

[9] The issue will be exacerbated to the degree that individuals are able to borrow funds, up to certain limits under the USA plan, to increase their savings deduction.

taxation of consumed wage income twice as there is under the USA plan,[10] and there is no taxation of corporate business profits twice as is commonly alleged in the current system. Business profits and employee fringe benefits (except pensions) are taxed at the business entity level. Wages, salaries and pension benefits are taxed at the individual level. Senator Specter's plan would allow for the deduction of home mortgage interest and charitable contributions; the Armey/Shelby Flat Tax would not.

States could readily piggyback on the business operational VAT contained in both these Flat Tax plans, just as they could in the USA plan. Unlike the USA plan, however, transfer pricing remains a problem because the Armey/Shelby and Specter flat taxes do not qualify as "border adjustable" taxes. Hence, export sales are taxable, and import purchases are deductible as business inputs. Therefore, the same incentives to under-price exports to related foreign parties and to overprice imports from related foreign suppliers exist as under the current corporate income tax. Moreover, without the "backstop" of taxation of repatriated dividends, income once shifted overseas by U.S. multinational corporations is removed from the U.S. tax base forever. Allowing global enterprises to shift income through transfer pricing is a major federal policy failure, and under these Flat Tax proposals it becomes even more important to solve this problem. On the other hand, the reduction of tax rates under the Flat Tax relative to the current corporate income tax may decrease the incentive for artificial income shifting somewhat.

The individual tax proposed in the Armey/Shelby and Specter Flat Tax proposals is designed in a manner that would make it difficult to impossible for States to retain a traditional individual income tax which includes interest, dividends and capital gains in the base. The administrative infrastructure for the taxation of these types of income would no longer exist because of the elimination of the information reporting on these items. States that prefer a traditional income tax as a part of their fiscal mix would effectively no longer have that choice.[11] On the other hand, as with the USA plan, a federalism benefit of the Flat Tax plans is that States could retain their sales taxes without inherent federal interference.

Possibilities

While major change in the federal tax system will present challenges to States and localities, it may also produce an opportunity to improve the operation of tax systems at all levels of government. Such improvements would likely require coordination and cooperation between federal, state, and local governments. State officials should be full partners with federal officials in exploring such potential improvements.

Interstate compacts between Congress and participating States should be explored as the mechanism most consistent with federalism for mitigating potential adverse impacts on the States from federal tax changes and for maximizing the benefits

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[10] Consumed wages are taxed at the individual level under the USA Tax, and, because they are not deductible from the business tax base, they are effectively taxed at that level as well.

[11] This narrowing of tax policy choices for the States might be potentially mitigated were Congress to empower States with the ability to require income information reporting by out-of-state companies or to continue to collect the information and share it with States on a cost-reimbursement basis. States, in turn, could cooperate through an interstate compact that would provide a basic, uniform legal structure for state income taxes. Such an approach would be consistent with federalism and would avoid forcing all the States into a "one size fits all" tax system controlled only by Congress. Beyond supporting principles of federalism, the federal interest in preserving a state option for income taxation (even if not used at the federal level) would be to prevent the rate of federal consumption taxes from being so high that they produce their own forms of economic distortion and incentives for evasion.

of coordination among federal, state, and local taxes.[12] Interstate compacts, freely entered into by States, could forestall congressional imposition of tax policy on the States. At the same time, interstate compacts provide a means of voluntarily harmonizing otherwise separate and potentially disparate tax policies. Compacts are especially called for if the federal government were to enter the field of *transactional* consumption taxation long relied upon by state governments as a major source of revenue.

States cannot afford to ignore the debate over the shape of the nation's tax system. All of the major proposals for federal change will constrain the tax choices available to the States to some degree. It is ironic that as States are being assigned more expenditure responsibilities, they may be left with fewer revenue choices. The choice that States can make now is to try to influence the decisions of Congress that will vitally affect their future tax authority and revenue systems.

[12] A resolution adopted by the Multistate Tax Commission at its 1995 Annual Meeting (which is attached to this article) commits the Commission to "study[ing] and consider[ing] carefully the potential for state administration of coordinated national taxes, including the use of an interstate compact as a legal vehicle, consistent with preserving state authority within the federal system, for establishing a coordinated system of national taxation within States participating in the compact."

Multistate Tax Commission

Impacts on State Tax Administration of Proposals for Major Federal Tax Changes

WHEREAS, a number of announced candidates for President in the 1996 election and members of the congressional leadership in both parties have recently set forth detailed proposals or otherwise called for major changes in fundamental federal tax policies, and

WHEREAS, several of these proposals call for enactment at the federal level of a comprehensive transactional tax on consumption, which has heretofore been almost exclusively a major source of revenue for States and local governments, and

WHEREAS, enactment of such a tax would raise significant issues of coordination with existing state and local sales taxes, would likely lead to pressure to conform state and local sales taxes to the federal base, and could constrain the ability of state and local governments to retain the existing level of reliance on sales taxes or to achieve increases in sales taxes that might be judged necessary in the future, and

WHEREAS, at least one announced proposal for a comprehensive federal consumption tax contemplates its administration by the States on behalf of the federal government, and

WHEREAS, some proposals for enactment of a comprehensive transactional tax on consumption contemplate such a tax as a complete substitute for federal corporate and personal income taxes, and

WHEREAS, elimination of the federal corporate and personal income taxes would eliminate federal income tax legal frameworks, definitions, income information reporting, tax withholding and tax auditing upon which States depend critically for cost-effective enforcement of their own taxes and thereby raise critical issues concerning the cost and feasibility of instituting these requirements and activities at the state level, and

WHEREAS, other proposals for comprehensive reform of the federal personal income tax base, the substitution of a consumed-income tax for the personal income tax, and the substitution of a business activities tax for the federal corporate income tax would, given widespread conformity to federal tax bases, similarly lead to major transitional adjustments in state tax policy and administration, and

WHEREAS, some proposals for overhaul of the personal income tax raise issues unique to States, such as a potentially greater share of the consumed-income tax base becoming subject, not to deferred taxation at the time of consumption, but rather permanent exemption if consumed in a non-taxing State, and

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WHEREAS, in sum, all of the major extant proposals for comprehensive federal tax reform have major implications for the ability of States to retain their current tax policies and systems of tax administration, and

WHEREAS, the proponents of these proposals have given virtually no indication that they are aware of their potential implications for States, and

WHEREAS, interstate compacts represent a partnership approach between Congress and the States that could be the means for coordinating overlapping federal and state taxes that is the most consistent with the balance of power within our federal system of government

NOW, THEREFORE, BE IT RESOLVED, that the Multistate Tax Commission respectfully calls upon the Congress of the United States to consider fully the potential impact on state tax policy prerogatives and state tax administration of all proposals for comprehensive tax reform that it may consider, to consult fully regarding these impacts with all relevant organizations of state officials, including the Multistate Tax Commission, prior to the mark-up of any such legislation, and to devote at least one hearing on any such piece of legislation to its potential impact on state taxation, and

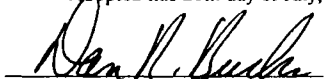
BE IT FURTHER RESOLVED, that the staff of the Multistate Tax Commission will analyze all of the major proposals for comprehensive reform of the federal tax system that are offered during the next several years and advise the Member States with regard to their impact on the ability and cost to the States of retaining their current systems of taxation, and

BE IT FURTHER RESOLVED, that the Multistate Tax Commission will seek to coordinate and serve as a clearinghouse for research by Member State revenue agencies on the impacts of the various tax overhaul proposals, and

BE IT FURTHER RESOLVED, that the Multistate Tax Commission will work diligently to bring before the U.S. Congress and other state government organizations all information available to it concerning the impact of federal tax overhaul proposals on state taxation and to ensure that Congress considers these impacts in its consideration of these proposals, and

BE IT FURTHER RESOLVED, that the Multistate Tax Commission shall study and consider carefully the potential for state administration of coordinated national taxes, including the use of an interstate compact as a legal vehicle, consistent with preserving state authority within the federal system, for establishing a coordinated system of national taxation within States participating in the compact.

Adopted this 28th day of July, 1995, by the Multistate Tax Commission.



Dan R. Bucks, Executive Director

Chairman ARCHER. Thank you, Mr. Bucks.

Mr. Lynch, would you proceed, please.

STATEMENT OF ARTHUR R. LYNCH, PRESIDENT-ELECT, GOVERNMENT FINANCE OFFICERS ASSOCIATION; AND DIRECTOR OF FINANCE, CITY OF GLENDALE, ARIZONA

Mr. LYNCH. Thank you, Mr. Chairman. Good afternoon. My name is Arthur R. Lynch and I am the president-elect for the Government Finance Officers Association. I am the director of finance for the city of Glendale, Arizona, Phoenix being one of our larger suburbs. We appreciate the opportunity to speak before you this afternoon.

Today, I want to describe to you how dramatically and prominently Federal tax policies are linked to State and local government finance in the areas of infrastructure and tax-exempt financing, public pensions and benefits, and also in State and local taxation.

Tax-exempt bonds will lose their unique standing as tax-exempt income under several of the reform proposals. The fiscal consequences of this change are an extremely serious matter. The State and localities will not be able to afford important projects, including federally mandated infrastructure facilities, without this proven source of below-market, low-cost financing.

Municipal bonds are the only debt instrument available to turn people's savings into schools, subways, tunnels, roads, and other infrastructure facilities. Remedying the infrastructure deficit should be one of our national priorities because of the fact that productivity improvements and national economic growth are tied to infrastructure investment. The infrastructure deficit particularly hurts businesses that rely on those public facilities to move their finished goods, to acquire supplies, to get things to the market, and to make a profit that can be reinvested.

Let me give you an example of some of the direct impacts that our citizens in the City of Glendale experienced. We just completed going to the financial markets with a bond financing. The tax-exempt rate on those bonds was a little below 5 percent. The cost to our city and, as a result, to our citizens was 5 percent plus the direct cost of issuance, the remarketing risk, and those other components that are passed on by the underwriting firms.

A taxable issuance of those very same securities would have resulted in an interest rate of approximately 2 percent higher, not only from the standpoint of the market rate but also to the city with the additional taxable costs of issuance that are there from having to tell the story about that particular bond. If those bonds are taken to the market as a special taxable issue, which we have done, they are usually at that higher cost, which means our citizens resultantly pay higher fees. Normally, that means that there is less opportunity to complete facilities, roads, and other infrastructure facilities which are needed.

Let me address the Federal tax provisions affecting the bonds. The Federal tax provisions that affect the bonds need to be changed, changed to reduce some of the regulatory complexity, to provide more flexibility for public-private partnerships, and to provide for other innovations. Low-cost tax-exempt financing should

not be forsaken, especially in light of Congress having created new mechanisms such as State revolving funds for financing wastewater and transportation issues.

Tax-exempt bonds are used to leverage the limited Federal contributions that go into these funds. I would like to also use an example from Glendale as we have used that type of financing. When we borrowed from the revolving fund to do wastewater projects, our interest rate was obviously subsidized or leveraged by the financial contributions. The interest rate was approximately 3.4 percent, whereas in a taxable market it would have been approximately 5.4 percent. On a $40 million deal, we were looking at what would have been an extra $800,000 in cost to our citizens if it was handled as a taxable deal.

The key point here is that the taxable market requires a higher rate of contribution in terms of interest, which also requires a higher Federal subsidy on those leveraged loan programs. What this means, translated to the average citizen that resides in our jurisdiction, is that there is less accomplished for the municipality in terms of the projects, which means less accomplished for them as citizens of both the locality and our Nation.

Tax reform will jeopardize the creditworthiness of State and local governments and could lead to municipal bond defaults if governments no longer have the revenues to pay their bondholders. Our revenue systems are so entwined with the Federal Tax Code that national reforms will throw many of these systems into chaos. I have included more detail about these issues in my written testimony.

One in particular is the loss of the income and property tax deduction. If it is eliminated, it would increase pressure on the States and localities to lower existing tax rates and would certainly make it more difficult to increase taxes to provide additional services in the future.

Let me now turn to my concerns about public pensions and benefit programs. State and local governments recognize the value of providing adequate retirement income for employees. Also, they provide health care for their employees and they take a very strong interest in Federal tax policies that support these programs.

Under all of the leading tax reform proposals, employee benefits would receive less preferential treatment than they do under the current law. Basically, the major impact is in three areas. Changes in the tax treatment of pensions and contributions will decrease the value of pensions to employees. The plan's sponsorship could decline, since there would be a higher cost and less affordability. And employees will have a stronger preference for wage income rather than the deferred pension income after reform.

As the health care providers of last resort, State and local governments also are concerned that proposals to tax employer-paid health insurance and individual health premiums may shift the payment of health care insurance from employers to employees. This could greatly increase the number of uninsured persons and our health care expenses, also.

One of the top problems and issues that has already been highlighted somewhat is that State and local governments might be taxed by the Federal Government. One proposal is to require gov-

ernments to pay a Federal excise tax based on the value of fringe benefits provided to government employees. As the Federal Government is turning more responsibilities over to State and local governments, it should not tax them.

The central issue of tax reform is one of who wins and who loses. Many of the reform changes would impose higher costs on State and local governments without providing resources or new mechanisms for dealing with those additional costs.

While there are some benefits associated with tax reform, we cannot conclude overall that it is a win-win for States and localities, and if it is not a win-win for States and localities, obviously, our constituents will also be sharing in the losing proposition.

Mr. Chairman, Members of the Committee, we welcome this opportunity to share our concerns with you, and we encourage you to call on State and local governments for assistance as you continue to review Federal tax policies.

Thank you, Chairman Archer.

[The prepared statement follows:]

Testimony

of

Arthur R. Lynch, President-Elect
Government Finance Officers Association
and
Director of Finance
City of Glendale, Arizona

on behalf of the

Airports Council International - North America
American Association of Port Authorities
American Association of School Administrators
American Public Gas Association
American Public Power Association
American Public Works Association
Association of Local Housing Finance Agencies
Association of Metropolitan Sewerage Agencies
Association of Metropolitan Water Agencies
Council of Development Finan. . Agencies
Council of Infrastructure Financing Authorities
Education Finance Council
Government Finance Officers Association
National Association of Counties
National Association of Higher Educational Facilities Authorities
National Council of Health Facilities Finance Authorities
National League of Cities
National School Boards Association
U.S. Conference of Mayors

and the following public pension organizations

National Association of Government Deferred Compensation Administrators
National Association of State Retirement Administrators
National Council on Teacher Retirement

concerning

The Impact on State and Local Governments of Replacing the Federal Income Tax

before the

Committee on Ways and Means
U.S. House of Representatives

May 1, 1996

Introduction

Good morning Mr. Chairman and members of the Committee. My name is Arthur R. Lynch and I am the President-Elect of the Government Finance Officers Association (GFOA), a professional association representing over 13,500 state and local government elected and appointed finance officials and other finance professionals. I come from Glendale, Arizona, where I serve as the Director of Finance. I am here today representing GFOA as well as the 18 other state and local government organizations and the following three public pension organizations listed below:

- Airports Council International - North America
- American Association of Port Authorities
- American Association of School Administrators
- American Public Gas Association
- American Public Power Association
- American Public Works Association
- Association of Local Housing Finance Agencies
- Association of Metropolitan Sewerage Agencies
- Association of Metropolitan Water Agencies
- Council of Development Finance Agencies
- Council of Infrastructure Financing Authorities
- Education Finance Council
- National Association of Counties
- National Association of Higher Educational Facilities Authorities
- National Council of Health Facilities Finance Authorities
- National League of Cities
- National School Boards Association
- U.S. Conference of Mayors

and the following public pension organizations:

- National Association of Government Deferred Compensation Administrators
- National Association of State Retirement Administrators
- National Council on Teacher Retirement

The purpose of this testimony is to provide a broad overview of the many and diverse possible impacts of tax restructuring on state and local governments, including cities, counties, retirement systems, school districts and other special districts and authorities. As you will see, the potential effects of various proposals are widespread and will affect many of the basic functions of state and local governments, including their ability to finance infrastructure and raise revenue. Anticipating and analyzing these effects will be important to Congress as it considers the many tax policy options it has to choose from in designing a new tax system. We intend to show how dramatically and prominently federal policies on taxation are linked to state and local finance. In particular, I will discuss the following possible outcomes of federal tax system overhaul:

- the loss of municipal bonds' unique standing as tax-exempt income,
- the loss of the only tool states and localities have for financing infrastructure,
- a decline in state and local government creditworthiness,
- erosion of retirement savings and health care coverage, and
- the imposition of new federal taxes and spending demands on state and local governments.

In spite of these possible developments, there are many state and local government officials who are supportive of federal income tax system reforms. Achieving simplification in tax compliance; stimulating economic growth aimed at increasing incentives for taxpayers to work, save and invest; and promoting fairness are indeed laudable goals. However, the question officials at each level of government should ask is if the undesirable and unintended consequences of tax reform are an acceptable price to pay for the promised, but perhaps unrealized, benefits of various replacement tax systems.

Municipal Bonds Will Lose their Unique Standing as Tax-Exempt Income

Municipal bonds lose their unique standing as tax-exempt income under a number of the replacement tax scenarios. If state and local governments lose access to this proven source of below-market, low-cost financing, they will not be able to meet their borrowing needs. Furthermore, the long-established preferential treatment for interest earned on bonds issued by state and local governments will be abandoned at a time when states and localities need more, not less, capacity to finance government programs. Municipal bonds are affected in the following three ways, and in each case, the preferential treatment that bonds now enjoy is eliminated:

- a flat tax is adopted and all investment income is exempt from income taxation,
- the current income tax system is modified and the exemption for tax-exempt interest is eliminated, and
- the income tax is replaced by a retail sales or other consumption tax and no interest income is taxed.

Analysts and observers agree that a change in the tax treatment of municipal bond interest will have an impact on state and local government borrowing. There is a difference of opinion, however, on what the impact would be. Some observers believe that yields on municipal securities would rise substantially and the value of outstanding bonds would fall, leading to increased costs of borrowing for state and local governments. Others maintain that lowering tax rates for all borrowers will offset the negative effects of tax reform on municipals bonds.

We understand the argument that is being made that post-tax reform interest rates will fall and state and local borrowing costs will be the same or lower even without the preferential treatment. However, state and local governments are concerned about the claim that rates will automatically come down if the proposals are passed. Market experts have suggested that interest rate sensitivity to tax code changes may be overstated and other factors influencing interest rates might stand in the way of a decline. These factors include

- the rate of inflation,
- the business cycle,
- overall borrowing needs,
- Federal Reserve policies
- the size of the federal budget deficit,
- interest rates in other countries, and
- rate of return expectations of tax-exempt investors and foreign investors who are not subject to the federal income tax.

The municipal bond market is an important source of capital financing and even the slightest upward adjustment in interest rates will cause a significant rise in borrowing costs over the

life of a bond. Generally, tax-exempt interest rates are approximately 20 to 30 percent less than taxable rates depending on a number of factors. If an A-rated government borrows $100 million for 30 years and its interest rate increases to a taxable equivalent from 5.9 to 8.6 percent, the interest it must repay increases by 57 percent.

With the loss of tax exemption, state and local governments will not be able to afford important projects, including those that are for federally mandated facilities. Questions also arise as to whether the impact of the loss of tax exemption will be shared equally by all municipal bond issuers or whether, small, infrequent borrowers would be more adversely affected than would large bond issuers. These borrowers might lose their access to the national capital market.

Without tax exemption, municipal interest rates would be expected to be higher than Treasury rates because municipal securities are riskier. It has been estimated that highly rated municipal bonds would pay a 30 to 50 basis point premium and lower-rated offerings of municipal issues could pay as much as 200 additional basis points, which is a full two percentage points higher. One potential benefit of the change in tax treatment of municipal bond interest is increased demand for state and local bonds by pension funds and other tax-exempt entities. Everything else being equal, this analysis might offer some encouragement for increased demand and lower interest rates; however, current municipal investors would be attracted to other credit markets if all investment income is treated in the same way so there might be a decline in their demand.

The fiscal consequences of the loss of tax-exempt bonds' unique status and higher borrowing costs are extremely serious matters for Congress to consider.

States and Localities Will Lose the Only Tool They Have for Financing Infrastructure

During recent years, there have been a number of studies that have estimated this nation's infrastructure needs and other studies that have shown the important relationship between infrastructure investment and productivity. Improved productivity creates jobs and incomes, makes the economy grow and spins off more income and savings that improve our standard of living. Municipal bonds are the only debt instrument available to turn people's savings into schools, subways, tunnels, roads and other infrastructure facilities. Low municipal bond rates are good public policy and tax-exempt financing accomplishes savings and investment, which is one of the important objectives of the tax reform effort.

The quantity of public capital infrastructure is inadequate and one doesn't have too look far to see crumbling infrastructure. Remedying the infrastructure deficit should be a national priority because national economic growth is tied to infrastructure investment. The infrastructure deficit particularly hurts businesses that rely on transportation facilities as well as other public facilities to acquire supplies, move finished goods to market and make a profit that can be reinvested.

Instead of destroying this special financing tool, Congress should be examining ways to make it better suited for tackling present-day infrastructure problems. Overregulation is the hallmark of tax-exempt financing and the bond provisions included in the Tax Reform Act of 1986 imposed oppressive regulatory requirements such as the arbitrage rebate on state and local government issuers. The regulatory regime that bond issuers must live with is a regulatory nightmare. Money spent on accountants, lawyers and rebate compliance staff in state and local governments should be put to more productive uses such as paying for infrastructure. The federal tax law needs to be changed, changed to provide flexibility for

public-private partnerships and other innovative techniques for making progress in public capital investment.

It is unthinkable for Congress to turn its back and walk away from the infrastructure deficit without providing some system of support for public capital infrastructure investment. Low-cost tax-exempt financing has not been able to provide all that is needed, but it should not be forsaken, especially now that Congress is creating new mechanisms such as state revolving loan funds that rely on state and local borrowing to leverage the limited federal contribution going into the funds.

The Creditworthiness of State and Local Governments Will be Jeopardized

Other aspects of tax reform will jeopardize the creditworthiness of state and local governments and could lead to municipal bond defaults if governments no longer have the revenues needed to pay their bondholders. The revenues of state and local governments are so entwined with the federal tax code that national reforms will reverberate throughout state and local government tax systems and throw many of those systems into chaos. Some examples of federal changes that will affect the ability of state and local governments to raise revenues are:

- changes in the mortgage interest deduction,
- changes in the property and income tax deduction,
- abandonment of the federal income tax,
- adoption of a federal retail sales tax, and
- adoption of a federal value-added tax.

Most local governments rely heavily on property taxes for the generation of revenue. If the home mortgage interest deduction were eliminated or limited, many analysts maintain this would cause real estate and property values to fall. If combined with the elimination of the property tax deduction, the effect on local property tax collections could be severe. Any noticeable loss in the value of homes will affect local governments, who nationwide rely on property taxes for 76 percent of their own-source revenues.

Many local governments will not be able to make up for this lost property tax revenue. According to a survey by the Advisory Commission on Intergovernmental Relations and the National Association of Counties, counties in 37 states have either state constitutional or statutory ceilings on either the property tax rate or the amount of property tax revenue. Local governments in many states also have to obtain voter approval for any increases in property tax rates.

The federal income tax deduction for state and local government income taxes is a long-standing feature of our system of fiscal federalism. This deduction prevents double taxation of income and builds fairness into the tax system by ensuring that taxpayers have the ability to pay their taxes. If this deduction were eliminated, it would increase pressure on states and localities to lower existing rates and would certainly make it more difficult to increase taxes in the future.

Many state and local income taxes are coupled with the federal tax system by using the federal tax base as the starting point for calculating their income taxes. If the federal income tax is eliminated, many governments may not be able to maintain their income tax and would need to explore other legal options. Clearly, if such changes occurred, a lengthy transition period would be needed for states and localities to make adjustments in their revenue

systems--and in some instances, they might have to go to the legislature to obtain legal authority to employ other sources. While not as common at the local level as the state level, an often overlooked point is that the income tax is a significant source of income for a number of local governments. In a similar vein, if the federal estate tax is repealed, as is proposed, states that rely extensively on the federal estate tax for their own death tax base most likely would have to abandon their own death tax revenue source.

Elimination of the federal income tax in favor of a national retail sales or another consumption tax would create a whole host of problems for state and local government sales tax systems. A national retail sales tax would preempt a state and local government revenue base and restrict the tax policy options of these governments. Most certainly, these governments would be required to conform to the federal tax base and they would lose their discretion to do as they now do and exempt certain transactions for public-policy purposes. Centralization of tax administration at the state level is expected to occur so that only one level of government is collecting the taxes. If states are asked to take on more administrative duties, they must be compensated fairly by the federal government for their services.

There are two particularly worrisome developments that are likely to occur if a federal retail sales tax is adopted. More tax evasion may be the result of the high retail sales tax rate brought about by the aggregation of local, state and federal sales tax rates. A powerful financial incentive will exist to avoid taxation altogether. Additionally, states and localities would be limited in their ability to raise their sales tax rates in the future because of limited tax headroom. Since all taxes are ultimately paid from the same pockets, an increase in federal tax collections would make state and local collectors less welcome.

Through the years, there has been considerable debate as to which would be the more desirable addition to the national tax system--a value-added tax (VAT) or a retail sales tax. For state and local governments, both options present problems. As with a federal retail sales tax, there is the concern that states and localities might find it more difficult to increase sales taxes. Another issue we believe needs to be given considerable thought is the tax treatment of state and local government services.

Recently, GFOA asked Association members from Canada to share some of their experiences with the implementation of the Canadian version of a value-added tax that went into effect in 1991. Local government services are not subject to the Goods and Services Tax because of the enormous difficulty involved in assigning a "price" for these services. Instead, local governments are treated as the ultimate consumer of their own services and the tax is imposed on the governments. Before selecting this approach, two others were considered: levying the federal VAT on local property taxes or having the local governments assess the value of their services, pay the tax and then collect the amount of the tax from the public. Local governments were able to obtain a rebate for a portion of the taxes they paid on their purchases from firms. However, Canadian local government officials noted that the complexity involved in obtaining a rebate is "horrendous" because of the administrative burdens.

In designing a VAT, Congress should consider these very complex issues and take into account the fact that states and localities might want or need to piggyback on to a federal VAT because of the disruption to their own tax systems caused by elimination of the federal income tax. Once again, we emphasize the fiscal dependency of our federal, state and local tax systems and the absolute necessity for public officials at all levels of government to be involved in tax reform discussions.

Finally, transition difficulties abound if a new federal tax system is adopted. While there

may be ways to ease these problems, they invariably add complexity and delay the benefits of the new tax system

Retirement Savings and Health Care Coverage Will Be Eroded

State and local governments recognize the value of providing for an adequate retirement income and providing adequate health care for their employees. It is for this reason that they have taken a strong interest in federal tax policies that provide incentives to stimulate retirement savings and promote health care coverage as well as federal programs to encourage private citizens to plan and save for retirement.

Under all of the leading tax reform proposals, employee benefits would receive less preferential treatment than they do under current law. If, as some believe, tax benefits are the driving force behind the size and formation of health and pension plans, then the tax restructuring proposals could create a serious concern for these employee benefit systems, impacting all employers and employees, including state and local governments and their employees.

Pensions --The value of pensions to employees is likely to decrease for two reasons. First, many of the proposals would effectively place all individuals' savings on a equal footing with amounts deferred under qualified pension plans. Second, contributions to pension plans might be included in the employees' current income, which is taxable. The overall effect on existing plans is uncertain, but there may be some preference for more current income (wage income) over deferred income (pension contributions) by employees.

If there is a decline in plan sponsorship due to federal tax policy changes, it is more likely to occur in the private sector where federal regulations are more onerous and where the profit motive may be stronger than the desire to achieve universal coverage for employees. There is some concern that the expected erosion in private sector pension contributions could spillover and affect state and local governments. To attract qualified employees, and compete with private employers, governments might consider scaling back pension benefits to provide a more attractive compensation package that gives greater emphasis to wages than to pensions.

The effect of decreased plan sponsorship may actually have the exact opposite effect than is desired under the reform proposals. Aggregate national savings may actually decrease even under a new tax system that encourages personal savings. Some employees might increase their personal savings, but the overall savings of lower-paid employees is likely to dwindle. This would occur if employers were not making pension contributions for these employees and the employees did not have the personal resources to offset the loss of their employers' contributions. If this occurs, there will be increased pressure on all governments to provide a safety net for their citizens who do not have adequate retirement incomes.

Health Benefits -- The advantages for health benefits are diminished under the tax proposals as well. For individuals, some of the tax alternatives would implicitly tax employer-paid health insurance as part of an individual's income and/or would tax individual health premiums. Regarding employers, most of the tax alternatives would no longer allow a deduction for employer-paid health insurance or any other fringe benefit. While the deduction does not apply to state and local governments, some proposals include an excise tax on certain benefits provided by tax-exempt entities. All of these considerations provide a disincentive for private and public sector employers to provide adequate health benefits to employees.

If the value of health insurance premiums is included in taxable income, coverage would be more expensive and all employers, private and public, would be expected to incur higher insurance costs and pass those higher costs on to employees as lower wages, higher employee premiums or less generous coverage. Health insurance rates for all purchasers also would increase due to individuals purchasing more individual coverage to make up for lower coverage from their employers. These individual purchases would increase average rates for all purchasers, including state and local governments.

While it is difficult to determine the full extent to which employee benefits will be affected by any new tax structure, Congress and the Administration need to be aware of the broad-based implications. They should also consider the possible impact on public programs, such as public hospitals, Social Security and Medicare. If individuals fail to take advantage of the new tax system to save the required amounts, and/or employers are less inclined to provide retirement and health benefits, federal entitlement programs and services may be significantly impacted.

New Federal Taxes and Spending Demands Will Burden Governments

On top of the problems and issues we have already highlighted, state and local governments may be burdened with new spending demands as a result of tax restructuring. The loss of tax-exempt financing for nonprofit organizations and the elimination of or reductions in the charitable deduction would be expected to increase pressure on state and local spending. Charitable organizations provide services that might otherwise fall to government. Another potential new cost is related to health care. The loss of the employer deduction for health care benefits may shift the payment of health care insurance from employers to employees. In turn, this might greatly increase the number of uninsured persons and put new pressures on the health care expenses of states and localities, who serve as health care providers of last resort.

Under various proposals, state and local governments would be required to pay new federal taxes. Just as the federal government now exempts states and localities from the federal income tax, they should be exempt from any new federal retail sales or value-added tax. With respect to the value-added tax, state and local governments should not have to pay it themselves and they should be able to obtain a rebate for taxes paid at earlier stages of production that affect the prices paid for their purchases.

A particularly bothersome proposal is the new excise tax that would be imposed on state and local governments and other tax-exempt employers under a flat tax. The tax would be based on the value of fringe benefits paid to employees of these organizations and is intended to put these employers on a level playing field with private sector employers who would lose their deduction for fringe benefits. As the federal government is turning more responsibilities over to state and local governments, it should not be taxing those entities and impeding their ability to finance new responsibilities.

Concluding Remarks

The central issue of tax reform is who wins and who loses. As we have shown, many of the reform changes would impose higher costs on state and local governments without providing resources or new mechanisms for dealing with these higher costs. While there are some positive impacts for state and local governments associated with tax reform, we cannot conclude that overall it is a win for states and localities.

Congress should carefully examine all of the impacts and if it proceeds with tax overhaul, it should find ways to ease the financial burdens states and localities will experience. As an example, it should examine the appropriateness of other federal laws in light of a new tax system. One candidate is the federal law that prohibits states and localities from taxing interest earned on federal securities.

Mr. Chairman and members of the Committee, we welcome this opportunity to share our concerns with you and encourage you to call on state and local government officials and their organizations for assistance as you continue to undertake your review of federal tax policies.

Chairman ARCHER. Thank you, Mr. Lynch.

Ms. Doxtator, welcome to the Committee. If you will identify yourself, you may proceed.

STATEMENT OF DEBORAH DOXTATOR, CHAIRWOMAN, ONEIDA TRIBE OF INDIANS OF WISCONSIN

Ms. DOXTATOR. Good afternoon, Mr. Chairman and Members of the Committee. My name is Deborah Doxtator and I am the chairwoman of the Oneida Tribe of Indians of Wisconsin. We are a member of the nation of the Iroquois Confederacy from which this American Government learned the concept of a government of, by, and for the people. We are proud that our model of governmental checks and balances, upper and lower houses, and separations of power became the foundation for the America which we now all enjoy.

We are also pleased that you acknowledge that our government and the treaties under which we have forged our relationship continue. On behalf of our 13,000 Oneida citizen members and our nearly 4,000 employees, I am honored to speak before you today.

It pleases me that this Committee understands that we are not simply a race of downtrodden. We are not simply an American minority. We are, and since the founding of this country have consistently been, a federally recognized governmental entity. As such, we come before you today to express our views on the tax proposals currently being considered.

It is important that Congress clearly understand the unique problems of Indian country before restructuring the Tax Code. Tax reform without this understanding could cause the already horrendous economic conditions in Indian country to become even worse. Any new tax structure should allow for the favorable treatment of income which is used for health care, education, and housing.

It is also imperative that Indian tribal governments be given every opportunity to provide for the needs of their membership, just as any State or local government would. Each bill should recognize the need for tribes to utilize tax-exempt financing methods and their ability to impose taxes of their own.

In brief, in Indian country, the unemployment rate was at 56 percent in 1990 and on some reservations it exceeds 85 percent. Of the 2 million American Indians and Alaskan natives in the United States, 605,000 live below the poverty level. The median family income of all American Indian families was $21,750, compared to $35,225 for all American families in 1990. The on-reservation per capita income level was $4,478, compared with $8,328 for all Americans in 1990.

As established under Revenue Ruling 67–284, Indian tribal governments are not subject to Federal taxation on their income. Tribal agencies and enterprises, depending on how they are organized, share the same exemption from Federal taxation on their income as the tribe itself. However, Indian individuals who reside and work on the reservation where they are members are subject to Federal income taxation unless a Federal treaty or statute provides an express exemption.

Unfortunately, several taxes which States are exempt from paying, including unemployment and insurance contribution taxes,

were not listed as a part of this act. We strongly believe tribes should be able to enjoy the same immunity from Federal taxation that Congress has given to the States and we hope that Congress would use this opportunity to correct this inequity.

The Committee has asked that I focus on how the proposed replacement systems offered by various Members of Congress would impact Indian tribal governments. Although it is difficult to address the advantages and disadvantages of each of the proposed bills, I can outline some general themes based upon the ways in which Indian tribal governments currently function and how these changes might impact individual Indian people.

In regard to the flat tax proposal, the treatment of tribal governments and tribal-owned agencies and enterprises under the tribal flat tax is opaque. The Armey flat tax proposal contains a blanket exemption from the business tax for an activity of a governmental entity. We would propose that this section of the bill be clarified to include an express exemption for Indian tribal governments and their subdivisions.

The Armey flat tax would apply a flat 17-percent rate to wages and pension distributions received by individuals. It is important to note that Indian tribes, as employers, are currently not eligible to offer salary-deferred pension plans to our employees. We encourage Congress to move on legislation allowing tribes to utilize 403(b) and 401(k) plans.

The family living allowance appears to be within reason when considering the per capita income levels of Indian people overall. Under this plan, a single head of household with three children would be able to earn $29,000 before the tax would begin.

In an effort to encourage non-Indian businesses to locate on reservations, we would suggest that section 102 of the bill, which imposes a tax on business activities, include a provision to allow taxes imposed by an Indian tribal government to be considered cost-of-business input. This designation has been given to taxes imposed by all other forms of government except tribes.

Regarding the national sales tax, these bills would impose a 15-percent national retail sales tax on the use, consumption, or enjoyment of any taxable property or service. State and local governments would not receive an exemption from the sales tax, according to the House version of the bill. Clearly, any tax structure which imposes a sales tax on an Indian tribal government will not be supported by tribes. These governments engage in various enterprises in an effort to generate funds to support the needs of their citizen members and are often the largest, if not only, employer on a reservation.

Imposing a tax on Indian tribal governments will decrease available funds for services and programs. Such a tax would create a hardship on a significant percentage of the tribal governments and impair the ability to meet the needs of our communities.

Finally, the House bill would call upon the States to enforce the sales tax. Historically, States have had little jurisdiction over matters occurring on Indian lands and tribal governments would oppose expanded State jurisdiction within the boundaries of a reservation. Tribes would prefer to either collect the taxes on sales within the boundaries of a reservation and forward those tax reve-

nues to the Federal Government or compact with a State or local government for the collection of such taxes within the boundaries of the reservation.

Regarding the consumption-based tax, this proposal offered by Senator Domenici provides no exemption for tribal governments or tribal entities from its consumption-based business tax. States and local governments are exempt from taxation on any gross profits derived from the exercise of any essential government function. Only mass transit and public utility services are treated as essential government functions. However, the government of any possession of the United States is exempt from any tax on gross profit earned by that possession.

Section 252 of the bill states that the governmental entities are subject to tax on any business activity of a type frequently provided by business entities. Again, tribes would be severely impacted by such a broad determination. At a minimum, the term "frequently provided" must be defined to consider the unique nature of Indian tribal governments and where they are located. Oftentimes, activities are not carried out on reservations unless provided for by the tribal government.

Mr. Chairman, due to the ambiguities of the status of Indian governments in these proposals, it is obviously difficult for us to give specific guidance to the Committee on which avenue of reform would be most beneficial and appropriate. It must be clear, however, that the unique status of Indian nations under 200 years of Federal Indian law and Federal policy must be considered as serious reforms are undertaken.

Because the elected leadership of our Nations must also be responsive to the needs of our constituents, the services which we provide when meaningful revenue can be secured closely mirror those of other more familiar levels of government, and because the range of need in most of our communities is so vast, I call upon the good offices of your Committee to include favorable language toward these governments and their constituents.

Taken broadly, we would be supportive of provisions that acknowledge Indian governments as governments and not within other categories of tax consideration. We ask that consideration be given to Indian governments regarding pensions and related benefits and acknowledgement of the appropriateness of their inclusion in the section 102, cost of business inputs opportunity.

Last, we would encourage the Committee to consider the recommendations offered by Senator McCain in S. 1306. These provisions would help alleviate problems associated with tax-exempt bonding.

Mr. Chairman, I thank you very much for this opportunity.

[The prepared statement follows:]

Oneida Tribe of Indians of Wisconsin

Post Office Box 365

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Oneidas bringing several hundred bags of corn to Washington's starving army at Valley Forge, after the colonists had consistently refused to aid them.

UGWA DEMOLUM YATEHE Because of the help of this Oneida Chief in cementing a friendship between the six nations and the colony of Pennsylvania, a new nation, the United States was made possible.

Testimony by Deborah Doxtator
Chairwoman of the Oneida Tribe of Indians of Wisconsin
Before the House Committee on Ways and Means
May 1, 1996

Good morning Mr. Chairman and members of the Committee. My name is Deborah Doxtator, and I am the Chairwoman of the Oneida Tribe of Indians of Wisconsin. We are a member nation of the Iroquois Confederacy from which this American government learned the concept of a government of, by, and for the people. We are proud that our model of governmental checks and balances, upper and lower houses, and separations of power, became the foundation for the America which we now all enjoy. We are also pleased that you acknowledge that our government and the treaties under which we have forged our relationship continue. On behalf of our 13,000 Oneida citizen members and our nearly 4,000 employees, I am honored to speak before you today.

Mr. Chairman, the same government-to-government relationship which held us back until the 1970's has finally enabled us to take our rightful place in the governmental arena. Although America, as often expressed by Senators Inouye and McCain, has yet to approach its obligation to the Indian nations under treaty and law, some of our nations are at last generating governmental revenue to offset part of that deficiency. These governmental revenues, our primary form of taxation, come to our nation and are returned in services, community development, employment, and our first hope in one hundred and fifty years for a secure future for our seven generations.

Our nation now has a beautiful new school and child care centers, a library, a museum, a nursing home, affordable homes including elderly units, and a facility for our Commission on Aging. We provide a police department that is cross-deputized and offers services within and outside of the reservation, comprehensive social services programs, and we are at last approaching a viable level of health care. This is all accomplished outside of state and local tax dollars.

Infrastructure development, including the building of new roads, water towers, extension of a sewer system, and the evolution of a nearly comprehensive department of public works, have dramatically improved the quality of life for area Indian and non-Indian residents. Oneida governmental revenue has allowed us to offer a minimum wage of nearly eight dollars per hour to our Indian and non-Indian employees. It has enabled us to impact dramatically on the negative conditions that were pervasive on our reservation.

As you understand, these governmental revenues are our primary "tax." Without meaningful revenue we would be unable to approach the level of needs of our constituencies. We would likely return to the impoverished conditions that existed only twenty years ago. We would again become reliant on dwindling external funds. Although we would continue to have the rights and authorities which we now exercise, it would simply be as it was before--in the absence of a legitimate budget, governmental services cannot be provided in legitimate ways.

Because many members of Congress have not had the benefit of learning about the actual history of America and its ongoing relations with the Indian nations, and therefore have (like most Americans) sometimes relegated us to historical phenomena, I am most encouraged that this committee has acknowledged the ongoing relationship and our governmental status. It pleases me that this committee understands that we are not simply a race of downtrodden, we are not simply an American minority, we are, and since the founding of this country have consistently been, a federally-recognized governmental entity. As such, we come before you today to express our views on the tax proposals currently under consideration. We do so as partners in America's growth, and as elected representatives of a body of people who have long been forgotten in the American panorama.

TRIBAL GOVERNMENTS AND THEIR SUBDIVISIONS

Indian tribes are one of the three sovereigns mentioned in the United States Constitution, the other two being the states and the federal government. Tribal sovereignty and authority predates the Constitution, and tribal authority is not restricted to the Constitution and how

that document relates to the States and the federal government. To date, tribes possess all aspects of sovereignty which have not been withdrawn by treaty or by federal statute. Accordingly, tribes enjoy sovereign immunity from suit similar to that of the Untied States, albeit somewhat more limited.

In general, agencies and enterprises of an Indian tribe are equivalent to the tribe itself. As such, the immunity extended to a tribe also extends to each of the agencies and enterprises created by the Tribe. Tribal agencies and enterprises can be federally chartered, state chartered, or organized as a tribal corporation. The sovereign immunity of the agency or enterprise varies depending on how the entity is organized.

FEDERAL INCOME TAX

As established under Rev. Rul. 67-284, Indian tribal governments are not subject to federal taxation on their income. Tribal agencies and enterprises, depending on how they are organized, share the same exemption from federal taxation on their income as the tribe itself. (Rev. Rul. 94-16; Rev. Rul. 81-295.) However, Indian individuals who reside and work on the reservation where they are members are subject to federal income taxation, unless a federal treaty or statute provides an express exemption.

There are two areas where Congress has granted an express exemption from federal income tax to individual Indians: 1) In accord with the Just Compensation Clause of the Fifth Amendment, Congress has exempted from taxation any federal money received by an Indian as compensation for the taking of property; and 2) Congress has exempted from federal taxation all income earned directly from an Indian's trust allotment, such as revenue generated from the sale of timber from lands which have been assigned by the federal government to an Indian person. (Squire v. Copoeman (1956))

Again, in summary, revenues generated by the tribe and used to support the activities of the tribe are not subject to the federal income tax, but all earnings received by individuals who work for the tribe or for any of the tribe's agencies or enterprises are subject to the federal income tax. The unique status of Indian nations would best be characterized as "non-taxed" entities rather than "tax-exempt" or "charitable" entities.

Treatment as a State

With the passage of the Indian Tribal Governmental Tax Status Act of 1982, Congress confirmed that tribes were to be treated as states for certain tax related purposes. This treatment is for purposes of any refund or credit, and for purposes of any exemption from, or payment of, certain federal excise taxes. This treatment allows the tax-free purchase or use of certain articles. However, two conditions must be met by the tribe: 1) The transaction must involve the exercise of an essential governmental function, and 2) The use of the article must be for exclusive use of the tribe in that essential governmental function.

Unfortunately, several taxes which states are exempt from paying, including unemployment and insurance contribution taxes, were not listed as a part of this Act. We strongly believe tribes should be able to enjoy the same immunity from federal taxation that Congress has given to the states and we hope that Congress would use this opportunity to correct this inequity.

One of the more critical areas of tax treatment is that which allows Indian tribal governments to be treated as states for tax exempt financing purposes. In this case both the tribe and any recognized political subdivision of the government which will utilize such funds for a substantial governmental function may engage in this activity. The Oneida have utilized this provision of the law to provide financing for the construction of a school, water and sewer development, a parking facility, and construction of roads. These projects were backed by the Tribe's revenue sources. No additional collateral (such as governmental guarantees) was needed.

Unlike our state and local counterparts, Indian tribal governments generally may not issue tax exempt private activity bonds. The debt is taxable and considered "private activity" if: 1) more than 10% of the proceeds of the debt will be used by or for the benefit of any private business, and 2) more than 10% of the debt is directly or indirectly secured by, or payable from, private sources. Please note that use by the federal government or an agency, such as the Bureau of Indian Affairs, constitutes "private" use. This prohibition not only reduces our ability to attract private enterprise to our reservation, but limits our ability to construct buildings to house the services we receive from the federal government.

TRIBAL TAXATION

Indian tribes, as sovereigns, have an inherent right to tax their membership and those non-members who choose to enter the reservation and enjoy the benefits offered by the tribe. Courts have held that tribes can tax the personal property held by a non-Indian located on the reservation, it can tax sales made on the reservation by non-Indian business owners, require non-Indians to purchase tribal licenses to do business on the reservation, and tax non-Indians on the

value of their leasehold interest tribal lands.

RESERVATION ECONOMIC AND SOCIAL CONDITIONS

It is important that Congress clearly understand the unique problems of Indian Country. Any new tax structure should allow for the favorable treatment of income which is used for health care, education, and housing. It is also imperative that Indian tribal governments be given every opportunity to provide for the needs of their membership, just as any state or local government would. Each bill should recognize the need for tribes to utilize tax exempt financing methods and their ability to impose taxes of their own.

The economic statistics in Indian country continue to be grim. In America today, there are 93,000 homeless or underhoused American Indians. Unemployment rates on reservations continue to exceed 40% and on some reservations it exceeds 85%. Of the 2 million American Indians and Alaska Natives in the United States, 605,000 live below the poverty line.

The results of poverty are further reflected in yet other statistics. Nine of the ten largest reservations, where 218,000 of 437,000 reservation Indians live, have each experienced an increase in poverty since 1980. For the country as a whole, the percentage of Indians living on reservations who live below the poverty rate has increased from 45 percent of the population in 1980 to 51 percent today. Indian teens have a suicide attempt rate four times higher than other groups. Indians have the highest rates of fetal alcohol syndrome, tuberculosis and diabetes in the U.S. Indian people have a higher rates of accidental death and shorter life spans than any other ethnic group.

TAX RESTRUCTURING

The Committee has asked that I focus on how the proposed replacement systems offered by various members of Congress would impact Indian tribal governments. Although it is difficult to address the advantages and disadvantages of each of the proposed bills, I can outline some general themes based upon the ways in which Indian tribal governments currently function and how these changes might impact individual Indian people.

1. Flat Tax

The treatment of tribal governments and tribal-owned agencies and enterprises under the Flat Tax is opaque. The Armey flat tax proposal contains a blanket exemption from the Business Tax for any activity of a governmental entity. We would propose that this section of the bill be clarified to include an express exemption for Indian tribal governments and their subdivisions.

The Armey Flat Tax would apply a flat 17% rate to wages and pension distributions received by individuals. It is important to note that Indian tribes as employers are currently not eligible to offer salary deferred pension plans to our employees. We encourage Congress to move on legislation allowing tribes to utilize 403(b) and 401(k) plans.

The "family living allowance" appears to be within reason when considering the per capita income levels of Indian people overall. Over half of all Indians below the poverty line are children under the age of five. Under this plan, a single head of household with three children would be able to earn $29,000 before the tax would begin. For the vast majority of American Indian people, the proposed allowance would be reasonable and appropriate.

In an effort to encourage non-Indian businesses to locate on reservations we would suggest that the section 102 of the bill, which imposes a tax on business activities, include a provision to allow taxes imposed by an Indian tribal government to be considered "cost of business inputs". This designation has been given to taxes imposed by all other forms of government except tribes.

2. National Sales Tax

These bills would impose a 15 percent national retail sales tax (RST) on the use, consumption or enjoyment of any taxable property or service. Under this legislation the seller of the goods or services must collect the tax. State and local governments would not receive an exemption from the sales tax, according to the House version of the bill. Tribal governments who are most in need would be hardest hit should this proposal be favorably considered. A far greater percentage of their revenue would be required for them to address the needs of their constituencies.

Clearly, any tax structure which imposes a sales tax on an Indian tribal government will not be supported by tribes. These governments engage in various enterprises in an effort to generate funds to support the needs of their citizen members and are often the largest, if not only, employer on a reservation. Due to the factors which control the ownership of reservation lands, tribes are often unable to attract private capital to reservation locations making non-tribal job

opportunities scarce in many, particularly isolated locations. High unemployment rates and low income levels impede tribes from creating a tax base within the reservation setting. Imposing a tax on Indian tribal governments will decrease available funds for services and programs. Such a tax would create a hardship on a significant percentage of the tribal governments and impair the ability to meet the needs of our communities.

Finally, the House bill would call upon the states to enforce the sales tax. Historically, states have had little jurisdiction over matters occurring on Indian lands, and tribal governments would oppose expanded state jurisdiction within the boundaries of a reservation. Tribes would prefer to either collect the taxes on sales within the boundaries of a reservation and forward those tax revenues to the federal government or compact with a state or local government for the collection of such taxes within the boundaries of the reservation.

3. Consumption Based Tax

The proposal offered by Senator Domenici (S. 722) would impose the USA Tax in two parts: 1) for individuals, it would maintain progressive tax rates (up to 40%), but would tax only income that is consumed; and 2) for business, it would impose a flat, low rate (11%) tax on gross profit less business inputs. All money put aside for savings would not be taxable.

S. 722 provides no exemption for tribal governments or tribal entities from its consumption-based Business Tax. States and local governments are exempt from taxation on any gross profits derived from the exercise of any essential government function. Only mass transit and public utility services are treated as essential government functions. However, the government of any possession of the United States is exempt from any tax on gross profit earned by that possession.

Section 252 of the bill states that governmental entities are subject to tax on "any business activity of a type frequently provided by (taxable) business entities." Again, tribes would be severely impacted by such a broad determination. At a minimum, the term "frequently provided" must be defined to consider the unique nature of Indian tribal governments and where they are located. Often times, activities are not carried out on reservations unless provided by the tribal governments.

Summary Thoughts

Mr. Chairman, due to the ambiguities of the status of Indian governments in these proposals, it is obviously difficult for us to give specific guidance to the Committee on which avenue of reform would be most beneficial and appropriate. It must be clear, however, that the unique status of Indian nations under two hundred years of federal Indian law and federal policy must be considered as serious reforms are undertaken.

Because the elected leadership of our nations must also be responsive to the needs of our constituents, the services which we provide--when meaningful revenue can be secured--closely mirror those of other more familiar levels of government, and because the range of need in most of our communities is so vast, I call upon the good offices of your committee to include favorable language toward these governments and their constituents.

Taken broadly, we would be supportive of provisions that acknowledge Indian governments as governments and not within other categories of tax consideration. We ask that consideration be given to Indian governments regarding pensions and related benefits, and acknowledgment of the appropriateness of their inclusion in the section 102, "cost of business inputs," opportunity. Lastly, we would encourage the Committee to consider the recommendations offered by Senator McCain in S.1306. These provisions would help alleviate problems associated with tax-exempt bonding.

Mr. Chairman, I thank you for this opportunity.

Chairman ARCHER. Thank you, Ms. Doxtator.

Let me, for the benefit of all who are within earshot or ability to read the record, make sure that this country knows that the Armey flat tax actually is a 20-percent tax in the first 2 years, anticipated to go down to 17 percent in the third year, provided economic growth is adequate to make additional revenues available. It is not a 17-percent tax but rather a 20-percent tax. I am not being critical of you, it is just that is the way it has been presented and it is not accurate to present it as a 17-percent tax.

Our next witness is Mr. Shafroth. If you identify yourself, you may proceed and we will be pleased to receive your testimony.

FRANK SHAFROTH, DIRECTOR, POLICY AND FEDERAL RELATIONS, NATIONAL LEAGUE OF CITIES

Mr. SHAFROTH. Thank you, Mr. Chairman. My name is Frank Shafroth and I am representing the National League of Cities, which is the largest and oldest organization representing the Nation's municipal elected officials. We represent approximately 140,000 municipal elected officials in some 17,000 cities and towns across the country.

We especially appreciate your leadership, Mr. Chairman, in calling for this hearing. We were concerned to be excluded from the Kemp Commission and so there was no local representation. We think the importance of recognizing the three-part Federal system we have of States, local governments, and the Federal Government is critical in the nature of tax reform.

Just to give you some idea of the importance of this issue to our membership, our board of directors voted last month to make this one of the five highest legislative priorities for the organization in 1996. That came just 3 weeks after our Election 1996 Task Force met in Wichita, Kansas. A key member of that commission is Hal Daub, a former member of your Committee. They made this one of the six critical issues where they will seek to have every member running for Congress, the Senate, and the two Presidential candidates address the impacts of tax reform proposals at the local level. What will it mean for the citizen in Houston or in Bellevue, Washington, not just for their Federal tax returns but for their State and local tax returns?

We think Federal tax reform could have profound impacts on local governments, local capital budgets, local kinds and levels of taxes, and local costs of borrowing. Sweeping changes of after-Federal tax income, potentially shifting much greater Federal tax liabilities to middle-income families in cities, could have local economic and sales tax impacts as these families suddenly find themselves with less disposable aftertax income.

Major shifts in how Federal revenues are raised could preempt traditional State and local revenue sources or could impose vast shifts in relative liabilities, imposing harsh penalties on many States and cities which have depended upon sales taxes, for instance, as compared to other cities and States that rely upon other sources of revenue.

Perhaps more importantly, and I think not well understood, cities by 1992 only received 3.5 percent of their total revenues from the Federal Government. Of increasing importance are State and

local tax revenues as they affect local budgets. Under the President's budget proposal, which the House Budget Committee could look at as early as tomorrow, the President has proposed reductions in programs affecting public capital investment in the range of 40 percent over the next 6 years, far increasing the importance of tax-exempt municipal bonds as the main source of more than 70 percent of public capital finance in the United States with those implications for the economy.

We share as an organization many of the concerns that some have with regard to tax reform about the low savings rates of Americans, the dissavings at the Federal level, and those provisions of the current Internal Revenue Code that encourage consumption and borrowing over savings and investment.

Finally, we hope that a serious look at Federal tax systems will enable your Committee to look at the generational consequences of our current system. We note that under either the proposal adopted by Congress and vetoed by the President last December or the President's proposal, the growth in entitlement spending for Americans over the age of 65 would grow at a rate of 16 percent over the next 6 years, continuing to accelerate the proximity of insolvency for both the Medicare and Social Security Trust Funds.

With regard to the specific systems, mostly I would like to focus on, and Mr. Chairman, we tried to provide a chart to look at the specific advantages and disadvantages of each of the major tax reform proposals. I have included a chart to attempt to set out the advantages and disadvantages for cities with these alternatives. Let me comment just briefly on two of the main alternatives, the flat tax and the national sales or consumption tax.

Looking at the flat tax, we think it has certain potential benefits for cities. Those benefits are that it could enhance State and local tax revenues for those States that are piggybacked on the Federal system. To the extent Federal tax expenditures are eliminated, those that piggyback might realize more income at the local level. We think it would discourage some of the efforts at avoidance, both of the legal kind you discussed, Mr. Chairman, and of the other kind. We think there will be relatively less disruption of the current system in place at the State and local level with some kind of a flat tax system.

Our belief is that the Tax Reform Act of 1986, which reduced tax expenditures by $200 billion, created a more simple code, lower rates, easier collection and enforcement, and a national perception of greater fairness to almost all taxpayers. Those are some of the pluses.

There are minuses. One I discussed and that is the elimination of the preference for tax-exempt bonds. Those would affect not only infrastructure, perhaps increasing the cost of roads, airports, highways, and other capital investment by as much as 30 percent at the State and local level, but also eliminating incentives for leveraging private investment for housing. The last form of low-income housing construction we have left is the low-income housing tax credit.

We have three other concerns in the flat tax area. For every winner, there is a loser. That is, if one person under a flat tax pays significantly less in Federal income taxes, someone else will pay

more, generally grouped by economic income. In the past 30 years, the relative level of per capita income has shifted dramatically between cities and suburbs, so a flat tax could have dramatically different impacts, depending upon where an American lives, with net results with total revenues for local governments.

Similarly, at least one major flat tax alternative, by taxing wages and benefits but not other forms of income, could exacerbate the generational concerns that we all have because it would mean retired Americans would be exempt from any taxation in the future. The full burden of taxpaying would fall upon citizens that worked. Again, that would have both geographical and generational consequences for Americans.

Let me turn briefly to the national sales tax. As with other proposals, we think any proposal that helps to discourage consumption, to discourage borrowing and encourage savings and investment, is a net plus for the economy for all three levels of government.

However, we think a national sales tax could have a more disruptive impact on cities than any other tax reform alternative. It would mark a major form of intrusion into a field of taxation heretofore almost entirely reserved to States and local governments. Perhaps most importantly, it would impose, I think one of my colleagues used the term "mother of all mandates," a significant collection and enforcement cost on State and local governments.

No two States have the same form of sales taxes. I think, Mr. Chairman, you will recollect the years we have spent between the Committee and the Internal Revenue Service trying to deal with gas tax avoidance by the Mafia, dealing with changes in the Code to require dying of certain kinds of fuel, with enormous difficulty, as we experienced this morning in your markup with determining who ought to be subject to that Federal gas tax. Does it apply to schools, to ambulances, to police cars? What kinds of public vehicles ought to be covered and what ought to be exempted?

Perhaps more seriously, in the national sales tax area, this is an area of enormous diversity amongst cities and amongst States. Under Mr. Schaefer's proposal, one could see citizens in cities in Alabama and Louisiana paying 40 percent on any services or products, as compared to citizens in cities in many other States paying only 20 percent, so vast geographic disparities.

Second, because of the nature of the application, one could see in, say, the Seattle, Washington, area, heavily dependent upon the export industry and the software industry, significantly lower Federal tax rates compared to, say, Detroit, that is almost uniquely dependent upon the domestic automobile industry.

So a national sales tax could have huge and disparate impacts on cities, depending upon the region of the country they are located, and dependent upon the relative income of the citizens of those cities.

I think a value-added tax is not very different from the perspective of local governments from a national sales tax. Again, that large disruptive impact of interfering with what has heretofore been a State and local source of revenue that the Federal Government has respected.

Finally and most briefly, on the USA tax proposed by Senators Nunn and Domenici, this has some similarity to the flat tax in that it preserves some form of an existing base that States and local governments could rely upon. It is clearly focused on savings and capital investment, which we like. It provides a modest incentive for tax-exempt municipal bonds not present in any of the other major alternatives. It does eliminate a lot of the current benefits in the Code that are critical for real estate, housing, and low-income persons in cities, and those raise concerns.

Generally, Mr. Chairman, that covers, I think, some of the key differences.

[The prepared statement and attachments follow:]

STATEMENT OF FRANK SHAFROTH, DIRECTOR
POLICY AND FEDERAL RELATIONS
NATIONAL LEAGUE OF CITIES

Mr. Chairman and members of the Committee, I am Frank Shafroth, Director of Policy and Federal Relations for the National League of Cities, the largest and oldest organization representing the elected leaders of the nation's cities and towns. We represent, directly and indirectly, nearly 140,000 elected municipal officials from some 17,000 cities and towns.

We appreciate the opportunity to present our views about the potential positive and not so positive effects of proposals to eliminate the federal income tax. We are especially grateful, Mr. Chairman, at your recognition of the importance of this issue to local elected leaders. Because of the interrelated nature of federal, state, and local tax systems; any changes at the federal level are certain to have major impacts at the local level.

Yet, given the nature of taxes, it is often hard to think about the consequences of federal tax changes when they actually hit the ground in San Marcos, Texas, or Bellevue, Washington.

Just to give the committee some idea of the relative importance of this issue of federal tax reform to our members, our Board of Directors voted last month to make federal tax reform one of the organization's five highest federal legislative priorities for 1996. Similarly, in February, our Election '96 Task Force, which includes a former member of your committee - Mayor Hal Daub of Omaha - selected federal tax reform as one of our highest priority issues for the 1996 Congressional and Presidential election campaigns. Our members want to ensure that candidates, the administration, and members of Congress take into account and consider the consequences of any tax reform plan at the local level. What would the likely impact be on local revenues, on local capital budgets, on local economies?

Federal tax reform could have profound impacts on local governments, local capital budgets, local kinds and levels of taxes, and local costs to borrow. Sweeping changes of after-federal tax income, potentially shifting much greater federal tax liabilities to middle income families in cities, could have local economic and sales tax impacts as these families suddenly found themselves with far less disposable income. Major shifts in how federal revenues are raised could preempt traditional state and local revenue sources, or could impose vast shifts in relative liabilities - imposing harsh penalties on many states and cities which have depended upon sales taxes, for instance, as compared to other cities and states that rely upon other sources of revenues.

Direct federal revenues to cities had declined to 3.5 percent of local revenues by 1992. Under the continuing resolution adopted last week, and under either the President's proposed six-year budget or the alternatives we expect the House and Senate Budget Committees to take up this week, this trend of a severely reduced direct federal role will increase. We anticipate that the President's budget proposal would reduce federal, public capital investment by nearly 40 percent over the next six years, hitting highways, bridges, airports, and other capital investment of great priority to all of our citizens. As the direct federal role has declined, cities have turned more and more to local taxes and fees to meet the priorities and needs of our citizens. Consequently, the health of local economies and avoidance of preemption or disruption of local revenue sources is critical to cities and towns.

Similarly, avoidance of major disruption of the ability of cities and towns to invest in public infrastructure, such as schools, prisons, highways, and water and wastewater facilities - mandated by the federal government - is a key concern. The main source of public capital investment today, outside of defense, is municipal bonds. Any proposal to disrupt or eliminate the incentives for this $1.2 trillion market could have severe, and long-lasting adverse impacts on the nation's economy because of the disinvestment it could lead to in facilities critical to growth and opportunity, not to speak of the 30 percent increases in water and sewer fees, airport taxes, tolls, and other forms of state and local revenue enhancements which would be required to maintain current levels of investment.

Like each of you, we have many concerns about the current system. Our budget and finance leaders will be meeting tomorrow in Austin, Texas, with leaders of the nation's state legislatures to begin our own re-examination of some of these issues, especially as they relate to investment, savings, and the national debt. For city leaders, many, many questions remain to be answered.

TAX REFORM

NLC supports the continued use of personal and corporate income as the primary federal tax base and a progressive rate structure that reflects a taxpayer's ability to pay. NLC opposes tax reform proposals which would exacerbate the federal deficit, increase the cost of municipal public capital investment, interfere with traditional state and local tax systems, or preempt the deductibility of state and local taxes.

But we share the concern of many at the low savings rates of Americans, the dissavings of the federal government, and those provisions of the current internal revenue code that encourage consumption and borrowing over savings and investment. We also remain concerned at the increasing tendency to look to the current code as a means of creating new federal entitlement expenditures, aggravating the federal deficit and long-term debt.

Consequently, we think proposals to modify the code which would discourage the growth of existing and creation of new federal tax expenditures could be a key step in addressing the longer term crisis the nation faces with regard to the debt and deficit.

Finally, we hope that a serious look at federal tax systems will enable your committee to look at generational consequences of our current system. Our view, consistently, is that as a nation we need to be investing in the future, not the past.

BACKGROUND

Nearly every candidate for the Republican Presidential nomination made tax reform a high priority in his platform. And Republican and Democratic leaders in the Congress have come forth with proposals which would make far greater changes in the federal tax code affecting the nation's cities and towns than ever before.

Not surprisingly, almost none of the candidates or Congressional leaders have talked about the potential impact of their proposals on state and local governments. For there, the disruption would be great -- not only for local governments, but also for taxpayers and citizens.

But What about the Federal System?

The federal tax system has become interwoven over the years with state income tax systems, as well as meshed with a federalism or intergovernmental quasi-cooperative system. That has meant, for instance, that the federal government has generally left the field of sales taxes to state and local governments. That is, Congress has chosen not to intrude upon a key revenue source traditionally reserved to state and local governments.

Similarly, states have structured individual and corporate income tax codes on the federal system.
That structure allows for greater simplicity for taxpayers, as well as better capacity to nab cheaters. That means, conversely, that federal changes have immediate and direct impacts on state and local revenues and budgets.

States and cities are barred by federal law from imposing income taxes on the interest earned by their citizens on Treasury bills or savings bonds. And the federal government, under the doctrine of reciprocal immunity, has not taxed the interest on the debt or bonds of cities and towns--so-called municipal, tax-exempt bonds.

For cities, that means that some $1.2 trillion dollars in outstanding capital borrowing is currently exempt from federal taxation. A loss or significant modification of that exemption, as proposed in every leading tax reform option, could have profound effects on the ability and cost of borrowing to meet capital and infrastructure needs of all cities and towns in the future. It could increase the cost of to states and local governments of public capital investment by as much as 30 percent.

With the General Accounting Office projecting that states and local governments currently need to spend in excess of $100 billion just on the rehabilitation and construction of public schools, an abrupt Congressional change affecting state and local borrowing authority could cost state and local taxpayers $30 billion - but result in no net additional benefit in an investment critical to the future of the nation.

These fundamental principles upon which federal, state, and local tax systems have evolved would all change under any of the proposals being bandied around in the Congress or by the 1996 GOP Presidential candidates.

What Are the Main Alternatives?

The candidates and Congressional leaders have basically offered three alternatives to the current federal income tax: a flat tax, a national sales tax, and a consumption tax.

The Flat Tax

The flat tax, most prominently supported by House Majority Leader Richard Armey (R-TX), former Presidential candidates Malcolm Forbes and Sen. Phil Gramm (R-TX), and the commission created by Senate Majority Leader Robert Dole (R-KA) and House Speaker Newt Gingrich (R-GA), would eliminate the current, graduated income tax on families and businesses and replace it with a 19 percent flat tax.

As Leader Armey says, one could compute one's taxes every year on a three-by-five card. House Minority Leader Richard Gephardt (D-MO) has indicated he supports a modified flat tax, but one with slightly graduated rates.

While all flat tax options are similar in that they would set one, single rate of federal-income taxes, they vary significantly with regard to how income would be defined and what deductions would still be available (See flat tax chart). Some would tax all income, others would tax only the income on wages and benefits. These are radically different approaches, especially with regard to generational impacts. What is common is that most would eliminate all or almost all deductions or tax expenditures.

Each of the flat tax plans would eliminate the deductibility of state and local taxes. Each would either eliminate the tax-exemption for municipal bonds or eliminate the current tax preference providing the exemption for state and local bonds, but not for corporate bonds.

Each would liminate deductions specifically incorporated in current federal laws to leverage private investment in cities, such as through Enterprise Zones, the targeted jobs tax credit, the low income housing tax credit, or the earned income tax credit.

Economists and accountants project that most of the flat tax plans would bring in substantially less revenue annually, increasing the federal deficit and national debt. A flat tax, by very definition, means that for every taxpayer who would owe less in federal income taxes, another taxpayer would owe more.

Municipal Perspective

A flat tax has potential benefits for local governments. The potential simplicity could enhance federal, state, and local tax revenues. There could be a reduction in efforts to "game the system" or to seek tax shelters. There would be relatively less disruption of the current system and the practice of states and local governments to piggyback on the federal code. Elimination of so many federal deductions could significantly increase state and local revenues based upon the federal system without any changes in state or local rates.

A flat tax could provide significant benefits through the curtailment of hundreds of billions of federal tax expenditures, eliminating both a significant source of revenue erosion affecting the federal deficit and national debt, as well as discouraging this method of "back door" spending. A flat tax could have the impact of putting all federal expenditure or spending decisions on one table, so that Congress could make more considered decisions about the allocation of resources. The nation saved more than $200 billion in tax expenditures as a result of the Tax Reform Act of 1986, simplifying the code, collection and enforcement, and providing a perception of much greater fairness for most taxpayers.

But for cities, a flat tax would create a number of downsides. The elimination of the deductibility of state and local taxes and any preference for municipal bonds would result in double taxation for most Americans and much higher state and local taxes to finance current public infrastructure investment. Under the current system, the federal internal code permits a deduction for state and local income and property taxes to ensure that a taxpayer does not have to pay taxes on income already deducted from his or her paycheck. The elimination of this deduction, as proposed in every flat tax alternative, would change a basic federalism principle of avoiding having different levels of government not tax each other.

Similarly, under the current doctrine of reciprocal immunity, states and local governments may not impose taxes on the interest earned on federal bonds, or on other properties or sales on federal reservations or properties, any more than the federal government has been able to tax the interest on state and local bonds.

Just as amending federal law to allow states and cities to tax the income on T-bills would increase the cost of borrowing to the federal government, so too the flat tax proposals would increase the cost of borrowing to local governments.

But, importantly, states and local governments borrow, not for operating, but for capital investment. The overwhelming amount of the nation's civil public investment is financed by state and local borrowing.

The consequences of eliminating that preference would be harsh in terms of discouraging and penalizing public capital investment and long term growth and productivity in the American economy.

The flat tax alternatives would terminate mortgage revenue bonds, the low income housing tax credit, enterprise and empowerment zone tax benefits, the targeted jobs tax credit, and other provisions Congress adopted to leverage private investment in cities and human capital. The low income housing tax credit has become, in this decade, the only source of construction financing for low income housing in cities. As the nation faces a time bomb with the expiration of nearly one million section 8 contracts over the next four years and no long-term budget authority at HUD to address the impacts on owners, assessed property values, and tenants; the Committee will need to think carefully about the potential impact on cities and towns with higher than average levels of poverty and economic distress. At a time when the nation confronts some of the greatest disparities ever measured, such eliminations could sharply accelerate this trend, especially when combined with the elimination of incentives for charitable contributions and 501(c)(3) non-profits.

The flat tax would also eliminate the mortgage interest deduction, one of the most expensive tax expenditures in the code. This elimination could affect the assessed property values of homes, forcing a reduction in property taxes at the local level. That, in turn, could force up business property taxes, or simply force up all property taxes at the local level to make up for the federal action.

In addition to the adverse impact on municipal public capital investment, flat tax approaches could discourage work and savings. Flat tax proposals to tax only pay checks and benefits would create incentives for corporate capital investment while discouraging jobs. At a time when we are all trying to encourage families to move from welfare to work, such a federal tax change would appear to frustrate a common purpose and goal of cities with the Congress.

Similarly, proposals to tax benefits would eliminate incentives for employers, including cities, to provide health care and retirement benefit plans. We are concerned at any proposal which might discourage savings and have long-term, adverse health consequences for employees and constituents.

Finally, we would note that one major branch of flat tax proposals, those which would tax only work and benefits, would further destabilize the generation problems we already confront. One needs only to look at the current, oncoming insolvencies we face in Medicare and Social Security to understand the vast disparities these systems impose solely on the basis of age.

If the Congress were to enact a flat tax that exempted all retirement income from federal taxation, it would add enormous new burdens on the current generation of workers-at a time when we already understand the burden for is unsustainable. We are apprehensive that the consequences for cities' economies and the national economy would be disastrous.

National Sales Tax

Sen. Richard Lugar, the former Presidential candidate, strongly opposes the flat tax and instead made a national sales tax a centerpiece of his Presidential bid. Lugar would replace the individual and corporate income tax with a national sales tax not just on goods, but also on services. Reps. Schaefer and Tauzin have proposed their own national sales tax alternative.

Lugar believes a national sales tax superior to a flat tax, because it would guarantee elimination of the IRS. Lugar says he envisions a system under which states would collect the new federal sales tax and send it to Washington. Like the flat tax, the national sales tax would eliminate all federal tax on the interest on corporate bonds, again eliminating the distinction, for investment purposes, between municipal and corporate bonds.

Municipal Perspective

As with a flat tax, a national sales tax could benefit cities and towns through the elimination of federal tax expenditures, dramatically reducing a major drain on federal revenues and the national debt. A national sales tax would discourage consumption and create an incentive for savings, perhaps altering Americans' current financial habits and providing for a much stronger capital base for the corporate sector. Any major change in national savings could increase corporate investment, making the nation's economic base and productivity more competitive compared to almost all of our economic adversaries. The stronger our national economy, the stronger local economies and revenues would likely be.

A national sales tax would eliminate the existing federal income tax bias towards disproportionate tax expenditures benefitting higher income Americans. There would be no discussion of the capital gains tax; there would no longer be disproportionate housing subsidies for Americans least in need. To that extent, Congress would have revenues, and Congress would make decisions on expenditure priorities through a more normal budget process. Every kind of housing expenditure, for instance, would be on one table, and Congress could more easily make determinations about how to spend federal resources.

But a national sales tax would have a more disruptive impact on cities than any other tax reform alternative. It would mark a major intrusion into a form of taxation heretofore almost entirely reserved to states and local governments.

It would impose enormous collection and enforcement costs on state and local governments. Because taxpayers at the state and local level have displayed such conflicting views and priorities about sales taxes, it would mandate changes disproportionately affecting every city in the nation - some where voters have been absolutely clear about the unacceptability of sales taxes from any level of government to some where sales taxes are the single greatest source of local revenues. Such a tax would mark an extraordinary preemption of state and local revenue authority. It would increase the cost to every city and town of public capital investment and the provision of services, such as schools, police and fire, and emergency rescue.

A national sales tax would force virtually every state to rewrite its tax code to replace current reliance on the federal income tax code. For cities, then, there would be a guaranteed double layer of disruption. But the disruption would go considerably further. For cities, sales tax revenues are the greatest source in states as varied as Louisiana and Alabama. But they are not collected by cities in many other states. Consequently, a federal sales tax would impose combined federal, state, and local sales taxes close to 40 percent in some cities compared to less than half that in others. Such a discrepancy would be certain to have consequences for tax collections at the local level, for retail merchants, and for jobs.

More broadly, a national sales tax would have widely disproportionate local consequences depending upon the types of corporate and retail businesses in any community. Where a Seattle might benefit because of the non-taxable export sales of Boeing and other users of its port facilities and its tax base reliance on the rapidly growing software and software service sector of its local economy, cities like Detroit, heavily dependent upon the domestic automobile industry, could face huge losses in automobile sales and consequent major losses in jobs, opportunities, and local tax revenues.

Much has been made of the value of eliminating the Internal Revenue Service that would be gained through a national sales tax. Little has been discussed about the creation of the huge, new enforcement agencies which would have to be created and financed by state and local governments to do the "dirty work" the federal government disposed. Some of you will remember the painstaking efforts of the Congress to deal with a relatively minute enforcement area of a national sales tax: the federal gas tax. Congress and the IRS have spent the better part of the last decade attempting to install control and enforcement measures to prevent the Mafia from selling gasoline to motorists and then absconding with the federal and gas taxes. In that process, we have seen statutory language adopted to dye gas. We have had intense discussions about which kinds of vehicles - from ambulances to garbage trucks to yellow public school buses - should be subject to the requirements and taxes.

The problem of cheating on federal gas taxes pales in comparison to the collection and enforcement problems inherent in converting to a national sales tax on a nation which has such a crazy patchwork, currently constructed on a system in which the federal government respects and defers in this area of taxation to cities, counties, and states.

In this larger context, we would note that the recent enactment of the Telecommunications Act of 1996 would further add to the difficulty of this as a national replacement tax. Our organization, and most of those testifying today, have testified on numerous previous occasions to propose changes in the Supreme Court *Bellas-Hess* decision to enhance state and local ability to collect sales taxes on out-of-state mail order catalogs. Now, with the age of the Internet, the ability of a citizen in Ames, Iowa to purchase an item from Auckland, New Zealand by the mere touch of a mouse renders sales tax collections a far more difficult prospect for all our levels of government. The world of retail sales is entering a revolutionary period with significant consequences for the shape and purpose of cities and commercial enterprises.

Finally, as with the flat tax proposals, a national sales tax would eliminate any preferences for municipal capital finance, for leveraging of private investment in jobs, housing, and opportunities in distressed areas of cities, and for state and local taxes. It would raise immense problems with regard to the direct federal taxation of local goods and services - what goods and services purchased by cities would be subject to such taxes; what goods and services provided by cities to their citizens would be subject to such taxes?

Without a federal income tax, there could be no provision for tax-exempt bonds. There could be no deduction for state and local taxes, for mortgage interest, nor tax credits for investments in enterprise zones, housing, or jobs. Because we already know the differences between so-called AMT municipal bonds and others, know the differences between Treasury and corporate bond interest rates, we can project increases in the range of 30 percent for the cost to cities to finance building a curb cut to meet ADA federal requirements, or a school, or a hospital. We can anticipate a reduction in assessed residential property values with consequences for local property tax realizations and budgets. We can anticipate that cities with citizens with higher than average disposable incomes would feel relatively less local revenue erosion than cities and towns with citizens with relatively smaller disposable income.

We have no way to anticipate how to finance the cost of collection and enforcement, which would appear to be one of the largest unfunded federal mandates ever inflicted by the federal government on state and local taxpayers.

Value Added Tax

From a municipal perspective, there is relatively little difference between a national sales and a value added tax. Both could entirely replace the current federal income tax relied upon by state and local governments. Both would penalize consumption and reward personal savings.

Heretofore, however, there has been little discussion of imposing a VAT collection and enforcement mandate on state and local governments, so that states and local governments could consider piggybacking on the federal VAT tax, but not have to incorporate

the immense costs associated with sales tax collection and enforcement. In addition, a VAT tax, through its more unique system of being built into the system at every step along the way, at least would create the appearance of avoiding a massive tax at the purchaser or retailer level, so that there might be less disruption at the local level.

But with respect to local revenues, disproportionate impacts on cities in different regions, municipal capital investment, and other adverse consequences of a national sales tax; the local consequences of a VAT would be similar.

USA Tax

Finally, Sens. Pete Domenici (R-NMEX) and Sam Nunn (D-GA) have put together a far more complicated proposal to replace the current income tax with a national consumption tax. Unlike either a flat tax or national sales tax, their consumption tax idea is complicated. Thus it has been drowned out in the discussion and debate so far.

The Domenici-Nunn effort arose out of their combined efforts to rethink how the federal government works, to address the deficit, and to focus on priorities for the future. Part of their concern was to change the focus of the federal tax system to ensure an incentive for investment and savings, and disincentives for borrowing and spending.

Basically, the consumption tax is intended to tax only income that a family or individual actually spends. That is, if a family received $3,000 for winning the lottery, and spent $1,000 for a vacation, $500 for a VCR, and invested the remaining $1,500 in a passbook savings account; the family would be subject to tax only on the $1,500 consumed. The remainder of the income would be tax-free--at least until it was removed from the account for spending or consumption.

Municipal Perspective

The USA tax, because it is focused on encouraging savings and investment, retains a modest preference for state and local public capital investment. It would preserve a federal income tax system, permitting states and cities to modify instead of rewrite existing revenue codes. It would not preempt or interfere with existing municipal or state tax systems.

As with all the other alternatives, the USA tax would discourage federal tax expenditures, promising important benefits over the long term for federal deficit reduction and, perhaps, resources to meet the looming insolvencies in the non-needs-tested entitlement trust funds.

But as with the other alternatives the committee is considering, the USA approach would significantly increase the cost to cities and local taxpayers of public capital investment and infrastructure. It would eliminate incentives to leverage investment in low income housing, jobs, and economic opportunities. It creates complexities which could bedevil the Congress and IRS for years in terms of determining the distinctions between consumption and non-consumption. Would payment for heart by-pass surgery be defined as consumption and taxable, but the purchase of a vacation home be defined as an investment exempt from federal taxation?

As with the other approaches, the USA approach incorporates no state and local impact analysis. It eliminates the reciprocal immunities and long history of respect between our three levels of governments' means and abilities to raise and collect revenues to provide facilities and services for the citizens.

What About Cities?

The national commission appointed by Leaders Dole and Gingrich included no municipal representative and no mention of local governments. It included no analysis of the impact on local taxes and fees, local budgets, or local capital investment costs of moving to a flat tax. No candidate in Iowa, New Hampshire, or anywhere along that tortuous campaign trail mentioned the impact of federal tax reform at the local level: what would it mean to local property, income, or sales taxes?

What would the impact be of Sen. Gramm's proposal to subject the holders of some $1.2 trillion in outstanding tax-exempt municipal bonds to a flat tax effective on the date of enactment?

We commend the committee, and you, Mr. Chairman, for holding this hearing. It is the first effort to begin to think about the most important consequences of change for the nation's citizens - all of whom live and work in cities, and all of whom pay taxes not just to the federal government, but also to states and municipalities.

The more information and analysis about the combined consequences of change, and the less ignorance, the better we are convinced the final changes will be.

NLC Policy:

Among NLC's principal tax reform policies are the following: preservation of municipal tax advantages such as deductibility of state and local taxes and retention of tax exempt interest on most municipal borrowings; continued use of personal and corporate income as primary tax base; a system which produces revenues sufficient to finance ongoing government services; no move toward a pure consumption tax but adjustment of current provisions that encourage consumption over savings; broadening of the tax base; changes to equalize the value of tax preferences to taxpayers and placing an overall limitation on total tax preferences which one taxpayer can utilize; a phasing-in of any major tax changes and a recognition of the interrelationship of the federal tax system with state and local tax systems.

STATE & LOCAL IMPACTS AND CONSEQUENCES OF REPLACING THE FEDERAL INCOME TAX

Income Tax		Flat Tax		Nat'l Sales Tax		VAT		USA	
Pros	Cons	Pros	Cons	Pros	Cons	Pros	Cons	Pros	Cons
• The devil one knows is better than the unknown devil. Addresses intergovernmental reciprocity. Provides for incentives for public capital investment, pension savings, and preferences for low & moderate housing and economic investment. • Provides a preference for state & local services.	• Rewards Consumption. • Is horrendously complicated. • Increases the federal deficit and national debt.	• Potential simplicity. Ends tax expenditures in cities. • Could significantly increase state and some local tax revenues.	• Double tax state & local taxpayers. • Eliminate preference for municipal bonds. • Eliminate incentive for housing & economic development. • Sharply increase federal tax liabilities for the majority of citizen in rural towns and large cities - eroding local economies. • Would disproportionately tax work at a time when trying to discourage welfare. • Would discourage retirement and pension benefits. • Would reduce property taxes • Would discourage charitable contributions. • Would impose huge generational tax on young Americans. • Would decrease health care preferences; leading to higher state and local costs.	• End tax expenditures. • Discourage consumption. • Enhance capital investment and savings. • Eliminate disproportionate tax subsidies to higher income Americans.	• Would tax state and local services and facilities. Impose major new collection mandate on state and local governments. Eliminate preferences for municipal bonds. • Eliminate incentives for low and moderate income housing. • Eliminate enterprise zones. Disrupt state and local tax system. • Preempt key source of state and local revenues. Impose major disruption on geographic sources of local income. Encourage cheating on a massive scale. • Create enormous enforcement difficulties (vs. Bellas-Hess telec-ommunications. • Would reduce property taxes. Would discourage charitable contributions. • Would disrupt virtually every state tax code.	• End tax expenditures. • Discourage consumption, encourage capital investment and savings.	• Would tax state and local services and facilities. Eliminate preferences for municipal bonds. • Eliminate incentives for low and moderate income housing. • Eliminate enterprize zones. • Disrupt state and local tax system. Preempt key source of state and local revenues. Impose major disruption on geographic sources of local income. Encourage cheating on a massive scale. • Create enormous enforcement difficulties (i.e. Bellas-Hess telec-ommunications. • Would reduce property taxes. • Would discourage charitable contributions. • Would disrupt virtually every state tax code.	• Incentives for savings and investment. • Recognizes some preference for municipal bonds and public infrastructure. • Would remove tax incentives for borrowing. • Would reduce incentives to increase tax expenditures. • Would involve less disruption of piggybacked state and local tax systems.	• Sharply reduce preference for municipal bonds. • Eliminate incentives for low and moderate income housing. • Eliminate enterprise zones.

FLAT TAX OPTIONS:

Issues & Consequences for Cities

Issues	Forbes	Gramm	Kemp	Armey	Municipal Impact
Tax would apply to:	earned income	all income	earned income	earned income	would impact whether workers would pay significantly higher taxes
Rate	17%	16%	unspecified	17%	would determine whether revenues would be adequate to prevent increase in the federal deficit
Impact on Municipal Bonds	would eliminate tax preference	would tax outstanding and future municipal bond interest	would eliminate tax preference	would eliminate tax preference	taxation or elimination of benefit could increase municipal capital improvement and borrowing costs by up to 30%
Deductibility of State and Local Taxes	would eliminate	would eliminate	would eliminate	would eliminate	would mean double taxation for state and local residents
Impact on Retirement and Pension Benefits	would tax	would tax	would tax	would tax	would affect municipal health care and retirement benefit plans as well as take home pay of municipal employees and residents
Impact on the Federal Deficit	would increase	would increase	says rate should be high enough to ensure revenue neutrality	would increase	reduced federal revenues could increase federal deficit, driving up federal, local, business, and personal borrowing costs
Mortgage Interest and Charitable Deductions	would eliminate	would retain deductibility	unspecified	would eliminate	could affect assessed property values in cities and incentives for charitable contributions
Payroll Taxes	does not address	does not address	employers and employees could deduct	not addressed	could affect municipal payrolls, determine which income levels in cities would owe more in federal taxes, and which would owe less
EZ, targeted jobs, EITC, and Low Income Housing tax credits	would eliminate	would eliminate	would eliminate	would eliminate	would reduce incentives for municipal investment

ALTERNATIVES TO THE FEDERAL INCOME TAX
Impact on Cities and Towns

ISSUE	FLAT TAX	NATIONAL SALES TAX	CONSUMPTION TAX
Description	Would eliminate existing, graduated federal income tax and virtually all deductions. Would not include interest, capital gains, dividends, or Social Security benefits as income. Would tax individual and corporate income at one, flat rate.	Would eliminate the individual and corporate income tax entirely and replace them with a federal sales tax.	Would add wages, dividends, interest (except on municipal bonds), asset proceeds, pensions; allow deductions for family "living allowance," charity, mortgage interest, and any savings or productive investments, a graduated tax would be imposed on what remained (the amount spent for consumption). Businesses would be subject to a comparable test and then a 10% fat tax.
Impact on municipal tax exempt bonds	Would eliminate	Would eliminate	Tax exempt status would be modified.
Deductibility of state and local taxes	Would eliminate	Would eliminate	Would eliminate
Impact on state and local revenues	Because the bill would eliminate all existing tax deductions, but only eliminate some current income (such as interest and dividends), a flat tax could significantly increase income tax revenues for states that rely on federal income tax definitions.	Would disrupt most state income tax codes and significantly and adversely impact state and local sales tax receipts.	Would disrupt
Impact on pension and employees benefit	Would subject to federal taxation	No impact	No impact
Key Players	**House Majority Leader,** Richard Armey (R-TX) - Senator Richard Shelby (R-AL) **House Majority Leader,** Richard Gephardt (D-MO) - Senator Arlen Spector *(R-PA) - **Chairman,** Senate Finance Committee Bob Packwood (R-OR) * *Denotes Presidential candidate*	Sen. Richard Lugar *(R-IND)	House Ways & Means, Committee Chairman Bill Archer (R-TX) - Sen. Sam Nunn (D-GA); Senator Pete Domenici (R-NM)

Chairman ARCHER. Thank you, Mr. Shafroth.

Unfortunately, we are under a time constraint because of the two lights and the buzzers for votes. Mr. Duncan, if you can limit your presentation to 4 or 5 minutes, then we can complete this panel and excuse this panel when we go to vote.

Mr. Duncan, you may proceed.

STATEMENT OF HARLEY T. DUNCAN, EXECUTIVE DIRECTOR, FEDERATION OF TAX ADMINISTRATORS

Mr. DUNCAN. Not a problem, Mr. Chairman. My name is Harley Duncan. I am executive director of the Federation of Tax Administrators, the association of the principal tax administration authorities in each of the 50 States, New York City, and the District of Columbia. It is a pleasure to be here and I want to commend you for holding a hearing on this often-ignored issue and aspect of Federal tax reform.

The Federation does not have a position for or against reform generally or for or against any particular proposal. Instead, my purpose today is to try to highlight for you the interrelationships between State and Federal income taxes and from that to demonstrate that the types of Federal restructuring proposals being considered by this Committee will have a profound effect on State tax systems. Those effects have not been fully identified and analyzed but need your serious attention as you evaluate restructuring proposals.

First, to the relationships between State and Federal income taxes. As you have heard, in the interests of simplicity for taxpayers and compliance at the State level, States currently model their personal and corporate income taxes after the Federal income tax. States conform closely to the definitions of item and items of expense. All but five of the States begin their personal and corporate income tax with a Federal starting point. Similar numbers of States use Federal definitions for itemized deductions.

In addition, States rely extensively on the Internal Revenue Service and its enforcement and compliance programs. In many cases, this is the only outside review of the reports of the taxpayers and it is not practical to expect States to step this up considerably, given that our income tax rates are about one-fourth the level of the Federal level.

Finally, States are reliant on the Federal information reporting mechanisms both to receive those reports and to have the legal authority to require payers to file the reports.

Because of these relationships, it will be difficult, if not impossible, for States to maintain and administer a personal or corporation income tax of the nature that is now imposed without a counterpart Federal tax. In my estimation, proposals which call for the repeal or fundamental alteration of the Federal income tax will effectively repeal State income taxes and require that they be modified in manners which mirror the Federal changes.

To attempt to duplicate the Federal infrastructure that is currently there would be a daunting task and would increase significantly the resources that the States would have to expend. More importantly, it would increase the burden on taxpayers because of the lack of uniformity that would likely result.

In short, if you repeal the Federal income tax, you repeal the State income taxes, and if you make fundamental changes, you will also make fundamental changes in State income taxes.

Quickly to some of the impacts, the first and foremost one is that in any of the restructuring proposals now under consideration, the States would have fewer tax policy choices available to them after the reform than they do at the present time. The national sales tax or a transactional value-added tax has the most extreme impact from a tax policy choice perspective because it does effectively repeal the Federal income tax. There are a number of issues regarding possible State administration of a national sales tax that I would encourage you to examine, as well.

A final issue to consider is that there is a corollary effect. As you make changes that the States must model, you shift the focus of authority over State income taxes and State tax bases to Washington at the same time that you are devolving authority and expenditure responsibility to them.

The central point, Mr. Chairman, is that the relationships are so intricate that they require very close examination, and we would ask that you work carefully with State and local governments as you design your proposals.

[The prepared statement follows:]

Testimony

Federal Tax Restructuring:
Impact on State and Local Governments

before the

Committee on Ways and Means
U.S. House of Representatives

by

Harley T. Duncan, Executive Director
Federation of Tax Administrators

May 1, 1996

Mr. Chairman and Members of the Committee:

My name is Harley Duncan. I am Executive Director of the Federation of Tax Administrators which is the association of the principal tax administration agencies in each of the 50 states, the District of Columbia and New York City. On behalf of the Federation, I want to extend our appreciation for the opportunity to testify today and to you and the Committee for holding a hearing on this extremely important, but often ignored, aspect of federal tax restructuring.

The testimony focuses on three objectives: (1) To provide an overview of the relationships between state and federal income taxes and to impart an understanding of the profound effects that federal tax restructuring will have on state revenue systems; (2) To examine the particular effects that various types of restructuring proposals under consideration will have on state tax systems; and (3) To encourage you to recognize that the magnitude of the impacts on state tax systems as well as the lessons that might be learned from state experiences with various forms of taxation are such that they deserve a significantly closer examination than can be accomplished here. Therefore, I encourage you to set up a formal working relationship with state and local officials to conduct an in-depth examination of these issues.

Preliminary Statements

Let me begin with two preliminary statements to put the rest of the testimony in perspective. First, no attempt is made this analysis to assess the tax policy, macroeconomic, simplicity or equity merits or demerits of any particular proposal or type of approach to federal tax restructuring. The Federation has not adopted a policy position that the federal tax should or should not be overhauled. Neither have we taken a position for or against any particular federal reform proposal. Instead, the efforts of the Federation have been directed to understanding the impacts of the various approaches to federal restructuring on state tax structures and to encourage an in-depth analysis and understanding of these impacts as the Congress proceeds to deliberate federal tax restructuring.

Second, I want to acknowledge an inherent bias underlying the analysis. To wit, in our federal system of government, states, are sovereign entities the activities of which are confined and dictated by the boundaries and teachings of the U.S. Constitution. As such, the Federation believes states should be accorded maximum flexibility to design their own revenue systems to meet the needs of their citizens and to reflect the desires of their citizens, keeping in mind considerations of burden on the taxpayer and administrability of the tax system as well as the requirements of the Constitution. To the extent that the choices of the states are constrained by

federal actions, this should be done in a cognizant and knowing manner after full discussion.

Relationships between Federal and State Income Taxes

Fundamental Premise

It is the basic premise of this analysis that states cannot effectively maintain and administer a personal or corporation income tax of the nature now imposed without a counterpart federal tax. That is to say, state income taxes are so closely related to and reliant on various features of the federal income tax code that, in my estimation, states will not be able to independently maintain a personal or corporate income that differs in fundamental ways from a federal income tax. Further, I believe proposals which call for the repeal or substantial modification of federal corporation or individual income taxes will also effectively require that state income taxes, at least as they are now structured, be repealed or similarly modified.[1]

State administrators arrive at the above conclusion because in today's environment, states [and taxpayers] are heavily reliant on the backbone and infrastructure of the federal income tax for the administration of state income taxes. There are three aspects of the current relationship which are important.

Structural Relationships

States conform closely to and rely on federal definitions of the various items of income and expense and in defining the treatment of various types of transactions etc.[2] This conformity with federal law is extensive. For example, 37 of the 42 states with a broad-based individual income tax base the state tax calculation on a federal starting -- either adjusted gross income (26 states), taxable income (8 states) or federal tax liability (3 states). For itemized deductions, 29 of the 34 states which allow such begin with or conform fully to federal itemized deductions, and 39 states follow federal Individual Retirement Arrangement rules. On the corporation income side, conformity with federal law is also substantial. All but 5 of the 47 jurisdictions with a corporate income tax, begin the state tax with federal taxable income, and all but two states have adopted federal depreciation schedules. Even where a state deviates from federal law, it most often calls for the addition or subtraction of an item that has been computed for federal purposes.

Without a federal tax, states would be required to maintain this infrastructure of rules, regulations definitions and treatments independently, a daunting task that certainly could not be accomplished within anything resembling current resources devoted by the states. It is inevitable that there would quickly be substantial non-uniformity among the states [to a much greater degree than present] which would impose inordinate burdens on taxpayers attempting to comply with multiple regimes. The magnitude of the difficulties is such that states would, in my estimation, soon begin to model any new federal regime.

Compliance Relationships

Beyond the structural relationships, states also rely extensively on the Internal Revenue Service activities as a part of and complement to their enforcement and compliance programs.[3] With respect to the corporation income tax, states are

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[1] Some may argue that states generally, or at least some states, would be able to continue to administer an income tax even in the absence of a federal counterpart. Even if this is true for some states, it is a certainty that the cost of administering such a tax would be exponentially greater than it is currently. Moreover, without a federal tax, there is likely to be an increasing lack of uniformity among the states which will create a variety of compliance difficulties for taxpayers. Both of these considerations will drive states to re-examine a decision to maintain a "stand-alone" income tax over time.

[2] For a more complete discussion of the relationships between state and federal income taxes, see Harley Duncan and Ronald Alt, "FTA Report: Impact of Federal Tax Changes on State Tax Systems," State Tax Notes, Vol. 7, No. 49 (December 3, 1993), pp. 233-238.

[3] Currently, all states but one have entered into an exchange of information agreement with the Internal Revenue Service under I.R.C. § 6103. Through the agreement, they can receive, at their option, a variety of reports and abstracts on a regular basis. Some of the information available includes

extremely reliant on federal determinations of taxable income. While states devote substantial resources to the audit of corporation tax returns, their audit activities are focused primarily on verifying the apportionment of income across states, examining the taxpayer's treatment of certain types of transactions, and determining the membership of the unitary group if the state employs combined reporting.

On the individual side, states also rely heavily on federal examinations and adjustments (particularly those involving the matching of information returns) as primary enforcement tools. In addition, states use federal income tax return data for a wide range of individual, independent enforcement programs.

Without, the federal income tax and the compliance offshoots, equivalent compliance efforts simply are not within the reach of most individual states. The Committee should remember that, on average, state personal and corporation income tax rates are roughly 20-25 percent of the federal tax rates.

Information Reporting

Finally, states are reliant on the federal information reporting mechanisms for income tax administration. To a very considerable degree, states simply mirror federal requirements [and forms, formats, etc.] for third-party information reporting and tax withholding. Seldom, does a state attempt to impose requirements in excess of the federal duties; some states do, however, rely only on federal information reports and do not require separate filings at the state level.

Attempting to replicate these systems individually would likely result in nonuniformity and increased burdens on taxpayers, not to mention additional expense at the state level. Moreover, states would likely encounter legal challenges to their ability to require certain entities who may not be physically present in a state to file information reports on transactions with residents of the state. Such reports are necessary for a full accounting of income and for insuring the taxpayer has the information necessary to prepare his/her return. Use of the federal reporting infrastructure eliminates the question.

Reasons for Conformity

States conform to the federal tax code primarily as a means to simplify and promote compliance with the state income tax. Conformity is of benefit to both taxpayers and tax agencies. Conformity makes it simpler for taxpayers to comply with state taxes because they do not have to deal with two separate sets of tax laws, rules and definitions and do not have to maintain two sets of accounts and books. Conformity reduces the complexity especially for firms and individuals operating on an interstate basis.

Conformity also serves the interests of states in that the reduced complexity promotes voluntary compliance. Moreover, with conformity, states can rely on federal compliance efforts to also assist and complement their efforts. It also improves the ability of states and the IRS to undertake cooperative and joint efforts to improve tax administration and compliance.

Relationships: Summary

The legal and operational interrelationships between state and federal business and individual income taxes is substantial and pervasive. As a consequence, federal tax restructuring proposals which make fundamental changes in the federal income tax will have profound effects on state income taxes specifically and state and local fiscal systems generally. These effects are so substantial -- they affect the very

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revenue agent reports for businesses and individuals, adjustments based on information return matching programs, and extracts from both the business and individual master files and the information returns master file.

manner in which sovereign entities will be able to raise revenues to meet the needs of their citizens – that they argue for additional examination by the Committee.[4]

Assessing the Impact of Restructuring Alternatives

This section of the testimony is intended to provide a high-level overview of the impact of the various restructuring alternatives that have been proposed on state tax systems and structures. As stated above, the intent is not to assess the policy merits or demerits of the various alternatives. Instead, it is intended to identify the impact on state tax systems, particularly from the perspective of the range of tax policy choices available to state policymakers. . That is to say, what is the impact of the measure on the tax sovereignty of the states in our federal system.

Time and space do not allow a complete discussion of all the relevant issues. More importantly, not all of the relevant issues and impacts have necessarily been identified. The intent of this analysis is to communicate that the range of identified impacts on state tax structures is so broad and profound that the Committee should find it necessary to form a special working group of federal and state officials to explore all the impacts and issues fully.

National Sales Tax Proposals

A federal tax restructuring which provides for the replacement of federal personal and corporation income taxes with a single federal consumption-based tax in the form of a traditional retail-level sales tax or a transaction-based value added tax (VAT)[5] will have a profound effect on state tax systems. For reasons outlined above, adoption of a NST would foreclose options to impose a state-level business or personal income tax or any close variant thereof. Instead of choosing from among sales, income, excise and property taxes in defining their revenue base, all states would effectively be constrained to financing all services from a retail sales tax, miscellaneous excise taxes, and property taxes. Consumption taxes would constitute over two-thirds of state and local tax receipts, compared to about 40 percent at the present time.[6]

Impact on Tax Policy Choices. The impact, of course, would be most extreme in the five states that do not now impose a state retail sales tax (Alaska, Delaware, Montana, New Hampshire and Oregon.) The question for those states becomes, are they to now shift from their historical choice (that in some cases has been repeatedly voiced by the voters at the polls) and switch to a retails sales tax? With a NST and no federal income tax, their other choices seem limited.

Even for those states which currently employ a retail sales tax, adoption of a NST could seriously constrain the tax policy choices available to them. The primary issue raised in this regard is the degree to which states would be able to define their own sales tax base in the face of a NST. That is, if there is a national sales tax base, what are the practical and administrative implications of states independently defining their own sales tax base and deviating from the national norm. In other words, will the complications that arise from a separately defined state tax base impose a

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[4] Certain federal restructuring proposals also call for elimination of the federal estate tax. States also couple to the federal estate tax and rely on that tax as the backbone of state death taxes. Twenty-seven states have only a "pick-up" state tax equal to the state death tax credit against the federal estate tax, and the remainder base their death tax on the federal tax. Again, it seems unlikely that states could, in large numbers, maintain state death taxes without a federal counterpart, at least with anything resembling current resources.

[5] This discussion focuses on the impact of a retail sales tax rather than a transactional VAT. From the perspective chosen for this analysis, however, (i.e., the effect on tax choices available to the states) the impacts of these two types of transaction-based consumption taxes will be effectively the same.

[6] At the federal level, replacing corporation and personal income taxes with a national consumption tax would cause consumption taxes to move from financing 10 percent of federal receipts to over 60 percent.

compliance burden on taxpayers that is so great as to create pressure to conform to the national base. The issue is likely to be framed in the context of national simplicity and efficiency versus state autonomy and sovereignty.[7]

If states are as a practical matter required to conform fully or closely to the national base, their tax policy choices will be constrained as compared to the current situation. They will likely tax transactions they have to this point chosen not to tax; conversely, they may be exempting transactions they have chosen to tax.

Decisionmaking Control over the Tax Base. From an intergovernmental fiscal perspective, there will be a substantial shift in power to the federal government if states are required as a matter of law or practice to conform to a national consumption tax base. In such a situation, the federal government would be in position of defining the tax base that is responsible for financing over 60 percent of federal, state and local services. The destiny of the states would, for the large part, be in the hands of the federal government and the tax policy choices they would make.[8] This would occur at the same time that actions are being taken to shift substantial expenditure responsibility to the states.

Administrative Issues/Questions. There are also a host of administrative questions and issues that would arise under a NST, particularly if, as some have suggested, states are to be responsible for administration of the national sales tax. All of these issues cannot be explored here, and they have not, in fact, been fully identified.[9] It will require extensive study and close collaboration between state and federal interests to do so. Some of the obvious questions include the degree, if any, to which the federal government would participate in financing the costs of collection. Likewise, there are numerous questions about federal involvement in overseeing state administration to insure quality, efficiency and consistency.

Beyond this, there are questions of jurisdiction of the states to tax. That is, will states be allowed to require direct marketers and others making sales into the state to collect state and local sales taxes if they are required to collect for the federal government. Even if the state were not collecting for the federal government, shouldn't this issue (direct marketing) be solved if the states are confined to a retail sales tax base?

Even if administration of the NST is consolidated, there are state level issues which will arise, and there will be a need for state-level records and examinations as well as federal. From a federal perspective the only important question is the taxability of a transaction. From a state perspective, the question of the jurisdiction to which the transaction should be allocated for tax purposes is important. Thus, there may well be reason to maintain a dual administration, not unlike exists with

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[7] For a discussion of this issue within the context of adoption of a federal credit-invoice (transactional) VAT, see Charles E. McLure, Jr., "State and Local Implications of a Federal Value-Added Tax," *Tax Notes*, March 28, 1988. McLure concludes that the difficulties in administration from differing state and federal transaction tax bases makes it likely, or at least wise decision, for the states to conform to the federal tax base.

[8] Some might argue that the same is now true because of the conformity between state and federal income tax bases. However, with income taxes, states can nonconform to some types of federal changes that do not impose inordinate compliance burdens on taxpayers and do not substantially reduce state tax compliance. For example, states can nonconform to a capital gains income exclusion because the taxpayers would know (and the state could receive an information report) on the total capital gains before exclusion. In addition, in the current situation, income taxes make up a much smaller portion of state and local tax receipts than would a consumption tax that was replacing current income and sales taxes.

[9] For a discussion of some of the issues involved in state administration of a federal tax, see Ernest J. Dronenburg, Jr., "SAFCT: State Administered Federal Consumption Tax: The Case for State Administration of a Federal Tax," Paper presented to the New York University, Annual State and Local Taxation Conference, November 30, 19595.

respect to income taxes today. Such dual administration exists also in motor fuel taxation where the federal government is concerned only with the taxability of the product, but states are concerned with the jurisdiction in which the fuel is used.[10]

Finally, federal and state policymakers must be concerned with potential noncompliance with a national sales tax, particularly at rates that would be necessary to replace federal and state individual and business income taxes. It is not unreasonable to arrive at estimates holding that a combined federal and state sales tax rate would need to run as high as 30-40 percent if it is intended to replace all federal and state income, sales and estate taxes.[11] The rewards and incentives for tax evasion with rates at such levels are sizable. With no (or at least unknown) 3rd party withholding and information reporting, there are likely to be certain types of enterprises that pose serious compliance issues, not unlike those faced by states today.

National Sales Tax: Summary. Replacing the federal income tax with a national sales tax would have serious implications for state tax systems. Not only would it effectively end state business and individual income taxes, it would likely concentrate control of the remaining sales tax base in the hands of the federal government. Further, administration of the tax would raise a number of complex issues, regardless of whether administration was consolidated or separate, which deserve further review.

"Consumed Income" Tax

Certain proposals have been made to convert the individual income tax to a "consumed" income tax where the base is equal to income from wages, interest and dividends less net additions to savings or investment. That is, there is an unlimited deduction for savings, thus giving rise to the term, Unlimited Savings Allowance or USA tax. A consumed income tax would have substantial impacts on state tax systems, but in terms of the effect on tax choices and tax sovereignty, the impacts are of a lesser, or more manageable, magnitude than adoption of a NST.

As to individual income taxes, the impacts of the consumed income tax are somewhat mixed. As a general proposition, however, it seems clear that the "consumed income" tax is an individual-level tax to which the states could conform or couple and which could be administered in much the same manner as current income taxes. Moreover, at least as a practical matter, a state would seem to be in a position to "nonconform" to the unlimited savings allowance.[12] Thus, it could effectively maintain a tax base which is similar to today's with all wages, interest, dividends and gains in the base and various adjustments made for items of expense.

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[10] State sales taxes (and consumption taxes in other countries) are generally imposed on a destination basis, i.e., where the good or service is delivered or used or consumed. This has proved particularly difficult for certain types of services. This could create both opportunities or problems in a NST context.

[11] Sen. Richard Lugar Sen. Lugar estimated that a rate of 17 percent would be sufficient to replace federal income and estate taxes. In 1994, federal income and estate taxes amounted to $731 billion, which implies an assumed federal tax base in Sen. Lugar's computations of about $4.3 trillion. State and local income, estate and sales taxes totaled about $400 billion in 1994 which would add an additional 9-10 percent to the required rate, based on the implied base. See U.S. Department of Commerce, Economics and Statistics Administration, *Survey of Current Business*, Vol. 75, No. 4) April 1995. Most observers believe Mr. Lugar's estimated rate was too low. [See, for example, William G. Gale, "Building a Better Tax System," *The Brookings Review*, , Fall 1995, p. 20. See also Bruce Bartlett, "Consequences of Replacing Federal Taxes with a Sales Tax," Joint Economic Committee, 1995.] The implied base of the 17 percent tax ($4.3 trillion) is approximately equal to total personal consumption expenditures ($4.6 trillion in 1994) which includes all personal purchases of housing, medical care and food. Allowing for some exemptions to this base, it is not impossible to imagine a tax rate of 40 percent as necessary to compensate for all repealed taxes.

[12] This is dependent on the precise manner in which the allowance is computed and if the taxpayer has at his/her disposal the requisite information to compute the amount to be added back for state purposes. It seems this information should be available.

Further, states could conform partially to the savings deduction, should they so choose.

The uncertainty regarding the consumed income tax involves the degree to which its adoption would interfere with the principle undergirding state income taxes of taxing income at the "source" or where it is earned and the issues stemming therefrom. At present, nearly all states with an income tax employ the source principle of taxation where all income which is earned or has its source within a state, even if earned by a nonresident, is subjected to tax.[13]

With the current "modified net income tax," it is entirely appropriate to employ the source tax principle. If, however, the tax is shifted to a "consumed income" base, it could be argued that the state in which the income was earned is no longer relevant, but it is the state where the income is consumed which is relevant. Since the state of consumption cannot be tracked with any specificity, the argument could be made that the state of residence would be the "default state of consumption" if you will. The question then becomes the degree to which this leads to a shifting of tax burdens among states and the avoidance of tax by those working in a consumed income tax state and living in a non-income tax state. If only part of the states were to shift away from the source principle, it would seem that potential double tax could arise if a "consumed income" state of residence were not to recognize tax paid to a source tax state.

Even if states can or do maintain the source principle of taxation, the problems and issues involved with taxing deferred earnings (which are present and vexing today) will likely be exacerbated. The unlimited deduction for savings will simply magnify the problem facing states today with the taxation of nonresident pensions, [i.e., taxation of payments to nonresidents when the work giving rise to the pension was performed in an income tax state and the individual retires to a non-income tax state.] There is no effective way to administer a tax on deferred earnings in an equitable fashion. With an unlimited deduction and deferral, the potential drain on the tax base of an income tax state is increased.

"Flat Tax" Proposals

Several proposals for federal tax restructuring include the "flat tax" approach wherein individuals would be taxed at a single rate after allowance for a tax-free threshold which includes a "standard deduction" and an allowance for personal exemptions. The tax base would be equal to gross active income (essentially wages and pension benefits, but not investment earnings).[14] The flat tax proposals most commonly discussed will leave the states with an income-based tax to which they can couple and conform. It will be a substantially different tax than the current one.

The flat tax base will not include income from interest, dividends and gains. This would seem to effectively prevent any state from including those types of income in the state tax base since the requirements imposed on payers to report this income to taxpayers and tax authorities will presumably be repealed. States are currently reliant on federal reporting and capture of the data for their enforcement purposes and for practical and legal reasons could not replicate those requirements for a state-level only tax.

The ability of states to allow any other type of exclusion or deduction will also be constrained if there are not otherwise existing systems for reporting to taxpayers and

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[13] States also tax on a residence basis whereby all income earned by a resident (regardless of where earned) is included within a return. A credit is given for taxes paid to other states to avoid double taxation.

[14] Rather than exclude savings from the tax base as in the consumed income proposals, the flat taxes generally exempt the return from savings. This is essentially a matter of timing of tax payments and from an economic perspective, the two taxes are much the same. There are differences in the two from the perspective used here.

tax authorities. For example, if there are no itemized deductions on the federal return, it will be difficult to allow such deductions at the state level unless there are reporting mechanisms in place.

In short, the flat tax proposals are likely to reduce the policy choices available to states by eliminating some of the federal infrastructure necessary to maintain a more complex tax system. States should, however, be able to establish a graduated rate, rather than flat-rate, structure if they so choose. The issue of taxing deferred earnings of nonresidents will remain an issue under this proposal, although it is not exacerbated as in the consumed income proposal.

Restructuring the Corporation Income Tax

On the business side, there are several proposals[15] to replace the corporation income tax with a subtraction method VAT, where the base is equal to total sales receipts minus purchases from other businesses including investments. The tax is an operational tax in that it is applied against the business entity and would be administered through an annual tax return rather than on a transactional basis.

To all appearances, the subtraction-method VAT proposed for the primary federal-level business tax is one that is compatible with state tax principles and practices. That is, it seems that states could conform or couple to the federal VAT base and then apportion the base among the states in much the same manner as they do today with the corporation income tax. The state of Michigan employs the functional equivalent of this with the Single Business Tax which is an apportioned VAT using the addition, rather than subtraction, method of arriving at the tax base. New Hampshire also employs a similar "business enterprise tax."[16]

In short, with these proposals, states would be able to retain an entity-level business tax that is related to the amount of business activity in the state. If the tax base finally adopted is indeed a broad-based VAT with few exclusions and complications, it could represent an improvement over the corporation income tax from an administrative and policy standpoint.

The Need for Further Investigation and Analysis

To this point, I hope I have been able to convince you of two things: (1) The potential impacts of federal tax restructuring on state tax systems is profound and will substantially affect the range of tax policy choices available to state policymakers; and (2) There is still much work to be done in identifying all the issues that should be considered at the federal and state levels as you address federal tax restructuring.

For these reasons, I would encourage you to form a partnership with state officials -- in the form of a staff-level working group or some other form -- to further analyze the state-level issues involved in federal tax restructuring. In our federal system, states and the federal government are partners in serving the citizens, and we must be cognizant of the impact of our actions on our partners at the other level.

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[15] See, for example, the USA tax proposal introduced by Sens. Nunn and Domenici and the flat tax proposal of Rep. Armey. The business tax in the Armey proposal is similar to the USA VAT proposal, but it allows a deduction for wages as part of its attempt to integrate personal and business taxes and tax all income only once. This does not directly affect the ability of states to "piggy-back" on the tax. It does, however, make the tax "non-border adjustable" under international trade agreements which means the tax cannot be removed from exported goods and imposed on imported goods like the VAT proposed by Nunn and Domenici. This difference may affect international trade and problems posed for tax administrators by transfer pricing issues. For a more complete discussion, see Dan Bucks, "Major Federal Tax Changes: Perils and Possibilities for the States," *Tax Administrators News*, July 1995.

[16] For discussion, see V. Hummel Berghaus, IV and William F.J. Ardinger, "The Policy and Structure of the Business Enterprise Tax," *New Hampshire Bar Journal*, December 1993, pp. 5-18. See also, Michigan Department of Treasury, "Analysis of the Michigan Single Business Tax," 1985.

This is especially true when it comes to federal tax restructuring because of the interrelationships between our tax systems.

A cooperative working relationship of the type I envision would pursue four objectives: (1) Identify and analyze fully the impact of federal restructuring proposals on state tax systems; (2) Educate the Members of Congress and state officials on the impacts of federal tax restructuring; (3) Identify state experiences with different forms of taxation which might be instructive for federal policymakers; and (4) Lay the groundwork for the effective implementation of such restructuring proposals as might be adopted.

Conclusion

The key points made in the testimony include:

- In the interests of simplicity for taxpayers, states currently model their personal and corporation income taxes after the federal income tax. States conform closely to federal definitions of the various items of income and expense and in defining the treatment of various types of transactions etc. In addition, states rely extensively on the Internal Revenue Service in their enforcement and compliance programs, and states are heavily reliant on the federal information reporting mechanisms for income tax administration.
- As a result, it will be difficult, if not impossible, for states to maintain and administer a personal or corporation income tax of the nature now imposed without a counterpart federal tax. To attempt to duplicate the federal infrastructure is a daunting task and would certainly increase significantly the state resources required to administer an income tax. It would also inevitably lead to a lack of uniformity and inordinate burdens on taxpayers. For these reasons, it is likely that any federal reform proposal that calls for the repeal or substantive modification of the federal income tax will also effectively require that state income taxes be modified in similar ways.
- As a result, all the current proposals for fundamental federal tax restructuring will have substantial impacts on the nature of state tax systems and the tax policy choices available to them. Each of the proposals will, to varying degrees, reduce the tax policy flexibility currently enjoyed by state governments.
- Replacing the federal income tax with a national sales tax has the most extreme impact because it effectively eliminates state income taxes as well. Further, it will likely constrain significantly the ability of states to define their own sales tax base
- The consumed income and flat tax proposals will change the fundamental nature of the income tax. They do, however, provide an entity-level, subtraction method VAT based on business activity to which the states could reasonably couple a counterpart state tax. Similarly, they retain an individual tax which includes at least earnings to which the states could also couple. In both cases, however, the nature of the individual tax will constrain the options available to the states.
- A corollary effect of the reduction in tax policy choices is that each of the proposals consequently tends to concentrate decision making about the tax base and fiscal resources available to states at the federal level. That is to say, Washington may be coming into greater control over state revenues at the same time they are devolving additional responsibilities to the states. The counter-direction of the two trends is a matter of concern.
- The impact of federal restructuring on states is such that the U.S. Congress should enter into a partnership with states to identify and analyze fully the ramifications of federal tax restructuring on state tax systems. We have suggested a staff-level working group as the appropriate starting point in this regard. The nature of the impacts is so profound and the importance of a state-federal partnership so critical that every effort must be made to work together in this important area.

Chairman ARCHER. Thank you, Mr. Duncan, and thank you for giving back a little of your time so I can go vote.

My thanks to each member of this panel. There will be no further questions. You are excused.

The Committee will stand in recess until I can come back from this vote.

[Recess.]

Chairman ARCHER. The Committee will come to order.

Randall Fields, Dan Wilford, William McLin, Hon. William Lukhard, would you please take seats at the witness table.

Gentlemen, thank you for coming to give us the benefit of your thinking on this structural tax reform consideration that we are building toward. Let me again ask you if you will summarize your oral testimony to within 5 minutes, we would be greatly appreciative. Your entire written statement will be entered in the record.

Mr. Wilford, would you identify yourself and then proceed.

STATEMENT OF DAN S. WILFORD, PRESIDENT, MEMORIAL HEALTHCARE SYSTEM, HOUSTON, TEXAS; ON BEHALF OF THE VHA, INC., IRVING, TEXAS

Mr. WILFORD. Yes, sir. Thank you, Mr. Chairman, Members of the Committee. Chairman Archer, I bring you greetings from your many, many friends in Houston.

Chairman ARCHER. Thank you.

Mr. WILFORD. Thank you for the opportunity to testify today about the impact of tax reform on tax-exempt health care organizations. My name is Dan Wilford. I am president of Memorial Healthcare System in Houston, a private, not-for-profit health system with five acute care hospitals, three specialty hospitals, and numerous outpatient facilities, all serving the community of Houston. I am here today representing VHA, Inc., an alliance of over 1,300 not-for-profit health care organizations. Memorial is a charter member of VHA.

First, let me say that VHA supports the efforts to make the Tax Code fairer, simpler, and more efficient. The task ahead is daunting and VHA wants to be involved in the process. While we support reform, we hope the Committee keeps in mind the special role not-for-profit health care organizations play in meeting the needs of individuals and communities where government is either unwilling or unable to respond.

Unlike investor-owned hospitals, which are accountable to stockholders, not-for-profit hospitals are accountable to the communities we serve. Not-for-profit health care organizations continue to play a vital role by not only providing care to medically indigent but by working in communities to improve overall health status. Between private community hospitals and State or local government hospitals, the not-for-profit sector accounts for 86 percent of all community hospitals in this country.

VHA is concerned that some of the proposals may jeopardize not-for-profit health care. Our concerns are focused in three areas: Application of new taxes to core activities of not-for-profit providers, elimination or dilution of essential tax incentives such as the exclusion for tax-exempt bond interest and the deduction for charitable contributions, and possible increases in State and local taxes which

could be triggered by a major change in the Federal tax status of charitable health care organizations.

Now I will briefly comment on the proposals that may affect not-for-profit hospitals. The flat tax would accommodate an exemption from tax for not-for-profit health care organizations. However, we see two major disadvantages of this proposal.

First, it would effectively eliminate the tax-exempt bond market. Hospitals that rely on tax-exempt bonds to fund capital improvements would be forced to acquire debt at higher interest rates. This would jeopardize the availability of capital for some not-for-profit hospitals.

The flat tax would also eliminate or restrict the deduction for charitable contributions. Many tax-exempt hospitals rely on donations to fund expansions, education and research, and charity care. Eliminating the deduction for charitable contributions may affect the ability of not-for-profit hospitals to continue their broader mission of service to the community.

A 15-percent national retail sales tax poses a threat to not-for-profit hospitals. The tax is essentially a sales tax applied to all services provided by not-for-profits that are "commercially available." Although investor-owned hospitals comprise only 14 percent of the inpatient hospital market, they do have a presence in most major markets. Therefore, many services provided by the not-for-profit hospital would be commercially available. This would have a more devastating financial impact than the simple loss of tax exemption under current law.

The value-added tax has some of the same disadvantages as a retail sales tax, though it would be possible to craft workable exemptions for not-for-profit hospitals.

The USA tax preserves the core exemption of not-for-profit hospitals, the deduction for charitable contributions, and the special treatment for tax-exempt bond interest income. However, the taxes imposed on unrelated business income could adversely affect hospitals.

Overall, VHA believes that the imposition of new taxes on health care organizations, the elimination of tax-exempt bonds, and the denial of charitable deductions could put not-for-profit health care in jeopardy. We urge the Committee to consider the important role of not-for-profit health care and design provisions in any new Tax Code that will preserve our unique role.

We appreciate this opportunity to present our thoughts to this Committee and wish you the best as you pursue your work.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF VHA INC.
TO THE COMMITTEE ON WAYS AND MEANS
OF THE UNITED STATES HOUSE OF REPRESENTATIVES

IN CONNECTION WITH THE HEARING ON
THE IMPACT ON TAX-EXEMPT ENTITIES OF
REPLACING THE FEDERAL INCOME TAX
May 1, 1996

Delivered by Mr. Dan S. Wilford
President
Memorial Healthcare System
Houston, Texas
On Behalf of
VHA Inc.
Irving, TX

VHA Inc. (formerly, Voluntary Hospitals of America, Inc.) appreciates the opportunity to submit this testimony on the impact on state and local governments and tax-exempt entities of replacing the Federal Income Tax. Structural tax reform is of great interest to not-for-profit organizations generally, and a serious matter for charitable hospitals throughout the United States.

My name is Dan Wilford, and I am the President of Memorial Healthcare System in Houston. Memorial Healthcare System is a private not-for-profit health care organization which operates five full-service acute care hospitals, three specialty hospitals and an ambulatory care center -- all in various neighborhoods throughout the city of Houston. Through our regional affiliate program, we have relationships with 12 other hospitals throughout south and east Texas that benefit from Memorial's shared purchasing services, medical staff, education programs and management team.

In 1995, Memorial Healthcare System provided to the community of Houston $266 million Houston in the form of uncompensated care, Medicare and Medicaid services, charity care, and community health improvement programs.

I am here today representing VHA. Memorial Healthcare System is a member of VHA, an alliance of over 1,300 not-for-profit hospitals and affiliated health care organizations. VHA provides to its members information, products, and services to help them improve community health, clinical effectiveness, and operational efficiency.

VHA's mission is directly related to the strength and charitable focus of the not-for-profit community hospital in the face of increasingly competitive economic pressures. Indeed, the need to develop economic strategies to ensure not-for-profit hospitals' ability to achieve their mission is a principal objective of VHA programs and activities.

Summary of Comments and Recommendations

Not-for-profit health care providers play a critical role in meeting community health needs. Federal tax benefits are important in helping such organizations carry out their mission and meet their needs for capital.

VHA supports efforts to make the tax code fairer, simpler, and more efficient. We agree with Chairman Archer that the economy loses substantial amounts of productivity every year because of our burdensome federal tax system. Even tax-exempt organizations are not exempt from having to expend millions of dollars to comply with the tax code in its current form. However, some of the tax reform proposals currently being considered could jeopardize the future of the not-for-profit health care sector, such as:

- Application of the new taxes to core activities of not-for-profit healthcare providers;

- Elimination or dilution of essential tax incentives, such as the exclusion for tax-exempt bond interest and the deduction for charitable contributions; and

- Possible increases in state or local taxes that could be triggered by such a major change in federal tax status of charitable health care organizations.

VHA looks forward to working with Chairman Archer and the Committee on Ways and Means to address these concerns in a creative and appropriate manner.

Role of the Not-for-Profit Sector

Historically, the not-for-profit sector has filled an important role in American society. First, it has served to lessen the burdens of Federal and State government. It has done so by taking on tasks which might otherwise fall to governmental agencies, but which are handled more efficiently and humanely by publicly supported charities. Such tasks have included providing food and shelter for the poor, and urgent and routine medical care for the indigent. Second, it has provided goods and services deemed to be inherently beneficial to the public--e.g., education, care for the elderly, and community-focused health care. Traditionally, the not-for-profit sector has used volunteers and funds provided by charitable contributions to subsidize the cost of such goods and services so that they may be distributed more widely.

Today, the not-for-profit sector plays an even larger role. Nearly one million charitable, educational, religious, health and social welfare organizations nurture and sustain the values that frame American life. While the U.S. Congress is considering substantial cutbacks in the Federal government's funding of education, social welfare and public insurance programs (including Medicare and Medicaid), not-for-profit organizations are being asked to do more than ever before in providing important community services and programs.

Special Role of Not-for-Profit Health Care

Not-for-profit health care organizations continue a centuries-old tradition of providing health care services to the sick. In addition, not-for-profit organizations today are demonstrating their accountability to the communities they serve by reaching beyond the bounds of traditional health care and managing and improving health status of people in communities. They embrace a broader vision of health and address the underlying causes of disease and injury in their community-wide health programs.

Approximately 86 percent of America's community hospitals are not-for-profit, with the majority organized as non-governmental 501(c)(3) institutions. They provide a broad range of health care services and programs including medical research, education, community health improvement, and acute inpatient care. These not-for-profit organizations also provide medical services to the community that are often unprofitable but essential, such as burn care, neonatal intensive care, care to people with HIV, and emergency medicine.

Not-for-profit hospitals today have grown into sophisticated health care provider organizations, but their charitable role is no less important. Moreover, Congress' decision not to enact universal health reform legislation means that voluntary hospitals will be challenged to assume even greater burdens now and in future years. Impending Medicaid and Medicare budget cuts will pose additional challenges for community-based health care providers. As in the past, not-for-profit charitable health care providers will be called upon to meet community health needs that Government is unable or unwilling to fulfill.

Importance of Tax Benefits for Not-for-Profit Organizations

The exemption from income tax of charitable and other not-for-profit organizations is long-standing.[1] The exemption permits not-for-profit organizations to set aside

[1] Prior to the enactment of the first corporate income tax, the tax "exemption" of non-profits existed primarily by statutory omission. Customs and excise taxes applied only to specified business entities and activities. When the income tax of 1894 imposed a flat two percent rate on all corporate income, Congress provided exemption for not-for-profit charitable, religious and educational organizations, as well as certain not-for-profit mutual organizations.

or retain earnings for future capital improvements. It also provides a uniform foundation for many state tax exemptions.

A second tax provision is the exclusion for tax-exempt bond interest. Charitable organizations with significant capital needs, such as hospitals and universities, rely on tax-exempt financing to provide much needed capital. Since not-for-profit hospitals cannot by law issue stock to raise money through equity markets, debt and retained earnings are their only sources of capital for much needed renovations, and health system improvements. At present, the markets for tax-exempt financing are very well established. At least in the short run, many hospitals and other not-for-profit entities would be simply unable to obtain debt financing at all if these markets were disrupted.

A third tax provision that directly benefits charitable organizations is the deduction for charitable contributions. Congress has long sought to encourage charitable donations through the tax system. The deduction for charitable giving has existed almost as long as the income tax itself. Charitable giving goes hand in hand with volunteering as the primary means by which many not-for-profit organizations are able to carry out their mission. In the health care context, individual and corporate contributions are essential funding sources for medical research and education, capital improvements and community health improvement organizations.

Income Tax Restructuring

VHA strongly supports the Congress' efforts to make the federal tax system simpler and more efficient. It also applauds Chairman Archer for pursuing reforms that would encourage savings and investment, improve the international competitiveness of U.S. business and increase tax revenues from the underground economy and non-compliant taxpayers.

However, the movement to completely replace the federal tax system poses a number of potential problems for not-for-profit organizations. These are discussed in detail below in the context of the different tax reform proposals. It is our hope that these problems will be faced squarely and resolved creatively so that the unique role of not-for-profit organizations will not be compromised or their influence eroded.

The Flat Tax

A flat tax, such as the one proposed by Congressman Dick Armey (H.R. 2060), has one significant advantage and several disadvantages from the perspective of not-for-profit health care systems.

The advantage of the Flat Tax is that it easily accommodates an exemption from tax for revenues derived by not-for-profit organizations. For example, H.R. 2060 contains a blanket exemption from the business tax for "any activity of a governmental entity or any other entity exempt from tax." VHA recognizes that under this approach, the tax-writing Committees may have to refine the standards for exemption and the taxation of unrelated business income ("UBI"). However, maintenance of tax exemption is a paramount issue for not-for-profit health systems. To the extent that deductions are eliminated from the tax base, exemption is even more critical because not-for-profit institutions that would not have significant tax liability under a net income tax will be forced to assume significant tax burdens if not exempted.

A major disadvantage of the flat tax is that it would effectively eliminate the tax-exempt bond market, which is a key source of capital for not-for-profit hospitals. H.R. 2060 eliminates tax on interest income, and as a result, tax-exempt bonds would become obsolete. Not-for-profit hospitals would be forced to fund capital improvements with taxable debt at a higher interest rate, which may cost millions of dollars in some cases. Furthermore, many not-for-profit health care organizations would be penalized not only by paying higher interest rates, but by limitations on their ability to borrow at all. Because not-for-profit hospitals are precluded

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Comparable measures were subsequently enacted after the Sixteenth Amendment was ratified, firmly establishing the principle of tax exemption of not-for-profit organizations.

from raising money through the equity markets, tax-exempt financing is a critical source of capital for health system renovations, expansions and consolidations.

Another disadvantage of the Flat Tax is that it may eliminate or restrict the deduction for charitable contributions. Under H.R. 2060, the charitable contribution deduction is completely eliminated. Tax-exempt hospitals are supported by charitable contributions both directly and indirectly. Some institutions (particularly those that focus on children's' healthcare) are heavily supported by donations. Other institutions, such as academic health centers, receive the benefits of charitable contributions more indirectly--e.g., through grants to fund medical research. In 1992, health care organizations derived an estimated $9.2 billion dollars from contributions. If the charitable contribution deduction were eliminated, healthcare organizations could lose a substantial portion of that amount.[2]

National Sales Tax

A national retail sales tax, such as the bill introduced by Congressmen Schaefer and Tauzin (H.R. 3039), has a number of significant disadvantages and very few, if any, advantages from the perspective of not-for-profit healthcare organizations.

The bill imposes a 15 percent national retail sales tax on the use, consumption or enjoyment of any taxable property or services. Contributions of property or services to certain "qualified" nonprofit organizations are exempt from tax. In addition, the provision of property or services by certain nonprofit organizations are exempt, but only if the property or service provided is (1) substantially related to the organization's exempt purpose and (2) not commercially available.

The first major disadvantage of the retail sales tax approach (as formulated by H.R. 3039) derives from the linkage of a particular item's tax treatment with its "commercial" availability. Congress should be well aware that investor-owned health care systems currently control 14 percent of the in-patient hospital market, and seek to control an ever larger share. Consistent with their duties to shareholders, such systems seek to enter profitable markets and to provide high-profit margin services. Under the bill, a nonprofit health system could lose the benefits of tax exemption with respect to a large number of activities simply because a for-profit system entered its market. It would not matter that the not-for-profit hospital used its returns from such activities to subsidize unprofitable community health services not offered by the for-profit system. This problem with the retail sales tax could be cured, however, by simply eliminating the "commercial availability" standard of H.R. 3039.

A second disadvantage of the retail sales tax may not be so easily remedied (assuming that the first one is not resolved). If tax-exempt hospitals become subject to a retail sales tax on all or a part of the healthcare services they provide, the result will be worse than loss of exemption under an income tax. If a currently exempt hospital were subject to income tax, it would be able to net its revenue against its expenses (including labor costs) to arrive at its net taxable income. Under the proposed sales tax approach, there would be no comprehensive netting of expenses and revenues. Rather, every dollar of revenue derived from "commercially available" patient services would be subject to tax at a flat 15 percent rate.

Like the Flat Tax, the Retail Sales Tax also results in loss of two secondary, but critically important, tax incentives--the special treatment of tax-exempt bond interest and the deductibility of charitable contributions. Because individuals would be taxed only on what they consume, income itself would not be taxed. Thus, hospitals and other tax-exempt organizations would have to borrow at significantly higher rates, if they could obtain debt financing at all. Likewise, donors would have no tax incentive to donate funds to charity. VHA does not believe that the elimination of these two tax incentives would be offset by an overall lowering of interest and tax rates.

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[2] See Clotfelder, Charles and Richard Schmalbeck, "The Impact of Fundamental Tax Reform on Nonprofit Organizations", Paper presented at the Brookings Institute conference on "The Economic Effects of Fundamental Tax Reform" (Feb. 15-16, 1996) pp. 10-13, 20-29, and Table 3.

Another disadvantage of non-income based tax systems generally is the possible triggering of increased State tax liability. Many State and local tax exemptions derive at least in part from exemption from federal income tax under Section 501(c)(3). Even hospitals that operate on extremely narrow margins or at a loss for income tax purposes would have substantial property tax liability if exemption standards were altered. In addition, repeal of Section 501(c)(3) could trigger adverse income and sales tax consequences in many States. Thus, VHA urges the Committee to retain the concept of federal tax exempt status even if it changes the basic framework of the tax code.

Value Added Tax

If applied at the same rate and to the same base of goods and services, a value-added tax (VAT) should collect the same amount of revenue and affect consumers the same way as a retail sales tax. The major advantage of a VAT is that it spreads the compliance burden over more firms and organizations.

Under a subtraction method VAT, a business pays tax on the difference between its sales receipts and the cost of its purchases from other businesses, including purchases of business equipment and other property. Under a credit-invoice method VAT (often referred to as a European-style VAT), businesses pay VAT on their sales, but receive a credit against their tax liabilities for VAT paid on inputs purchased from other businesses. In order to maintain the greatest degree of simplicity, some VAT proposals (e.g., the proposal of Congressman Gibbons) contain no exemption for sales by or to nonprofit organizations.

It is difficult, but not impossible, to craft workable VAT exemptions. For example, exemption from tax does not remove all of the tax on a product if an exempt entity cannot claim a credit for tax previously paid on inputs. Under Canada's goods and services tax ("GST"), charitable non-profit organizations not only are exempt with regard to most of their goods and services, but also are allowed a 50 percent input credit. Alternatively, "zero-rating" can remove all of a tax on a product because the organization pays a zero rate on its value added and receives a credit for all of the tax previously paid on inputs.

Like the retail sales tax and the flat tax, a VAT that completely replaces the income tax would effectively eliminate the charitable contribution deduction and the tax-preferred status of 501(c)(3) bonds.

Income Tax with Unlimited Savings Deduction

The proposal to retain an income-based system with an unlimited deduction for savings, such as the USA Tax proposed by Senators Domenici and Nunn (S. 833), preserves the core exemption of not-for-profit hospitals, but diminishes other tax benefits available under current law.

One major advantage of S. 833 is that it effectively preserves the tax exemption of nonprofit health care organizations that qualify as charitable organizations under section 501(c)(3).

One apparent disadvantage of S. 833 is its formula for the calculation of UBI. The USA Business Tax is an 11 percent tax imposed on gross profit derived from all domestic sales of goods and services. In calculating gross profit, the computation eliminates any deduction for employee compensation and fringe benefits. This calculation would adversely affect the health care industry or any other industry that is burdened by high labor costs.

One advantage of the Nunn/Domenici plan is that it maintains a deductions for charitable contributions, as well as the exclusion for tax-exempt bond interest. However, S. 833 restricts the deduction for most contributions of property (e.g., stock or real estate) to the lesser of the donor's original cost basis or fair market value.

Issues Posed for Not-for-Profit Organizations by Structural Tax Reform

Structural tax reform could adversely affect many not-for-profit organizations. Issues that particularly concern VHA as an alliance of not-for-profit health care organizations include the following:

- Whether the New Taxes Will Apply to Not-for-Profit Organizations

  It is critical that the "Business Tax" portion of any proposed replacement tax exempt income or gross receipts that not-for-profit organizations derive from activities related to their exempt purpose. Many consumption-based tax proposals apparently would tax not-for-profit organizations that provide goods and services. Exemption from such taxes should not be tied to a particular service or product, but rather the type of entity that supplies it. **VHA believes that not-for-profit health care organizations should be exempted from any such new taxes, except with respect to unrelated business income that would be subject to tax under current law.**

- Whether Exemption May Result in Partial Taxation

  Exemption from income tax completely eliminates tax on not-for-profit organizations. Exemption from a consumption-based tax only exempts the value added by the not-for-profit organization from tax, not the tax on the goods and services it purchases from other businesses. **VHA strongly suggests that the Committee consider a mechanism to enable a not-for-profit health care organization to receive full credit for tax previously paid on inputs, as well as an exemption for its own value added.**

- Whether Essential Tax Incentives Will be Eliminated or Diluted

  Not-for-profit organizations depend not only on exemption from income tax, but also on current law incentives for charitable deductions and tax-exempt bond financing. Many of the reform proposals, by eliminating or diluting the exclusion for tax-exempt bond interest, would sharply increase not-for-profit hospitals' "cost of capital" and, in some cases, restrict its availability. Such proposals would also eliminate or restrict the tax incentives for individual and corporate donations that fund medical research and community health initiatives. **VHA would like to work with Chairman Archer and his staff to maintain appropriate incentives for meeting not-for-profit hospitals' capital needs and charitable giving objectives.**

- Any Erosion in the Federal Tax Exemption for Charitable Health Care Organizations May Trigger Increased State Taxes

  Many State tax exemptions derive at least in part from exemption from federal income tax under Section 501(c)(3). Even hospitals that operate on extremely narrow margins or at a loss for income tax purposes would have substantial property tax liability if exemption standards were altered. In addition, repeal of Section 501(c)(3) could trigger adverse income and sales tax consequences in many States. **VHA urges the Committee to retain Federal tax exempt status even if it changes the basic framework of the tax code.**

Conclusion

The not-for-profit sector contributes significantly to the public good by lessening the burdens of government. It provides many essential services efficiently and compassionately. It promotes and nurtures American values of altruism, volunteerism, and pluralism. In view of anticipated cuts in Medicaid and Medicare, not-for-profit hospitals and health care organizations will be challenged to do more than ever before to maintain access to quality care for all Americans.

Although VHA supports the Committee's efforts to reform the tax system, it has several concerns regarding the possible impact of any new tax system on not-for-profit organizations. These include concerns regarding (i) the scope and applicability of a consumption-based flat tax, and (ii) the difficulty of fashioning revenue-neutral exemptions, (iii) the potential elimination of essential tax incentives, such as the exclusion for tax-exempt financing or the deduction for charitable contributions, and (iv) adverse state consequences triggered by a change in the federal tax system..

VHA looks forward to the opportunity to work with Chairman Archer, the Members of the Committee, and their respective staffs to address these concerns in a creative and appropriate manner.

Chairman ARCHER. Thank you, Mr. Wilford.

Mr. McLin, if you will identify yourself for the record, you may proceed.

STATEMENT OF WILLIAM M. McLIN, INTERIM PRESIDENT, NATIONAL HEALTH COUNCIL; ON BEHALF OF INDEPENDENT SECTOR

Mr. MCLIN. My name is Bill McLin and I am speaking on behalf of the Independent Sector. I am the president of the National Health Council, an umbrella organization of more than 100 national health-related groups. The Council's core membership is composed of America's leading voluntary health agencies, including the American Cancer Society, the Arthritis Foundation, and the National Easter Seals Society.

These voluntary health agencies provide unique and indispensable services to individuals and the families of those with debilitating and life-threatening illnesses, chronic health conditions, and physical and developmental disabilities. These services are made possible by the generous support of the donating public.

I am appearing today for the Independent Sector, a national leadership forum working to encourage philanthropy, volunteering, not-for-profit initiative, and citizen action. Let me be clear at the outset that the Independent Sector does not support or oppose tax reform. My testimony is limited to some of the consequences that various tax reform proposals may have on the ability of charitable, educational, and religious institutions to continue to provide the services that constitute their reasons for being.

Tax reform poses two direct challenges to the Independent Sector. First, whether charitable organizations will continue to be exempt from a replacement tax system to the same extent as at present or whether a new system will shift some of the burden of revenue production to nonprofits. Second, whether a replacement tax system will offer incentives for charitable giving and whether those incentives will be as broadly based and effective as in times past.

The impact of tax reform on charitable organizations cannot be taken out of context of other developments that affect them. The structural tax reform debate comes at a time when charities are facing great challenges. As the Federal Government begins the process of cutting domestic discretionary spending, many are calling on charities to take up the slack, and I say we will do what we can, although it is unlikely the charities can increase private contributions enough to make up for Federal tax cuts.

Tax exemption for charitable educational religious institutions is deeply rooted in American history and has been a feature of every Federal income tax law enacted since 1863. Charitable tax exemption embodies the American tradition of independence, pluralism, and of pragmatic problem solving. It provides a way of government to support private efforts that improve the collective well-being.

It recognizes the public interest in a system that allows volunteers to create a diversified, fluid group of private organizations that can initiate new projects to respond to new needs, offer alternatives to government as the sole provider of service, and act in areas where government is forbidden or it ought not to act. Finally,

tax exemption recognizes that charities build community by mobilizing private resources for the public good, not private gain.

The second key issue for nonprofits is maintaining tax incentives for charitable giving. In 1992, approximately 32 million taxpayers who itemized deductions on their personal income tax returns reported about $63 billion in charitable contributions. According to the accounting firm of Price Waterhouse, this amount would have been $20 billion lower if contributions had not been deductible. Deductibility of contributions recognizes a general principle that income and assets that are given away to charity are not used for personal benefit.

Deductibility is an important aspect of pluralism. The charitable deduction has endured through five wars, a depression, innumerable recessions, budget surpluses and deficits, and top marginal rates ranging from 15 to 90 percent. It is economically important for charities, but it is also highly symbolic of the importance of the unique role charities play in American society.

People contribute to charitable causes because they are motivated to help others, not to gain a tax deduction. However, deductibility does influence how much they give. People who itemize their deductions make larger gifts than people who do not itemize, a fact that holds true across all income levels. In 1980, when the top marginal rate was 70 percent, and in 1993, when it fell to 39 percent, there were substantial drops in the average amount given by all income groups of $100,000 or more.

Sales tax, value-added taxes pose two problems for charities. Neither is conducive to maintaining tax incentives for charitable giving and both are likely to result in direct taxation of exempt organizations. The key exemption issue for charities in either a national sales tax or a value-added tax is whether they would be compelled to pay tax on the goods and services they buy, collect tax on the goods and services they provide, or be exempt on both counts. Lack of full exemption will transfer some portion of the Nation's tax burdens to charities.

National sales or value-added taxes also lack an incentive for charitable giving. People who receive additional income because of the abolition of the income tax have no tax incentive to give that money to charity. Since no tax is due until consumption occurs, they can simply keep and invest the extra income. We hope that many of these people will be motivated to give a portion of their additional income to charity, but it is unlikely that additional contributions will make up for losses caused by the loss of the charitable deduction.

In closing, Brian O'Connell, past president and founder of the Independent Sector, told the Senate Finance Committee in 1982,

> A flat tax or a value-added tax or any other kind of tax will not destroy the willingness of Americans to give of themselves for the larger good. But, any tax restructuring that eliminates the charitable deduction will suddenly remove one of the ways this country has found to enhance giving. The resulting decrease in giving will move us away from the very kind of society we have determined that we want.

These words are as true today as they were 14 years ago.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

Statement by
William M. McLin

INDEPENDENT SECTOR Testimony

House Ways and Means Committee
Hearing on Impact on State and Local Governments
and Tax-Exempt Entities
of Replacing the Federal Income Tax

I am William M. McLin, Interim President of the National Health Council, an umbrella organization of more than 100 national health-related groups including America's leading voluntary health agencies such as the American Cancer Society, the Arthritis Foundation and the National Easter Seal Society. Previously, I was the Executive Vice President of the Epilepsy Foundation of America. Today I am representing INDEPENDENT SECTOR, of which the National Health Council is a Member organization.

INDEPENDENT SECTOR is a national leadership forum, working to encourage the philanthropy, volunteering, not-for-profit initiative, and citizen action that help us better serve people and communities. Founded in 1980, INDEPENDENT SECTOR is a national coalition of 785 voluntary organizations, foundations, and corporate giving programs.

INDEPENDENT SECTOR does not support or oppose tax reform. We are not here today to praise or critique any particular tax reform proposal. We are here to point out some of the consequences that various tax reform proposals may have on the ability of charitable, educational, and religious institutions to continue to provide the services that constitute their reasons for being. Tax reform proposals do not have charities as their target, but, as one analyst remarked, like bystanders at a gunfight, nonprofits have a good chance of being hit.

Tax reform poses two direct challenges for the independent sector. The first is whether a replacement tax system will exempt nonprofits from paying tax to the same extent as at present, or whether the new system will shift some of the burden of revenue production to nonprofits. The exemption problem is most acute in the case of the proposals to replace the income tax with taxes on business transactions. Either a national sales tax or a value added tax could badly damage charities if they do not explicitly exempt the goods and services that charities provide. The second is whether a replacement tax system will continue to offer tax incentives for charitable giving and whether those incentives will be as broadly based and effective as in times past. This problem arises to a significant degree in all tax reform proposals that are not based on an income tax or that do not incorporate a deduction for charitable giving.

The impact of tax reform on charitable organizations cannot be taken out of the context of other developments that affect them. The structural tax reform debate comes at a time when funding challenges and service demands on charities are greater than ever before. The federal government has begun the process of cutting domestic discretionary spending in many areas that are of concern to nonprofits and these cuts will grow over the next several years. Many are calling on charities to take up the slack and we will do what we can. Still, it is not likely that charities can increase private contributions enough to make up for federal cuts, even under the present tax system. Changes to the code that weaken or eliminate tax incentives for charitable giving will only worsen the situation.

Tax Exemption

Tax exemption for charitable, educational, cultural and religious institutions is deeply rooted in American history. American colonists carried with them to their new land both the British tradition of active private philanthropy and a strong spirit of self-help. From the earliest colonial days, Americans relied on voluntary, nongovernmental organizations and associations to provide for public needs. Government came later, absorbing and amplifying the services that originated with voluntary associations. The colonists brought with them as well the British practice of removing governmental obstacles in the way of charities. By the time of the Revolution, tax exemption was firmly enshrined in Colonial law. Today, every state exempts the property of charitable institutions from taxation and most provide exemptions from income, inheritance, and sales taxes as well.

The federal government followed state precedent. Since 1863, when the income of charitable organizations was exempted from the corporate tax enacted to finance the Civil War, the various income tax laws enacted by Congress have included an exemption for charitable, educational, and religious organizations. Not long after the initiation of the federal income tax, the Supreme Court wrote, "the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain."

While not a uniquely American invention, charitable tax exemption incorporates and reflects an approach to meeting public needs that embodies the American tradition of independence, of pluralism, and of pragmatic problem-solving. Tax exemption provides a way for government to support private efforts that improve the collective well-being. Tax exemption acknowledges that the public benefits when individuals band together to act on their own beliefs and opinions, rather than waiting for the government to take care of social needs. Tax exemption recognizes the public interest in maintaining a system that allows the creation of a diversified, fluid group of private organizations that can initiate new projects to respond to new needs, offer alternatives to government as the sole provider of services, and act in areas where government is forbidden to or ought not act. Finally, tax exemption recognizes that charities build community by mobilizing private resources for the public good, not for private gain. By taking a portion of their resources, taxing charities substitutes the government's choices about the public good for those made by the countless volunteers who contribute to and govern the operations of charitable, educational, and religious institutions.

Around the world governments are struggling to establish the kind of private voluntary sector that is so widespread in America. Leaders in other countries increasingly recognize the importance of a strong voluntary sector in building communities and nations. This recognition comes not just from a desire to create a group of private organizations that can provide governmental services more cheaply and efficiently, but because these leaders recognize that nonprofit voluntary organizations are important alternatives to government. Czech President Vaclav Havel describes the role of voluntary organizations in the emergence of democracy as one of rehabilitating values, such as trust, openness, responsibility, and love, which are the foundation of community. Charitable organizations reduce the burden of government in part by fostering values that make governing possible.

Deductibility of Contributions

The second key issue for nonprofits in the tax reform debate is the question of charitable deductions: the ability of individuals, businesses, and estates to deduct from their income contributions to charitable, religious, and educational organizations. Maintain-

charities do without themselves making contributions. Deductibility is an important aspect of pluralism. In place of a system in which the government makes all social policy decisions, the tax deduction for charitable contributions encourages individuals to make their own choices about the programs and institutions that best meet community and national needs. The charitable deduction has endured through five wars, a depression, innumerable recessions, budget surpluses and deficits, and top marginal rates ranging from 15 to 90 percent. It is economically important to charities, but it is also highly symbolic of the importance of the unique role charities play in American society.

The value of the charitable contributions deduction has been steadily eroding over the years. Nonitemizers lost their ability to deduct charitable contributions in 1986. In 1990, upper-income taxpayers watched the value of their deductions, including the charitable deduction, decline as a result of the 3% floor. INDEPENDENT SECTOR opposed both these measures and continues to support restoration of the full deductibility of charitable contributions.

People contribute to charitable causes because they are motivated to help others, not to gain a tax deduction. However, deductibility does influence the amount they give. People who itemize their deductions make larger gifts than people who do not itemize, a fact that holds true across all income levels.

Some argue that a flat tax will cause giving to go up, despite the loss of the deduction, because taxpayers will have more disposable income and because the vast majority of taxpayers do not itemize deductions and so are not affected by the change in deductibility. Having more money in one's pocket clearly means that one can afford to be more generous and there will be some increase in giving, particularly by nonitemizers. However, that increase is not likely to be enough to offset the disincentives created by the loss of deductibility. Any increase in income that results from a flat tax will be apportioned among a large number of consumption alternatives to charitable contributions, as well as used to increasing savings, which is one of the goals of tax reform. Although nonitemizers are not affected by the loss of the deduction, tax reform includes no special incentive to them to increase their giving, while providing a substantial disincentive to those who do itemize. According to Dr. Charles Clotfelter, Professor of Public Policy Studies, Duke University, "The negative effect of the elimination of the charitable deduction completely swamps the positive effect of an increase in after-tax income anticipated by proponents of a flat tax with no charitable deduction, because the cost of giving to the taxpayer would rise to one full dollar for each dollar given. Thus, an increase in after-tax income as a result of eliminating the charitable deduction, will be outweighed by the increased cost of giving."

Price/Waterhouse agrees. Their analysis shows that the average itemizer has an average tax rate of 25%, meaning that after-tax income is 75% of before-tax income. Under a flat tax of 17%, after-tax income would rise to 83% of before-tax income, making the average itemizer's after-tax income about 11% higher than under current law. However, elimination of the charitable deduction would increase the price of giving by 33% (the after-tax cost of a $1.00 gift would rise to $1.00 from $0.75 under current law). Hence the average itemizer would have about 11% more income with which to make gifts, but each gift would cost her 33% more than at present. In addition, economic research strongly indicates that individuals will reduce their contributions more for a given increase in price than they will increase them as a result of having more after-tax income.

IRS data clearly show that giving by upper-income taxpayers is very responsive to changes in tax policy that affect top marginal rates. In 1980, when top marginal rates

were 70%, taxpayers with incomes of $1 million or more gave, on average, $207,089. In 1993, when top marginal tax rates fell to 39.6%, giving by that same income group dropped to $108,883, or 47%. Over that same period, there were similar drops in both marginal tax rates and giving by all income groups of $100,000 or more.

Reductions in giving by upper-income taxpayers will disproportionately affect some types of charities, including universities and arts organizations. However, religious institutions and many human service charities also will be affected. These organizations rely on large givers to fund the cost of constructing and rehabilitating buildings and of acquiring capital equipment. Reduced tax incentives for large gifts will adversely affect capital giving campaigns for many types of charitable organizations.

Eliminating the charitable deduction will dramatically increase the after-tax cost of giving. Other changes that accompany some tax reform proposals will have an effect on charitable giving as well. While INDEPENDENT SECTOR neither supports nor opposes elimination of capital gains or estate taxation, both have consequences for the sector. Eliminating the capital-gains tax will produce a dramatic increase in the after-tax cost of contributions of appreciated property. Eliminating the estate tax will substantially alter the current incentives for bequests to charities. To provide charitable tax incentives under a flat tax that are comparable with those we have today will require something more than simple continuation of the charitable deduction, just as replacing the income tax with a national sales tax, a VAT or some other form of consumption tax will require an imaginative approach to providing continued tax incentives for charitable activity.

Corporate Giving

Corporate giving also will suffer under most tax reform proposals. While a number of flat tax proposals maintain the deduction for charitable giving for individuals, none continues it for businesses. Clotfelter and Schmalbeck estimate that corporate giving may decline as much as 15% to 45% below current levels. An unintended effect could be to switch more giving into the category of corporate sponsorship, for which an expense deduction presumably still would be available, changing the mix of charities that benefit from corporate largesse.

Repeal of Estate Tax

Repealing estate taxes is a feature of some tax reform proposals. As I said before, INDEPENDENT SECTOR does not take a position for or against repeal of the estate tax. However, repeal is likely to have consequences for charitable organizations. Clotfelter and Schmalbeck estimate that the value of charitable bequests could fall between $1.8 billion and $3.2 billion, a reduction of between 24% and 44% from the 1993 total of $7.3 billion. While the authors caution that these estimates are fraught with uncertainty, even Arthur Hall, a principal proponent of the flat tax, agrees that repealing estate taxes will significantly affect gifts of estate assets to charity.

A related issue—and one that is impossible to estimate—is the effect that repeal of the estate tax might have on the incentives donors have to make charitable gifts during their lifetime. Common sense tells us that some of these gifts are motivated in part by the desire to reduce the size of the estate that will be subject to tax at a time when donors are still able to appreciate the results of their gifts.

Repeal of the Capital Gains Tax

As in the case of repeal of the estate tax, INDEPENDENT SECTOR does not take a position for or against repeal of the capital gains tax. Again, however, repeal is likely to have a significant adverse effect on charitable institutions that should be taken into account in structuring new incentives for charitable giving.

Current law offers substantial incentives to donors to make gifts of appreciated property by allowing donors to deduct the property's fair market value, including the amount by which its value has appreciated while in the possession of the donor. Eliminating the charitable deduction will eliminate this incentive to make gifts of property. This effect will be heightened if Congress also repeals the tax on capital gains. Right now, donors who sell appreciated property must include the value of the appreciation in income and pay tax on it. Repealing the tax on capital gains would mean that taxpayers could elect to sell the asset and keep the profit free of tax, making the cost of giving the property away much higher.

Business Transaction Taxes

Sales taxes and value added taxes pose two problems for charities. Neither is conducive to maintaining tax incentives for charitable giving and both are likely to result in direct taxation of exempt organizations. In fact, a comprehensive transactions tax with no exemption for charities is something of a worst-case scenario because of the substantial shift of the tax burden to the nonprofit sector that is likely to result.

National Sales Tax

The key exemption issue for charities in a national sales tax is whether they would pay tax on goods and services that they purchase, collect tax on goods and services they sell, or be exempt on both counts. The general, but by no means universal, pattern in the states is to exempt charities from paying sales tax on purchases, but require them to collect tax on sales of tangible property and some taxable services.

At the moment, the federal government seems far less likely than the states to exempt charities from paying tax on purchases. Ease of administration and revenue needs both argue strongly for not exempting charitable organizations. However, the lack of exemption means that this version of tax reform will transfer some portion of the nation's tax burden to charities.

The issue of how to handle charitable sales is even more difficult. Many charities realize a portion of their income from fees and charges. A fifteen or twenty-five percent tax on university tuition, museum admissions, or nursing home bills will generate a significant tax liability on previously exempt nonprofits. The regressive nature of a sales tax will create particular problems for charities because most subsidize a portion of the cost of their services for those who cannot afford them. As the cost of the service goes up, so will the number of people who need subsidies. Repeal of the income tax could mitigate that effect to some extent since people will have higher incomes, but that effect is limited at the lower end of the economic scale where the amount of federal tax paid is low or nonexistent.

Sales taxes also have the problem of lacking an incentive for charitable giving. People who receive additional income because of the abolition of the income tax have no tax incentive to give that money to charity. Since no tax is due until consumption occurs, they can simply keep and invest the extra income. We hope that many of these people will be motivated to give a portion of their additional income to charity, but it is unlikely that additional contributions will make up for losses caused by loss of the charitable deduction.

Value Added Tax/Business Activities Tax

Exemptions are even more difficult in the VAT model. Because tax typically is imposed at each stage of the transaction, it is difficult to relieve charities of the tax burden without adding a substantial layer of complexity to the system. If charities are exempted from tax only on their sales, they will carry the burden of taxes collected on their purchases. If charities are to be fully exempted, there will be a need for a system to track the total tax and a mechanism for refunding it. As with a national sales tax, there are no incentives for charitable giving.

Tax-Exempt Bonds

Under current law a charity that issues $150 million of exempt bonds receives an annual subsidy of approximately $2 million. Most tax-reform proposals will eliminate the value of this subsidy.

Conclusion

Brian O'Connell, past President of INDEPENDENT SECTOR, told the Senate Finance Committee in 1982:

> A flat tax or a value added tax or any other kind of tax will not destroy the willingness of Americans to give of themselves for the larger good. But, any tax restructuring that eliminates the charitable deduction will suddenly remove one of the ways this country has found to enhance giving. The resulting decrease in giving will move us away from the very kind of society we've determined that we want.

These words are as true today as they were fourteen years ago.

AAFRC Trust for Philanthropy
Access Video Fund
ACCESS: Networking in the Public Interest
Accountants for the Public Interest
The Advertising Council
Advocacy Institute
Aetna Foundation
Affiliated Leadership League of and for the Blind of America
The Africa Fund
Aga Khan Foundation U.S.A.
Agricultural Educational Foundation (AEF)
Aid Association for Lutherans
Aid to Artisans
Alcoa Foundation
Alliance for International Educational and Cultural Exchange
ALSAC/St. Jude Children's Research Hospital
Alzheimer's Association
America's Charities
America's Development Foundation
American Arts Alliance
American Association for Higher Education
American Association for the Advancement of Science
American Association of Community Colleges
American Association of Fund-Raising Counsel
American Association of Museums
American Association of Retired Persons
American Association of University Women
American Autoimmune Related Diseases Association
American Cancer Society
American Chemical Society
American Council for the Arts
American Council of Learned Societies
American Council on Education
American Craft Council
American Diabetes Association
American Ditchley Foundation
American Express Company
American Farmland Trust
American Fisheries Society
American Foundation for the Blind
American Heart Association
American Humane Association
American Humanics
American Indian College Fund
American Indian Graduate Center
American Institute for Cancer Research
American Institute of Philanthropy
American Leadership Forum
American Library Association
American Medical Association
American Museum of Natural History
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American Social Health Association
American Solar Energy Society
American Stock Exchange
American Symphony Orchestra League

American Tinnitus Association
Americans for Indian Opportunity
Amigos de las Americas
Amoco Foundation
Apple Computer
Applied Research and Development Institute
The Arc of the United States
Arca Foundation
ARCO Foundation
ARNOVA - Association for Research on Nonprofit Organizations & Voluntary Action
ARROW
Arthritis Foundation
Arts & Business Council
Asian Pacific American Legal Consortium
The Aspen Institute
The ASPIRA Association
The Association of Theological Schools
Associated Grantmakers of Massachusetts
Association for Healthcare Philanthropy
Association for Volunteer Administration
Association of Advanced Rabbinical & Talmudic Schools (AARTS)
Association of America's Public Television Stations
Association of American Universities
Association of American University Presses
Association of Art Museum Directors
Association of Black Foundation Executives
Association of Catholic Colleges and Universities
Association of Episcopal Colleges
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Association of Jewish Family and Children's Agencies
Association of Junior Leagues International
Association of Lutheran Development Executives
Association of Performing Arts Presenters
Association of Science-Technology Centers
AT&T Foundation
Atlantic Foundation of New York
Mary Reynolds Babcock Foundation
Bainbridge Educational Foundation
Ball Brothers Foundation
Association of Baltimore Area Grantmakers
Battle Creek Community Foundation
The Bauman Foundation
BellSouth Corporation
Benton Foundation
Beverly Foundation
Big Brothers/Big Sisters of America
Bing Fund Corp.
Blandin Foundation
Blanton-Peale/Institutes of Religion and Health
H&R Block Foundation
Blue Cross of California, Public Benefit Programs
Borden Foundation
Boston Foundation
Boy Scouts of America
Boys & Girls Clubs of America

Brain Trauma Foundation
Otto Bremer Foundation
Greater Bridgeport Area Foundation
Bristol-Myers Squibb Foundation
Brunswick Foundation
The Burnett Foundation
Edyth Bush Charitable Foundation
The Bush Foundation
California Association of Nonprofits
California Community Foundation
California Wellness Foundation
Camp Fire Boys and Girls
Cancer Care
CARE
Carnegie Corporation of New York
The Annie E. Casey Foundation
Catalyst
Caterpillar Foundation
Catholic Charities USA
CBS Foundation
Center for Corporate Public Involvement
Center for Creative Leadership
Center for Creative Management
Center for Media Education
Center for Non-Profit Corporations
Center for Nonprofit Management University of St. Thomas
Center for Policy Alternatives
Center for Public Service, Seton Hall University
Center for Research in Ambulatory Health Care Administration
Center for the Study of Philanthropy-City University of NY
Center for the Study of the Presidency
Center for Women Policy Studies
Centre on Philanthropy
Challenger Center for Space Science Education
Champion International Corporation
Chase Manhattan Foundation
The Chevron Companies
The Chicago Community Trust
Chicago Tribune Foundation
Child Care Action Campaign
Child Health Foundation
Child Welfare League of America
Children's Aid International
Children's Fund of Connecticut
Chorus America (APVE)
Christian Church Foundation
Christmas in April USA
Chrysler Corporation Fund
Church Women United
Citibank
Citizens' Scholarship Foundation of America
City Cares of America
City Innovation
City Year
Edna McConnell Clark Foundation
The Cleveland Foundation

Van Cliburn Foundation
The Clorox Company Foundation
Close Up Foundation
The Coca-Cola Company
College Board
Colonial Williamsburg Foundation
Colorado Association of Nonprofit Organizations
The Colorado Trust
Columbia Foundation
Columbus Foundation
Combined Health Appeal of America
Comerica Incorporated
Commonwealth Community Foundations
Commonwealth Fund
Communications Consortium
Community Anti-Drug Coalitions of America
Compeer, Inc.
Compton Foundation
Conference of National Park Cooperating Associations
Conference of Southwest Foundations
Congress of National Black Churches
The Conservation Fund
Consortium of Endowed Episcopal Parishes
Cooperative Development Foundation
Coordinating Council for Foundations
Corning Incorporated Foundation
Coro/Eastern Center
Corporation for Enterprise Development
Council for Advancement and Support of Education
Council for American Private Education
Council of Better Business Bureaus/Philanthropic Advisory Service
Council of Energy Resource Tribes
Council of Independent Colleges
Council of Jewish Federations
Council of Michigan Foundations
Council on Foundations
Council on International and Public Affairs
CPC International
Nathan Cummings Foundation
Cystic Fibrosis Foundation
Dade Community Foundation
Charles A. Dana Foundation
Dance/USA
Danforth Foundation
Dayton Hudson Foundation
Deafness Research Foundation
Delaware Association of Nonprofit Agencies
Direct Relief International
Geraldine R. Dodge Foundation
Dole Foundation for Employment of People with Disabilities
Gaylord and Dorothy Donnelley Foundation
R.R. Donnelley & Sons Co.
Donors Forum of Chicago
Donors Forum of Ohio
Donors Forum of Wisconsin
The Dow Chemical Company

Joseph Drown Foundation
Peter F. Drucker Foundation for Nonprofit Management
The Drug Policy Foundation
The Duke Endowment
DuPont
The Durfee Foundation
Earth Share
Eastman Kodak Company
Ecolab Foundation
Ecumenical Center for Stewardship Studies
Educational Testing Service
El Pomar Foundation
Elderhostel
Elderworks
Enterprise Foundation
Environmental Defense Fund
Environmental Media Services
Environmental Support Center
Epilepsy Foundation of America
The Equitable Foundation
Eureka Communities
Evangelical Council for Financial Accountability (ECFA)
Evangelical Lutheran Church in America
Exxon Corporation
Fairfield County Community Foundation
Maurice Falk Medical Fund
Families International
Fannie Mae Foundation
Fel-Pro/Mecklenburger
First Interstate Bank of California Foundation
First Nations Development Institute
First Nonprofit Companies
Father Flanagan's Boys' Home
Community Foundation of Greater Flint
Florida Association of Nonprofit Organizations
Food Research & Action Center
The Ford Foundation
Ford Motor Company Fund
Henry Ford Museum and Greenfield Village
Foreign Policy Association
The Foundation Center
Foundation for Advancements in Science and Education
Foundation for Independent Higher Education
Foundation for the Carolinas
Foundation for the National Capital Region
The Freedom Forum
The Fresh Air Fund
Frey Foundation
Friends of the National Library of Medicine
Lloyd A. Fry Foundation
H.B. Fuller Company
The Fund for New Jersey
GE Fund
General Board of Global Ministries The United Methodist Church
General Conference of Seventh-day Adventists
General Mills Foundation

General Service Foundation
The Wallace Alexander Gerbode Foundation
J. Paul Getty Trust
Gifts in Kind America
Giraffe Project
Girl Scouts of the U.S.A.
Girls Incorporated
Global Fund for Women
Morris Goldseker Foundation of Maryland
Goodwill Industries International
Goodyear Tire & Rubber Company
Edwin Gould Foundation for Children
Graco Foundation
Grantmakers In Health
Grantmakers of Western Pennsylvania
Lucile & Robert H. Gries Charity Fund
George Bird Grinnell American Indian Children's Fund
Grotto Foundation
GTE Foundation
George Gund Foundation
Alan Guttmacher Institute
Miriam and Peter Haas Fund
Walter and Elise Haas Fund
Evelyn and Walter Haas, Jr. Fund
Walter A. Haas School of Business Public & Nonprofit Management Program
Habitat for Humanity International
Hallmark Corporate Foundation
Luke B. Hancock Foundation
Mary W. Harriman Foundation
Harris Trust & Savings Bank
Hartford Foundation for Public Giving
Charles Hayden Foundation
Edward W. Hazen Foundation
William Randolph Hearst Foundations
The William and Flora Hewlett Foundation
High/Scope Educational Research Foundation
Hispanic Association of Colleges and Universities
Hispanic Association on Corporate Responsibility
Hispanic Policy Development Project
Hispanics in Philanthropy
Hitachi Foundation
Hoblitzelle Foundation
Hoffmann-La Roche Foundation
Hogg Foundation for Mental Health
Hole In The Wall Gang Fund
Honeywell Foundation
The Hospital for Special Surgery
Hostelling International-American Youth Hostels
Hudson-Webber Foundation
Human Life International
Humboldt Area Foundation
Hubert H. Humphrey Institute/Public Policy, Philan. & the Nonprofit Sector
Huntington's Disease Society of America
IBM Corporation
Illinois Association of Nonprofit Organizations
IMPACT II

Independent Charities of America
The Indiana University Center on Philanthropy
Innovation Network
Institute for Educational Leadership
Institute for Women's Policy Research
Intel Foundation
InterAction-American Council for Voluntary International Action
Interlochen Center for the Arts
International Alliance of Executive and Professional Women
International Center for Journalists
International Center for the Disabled
International Development Conference
International Executive Service Corps
International Primate Protection League
International Service Agencies
International Society for Third Sector Research
The James Irvine Foundation
Ittleson Foundation
Jacksonville Community Foundation
JCC Association of North America
Jerome Foundation
The Jewett Foundation
JM Foundation
Johnson & Johnson
The Johnson Foundation
Walter S. Johnson Foundation
Christian A. Johnson Endeavor Foundation
Robert Wood Johnson Foundation
Joint Action in Community Service (JACS)
Joint Center for Political and Economic Studies
Josephson Institute of Ethics
The Joyce Foundation
JSJ Foundation
Alexander Julian Foundation
Junior Achievement
Henry J. Kaiser Family Foundation
Ewing Marion Kauffman Foundation
W.K. Kellogg Foundation
James S. Kemper Foundation
Harris and Eliza Kempner Fund
Kerr Foundation
Charles F. Kettering Foundation
The Esther and Joseph Klingenstein Fund
John S. and James L. Knight Foundation
Kosciuszko Foundation
KPMG Peat Marwick Foundation
The Kresge Foundation
Samuel H. Kress Foundation
Albert Kunstadter Family Foundation
Land Stewardship Project
Land Trust Alliance
Laubach Literacy Action
Laurel Foundation
Lawyers' Committee for Civil Rights Under Law
League of Women Voters of the United States
Sara Lee Foundation

Leukemia Society of America
The Lighthouse Inc.
Lilly Endowment
Eli Lilly and Company
Lincoln Filene Center, Tufts University
Literacy Volunteers of America
Local Initiatives Support Corporation
Lupus Foundation of America
Lutheran Brotherhood Foundation
John D. and Catherine T. MacArthur Foundation
MANA, A National Latina Organization
Mandel Center for Nonprofit Organizations Case Western Reserve University
March for Life Education & Defense Fund
March of Dimes Birth Defects Foundation
Marin Community Foundation
John and Mary R. Markle Foundation
Marsh & McLennan Companies
Maryland Association of Nonprofit Organizations
MATHCOUNTS
Matsushita Electric Corporation of America
Mayo Foundation
McConnell Foundation
Robert R. McCormick Tribune Foundation
McGregor Fund
McKesson Foundation
McKnight Foundation
The Meadows Foundation
Medical Education for South African Blacks
Medtronic Foundation
Richard King Mellon Foundation
Memorial Sloan-Kettering Cancer Center
Community Foundation of Greater Memphis
The Menninger Foundation
The John Merck Fund
Mercy Medical Airlift
Merrill Lynch & Co. Foundation
Metropolitan Association for Philanthropy
Metropolitan Atlanta Community Foundation
Metropolitan Life Foundation
The Metropolitan Museum of Art
Mexican American Legal Defense and Educational Fund
Eugene and Agnes E. Meyer Foundation
Michigan Nonprofit Association
Midwest Center for Nonprofit Leadership L.P. Cookingham Institute
John Milton Society for the Blind
Milwaukee Foundation
The Minneapolis Foundation
Minnesota Council of Nonprofits
Minnesota Mutual Foundation
Mississippi Center for Nonprofits
Mobil Foundation
Monsanto Fund
Moore Foundation
Stewart R. Mott Charitable Trust
Charles Stewart Mott Foundation
Muscular Dystrophy Association

Museum Trustee Association
Muskegon County Community Foundation
Mutual of New York
NAACP Legal Defense and Educational Fund
National 4-H Council
National ABLE Network
National Academy of Public Administration
National Action Council for Minorities in Engineering (NACME)
National AIDS Fund
National Alliance for Choice in Giving
National Alliance for the Mentally Ill
National Alliance of Breast Cancer Organizations
National Alliance of Business
National Assembly of Local Arts Agencies
National Assembly of National Voluntary Health and Social Welfare Organizations
National Assembly of State Arts Agencies (NASAA)
National Assistance League
National Association for Bilingual Education
National Association for Community Leadership
National Association for Visually Handicapped
National Association of Community Action Agencies
National Association of Homes and Services for Children
National Association of Independent Colleges and Universities
National Association of Independent Schools
National Association of Schools of Art and Design
National Association of Schools of Dance
National Association of Schools of Music
National Association of Schools of Public Affairs and Administration
National Association of Schools of Theatre
National Association of Service & Conservation Corps
National Association of Student Personnel Administrators
National Association of United Methodist Foundations
National Association on Drug Abuse Problems
National Associations in Colorado Springs
National Audubon Society
National Board for Professional Teaching Standards
National Catholic Development Conference
National Catholic Educational Association
National Center for Learning Disabilities
National Center for Nonprofit Boards
National Charities Information Bureau
National Civic League
National College Access Network
National Committee for Responsive Philanthropy
National Committee to Prevent Child Abuse
National Community Reinvestment Coalition
National Concilio of America
The National Conference
National Consumers League
National Council for Adoption
National Council for International Visitors
National Council for Research on Women
National Council of Educational Opportunity Associations
National Council of La Raza
National Council of Nonprofit Associations
National Council of Private Agencies for the Blind and Visually Impaired

National Council of the Churches of Christ in the USA
National Council on Child Abuse & Family Violence
National Council on Economic Education
National Down Syndrome Society
National Easter Seal Society
National Executive Service Corps
National FFA Foundation
National Foundation for Cancer Research
National Foundation for the Centers for Disease Control and Prevention
National Geographic Society Education Foundation
National Headache Foundation
National Health Council
National Health Foundation
National Hispana Leadership Institute
National Hispanic Scholarship Fund
National Home Library Foundation
National Hospice Organization
National Humanities Alliance
National Institute for Dispute Resolution
National Institute for the Conservation of Cultural Property
National Interfaith Hospitality Networks
National Lekotek Center
National Medical Fellowships
National Military Family Association
National Multiple Sclerosis Society
National Neighborhood Coalition
National Network for Youth Youth Services
National Parkinson Foundation
National Peace Corps Association
National Press Foundation
National Public Radio
National Puerto Rican Coalition
National Retiree Volunteer Coalition
National Society for Experiential Education (NSEE)
National Society of Fund Raising Executives
National Stroke Association
National Trust for Historic Preservation
National Urban Fellows, Inc.
National Urban League
National Victim Center
National Wildlife Federation
National Youth Employment Coalition
National Youth Leadership Council
Native American Rights Fund
Native Americans in Philanthropy
Natural Resources Defense Council
The Nature Conservancy
Neighborhood Reinvestment Corporation
New Hampshire Charitable Foundation
The Community Foundation for Greater New Haven
The New York Botanical Garden
The New York Community Trust
New York Life Foundation
The New York Public Library
New York Regional Association of Grantmakers
The New York Times Company Foundation

Nokomis Foundation
Nonprofit Academic Centers Council Indiana University
Nonprofit Coordinating Committee of New York
Nonprofit Management Association
Nonprofit Management Program, New School for Social Research
Nonprofit Resource Center
The Nord Family Foundation
The Nord Family Foundation
Nordson Corporation Foundation
North American Association for Environmental Education
North Carolina Center for Nonprofit Organizations
Northern California Grantmakers
Northwest Area Foundation
NOW Legal Defense and Education Fund
NYNEX Foundation
Oakleaf Foundation
OICs of America
Older Women's League (OWL)
OPERA America
Operation Smile International
Oral Health America
Outward Bound USA
Pacific Telesis Foundation
David and Lucile Packard Foundation
Pact
Paget Foundation
Community Foundation for Palm Beach & Martin Counties
Parents Anonymous
Park Ridge Center for the Study of Health, Faith and Ethics
Partners of the Americas
Pax World Service
Peninsula Community Foundation
William Penn Foundation
J.C. Penney Company
University of Pennsylvania Center for Community Partnerships
Pew Charitable Trusts
The Pfizer Foundation
The Philanthropic Group
Philip Morris Companies
The Piton Foundation
The Pittsburgh Foundation
Points of Light Foundation
Population Council
Population Resource Center
Premier Industrial Foundation
Presbyterian Health Foundation
Presbyterian Women
Presidential Classroom for Young Americans
Princeton Project 55
Procter & Gamble Fund
Project Hope
Project SEED
Prudential Foundation
Public Affairs Council
Public Agenda Foundation
Public Allies

Public Education Fund Network
Public Leadership Education Network
Public Radio International
Radio and Television News Directors Foundation
Rainbow Research
Raychem Corporation
Raytheon Company
Reader's Digest Foundation
Reading is Fundamental
Recording for the Blind and Dyslexic
Religion in American Life
Replication and Program Strategies
Research! America
Resourceful Women
Retirement Research Foundation
Charles H. Revson Foundation
Rhone-Poulenc, Inc.
Sid W. Richardson Foundation
Mable Louise Riley Foundation
Fannie E. Rippel Foundation
Rochester Area Foundation
Rockefeller Brothers Fund
Rockefeller Family Fund
Rockefeller Financial Services
Rockefeller Foundation
Rohm and Haas Company
Rosenberg Foundation
SAFECO Insurance Companies
The Saint Paul Companies
Saint Paul Foundation
The Salk Institute for Biological Studies
Salvation Army
San Antonio Area Foundation
San Francisco Foundation
University of San Francisco-Institute for Nonprofit Organization Management
Save the Children Federation
Dr. Scholl Foundation
School Food Service Foundation
The School for Field Studies
Sears Merchandise Group
Seattle Foundation
Second Harvest
Shepherd's Centers of America
Sherwin-Williams Company
Sierra Club
Sierra Health Foundation
Harry Singer Foundation
The Sister Fund
The Skillbuilders Fund
Skillman Foundation
Alfred P. Sloan Foundation
Smithsonian Institution
John Ben Snow Foundation
Social Welfare Research Institute Boston College
Society for Values in Higher Education
Southeastern Council of Foundations

Community Foundation for Southeastern Michigan
Southern California Association for Philanthropy
Southern Education Foundation
The Spencer Foundation
Spunk Fund
W. Clement & Jessie V. Stone Foundation
Levi Strauss & Company
Stronghold Foundation
Student Conservation Association
Student Pugwash USA
The Studio Museum in Harlem
Subaru of America Foundation
Support Centers of America
Synergos Institute
Taconic Foundation
Tandy Corporation
Community Foundation of Metropolitan Tarrant County
TechnoServe
Tenneco
Texaco Foundation
Theatre Communications Group
3M
Time Warner
Travelers Aid International
The Trilateral Commission
The Parish of Trinity Church in the City of New York
Trust for Public Land
TV-Free America
U.S. Trust Company Foundation
Union Institute-Center for Public Policy
United Cerebral Palsy Associations
United Leukodystrophy Foundation
United Negro College Fund
United Scleroderma Foundation
United States Catholic Conference
United States Committee for UNICEF
United States-China Educational Institute
United Way International
United Way of America
UPS Foundation
US West Foundation
Vellore Christian Medical College Board (USA)
Very Special Arts
Volunteers of America
Volvo North America Corporation
Izaak Walton League of America
Washington Center
Washington Council of Agencies
Washington Mutual Savings Bank
Washington Regional Association of Grantmakers
The Wege Foundation
Weingart Foundation
Weyerhaeuser Family Foundation
Whirlpool Foundation
Mrs. Giles Whiting Foundation
Amherst H. Wilder Foundation

Woodrow Wilson National Fellowship Foundation
The Winston-Salem Foundation
Wisconsin Energy Corporation Foundation
Women and Philanthropy
Women's College Coalition
Women's Funding Network
Women's Research & Education Institute
Robert W. Woodruff Foundation
Woods Fund of Chicago
Greater Worcester Community Foundation
World Federation for Mental Health
World Institute on Disability
World Resources Institute
World Servants
World Vision
Wyman Youth Trust
Xerox Corporation
YMCA of the USA
Young Audiences
Youth Service America
YWCA of the USA
Zellerbach Family Fund

Chairman ARCHER. Thank you, Mr. McLin.

Mr. Lukhard, if you will identify yourself, you may proceed.

STATEMENT OF HON. WILLIAM L. LUKHARD, CHAIRMAN, GOVERNMENT RELATIONS COMMITTEE, UNITED WAY OF VIRGINIA; ON BEHALF OF THE UNITED WAY OF AMERICA, AND FORMER COMMISSIONER, DEPARTMENT OF SOCIAL SERVICES, COMMONWEALTH OF VIRGINIA

Mr. LUKHARD. Thank you, Mr. Chairman. I am William Lukhard. I chair the Government Relations Committee for the United Way of Virginia.

I am here today on behalf of the United Way of America, its 1,400 State and local United Ways across the country, some 44,000 affiliated agencies providing a variety of human services, and particularly the millions of people they serve. I thank you for the opportunity to provide the Committee with our perspective on structural tax reform.

We recognize the complexity of our current tax structure and support efforts to induce fairness, simplicity, and equity into the tax system. As of this time, United Way has not embraced any one tax package or set of reforms over another.

However, we strongly believe that the charitable deduction is a significant contribution to philanthropic behavior. As an example, in 1985, nonitemizing taxpayers were permitted to deduct 50 percent of their charitable contributions. The result was $9.5 billion. In 1986, they could deduct a full 100 percent, and according to the Internal Revenue Service, they gave $13.4 billion, an increase of 40 percent.

The Tax Reform Act of 1986 flattened individual tax rates, attempted to close loopholes, and removed the charitable deduction for nonitemizers. That also reduced the value of the charitable deduction by imposing a 3-percent floor on those deductions for high-income taxpayers. Again, according to the IRS information, among the taxpayers with incomes, say, of over $1 million or more, the average charitable deduction per tax return dropped from slightly over $207,000 to slightly under $109,000 from the years 1980 through 1993.

Where some data show, as a previous gentleman said, that Americans give to charity for reasons not solely related to contributions being deductible, we believe the charitable deduction is an influencing factor on the amount and timing of the particular gift.

We have reservations about the proposed national sales tax and are examining the potential consequences that tax reform would have for nonprofits. We are concerned about the potentially regressive nature of the flat tax and the potential cost that would be borne by charities; not only on the sense of the direct taxes that might be paid by nonprofits for the goods and services they purchase or that they may have to charge for the services they deliver, but also the regressive tax nature on the lower income individuals.

Hypothetically, for example, someone earning between, say, $10,000 to $15,000 a year with a 15-percent sales tax would be paying $1,500 to $2,250 in taxes. That is in the pure form. Obviously, they are not paying that rate of tax now in terms of income tax. They will likely be saving very little, if any, and therefore their

needs on these service agencies will become greater. In the aggregate, then, there will be more demand on these agencies if we do away with the contribution deduction. Then there will be less resources for agencies to serve these particular individuals.

With regard to the flat tax system, we are again concerned about its potential regressive nature. There are proponents of the flat tax who suggest that individual giving will increase as disposable income increases. While it is possible that if we increase our efforts, giving could increase, we are concerned that the decline in individual giving will not be reversed by a flat tax.

The tax proposal of Senators Nunn and Domenici merits attention because it might not reduce incentives to give as much as the flat tax potentially would. More study is needed on each of these plans to determine what impact tax reform will have on charities.

But regardless of what proposals are advanced now or in the future, we would encourage you to look carefully at all the available studies and data relating to the matter. With the continuing decrease in Federal and State funding, we have heard that charities will be expected to do more. If this is true, changes in the Tax Code should provide greater incentives, not disincentives, to charitable giving. We urge you to review the matter carefully and particularly to assess whatever behavioral consequences there may be for individual taxpayers.

United Ways support high quality services for millions of Americans, from child care to emergency services to services for the elderly. United Ways and their affiliated agencies work to enhance our communities and the lives of our neighbors. We believe that any effort to reform the tax system should continue to encourage charitable giving and be supportive of the valuable activities of our charitable community.

I thank you again for the opportunity to testify.

[The prepared statement follows:]

HEARING OF THE COMMITTEE ON WAYS AND MEANS
STATEMENT OF THE
HONORABLE WILLIAM L. LUKHARD

MAY 1, 1996

Good morning, Chairman Archer, members of the committee. I am William Lukhard, a United Way Volunteer and Chairman of the Government Relations Committee, United Way of Virginia. I am here today to testify about various proposals to reform our tax system on behalf of United Way of America, 1,400 state and local United Ways, the 44,000 affiliated agencies and particularly the millions of people they serve. Thank you for this opportunity to provide the committee with our perspective on structural tax reform.

We, like many Members of Congress, are studying various tax reform proposals and assessing the potential impact that they would have on United Ways, United Way agencies, donors, and ultimately, recipients. We recognize the complexity of our current tax structure and support efforts to induce fairness, simplicity and equity into the tax system. At this time, we have not embraced one tax package or set of reforms over another.

Over the years, policy makers have used the tax code to influence the behavior of tax payers. For example, we have a generous mortgage deduction to promote homeownership, and we have a deduction for charitable contributions to encourage charitable giving. We believe that the charitable deduction is a significant contributor to philanthropic behavior, and strongly oppose eliminating it.

The Tax Reform Act of 1986 attempted to flatten individual tax rates to lower our taxes and impose greater fairness in the system in a deficit-neutral fashion. In addition, tax reform attempted to close loopholes, and it removed non-itemized deductions. At the same time, the 1986 act reduced the value of the charitable deduction by imposing a three percent floor on those deductions. While charitable giving has remained somewhat constant during the last ten years, individual giving has dropped precipitously. Accordingly, we would support eliminating the three percent floor in <u>any</u> tax reform proposal.

We have reservations about each of the major tax reform proposals that have been mentioned this morning. Few analyses have focused attention thus far on the potential impact these tax plans would have on planned giving and estate planning. Thousands of non-profits depend on large gifts of money and property. We have reservations about a proposed national sales tax and are examining the potential consequences a national sales tax could have for non-profits. It is a fact that lower income individuals give more, per capita, to charity than any other income group. We are also concerned about the potential regressive nature of a sales tax and the potential costs that would be borne by charities.

With regard to a flat tax system, we again are concerned about it's potentially regressive nature. Proponents of a flat tax suggest that individual giving will increase as disposable income increases. While it is possible that if we increase our efforts giving could increase, we are concerned that the decline in individual giving will not be reversed by a flat tax. The Unlimited Savings Allowance ("USA") tax reform proposal submitted by Senators Nunn and Domenici merits attention because it might not reduce incentives to give as much as a flax tax would; but the Nunn-Domenici USA plan with its generous deductions to promote saving might encourage taxpayers to choose saving over charitable contributions. More study is needed on each of these plans to determine what impact tax reform will have on charities.

Regardless of what proposals are advanced, now or in the future, we would encourage you to look carefully at all of the available studies relating to this matter. What we do know is that Americans over the years have been the most generous people on earth, supporting as they do thousands upon thousands of worthwhile charitable activities. With the continuing decrease in federal and state funding, we have been hearing that charities will

be expected to do more. If this be true, changes in the tax code should provide greater incentives -- not disincentives -- to charitable giving.

While some data show that Americans give to charity for reasons that are not solely related to whether their contributions are deductible, we nonetheless urge you to review this matter carefully and, particularly, to assess whatever behavioral consequences there may be for individual taxpayers.

United Ways have the reputation of being the most efficient and effective fundraisers across the nation. They support high-quality services for millions of Americans. From child care to emergency services, to services for the elderly, United Ways and United Way agencies work to enhance our communities and the lives of our neighbors. We believe that any effort to reform the tax system should continue to encourage charitable giving and be supportive of the valuable activities of our charitable community.

Thank you again for this opportunity to testify before your committee.

Chairman ARCHER. Thank you, Mr. Lukhard.

Mr. Fields, welcome to the Committee. I would like to repeat what I said a little earlier, generally that we would appreciate it if you would keep your oral testimony to within 5 minutes. Your entire written statement will be submitted and printed in the record. If you will identify yourself for the record, you may proceed.

STATEMENT OF RANDALL H. FIELDS, MEMBER, BAPTIST JOINT COMMITTEE

Mr. FIELDS. Thank you, Chairman Archer, and I apologize for being late. We thought that you had a few more votes maybe to take care of, but I apologize for that.

Chairman ARCHER. You are just in time. No problem.

Mr. FIELDS. Thank you very much, sir. My name is Randall Fields. I am an attorney in private practice in San Antonio, Texas, and I manage the business and health law section of Johnson, Curney & Fields in San Antonio.

In addition to my profession, though, I am also very active on a voluntary basis in a number of religious, educational, and charitable organizations. I currently serve as the chairman of the Board of Regents of the Baylor University System. Baylor is the Nation's largest Baptist university. We have a 12,000-student campus in Waco, Texas. We also oversee the Baylor Medical Center in Dallas, Texas. I am also the founding president of a foundation to support our public school district in San Antonio, the North Side Independent School District, which serves about 60,000 students. In addition to that, I am a past chairman of the Deacon Council of Trinity Baptist Church in San Antonio, which is a 10,000-member downtown church in San Antonio that has extensive community service programs.

But I am here today as a member of these other groups but representing the Baptist Joint Committee. The Baptist Joint Committee represents over a dozen Baptist groups and denominations throughout the country relating to religious liberty and separation of church and state.

I would like to make the first point that we feel that any effort to limit or eliminate the tax-exempt status of churches and religious organizations would raise serious religious liberty concerns.

So I come to the Committee with a perspective that may be a little unique from the other panel members' standpoint in that all of my services that I have mentioned above are purely voluntary. I do not get paid a dime to do any of those, but I do it because I want to, to help our community out. I think that there are many thousands and millions of people like me across the country that the proposed legislation would impact.

As a businessman, I can tell you that any segment of our government that has a negative impact on the productivity of the private sector from an economic standpoint should be examined thoroughly and, where possible and of benefit to all the citizens, should be changed. From that standpoint, we certainly applaud the efforts of Congress and especially a number of the Members of this Committee for undertaking an examination of the Federal tax system. We think it is high time that that be done, and again, as a private businessman, I am glad that we are doing that.

Our plea today, though, is that in making this examination and any possible adjustment, that we make an effort to maintain and enhance the charitable giving sector from a voluntary standpoint, both in the intermediate term and the long term. As has been said a number of times before today in previous hearings, any replacement tax system would have ripples throughout the economy, regardless of how extensive it was. Our big concern is that in adopting a replacement tax system, that smaller charities, especially, not be swept under by the tidal wave that is likely to result from that.

I think that you can divide charitable giving into two broad categories. One is what I would label the large capital gifts, and then other gifts that are smaller gifts. Taking the second category first, my feeling is that the smaller gifts have three driving forces behind them. One is the general state of the economy. Another is the esteem with which the individual charitable institution is held by the publics that serve them. And then the third, to some degree, is the incentive of deductibility.

The large capital gifts, on the other hand, have the same three driving forces, but to a much, much greater extent the deductibility that is built into the present tax structure.

Basically, what we would ask the Committee to recognize, and I know that you do, is that cash flow is so important to all charities that a disruption or a dislocation in the giving of especially large capital gifts over more than a 1- or 2-year period could have a devastating effect on the charitable sector as far as the smaller charities go. Here, I am including not only hospitals, educational institutions, but even churches which depend on large capital gifts to maintain their building programs and their efforts to provide community services.

In conclusion, I would just say that any change in the basic tax structure should have built into it a transition period. Chairman Archer has already spoken to that earlier today, and I know that will be on the Committee's mind. The transition period should provide support at least for the large capital gifts that sustain many, many charities. Without these safeguards, we feel that a number of the smaller charities would cease to exist, and at the very least, go into their endowment. We think that by doing that, that would throw services back on the governmental sector and that is what we are concerned about.

We appreciate your time and thank you for addressing this important matter.

[The prepared statement follows:]

THE IMPACT OF VARIOUS REPLACEMENT TAX SYSTEM PROPOSALS ON CHARITABLE CONTRIBUTIONS

Statement Submitted at Hearings of the
Committee on Ways and Means
United States House of Representatives
Randall H. Fields
May 1, 1996

Volunteerism Background

My name is Randall Fields. I am an attorney in private practice in San Antonio, Texas, and manage the business and health law section of Johnson, Curney & Fields.

In addition to my profession, I am very active on a voluntary basis in several religious, educational and charitable non-profit organizations, currently serving as Chairman of the Board of Regents of the Baylor University System. Baylor is the nation's largest Baptist university, with a 12,000 student campus in Waco, Texas. The Baylor Medical Center, also a part of our system, is a major, regional non-profit hospital system in Dallas, Texas.

I am the founding President of San Antonio's Northside Education Foundation, a charitable organization formed to coordinate and promote voluntary support for San Antonio's Northside Independent School District, the State's seventh largest and one of the fastest growing public school districts in America, serving almost 60,000 students.

I am also a past Chairman of the Deacon Council and Finance Committee at San Antonio's Trinity Baptist Church, a 10,000 member downtown church with an extensive community service program.

I am here today on behalf of the Baptist Joint Committee, a non-profit organization serving a dozen Baptist denominations and other groups in the United States on matters relating to religious liberty and the separation of church and state. Any effort to limit or eliminate the tax-exempt status of churches and religious organizations raises serious religious liberty concerns.

Economic Needs

As a businessman, I have a great interest in the productivity and competitive position of our nation. To the extent that any segment of our government negatively impacts America's long term financial position in the world order, that segment should be thoroughly examined and, where possible, adjusted for the benefit of all citizens.

I applaud the efforts of Congress, especially those members present today, to undertake examination of our Federal tax system, and seek ways to lessen the financial and administrative burden on taxpayers, while promoting productivity and competition.

My plea today is that, in making this examination and possible adjustment, efforts be taken to maintain and enhance the charitable giving sector of our economy, both in the intermediate term (two to five years) and long term (beyond five years).

Impact of Change on Charitable Giving

Any change in the Federal tax structure will always send ripples through the economy. The replacement tax systems that have been proposed, when and if implemented, will magnify those ripples to tidal wave intensity without appropriate precautions.

One area of the economy that could be swept under in this process is what I will call the "Capital Gift" component of charitable giving. By this term, I refer to large, charitable donations that are motivated, at least in substantial part, by deductions and other encouragement built into the current Federal tax structure. Included are large gifts made during life, that are encouraged by annual charitable tax deductions, and large donations made in connection with estate planning for those estates exceeding the gift and estate tax exemption threshold.

Gifts Other Than Large Capital Gifts

In working with numerous charities and other non-profit organizations, it is my impression that the volume of gifts other than large Capital Gifts (see below) is driven by three principal factors:

(1) the general state of the economy;
(2) the esteem with which a particular charitable organization is held in the eyes of the "public" that normally supports that organization; and
(3) to some degree, the incentive of deductibility.

If a Federal tax system restructure results in either no general economic change or a general economic enhancement during the intermediate term, the volume of small gifts should remain the same or perhaps grow somewhat. However, any restructuring that limits or eliminates the deductibility of contributions could diminish the volume of small gifts.

Large Capital Gifts

Large Capital Gifts are driven in today's economy by the same factors but to a much greater extent by the incentive of deductibility.

If these incentives were to be greatly reduced or eliminated by a fundamental restructuring of the current Federal Tax system, the immediate result would be dislocation of resources from the charitable sector to other sectors, such as savings. Eventually, a growing economy and altruism would, hopefully, make up the difference. The question is, how long would this dislocation last? At the least, it would probably last several years and, perhaps, even longer. This would be a critical and stressful time in the life of every charitable institution in the United States.

The life blood of all charities, like any other economic organization, is cash flow. Disruption in cash flow from large Capital Gifts for an extended period of time (that is, several years or, in some cases, even several months) can be life-threatening to charitable institutions. Well-endowed non-profit institutions might be forced to deplete their endowment base. Many smaller institutions would likely not survive.

Intermediate Term Cost

The cost of a material decrease in large Capital Gifts to non-profit organizations would be immediate and direct. The cost to society would be more long-term and indirect. If these organizations are performing societal functions necessary for our way of living, the demise of such organizations would shift the burden of these functions right back to the governmental sector.

An admirable goal of Congress in the last few years has been to decrease the size and cost of government at all levels. To inadvertently reverse that trend, even in the intermediate term, would not seem to serve the public interest.

Conclusion

In conclusion, the effect on charitable giving of fundamental tax reform legislation, without appropriate safeguards, could be substantial and negative on large Capital Gifts, and could last for several years. Without adequate safeguards for the charitable sector, the result could be the demise of many charitable institutions, and a shift back to government of the responsibility for, and cost of, services now performed on a voluntary basis by the charitable and non-profit sector.

Thank you for addressing this very important matter.

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Chairman ARCHER. Thank you, Mr. Fields.

Over the years, those of you who have followed my record on this Committee will know that there has been no greater champion for private philanthropy and for adequate incentives to see that the private sector does more and that the Federal Government does less. I continue to hold that view and am very sensitive to that.

But I must also say that in a total perspective, rather than just an isolated, limited viewpoint, if we want to give the greatest incentive for charitable contributions using something similar to the current Tax Code, we would raise the top marginal tax rate back up to 91 percent so that the Federal Government was, in effect, paying 91 cents out of every dollar that was contributed and the individual only 9 cents. If our only goal in life is to increase the incentives for private philanthropy, that clearly would be a justifiable way of doing it.

I heard complaints from friends of mine who were in philanthropic or religious institutions complain when we reduced the rate from 70 to 50 percent because they said that that was going to be a discouragement to the giving to their organizations. But clearly, there has to be a balance in there.

I think you mentioned—at least one of you mentioned—that the overall state of the economy has a lot to do with giving, too, and high marginal tax rates, even if you continue with the deduction for charitable contributions, are a big deterrent to an active and vibrant economy and moving the real take-home pay of people forward, so it does get to be a balance.

I also would say that in the perspective of history, I was born in 1928, and I just looked at what the income tax was in 1928. I am sure you could not guess, because I could not have guessed, had I not just looked it up. The income tax was 1 percent up to $4,000, and $4,000 in 1928 was a massive amount of money. The maximum rate was 25 percent and that was over $100,000, which was virtually unthinkable as the earnings of anybody in 1928.

By 1931, the rate had gone down to three-eighths of 1 percent for the overwhelming majority of all Americans, because once again, that was the rate up to $4,000. The maximum rate had been reduced 1 percent to 24 percent for over $100,000.

The reason I mention that is that in those days, a charitable contribution had very little incentive under the Tax Code. I do not propose to tell you that I remember what was happening the day I was born—I am not that advanced in my capabilities—but I do remember very well in the midthirties when I was growing up, and I remember going to church and I remember the priest saying it was our responsibility to give to others who were less fortunate. We were not that fortunate ourselves, but we were still given the obligation to give to others who were less fortunate.

The attraction for giving then, as I recall, was that people gave an awful lot. There was no Federal program for welfare. There was no Social Security Program. There was no safety net coming from the Federal Government. There was no big incentive for charitable contributions in the Tax Code, but the giving was fantastic, of people helping other people in the spirit that I think made this country great.

So I believe that we can go to that again. I think that heart is still in every American. But I must say to you that I think part of the problem today is that when you go to an American who is paying the kind of taxes that they are paying to government and government has provided all of these safety net programs and all of these problem solving spending programs, that the human nature in an American is to say, I already gave at the office. Do not ask me to give at home.

I gave when the IRS came in and told me I had to give. It always troubles me that people say this is a voluntary tax system. Just try not to be voluntary and end up in prison. I do not call that voluntary. This is a mandatory tax system where the IRS takes from every earner that it can find and locate and mandates that that money come up here. Then it is turned into other spending programs to solve people's problems.

It is very difficult to motivate people that have given massive amounts in all of their taxes to say, yes, I still want to come forward and I want to help because my heart is there to help other people who are less fortunate with some sort of a program, whether it be health or whether it be religion or whether it be poverty or whatever it might be.

So I would only say that I appreciate your testimony and I understand where you are coming from. We have had this system for so long that it is hard to perceive how we might survive without it. But we will definitely, in whatever we do, as far as I am concerned, be certain that there will be adequate opportunity for people to give to help other people in a philanthropic way. That is what all of you are about and I applaud all of you for it. I think it is one of the great strengths of this country.

I am very glad to get your testimony and I just want you to know that whatever we do, I am going to be very sensitive to the kind of work that you are out there doing.

Does any other Member wish to inquire?

[No response.]

Chairman ARCHER. Thank you very, very much. I appreciate your coming and giving us your testimony.

Our next panel is Charles Clotfelter, Sherry Hayes, Eugene Tempel, Peter Swords, and Larry Rosen, if you would come and take seats at the witness table.

There is a little light in the center there that will be green, yellow, and red. The green means go, go for it, the yellow means you have 1 minute left, and the red means your 5 minutes have expired. I am not going to shut you off at the end of 5 minutes, but without objection, your entire printed statement will be entered in the record. If you would summarize and try to stay within that 5-minute light for your oral testimony, we would be greatly appreciative.

Mr. Clotfelter, if you would start off, we would be glad to hear from you. If you will identify yourself for the record, you may proceed.

STATEMENT OF CHARLES T. CLOTFELTER, PROFESSOR, ECONOMICS AND PUBLIC POLICY STUDIES, DUKE UNIVERSITY, DURHAM, NORTH CAROLINA

Mr. CLOTFELTER. Thank you. I am Charles Clotfelter. I am professor of Public Policy Studies and Economics at Duke University. Even though Duke University is a nonprofit organization, I do not represent any organization today. Like most professors, I am a loose cannon.

What I would like to do is highlight some research that I have done with Professor Richard Schmalbeck at the law school on the effects of tax reform on the nonprofit sector and charitable giving.

The United States is distinctive among developed countries in the reliance that we put on the nonprofit sector and the advantages that we give to the nonprofit sector in our tax law, and I do not think that is just a coincidence. To understand how tax reform plans might affect the nonprofit sector and charitable giving, it is useful to focus on two aspects of current Federal tax treatment, that is, exemption and the deductibility of charitable contributions.

How do these affect charitable giving and the nonprofit sector? The exemption, of course, relieves nonprofit organizations of paying income tax, but more important, it relieves them of the responsibility of having to do a lot of accounting procedures, because, in effect, the income is not going to be there anyway.

The more important aspect is the deductibility of contributions, and that is what we put most of our attention on in our study. Let me just say a word about how taxes affect charitable giving. There have been numerous economic and econometric studies of the effect of taxes on charitable giving and I have been involved in some of those. Even though there continues to be disagreement as to the precise effects of taxes, three conclusions seem to be widely accepted.

One, taxes are rarely the dominant motivation for people to make charitable contributions. People give for a wide variety of reasons, and tax benefit is only one effect, and is rarely the motivating effect. However, tax policy can affect the amount that people give.

Second, taxes influence giving by determining how much money people have left over after taxes. That is the income effect.

The third thing is that the charitable deduction itself has an impact on the net of tax cost or tax price of giving away a dollar. For example, a taxpayer facing a marginal tax rate of 30 percent gives away dollars to charity that only reduce his or her consumption by 70 cents. Tax plans that would either change tax rates or affect deductibility would affect this net cost.

Empirically, this tax effect makes a difference and is a central feature in calculations such as ours on the potential effect of tax reform. Some have questioned whether this tax price effect is that important, owing to the fact that during the eighties, even though marginal tax rates were cut twice, charitable contributions continued to keep growing.

In fact, what happened during the eighties is that the burden of charitable giving was subtly shifted from upper income classes to the middle-income classes, and second, nonprofit organizations ex-

erted mightily to continue to get contributions by stepping up their fundraising activities.

To get an idea of how these tax reform proposals might affect charitable giving by individuals, we did some simulations. What they showed was that the Armey, Shelby, and the Gephardt plans would reduce contributions on the order of 10 to 22 percent from current levels. The USA tax, which keeps the deduction in place, would have increases on the order of 11 to 31 percent.

So in conclusion, even though taxes are not the reason why people give, they do have an impact and tax reform proposals such as these would also have an impact.

[The prepared statement follows:]

THE EFFECTS OF TAX REFORM PROPOSALS ON CHARITABLE GIVING AND THE NONPROFIT SECTOR

Testimony Before the House Ways and Means Committee

May 1, 1996

STATEMENT OF CHARLES T. CLOTFELTER, PROFESSOR
DUKE UNIVERSITY

I am pleased to have the opportunity to testify about the effect of current tax reform proposals on charitable giving and the nonprofit sector. I will be basing my remarks on research that I have undertaken in collaboration with Professor Richard Schmalbeck at Duke.[2] The views I will express are mine and are not necessarily those of any organization, including Duke University, the American Council on Education, or the Association of American Universities.

After a brief overview of the nonprofit sector and its treatment under current tax law, I will describe the manner in which I believe current tax reform proposals might, if adopted as law, affect charitable contributions and nonprofit organizations. I will then present some illustrative calculations intended to give an idea of the likely magnitude of these effects.

The Nonprofit Sector and Its Tax Treatment

The nonprofit sector of our economy consists of a vast and heterogeneous collection of religious groups, schools, hospitals, associations, and other nongovernmental organizations that serve a host of important functions. These organizations range from the tiniest churches and fraternal associations to giant research universities and international relief agencies. Some exist entirely for the benefit of their members, while others are exclusively devoted to helping needy individuals, such as the indigent or homeless. Many operate quite independently of government, while others act as virtual extensions of government programs, wholly dependent on government funding. Far from being a minor detail in the institutional landscape of the country, this sector constitutes a segment of the nation's economic activity whose size and significance make it impossible to ignore. There are about 1.5 million nonprofit organizations operating in the U.S. In 1992 their total revenue was over $600 billion, and they accounted for about a tenth of the Gross Domestic Product.

The bulk of charitable contributions comes from individual donors. In 1994, individuals contributed some $105 billion. By comparison, $8.8 billion came from charitable bequests, and $6.1 billion from corporations. While it is important to consider the effect of tax changes on contributions from estates and corporations, these figures suggest that the most important effects are to be found in contributions by individuals.

The United States is distinctive among the developed countries in the extent to which it has chosen to rely on such nongovernmental, nonprofit entities to carry out vital social functions, and, concomitantly in the extent of favorable treatment these entities enjoy in the nation's tax laws.

As a general rule, nonprofit organizations are exempted from federal income taxation. They are also usually exempted from taxes at the state and local levels. Certain nonprofit organizations, the charitable and educational organizations covered by section 501(c)(3) of the Internal Revenue Code, receive the additional tax advantage of being eligible to receive deductible contributions. Contributions account for about 10% of the revenue of the entire charitable sector, but they are more important outside of the health subsector, accounting for 14% of revenues in education and research, 27% in social services, and 36% in cultural organizations.

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[1] Professor of Public Policy Studies and Economics, Duke University.

[2] See Charles T. Clotfelter and Richard L. Schmalback, "The Impact of Fundamental Tax Reform on Nonprofit Organizations," a paper presented at a Brookings Institution conference, "The Economic Effects of Fundamental Tax Reform," February 15, 1996.

One important effect of this deductibility is to reduce the net cost, or "tax price," of making charitable donations, which is measured by the amount of consumption forgone per dollar of contributions. Without a deduction, each dollar of contributions reduces potential consumption by a dollar, making the tax price equal to one. By contrast, if contributions are deductible, a taxpayer with a marginal tax rate of, say, 30% faces a tax price of 70 cents per dollar given. Gifts of appreciated property are especially favored; subject to some limitations, donors may deduct the full market value of such property, even though they have never been taxed on the amount of the appreciation.

Because reform schemes often feature either a reduction in marginal tax rates or the complete elimination of the charitable deduction, the price effect is especially important. Some observers have dismissed the importance of such a price effect, citing the continual rise in aggregate contributions during the 1980s, a decade in which marginal tax rates were cut significantly in upper income classes. Because factors other than marginal tax rates affect giving, many of which changed over this same period, this observation cannot serve as definitive evidence on the empirical importance of the price effect. In fact, there is broad agreement among economists that the tax price, as well as after-tax income, does have an impact on the level of contributions. Disagreement remains only about the size of these effects.

Four Tax Reform Plans

In our study, Richard Schmalbeck and I considered four basic varieties of tax reform plans, each exemplified by a specific proposal: 1) a business-transactions tax, such as a value-added or retail sales tax, such as that proposed by Senator Lugar; 2) a consumed-income tax, in which there is a general deduction of net savings, exemplified by the USA tax; 3) a "flat-tax" consumption tax, in which the wage element of the tax base is treated at the individual level, exemplified by the Armey-Shelby proposal; and 4) a modified income tax system in which rates are flat in all but the upper-income ranges, and deductions drastically curtailed, as exemplified by the Gephardt plan.

How Tax Reform Proposals Would Affect Nonprofit Organizations and Charitable Contributions

Tax exemption. All of the major categories of tax proposals currently being discussed could be designed to provide exemption for nonprofit entities, and most of the specific plans under consideration have in fact done so. Generally, they have in common as well the preservation of a device--like the current tax on unrelated business income--that would treat even exempt organizations as taxable on those sales of goods or services that are unrelated to the purpose for which the organization's exemption was granted. However, proposals can and do differ in the breadth and value of the exemption, and in the exception for unrelated business income.

The issue of tax exemption for nonprofit organizations is most pertinent in the case of a business transactions tax, which, if it were the primary source of federal revenue, would need to have both a fairly high rate and a relatively broad tax base. A comprehensive transactions tax that provides no exemption for nonprofit organizations presents something of a worst-case scenario for those entities, since under such a tax payments of university tuition, hospital bills, museum admissions, and the like, would all generate a significant tax liability. Such a tax liability would likely raise the effective price of all these services, leading to establishment of a new equilibrium at a higher gross price. While it would be relatively straightforward to exempt nonprofit organizations from a national sales tax, exempting them under a value-added tax would be more complex.

Incentives to make donations. We identified four kinds of effects that tax reform proposals might have on the incentive to make charitable contributions. The first, and we believe the most important, potential effect would be on the net income and tax price faced by donors. Any plan that eliminates the charitable deduction would increase the net cost of contributing each dollar. Changes in tax rate schedules would also affect after-tax income and the tax price under plans that retain the deduction. This effect is the only one for which currently available econometric models provides much guidance. For the remaining three effects, it is possible only to describe them. The second effect would apply to any reform that eliminates the estate and gift tax. Because the current estate and gift tax provides an important incentive for lifetime giving under the current tax system, eliminating that tax would reduce further the incentive for living individuals to make contributions. A third potential effect, arising in business transactions taxes that provide an exemption for nonprofit services, would be to lower the effective price of nonprofit services relative to other, non-exempt goods and services, thus establishing a price differential that could have the same sort of price effect as the current deduction does. A fourth possible effect, and here we have virtually no precedent to guide us, would be the influence on current contributions of allowing a deduction for all saving, as under the USA tax.

In order to assess the likely effects of various tax reform plans, we made calculations based on econometric models of charitable contributions by individuals. The simulations employ two sets of parameters, reflecting the range of estimates produced in empirical studies. Both sets embody a price effect arising from the deductibility of contributions, as well as an income effect based on after-tax income. Other than its impact on tax liability and net income, no explicit attention is paid to the effects of the estate and gift tax or the deductibility of saving. These models employ data that are aggregated at a fairly high level and thus are used only to suggest the relative magnitudes of proposed changes. To simulate effects on individual giving, tax return data on contributions by itemizers and nonitemizers were used to calibrate a model that estimates the level and distribution of contributions under different hypothetical tax regimes, all calculated for the year 1996. Behavioral effects are simulated using estimated parameters from econometric studies of various forms of charitable giving.

To assess the likely effect of various proposals, we calculated what contributions would be under each one, under the idealized assumption that no other changes were to take place. We begin with a baseline level of contributions for 1996, including both itemizers and nonitemizers, which is based on 1992 levels inflated by means of the Consumer Price Index to 1996 levels and divided up according to an assumed distribution of gifts by donee group. By this method, we estimate that contributions by individuals in 1996 would be $116 billion, of which the largest portion are gifts made to religious organizations. Contributions from living individuals to institutions of higher education are estimated to be about $4 billion. High income taxpayers, defined as those with incomes over $100,000 in 1992, who represented 3.9% of all taxpayers, account for an estimated 22.9% of total giving, slightly less than their 23.6% share of adjusted gross income.

For each proposal, we calculated for each taxpayer group (taxpayers arranged by filing and itemization status) at each income level the taxes, after-tax income, tax rates, and price of giving that would apply. The tax rates were adjusted so that each proposal would raise the same revenue as the 1996 actual tax law. We then applied behavioral parameters from two alternative models to calculate the hypothetical level of contributions under each proposal.

Using the baseline set of parameters, the calculations imply a 10% reduction in total giving by individuals under both the Armey-Shelby and Gephardt proposals, both of which eliminate the charitable deduction. These two proposals differ most in the effect on the patterns of giving over the income spectrum, with the more progressive Gephardt proposal reducing net incomes of the affluent relative to the Armey-Shelby plan, thus cutting their contributions relatively more. By contrast, the USA tax, featuring a charitable deduction for all taxpayers, is seen as increasing giving, by about 11%.

The effects of these price effects -- negative for the plans that drop the deduction and positive for the USA tax -- are accentuated by the larger price elasticity of the alternative model. In this case, the Armey-Shelby and Gephardt plans show a decline of 22% while the USA tax is associated with an increase of over 30% in giving. Like the first simulation, the share of all contributions made by those in the top income classes falls as a result of the tax change, thus resulting in a greater decline in contributions to organizations historically favored by more affluent donors. To reiterate, these calculations should be treated as simply illustrative of the sorts of magnitudes one would expect in comparing one tax regime to another in the long run, and under the assumption that nothing but the tax regime changed. As expected, proposals that eliminate the charitable deduction are likely to cause contributions to be less than they otherwise have been.

Conclusion

The key provisions of the several tax reform options considered in this paper do not appear to have nonprofit organizations as their intended targets. However, it appears that at least some of the options presently being discussed are likely to have significant and adverse effects on nonprofit organizations. Two are worth highlighting. First, nonprofits generally would be badly damaged by any sort of business transactions tax that does not explicitly exempt the provision of goods and services by nonprofits. Second, incentives to make contributions to charitable organizations are likely to be most diminished by the various flat tax proposals, especially those that make no provision for deductibility of such contributions. The magnitude of these effects remains quite uncertain, however. There are many details missing from the current tax proposals, and our knowledge about likely behavioral responses is also quite imperfect.

Mr. McCrery [presiding]. Thank you.
Ms. Hayes.

STATEMENT OF SHERRY HAYES, VICE PRESIDENT, INTERHEALTH, ST. PAUL, MINNESOTA

Ms. Hayes. Thank you, Mr. Chairman and other Members of the Committee and staff for the opportunity to testify today. My name is Sherry Hayes. I am vice president of an organization called InterHealth. We are an interfaith, interindustry organization that includes nonprofit hospitals, health care systems, social service providers, medical groups, foundations, and strategic business partners. Our values are rooted in the Judeo-Christian tradition of healing as a mission.

We view ourselves as partners to both government and the for-profit sector, working toward the common goal of a more civil society. It is with this orientation that we applaud the efforts of the Committee and we embrace the discussion of a replacement tax system as a challenge in our mind to better respond to the needs of individuals as well as the needs of those communities.

It is an opportunity, as well, to revisit some of the underlying principles of tax exemption, something we have not done, frankly, for a very long time, to strengthen the Federal commitment to and hopefully partnership with the voluntary sector through the removal of current barriers.

Though we do not oppose any approach to tax restructuring, we do have several concerns with the proposals that are being considered. First, we object to the application of a consumption-based tax to health care services that are rendered on a nonprofit basis. We strongly recommend that the Committee eliminate commercial availability, the standard that currently exists in H.R. 3039, and hopefully work with you to recognize that not all health care is the same.

As mediating institutions, particularly, faith-based providers deliver a safety net of services that are either not provided for by government or are not unilaterally profitable in the private commercial market. In that regard, we sort of see ourselves as buffering some of the rougher edges of capitalism, and in today's vernacular, sort of government bureaucracy.

Beyond the provision of charity care, religiously affiliated hospitals have as a part of their mission the provision of spiritual care. We treat the body, we treat the mind, and we treat the spirit. These institutions are inextricably linked to their communities, to their families and churches, and they provide preventive as well as healing services, regardless of one's ability to pay. It is a mission for us.

And, to the extent that there are services that are profitable, those margins remain in the communities and within the delivery system, as opposed to those being diverted away from the community and the delivery system in a proprietary system by investor-owned entities.

Things like local stewardship, pastoral care, parish nursing programs, the ministries, and in addition to that, I think, the moral institutional culture of some of these systems all contribute not to a commercially available product per se but to the healing of

human beings and the community as a whole. It is unique and it is critical and we would hope that it would be strengthened during consideration of tax reform.

Second, whatever approach the Committee chooses to take on tax reform, the availability of tax-exempt financing must be preserved and expanded. Research shows that 95 percent of the interest savings on tax-exempt bonds is returned to the community in the form of charity care. The current restructuring and consolidation underway in the health care sector is bringing better care and it is bringing more efficiency back to our communities.

But the current $150 million bond cap for nonhospital debt is a serious impediment to those consolidations, serving as a barrier to the nonprofit sector's ability to develop integrated systems of care across communities.

Our third point is ancillary. Others have made it, but we feel it is significant, and that is InterHealth is concerned that a major change in Federal tax status of charitable health care organizations will trigger increases in State and local tax burdens.

Our fourth concern is that current tax barriers to nonprofit provision of care be eliminated. We support both the AHA and CHA proposals to enact specific tax exemption for integrated delivery systems and to establish in the Code comparable to the hospital exemption, a specific exemption for clinically and financially integrated health delivery networks, imposing appropriate requirements to ensure that they are assessing and addressing the needs of community beyond the enrolled populations.

We believe that coordinated care through nonprofit mission-driven delivery systems is a critical component to a civil society. The community focus and accountability, the availability of charity care, and emphasis on whole prevention and healing is, frankly, not a commodity. It is not available commercially.

We welcome the opportunity to assist the Committee and its staff in thoughtfully addressing these concerns. With such changes, we believe that it would be possible to maintain appropriate support for the mission of religiously affiliated organizations under any of the tax alternatives pending before the Committee.

Thank you very much for your time.

[The prepared statement follows. Additional materials are being retained in the Committee's files.]

STATEMENT OF INTERHEALTH TO THE COMMITTEE ON WAYS AND MEANS OF THE UNITED STATES HOUSE OF REPRESENTATIVES

IN CONNECTION WITH HEARINGS ON THE IMPACT OF FUNDAMENTAL TAX REFORM ON STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS

May 1, 1996

Delivered by Sherry Hayes
Vice-President
InterHealth
St. Paul, Minnesota

On behalf of InterHealth, I commend Chairman Archer and the Ranking Member Gibbons for their vision and leadership on this important issue -- the fundamental reform of our tax system. I would also like to thank the Chairman, distinguished Committee members, and staff for the opportunity to testify today.

InterHealth is an interfaith, interindustry values-driven organization of nonprofit hospitals, health care systems, social services providers, medical groups, foundations and strategic business partners. InterHealth was founded in 1984 to bring leaders of faith-based health organizations together to share information on the changing needs of the health delivery system. Our values are rooted in the Judeo-Christian heritage of healing as a mission.

This Congress has already shown an understanding of the value of community, a commitment to correcting incentives and disincentives created through federal programs and a desire to remove barriers between government and people. Systemic tax reform is the most challenging opportunity to further that agenda. As mediating institutions, we view ourselves as partners in that agenda, toward a more civil society. The decisions that you make relative to the taxation of currently exempt organizations will be critical in determining the ultimate success of our common goals. It is an opportunity to revisit the underlying principles behind tax-exemption and to strengthen the federal commitment to and partnership with the voluntary sector through the removal of current barriers.

The Mission of Health Care

The provision of health services grew from the church as a means to fulfill missions through addressing the root needs of society. Among those root needs were the improvement of health, the alleviation of pain and suffering, preservation of safe and healthy environments in which to live and raise our children, etc. We began as and continue to serve as, philanthropic social institutions. There was not a root need to profit from the provision of services. Nor was there a root need to return proceeds to shareholders.

Mediating institutions such as voluntary hospitals, now evolving into community-based integrated delivery systems, began alongside of and in response to the rise of capitalism through the industrial revolution. As mediating institutions, we provide a safety net of services that are either not provided for by government, or which are not to be found of unilateral profitability in the private, proprietary sector. We exist, in partnership with government, to buffer some of the rougher edges of capitalism.

Religiously affiliated hospitals, in particular, have as part of their mission the provision of spiritual care, treating the mind, spirit and body. These institutions and systems are inextricably linked to their community's families and churches, and provide prevention as well as healing services within the context of those communities to all, regardless of ability to pay. Their local stewardship, pastoral care services, Parish Nurse programs, Diaconal ministries, training programs for health professionals, chaplaincy programs, moral and institutional cultures all contribute not to a commercially available product, but to a healing of human beings and the community as a whole.

Peter Drucker writes,

> *"The nonprofit institution neither supplies good or services, nor controls (through regulation). Its 'product' is neither a pair of shoes, nor an effective regulation. Its product is a changed human being. The nonprofit institutions are human change agents. Their 'product' is a cured patient, a child that learns, a young man or woman grown into a self-respecting adult; a changed human life altogether."*

With increased participation from both public government and private sectors, form followed function and a private, for-profit sector arose. In today's dynamic and highly competitive "market", for-profit organizations are seeking to partner or acquire traditional not-for-profit community hospitals and teaching institutions. Similarly, not-for-profit community based providers are incorporating business management and efficiency techniques. A significant realignment of tax incentives would have a substantial impact on decisions effecting mission and margin, and ultimately delivery of care.

Health care at its best is about improving the health of the whole community - mission. Measures such as health outcomes, health status trends, procedure effectiveness, continuous quality improvement, charity care levels and epidemiological data all enable us to quantify the more tangible aspects of the provision of health care. They do not, to a comparable extent, enable us to measure the value of the link to the community and shareholders, the preservation of resources within a community, the moral cultures of the systems of care, the value of altruism and human dignity, the value of wellness promotion or the value of the spiritual and emotional dimensions of healing.

Health care can also be about improving profits - margin. Here the measures are more readily communicated; efficiencies, savings, staffing and bed reductions, case-mix, capital and return to stockholders through which revenues are removed both from the delivery system and the community. Treated as a commodity, the nature of the service itself is changed. And we know that healthcare is subject to market failure as a function of the way in which it is purchased and the personal and often critical nature of the service. We cannot rely purely on a market discipline. Health care is different and should not be subjected to a tax as a commercially available product. To do so, would almost certainly marginalize the root needs of individuals and communities.

As the government minimizes its role, devolving control and services to the local level, it is critical that care be taken to strengthen those mediating institutions at the community level. We encourage the Committee to review current policies impacting both taxable and tax-exempt health care providers to ensure not only that tax-exempt organizations are held accountable for exemptions and incentives, but to remove current legal and regulatory barriers that put not-for-profit at an inappropriate competitive disadvantage.

Public Benefit of Tax Incentives

While it is difficult to quantify empirically the relationship between tax-exemption and community benefit, distinctions can be found in the manner of the delivery itself, how it is priced, and what is done in the community.

The current restructuring and pressures to contain costs in the health care system, coupled with the increasing numbers of uninsured and underinsured, pose a particular challenge to the not-for-profit, mission driven health system.

Exemption from federal and state income tax provides resources to subsidize uncompensated care. According to a study by the American Hospital Association, 1992-1993 trend comparisons between not-for-profit and investor-owned hospitals of actual costs of uncompensated care showed $9.2 billion in costs for not-for-profit and $886 million for investor-owneds. Perhaps more significant, not only did the aggregate dollar costs increase between 1988 and 1993, but the costs to not-for-profit hospitals increased by 53 percent, compared to an increase of 19 percent for the investor-owned facilities.

Similarly, tax-exempt bond financing reduces interest outlays that are also available to fund community benefit programs. Recent Agency for Health Care Policy research has confirmed that non-profit hospitals pass through 95 percent of the savings of tax-exempt bonds in the form of uncompensated care. Most recently, researchers from the University of Alabama and University of Pennsylvania have released preliminary empirical findings concluding that "tax-exempt debt is an effective instrument for increasing the charity care supplied by hospitals."

Beyond the charitable definitions of community benefit, are countless valuable services provided by tax-exempt hospitals and systems through community-wide, collaborative efforts to improve the quality of life and promote wellness. It is the mission driven, not-for-profit sector which has been the innovator in high-cost programs such as trauma and burn centers, neonatal centers, community prevention and screening activities, education and research. Our ability to offer these low-margin services is bolstered by charitable contributions and foundation grants.

There is a new industry developing, however. It is not about hospitals or doctors or illnesses, or communities or arguably even patients. It is about covered lives. The value structure of these new enterprises will prominently include quality care, appropriate use of the medical system and cost containment. At risk are the value of healing, wholeness and compassion. The taxation of health care services as a commodity, on the grounds that "it" is available in the private market, significantly adds to that risk.

To ensure the continued relationship between provider and patient and to strengthen the role of community-based networks of care, the

House Ways and Means Committee demonstrated significant vision and leadership in its support of direct contracting with provider-sponsored networks. While that legislation has not yet become law, we applaud you for the recognition of the critical importance of strengthening and preserving community accountable care. Similarly, we ask your consideration of the following concerns and suggestions relative to the various proposals to replace the current tax system.

Tax Reform Issues Posed for Religiously-Affiliated Health Care

Fundamental tax reform poses several important issues for religiously affiliated nonprofit health care organizations. The first is whether the new consumption taxes--whether they are income-based or transaction-based--will apply to tax the services provided by nonprofit health care organizations. The second is whether the new tax proposals will adversely affect the cost and availability of financing for nonprofit health care organizations. The third is how such proposals would affect the charitable support of community health care organizations and programs through contributions and grants. The fourth involves ancillary impacts, such as whether elimination of federal tax exemption would trigger adverse tax changes at the state or local level.

Whether the Proposals Will Tax Nonprofit Health Services

Many of the proposals apparently would tax nonprofit organizations that provide goods and services. InterHealth believes the proposed taxes should exempt the income or gross receipts that nonprofit organizations derive from activities in support of their charitable mission.

H.R. 3039 imposes a 15 percent national retail sales tax on the use, consumption or enjoyment of any taxable property or services. While contributions of property or services to certain qualified nonprofit organizations are exempt from tax, the provision of property or services by certain nonprofit organizations would be subject to tax in many instances. Exemption is preserved only if the property or service provided (i) is substantially related to the organization's exempt purpose and (ii) not commercially available.

The use of a commercial availability standard in H.R. 3039 poses particular problems for nonprofit health care. It would make the tax treatment of nonprofit healthcare providers subject to the market-driven behavior of for-profit chains. Investor-owned health care systems currently control a significant share of the in-patient hospital market, and seek to control an ever larger share. Such systems tend to favor profitable markets and high-profit margin services. Under the bill, a nonprofit health system could lose the benefits of tax exemption with respect to a large number of activities simply because a for-profit system entered its market. This problem with the retail sales tax could be solved by eliminating the "commercial availability" standard of H.R. 3039.

Many Value-Added Tax (VAT) proposals would dramatically increase the tax burden on nonprofit healthcare organizations. For example, Congressman Gibbons has proposed a broad-based VAT that contains no exemption for goods or services provided by nonprofit organizations. While we respect Congressman Gibbons' desire to achieve simplicity and uniformity, we believe that such an approach would have a disastrous impact on nonprofit organizations, particularly charitable health care organizations. The result, we believe, could be worse than loss of income tax exemption, because labor and other costs would appear to not be deductible. By contrast,

we recognize that H.R. 3039 does provide an offset mechanism for employee costs, so there would be partial netting of income and expenses.

The advantage of the Flat Tax is that it easily accommodates an exemption from tax for revenues derived by not-for-profit organizations. For example, H.R. 2060 contains a blanket exemption from the business tax for "any activity of a governmental entity or any other entity exempt from tax." InterHealth would anticipate that if the Ways and Means Committee is inclined to adopt a Flat Tax, it would be necessary to further refine the standards for exemption and the taxation of unrelated business income ("UBI"). In this regard, InterHealth would like to work with the Committee to develop standards that ensure that exemption standards encourage the further development of community-oriented healthcare.

The USA Tax proposed by Senators Domenici and Nunn (S. 833) reduces the types of entities eligible for exemption and preserves the core exemption of not-for-profit hospitals and healthcare organizations that qualify as charities.

InterHealth applauds the thoughtful approach of the drafters of S. 833. One apparent disadvantage of S. 833, however, is its formula for the calculation of tax on business activities, including the unrelated activities of exempt organizations. The USA Business Tax is an 11 percent tax imposed on gross profit derived from all domestic sales of goods and services. In calculating gross profit, the computation eliminates any deduction for employee compensation and fringe benefits. This calculation would adversely affect the health care industry or any other industry that is burdened by high labor costs.

Whether Financing Will Be Made More Costly or Unavailable

A major disadvantage of the many tax reform proposals is that they eliminate the tax-exempt bond market, which is a key source of capital for not-for-profit hospitals. For example, under a retail sales tax or VAT, income would not be subject to tax at all, making tax-exempt bonds obsolete. Similarly, most flat tax proposals, such as H.R. 2060, would eliminate all tax on interest income, thus leveling the playing field for currently taxable and tax-exempt debt.

Under either of these approaches, not-for-profit hospitals would be forced to fund capital improvements with taxable debt at a higher interest rate, which could cost millions of dollars in some cases. Furthermore, some not-for-profit healthcare organizations would not only pay higher interest rates, but also could face severe constraints on their ability to borrow at all. Because not-for-profit hospitals are precluded from raising money through the equity markets, tax-exempt financing is a critical source of capital for health system renovations, expansions, and consolidations.

Similarly under current law, 501(c)(3) hospitals are exempt from the $150 million bond cap. In light of the significant integration of physician group practices, primary care physicians, hospices, outpatient surgery centers, long-term care facilities and inpatient hospitals into provider sponsored networks, hospitals are confronting consolidation and integration problems with the non-hospital bond limit. InterHealth thanks those Committee members who have worked to either eliminate the $150 million bond cap for non-hospital debt, or to extend the hospital exemption to integrated delivery networks. We appreciate all efforts to remove such discriminatory barriers.

One tax reform plan that preserves some advantage for nonprofit financing is the Nunn-Domenici bill, S. 833. It does so by excluding

tax-exempt bond interest from income, while providing a deduction for other forms of savings.

How the Proposal Will Affect Charitable Contributions and Grants

Not-for-profit organizations depend not only on exemption from income tax, but also on charitable contributions and foundation grants. Many of the reform proposals eliminate or restrict the tax incentives for individual and corporate donations that fund medical research and community health initiatives.

For example, H.R. 2060 eliminates all deductions, including the deduction for individual and corporate charitable contributions. However, elimination of the charitable contribution deduction is not inherent in the structure of the Flat Tax. Senator Specter has introduced a Flat Tax that preserves a deduction for most individual charitable contributions.

A consumed-income tax, such as the proposed Domenici-Nunn USA tax, more easily accommodates a deduction for charitable contributions. S. 833 maintains a charitable contribution for individual charitable contributions with no annual dollar cap on deductible contributions. Since many health care organizations and medical research foundations benefit from a relatively small number of large dollar donations or grants, the elimination of such contribution caps is of importance. One disadvantage of S. 833 is that it fails to preserve an incentive for corporate contributions.

Ancillary Impacts

InterHealth is also concerned that a major change in the federal tax status of charitable health care organizations could trigger increases in the state and local tax burdens to which such organizations are subject. Most State codes require at a minimum that the organization seeking exemption from a state property, income or sales tax be recognized as exempt at the Federal level under section 501(c)(3). Since many States are already looking to large nonprofit institutions for increased revenues, loss of Federal tax exemption as a measuring stick would likely exacerbate this trend.

If this were to occur, even those hospitals with little or no net income would be subjected to local property taxes and State sales taxes.

Many of the tax reform proposals have wisely attempted to retain some concept of a "qualified" nonprofit organization. For example, H.R. 3039 maintains an exemption for religious, charitable and many other types of organizations so long as no part of their net earnings inure to the benefit of private individuals. It also has the advantage of maintaining tax-preferred status for social welfare organizations, such as non-staff model health maintenance organizations operated on a nonprofit basis.

InterHealth also thinks that it is important to maintain exemption standards that encourage public benefit and discourage private gain. In this regard, the Committee commends Chairman Archer and the several other Members who have worked with the health care community to pass workable intermediate sanctions, most recently as part of the Taxpayer Bill of Rights.

Additional Barriers

In large part as a function of the rapid changes in the health care delivery system, current tax law poses significant burdens on and barriers for

not-for-profit health care providers. In addition to the difficulties posed by the tax-exempt bond financing issue, provider sponsored networks and integrated delivery systems are further restricted by current tax policies with regard to capitation and governance. InterHealth supports the American Hospital Association and Catholic Health Association proposals to:

- Enact specific tax-exemption for integrated delivery systems, requiring that boards be composed of members of the community, obligated to comply with the requirements of the community benefit standard and subject to intermediate sanctions.

- Establish in the tax code a specific exemption for clinically and financially integrated health delivery networks, imposing requirements to ensure that they are assessing and addressing the needs of the community beyond their enrolled populations.

Conclusion

Religiously affiliated nonprofit health care organizations serve as mediating institutions in partnership with both government and the private for-profit sector. They contribute in significant and numerous ways to the general health and welfare of the community.

InterHealth supports the Committee's leadership in moving to radically reform the current tax system. However, we have several serious concerns about the impact of possible replacement taxes on nonprofit health care as the proposals are currently drafted. These concerns include (1) the application and scope of a consumption-based tax to health care services, (2) the effect of such taxes on the cost and availability of debt financing, (3) the elimination or restriction of tax incentives for charitable giving for both individuals and corporations; (4) the ancillary effects of fundamental tax reform, such as increased exposure to state income, sales and property taxes and (5) the removal of tax barriers from current law.

InterHealth welcomes the opportunity to assist the Committee and its staff in thoughtfully addressing these concerns. We believe that with such changes, it would be possible to maintain appropriate support for the mission of religiously affiliated health care organizations under any of the tax alternatives currently before the Committee.

Mr. MCCRERY. Thank you, Ms. Hayes.

Mr. Tempel.

STATEMENT OF EUGENE R. TEMPEL, VICE CHAIR, BOARD OF DIRECTORS, NATIONAL SOCIETY OF FUNDRAISING EXECUTIVES, ALEXANDRIA, VIRGINIA

Mr. TEMPEL. Good afternoon, Mr. Chairman, Members of the Ways and Means Committee. My name is Gene Tempel and I am vice chancellor of Indiana University-Purdue University at Indianapolis, but I am testifying today as vice chair of the Board of Directors of NSFRE, the National Society of Fundraising Executives.

NSFRE is a professional association with 16,000 members, all who generate philanthropic support for a wide variety of the not-for-profit charitable organizations. It was founded in 1960. It is a 501(c)(6) organization headquartered in Alexandria, Virginia.

We appreciate the opportunity to discuss the effects of tax reform on tax-exempt nonprofit organizations. A number of econometric studies have been conducted on whether such reform will be helpful or harmful to the charitable sector. My colleagues today have covered this topic and I refer to some of these studies in my own written testimony. But what I want to talk about today is choices.

It seems to me the choice for nonprofits boils down to this: Should the government encourage or discourage charitable giving? In other words, should the government encourage those who choose private support of health, welfare, education, and other services, or should contributing to the public good be a simple consumer choice at the same level as taking a vacation, buying a new suit, or going out to eat dinner?

Americans do have a strong streak of independence and self-reliance. We know that. We also have a strong tradition of philanthropy, voluntary action for the public good. Since colonial days, Americans have helped one another by donating their money to literally thousands of causes, from aiding the indigent to creating hospitals and libraries, supporting civil rights, health research, care for children and the elderly. In essence, Mr. Chairman, the choice we are making is about who we are as a people and what ideas and values we hold most dear.

I believe the government sends a strong signal to the public when it makes choices about what it funds, what deductions it keeps or creates. When Congress created the charitable deduction in 1917, it was expressing the belief that philanthropy was an important value, that nonprofit organizations were a partner with the government in meeting public needs, and that individuals should not be taxed fully on income which is donated to charity because that money will be used for the public good, not for private or personal advantage.

Although the focus of this hearing is on the elimination of the tax system, the point remains, the deduction encourages people to help others and not themselves. It sends a signal to the American people that philanthropy is an important tradition which should be encouraged and preserved. It helps strengthen American society.

As a professional fundraiser, let me assure you that American people respond to these signals. Certainly, one of the reasons they choose to give is that they believe in the cause or believe it is the

right thing to do, but almost every contributor I talk to tells me that the tax structure and its deductions play a huge role in giving, particularly as the amount increases.

Just last week, I brought together a group of executives to discuss philanthropy in rural America. Included in the group was an insurance executive who recently placed an appreciated parcel of land he owned in a charitable remainder trust. He told me flat out that the charitable deduction to his current income made the gift possible.

While the government may have lost something in taxes, the entire asset is now in the public trust and will be used for needs in rural southern Indiana. Without the deduction, the property likely would have been sold, some taxes paid, but most of the money passed on to children for private use. I want to stress that we are not just talking about the very wealthy. This was a person of moderate income and moderate means, just like many contributors.

I have also been privileged to work on behalf of the Indiana University Center on Philanthropy and several other countries interested in building a stronger philanthropic base as a means of meeting public needs. In Mexico and Thailand, for example, we are working with local leaders who advocate for a more generous charitable deduction. It would be ironic for these governments to adopt the current U.S. policy on charitable deductions, which they view as a model, while we abandon our own.

I do not believe this is a choice that the American people want. The average citizen has said time and time again that there is a unique place for charities. A recent poll by the American Institute of Certified Public Accountants indicates that Americans favor keeping the charitable deduction by a 3-to-1 margin.

In fact, this Congress recently asserted the unique position of charities when it unanimously passed charitable gift annuity legislation. Every Member of this Committee voted in favor of separating charitable annuities from other annuities because you recognized that charitable annuities are not for personal gain but for public use.

Mr. Chairman, just a few moments ago, you referred to the state of philanthropic support in your community with a small tax incentive. That was a time of close community involvement and great religious participation. I grew up in such a small community in southern Indiana in the fifties like that myself, but today, we have a loss of community, we have a breakdown in civil society and less participation in religion. So we believe we need all the tools at our disposal to help encourage local participation in philanthropy.

In conclusion, I would like to say you have made it clear that you would like to tear the income tax system out by its roots and throw it aside. If you can create a system that is simple, equitable, and more importantly, fair, we will applaud you. Our members at NSFRE are willing to work with you and your Committee staff to achieve that goal. To be fair, however, the new system should recognize that those who make charitable contributions provide for the public good and deserve parity with those who do not by providing a charitable deduction.

We have no interest in defending the status quo if reforms are necessary, but when we talk about tax reform and tax policy, we

are talking about important choices, choices which will have ramifications for every person in America. Americans have chosen to make philanthropy part of their everyday lives, partly due to the encouragement received from the government. We simply ask that as the Congress shifts programs from the government to not-for-profits, it provide the encouragement for citizens to support those needs at the local level through the strongest signal possible.

Research shows that tax incentives heavily impact the size of charitable gifts. Donors tell us repeatedly that the national importance placed on philanthropy by the charitable deduction sends a strong signal to them when they choose to give. It is our responsibility and the responsibility of Congress to respond to those choices and ensure that the government continues to encourage giving. Our society, our values, our national character, and our individual moral obligations demand no less.

Thank you, Mr. Chairman, for the opportunity to testify, and I will be glad to answer any questions you might have.

[The prepared statement follows:]

WRITTEN STATEMENT OF

MR. EUGENE R. TEMPEL, Ed.D., CFRE
ON BEHALF OF
NATIONAL SOCIETY OF FUNDRAISING EXECUTIVES

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

ON THE IMPACT ON STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ENTITIES OF REPLACING THE FEDERAL INCOME TAX

MAY 1, 1996

Good afternoon, Mr. Chairman and members of the Ways and Means Committee. On behalf of the more than 16,000 members of the National Society of Fund Raising Executives, I would like to thank you for allowing me the opportunity to testify here today. I am Vice Chancellor of Indiana University - Purdue University at Indianapolis and Director of the Center of Philanthropy there, but I am testifying today as Vice-Chair of the Board of Directors of the National Society of Fund Raising Executives (NSFRE). NSFRE is the professional association for individuals generating philanthropic support for a wide variety of not-for-profit, charitable organizations. Founded in 1960, NSFRE is a 501(c)(6) organization. NSFRE employs a strong local chapter framework; our 127 chapters are located in almost every state and metropolitan area, and in Canada and Mexico. Our headquarters is located in Alexandria, Virginia.

My remarks today will focus on the effects of tax reform on tax-exempt, not-for-profit organizations. In particular, I will look at reform from the perspective of fundraisers who are in contact with hundreds of potential donors every day. I talk with a wide variety of potential contributors, from people who have just received large windfalls of money, land, or other asset and want to donate part or all to charity, to someone who just wants to contribute a certain amount of money on a regular basis to his or her favorite charity. Almost every single one of them asks about the tax code and deductions for his or her charitable gift. Donors are extremely concerned about how tax reform will affect the cost of giving, to whom they choose to give, how much they choose to give, and how often they choose to give. The decisions that are made here on Capitol Hill will have a profound effect on charitable giving choices throughout the nation.

I have been following the debate on tax reform and not-for-profit organizations for the past several months and whether such reform would be helpful or harmful to the charitable sector. As I have listened to each new study being introduced to support various positions, it seems to me that the choice concerning tax reform and not-for-profits boils down to this fundamental question: Should the government encourage charitable giving?

I understand there is an argument that says tax policy and social policy are two separate items that are not and should not be related. I find this argument to be superfluous, simply because tax policy, and thus tax reform, inherently affects social policy. Whether we choose to tax savings, whether we tax income or consumption, whether we decide to exempt home ownership and charity; these are all choices in tax reform that will have tremendous consequences for our society. Thus, the real question is whether or not government should encourage philanthropy and volunteerism. Should the government encourage those who choose private support of health, welfare, education, and other services, or should contributing to the public good be a simple consumer choice, at the same level as taking a vacation, buying a new suit, or going out to eat for dinner?

The answers to these questions will tell us a lot about ourselves and our nation. A quick look at our past shows us that philanthropy is part of our national spirit and culture. Americans have a strong streak of independence and self-reliance, but we also have a tradition of coming together to help those less fortunate than ourselves. Since Colonial days, Americans have chosen to help one another by donating their money to literally thousands of causes, including aiding the indigent, creating hospitals and libraries, and supporting civil rights, health research, and care for children and the elderly. In essence, Mr. Chairman, the choice we are making is about who we are as people, and what ideas and values we hold most dear.

There are a number of reasons the government should continue to encourage charitable giving. First, charitable giving complements the 104th Congress' goals of increased reliance on the private sector and the downsizing of government. In the last year and a half, this Congress has instituted a number of changes designed to bring power back to states, localities and the average taxpayer, and reduce the size and bureaucracy of the federal government. Charities perform services far more efficiently than government, especially once local involvement and volunteer services are considered, and serve needs that government cannot or will not meet. By supporting charities, citizens are empowering local, charitable groups and decreasing their reliance on the federal government. Through local not-for-profit organizations, citizens take responsibility for themselves and their communities. Ironically then, elimination of the charitable deduction works against Congress' efforts to restore power to localities and citizens' groups. After all, the more charities get involved and perform services, the less government intervention is needed.

Second, charitable incentives (like the charitable contributions deduction) more than pay for themselves. Research by economist Martin Feldstein and others at Harvard University indicate the increase in contributions caused by the charitable deduction is greater than the tax revenue that is lost. Based on data from the Internal Revenue Service, for every dollar of tax revenue lost because of the charitable deduction, charitable organizations received between $1.15 and $1.29 in additional contributions. So instead of money going to Washington and working its way back through the federal bureaucracy, the charitable contribution causes even more money to stay in a locality and directly benefit the citizens there.

Third, not only does the charitable contribution deduction empower localities and charitable organizations, it also empowers the individual contributor as well. When a taxpayers makes a contribution, he or she gets to choose where his or her money will go and how much to give. The individual gets to decide what public purposes to support, instead of his or her money going to taxes and being distributed for all sorts of programs. Thus, the charitable deduction is one of the easiest ways to simplify the tax system for the average citizen and get him or her more involved in policy making. Additionally, donors also volunteer, so their efforts are compounded.

Fourth, the charitable deduction has proven to be an effective mechanism that is very simple to administer. It requires little government manpower other than what is needed in any case for income tax collection and verification. It does not pose the kind of constitutional problems that other systems such as federal matching grants or credit systems may encounter, particularly when religious organizations are concerned. Even under a new tax system, a charitable deduction or similar mechanism should be easy to implement and oversee because it is largely insulated from government anyway. Again, matching grants and credits are more susceptible to political manipulation because they can be seen to involve government funds.

Government sends strong signals to the public when it makes choices about what it funds, what deductions it enacts, and what exemptions it keeps. When

Congress enacted the charitable tax deduction in 1917, it was expressing the belief that private philanthropy was an important value, and that individuals should not be taxed fully on that portion of their income which is donated to charity because that money will be used for the public good, not for someone's personal advantage. Although the focus of this hearing is the effect of eliminating the income tax system, the point remains: the deduction encourages people to help others, not themselves. It sends a signal to the American people that philanthropy is an important national tradition which should be encouraged and preserved.

As a professional fund raiser, I can assure you that people respond to these signals. Fund raisers are in contact with hundreds of potential contributors every week. Without a doubt, one of the reasons they choose to contribute is that they believe it is the right thing to do. But contributors also say that the tax structure and its deductions play a huge role in giving, particularly as the amounts increase. Just last week, I brought a group of executives together to discuss philanthropy in rural America. Included in the group was an insurance executive who recently placed an appreciated parcel of land he owned in a charitable remainder trust. He told me flat out that the charitable deduction to his current income made the gift possible. While the government may have lost some of the value of the gift it would have received in taxes, the entire asset is now in the public trust and will be used for needs in rural Southern Indiana. Without the deduction, the property would likely have been sold, some taxes paid and the money passed on to children. I want to stress that we are not just talking about the very wealthy and their donations. The example I just gave concerned a person of moderate income and means, just like the majority of contributors.

As that example indicates, the importance of the tax structure and incentives to give cannot be understated. According to research conducted for Independent Sector by Price-Waterhouse, The Effect of Tax Incentives on the Level of Individual Charitable Contributions, charitable contributions reported by itemizers would have dropped by approximately $20 billion in 1992 if there had been no charitable deduction. That report also indicates that contributions would have increased by an additional $3 billion had the contributions of non-itemizers been deductible. Clearly, the existence of the charitable deduction is an important factor in whether people give and how much they choose to contribute. Research by Dr. Richard Steinberg, Professor of Economics, Public Affairs, and Philanthropic Studies at Indiana University - Purdue University at Indianapolis, further confirms this assertion. Taking into account differing incomes and price elasticities, Dr. Steinberg's study of several different tax reform plans (none had a charitable deduction or other incentive) found that giving would decrease under each.

The total amount of giving decreases without a charitable deduction because a deduction reduces the cost of giving for a taxpayer. Without a charitable deduction, a contribution costs a taxpayer the exact amount of the gift (i.e. a one-dollar contribution costs one dollar). When donations are deductible, the cost of giving is equal to $1 minus the marginal tax rate. Fundraisers refer to this cost as the "tax-price" of giving -- the after-tax cost of giving a dollar to a tax-exempt charitable organization. Most econometric studies predict that the percentage decrease in charitable donations is about 1.2 times the percentage change in the tax-price of giving. Thus, for example, under a flat tax with no charitable deduction, charitable giving by taxpayers in the 31% tax bracket would fall by over 37%.

The cost of giving (tax-price) is the primary reason even the increased personal income that may come with tax reform will not lead to increases in donations. Common sense suggests that holding all else equal, charitable giving of money and time (volunteerism) will increase if after-tax income increases. Most econometric studies confirm this assumption. However, the increase in contributions because of this factor is small compared to the negative effects of the increased cost of giving that would take place under tax reform systems with no

charitable deduction. The cost of giving is far more compelling than any increase due to more after-tax disposable income. Thus, the signal that the federal government sends to the public by retaining the charitable deduction (and keeping the cost of giving down) is critical for charities to continue to perform their public services.

Another factor that fund raisers have to contend with are spending cuts in federal funds flowing to agencies and programs of charitable concern. A study conducted by Lester Salamon of Johns Hopkins University and Alan Abramson of The Aspen Institute, Congressional FY 1996 Budget Resolution: Implications for the Nonprofit Sector), concludes that over the next seven years (1996 - 2002), the total amount of federal money going to agencies and programs of charitable concern will be cut by $772.7 billion. To make up for that reduction, donations to the charitable sector would have to be increased by nearly 250%, or 50 times more than it has increased for each of the last several years.

Recent studies show that when the federal government cuts spending on charitable programs and related agencies, donations actually increase. However, for every dollar cut, contributions only increase between one and thirty cents, depending upon the particular agency or grant program. According to research by Professor Steinberg and Jerald Schiff (with the International Monetary Fund), cuts in federal grants for public assistance resulted in only a 1.8 percent replacement rate (i.e. 1.8 cents in donations for every dollar cut). Cuts in grants for elementary and secondary education resulted in a 28.6 percent replacement, while reductions in federal health grants resulted in a 29 percent response rate. Thus, the increased donations in no way make up for the losses in charitable spending.

Further compounding the problem, a number of econometric studies have found that state governments tend to respond to federal cutbacks by cutting spending further. Instead of responding to federal cutbacks by increasing their aid to charitable programs or agencies, most state and local governments tend to mimic the federal cut. Research by Lawrence Lindsey (Governor of the Federal Reserve Board) and Professor Steinberg found that every dollar reduction in federal grants caused an additional $1.28 reduction in state government spending with only a resulting $0.045 increase in donations. The total reduction in "charitable spending" (federal or state programs dealing with charitable concerns) was $2.23 per dollar of federal cutback. Therefore, any donations to charities have to make up for losses at both the state and federal levels.

Tax reform could also have an effect on volunteerism as well. While intuitively it makes sense to think that the level of volunteerism might rise in order to make up for decreased contributions, the opposite is actually true: Contributions of time and money are complementary and decline together. Without the charitable deduction and other incentives, not only would donations go down, but also the amount of time that the average citizen volunteers his or her time. A study by economists Paul Menchik and Burton Weisbrod estimate that a one percent increase in the price of a contribution (i.e. what it costs the taxpayer to make that gift) would results in a complementary 1.25 percent decrease in hours volunteered. Presumably a new tax system (without a charitable deduction) would reduce the tax rate and thus increase the cost of giving, leading to fewer contributions and fewer hours volunteered.

But apart from the tax structure, deductions and statistics, the committee needs to remember what the charitable contribution is all about: providing for the public good. It is perhaps unique among deductions because it not for personal or private gain, but public benefit. Its importance was recently noted by Jack Kemp, the chairman of the National Commission on Economic Growth and Tax Reform, who said that the controversy surrounding the charitable deduction was a "silly debate." He correctly pointed out that the deduction costs the U.S. less than one percent of its revenue and asked, "Can you imagine that we're arguing about this?"

Like Mr. Kemp, NSFRE cannot imagine that such a huge debate is raging over a deduction that is based on human generosity and sacrifice, and has helped so many people in this nation eat a healthy meal, receive clothing and shelter, get basic medical care, and receive a college education for the first time in their family's history.

I have been privileged to work on behalf of the Indiana University Center on Philanthropy in several other countries interested in building a stronger philanthropic base as a means of meeting public needs. In Mexico and Thailand, for example, we are working with local leaders to advocate for a more generous charitable deduction. It would be ironic for these governments to adopt the current U.S. policy on charitable deductions, which they view as a model, while we abandon this important endorsement of philanthropy.

I do not believe that this choice is what the American public wants. American citizens have said time and time again that there is a unique place for charities, and that they do deserve certain exemptions because of the work they do. A recent poll by the American Institute of Certified Public Accountants indicates that Americans favor keeping the charitable deduction by a three-to-one margin. In fact, this Congress recently asserted the unique position of charities when it unanimously passed charitable gift annuity legislation. A plaintiff in Texas argued that charities gift annuities should be treated like regular commercial annuities, but this Congress refuted that argument. Every member of this committee voted in favor of keeping the exemption for charities because you know that charitable annuities are not for personal gain, but to encourage donors to contribute assets to the public good.

Mr. Chairman, you have made it clear that you would like to "tear the income tax system out by its roots and throw it by the side." Your committee has made great strides so far, and if you can create a system that is simple, equitable, and most importantly, fair, we will applaud you. NSFRE is willing to work with you and your staff to achieve that goal. To be fair, however, the new system should encourage charitable contributions as an important means of providing for the public good. We have no interest in defending the status quo if major reforms are necessary. We believe that a tax system can be created that keeps incentives for charitable giving while vastly improving the current system. For example, while NSFRE does not agree with all aspects of the proposal, a progressive consumption tax -- such as the one introduced by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM) -- might increase contributions.

When we talk about tax reform and tax policy, we are talking about important choices -- choices that will have ramifications for every person in America. For many years, Americans have chosen to support philanthropy and make it part of their everyday lives, partly because of their own altruistic impulses and partly due to encouragement (both directly and indirectly) from the government. Every indication shows that the public will continue to do so.

Research shows that tax incentives heavily impact the size of charitable gifts. Donors tell us repeatedly that the national importance placed on philanthropy by the charitable deduction sends a strong signal to them when they choose to give. It is the responsibility of Congress to respond to those choices and ensure that the government continues to encourage giving. Our society, our values, our national character, and our individual moral obligations demand no less.

Chairman ARCHER. Thank you, Mr. Tempel.

Mr. Swords, if you will identify yourself, you may proceed.

STATEMENT OF PETER SWORDS, PRESIDENT, NONPROFIT COORDINATING COMMITTEE OF NEW YORK

Mr. SWORDS. My name is Peter Swords and I am the executive director of the Nonprofit Coordinating Committee of New York City, which is an umbrella group of some 700 nonprofits of all various types. I am also a constituent of Representative Rangel and I want him to be assured that his absence will not affect my vote.

I am not here to talk about tax reform. I am here to preach about the importance of the charitable exemption. I want to do that by focusing on the flat tax to make my point.

If you have a flat tax, all deductions will not be eliminated. There will, for example, have to be deductions in order to get from gross to net income. Business expenses are not in the tax base to begin with. Business expense deductions will be necessary to define the tax base of any flat tax.

So, likewise, we believe that money and wealth given over forever for the good of the whole community, dollars that will not be used for any individual benefit, should also not be in the tax base to begin with. We tax dollars and wealth that we would otherwise use for ourselves and not dollars which will help others.

Thomas Hobbes a long time ago said, "We tax only what we take out of the pot, not what we put into the pot." If you have a flat tax, you will need an exemption for charitable dollars so that you will only tax what we take out of the pot and we will not penalize the kind of generosity that you were talking about earlier, which is what, in effect, eliminating the charitable deduction would do.

It should be noted that the approach that I have been arguing for powerfully confirms one of the principal glories of America's nonprofit sector, mainly its pluralism. Our view of what qualifies for charitable exemption places more emphasis on the fact that no one is personally benefiting from these charitable nonprofits than on an evaluation of the nature of the goods they are providing.

Thus, it is up to the founders of nonprofit organizations to decide what is in the public interest rather than leaving the decision to government. Letting the government decide what is in the public interest would be appropriate if the exemption is seen as a way of encouraging efforts that the government approves of. The trouble with this latter view is that government may change its mind. Today, it favors the right to bear arms; tomorrow, it does not. Today, it favors affirmative action and encouragement of the arts; tomorrow, it does not.

On the other hand, if the exemption is seen as a tax base provision, as just mentioned, it is up to the initiators and supporters of the individual nonprofits to decide what is in the public's interest. American history has shown time and time again that nonprofits have identified emerging social problems long before government or political parties have.

Furthermore, it is commonplace wisdom that nonprofits are able to respond to problems with more flexibility and creativity than the government can. Finally, and related to the pluralism point, it is likely that many more Americans now volunteer to work for non-

profits than would be the case if the sector was defined solely by government policy and party politics.

One can believe in the worth of government while simultaneously seeing the great value to our polity of having a nonprofit sector operating independently and parallel to the government in identifying and providing public goods and services. Who can doubt that such a system offers us a wider range of public benefits, a richer palette of public goods than would be the case if defining the public good was left exclusively to the government?

But note, if we do away with the charitable tax exemption and tax nonprofits, logic inevitably dictates that the nonprofit sector will wither and the provision of public goods will more and more be left exclusively in the hands of the government. America will then have given up one of its most significant contributions to civilization.

Thank you.

[The prepared statement and attachment follow:]

Testimony of Peter Swords, President, Nonprofit Coordinating Committee of New York

Hearing on the Impact on State and Local Governments and Tax-Exempt Entities of Replacing the Federal Income Tax

Committee on Ways and Means, U.S. House of Representatives

My name is Peter Swords. I am the President of the Nonprofit Coordinating Committee of New York, usually referred to as NPCC. NPCC, a coalition of nearly 700 New York City 501(c)(3) nonprofit organizations, works to advance the nonprofit sector. We were formed in 1983 in the crucible of an attempt to narrow the charitable property tax exemption in the city, so I feel quite at home today.

We have no position on the desirability or not of a flat tax or other possible alternative systems. Our position is that if an alternative system be adopted the exemption for 501(c)(3)-type organizations should be retained whether the current Federal income tax system be replaced with either a flat tax, a national sales tax or a value added tax. 501(c)(3)-type nonprofits are those nonprofits formed exclusively to advance the public's interest and will henceforth be referred to as charitable nonprofits. (We assume that in any income tax or income tax with an unlimited savings deduction, the charitable exemption for 501(c)(3)-type organizations would continue.)

It is our view that, while the legislative history is thin, from the beginning of the country's history charitable nonprofits were never intended to be included in the tax base - any tax base, whether the early 19th century corporation tax base, the various local property tax bases, local sales tax bases or the Federal income tax base. This is for a very simple reason. We, the people of the United States, never meant to tax money or wealth that would only be used for the good of the whole community. In order to finance the collective goods government provides, we tax money that would otherwise be used to advance personal, individual interests, whether through consumption or perhaps savings (consumption in the future) and not, to repeat, money that would be used only for the whole society. Since most nonprofits could not pass any tax on to the people they serve, and, since they have no owners whose distribution of profits could be reached to pay the tax, any tax inevitably works to reduce the level of goods and services nonprofits provide. In sum, taxes should reduce personal consumption and not the level of goods and services provided by charitable nonprofits.

At this point I would like to point out that the justification and need for the charitable tax exemption applies as much to the charitable contribution deduction as it does to the exemption per se. Money given to a charity by an individual is not going to be used for any individual, private purposes and if taxed (which is what an elimination of the charitable contribution deduction would ultimately entail), would simply mean that that much less money would be available for the charity with a consequent reduction in the provision of charitable services. For identical reasons the estate and gift tax deduction should be maintained in any

change.

We then would argue that if the shift is to some sort of flat tax, charitable nonprofits ought to be exempted as a way of defining the tax's base. Such a tax should be on income that would otherwise be used for ourselves. We must exempt nonprofits because we do not mean to reduce the amount of public services they provide so as to finance government. Similar arguments apply to any kind of national sales tax or value added tax. They should be meant to bear on individual consumption, not on the provision of public benefits. While there might be mild administrative problems in figuring out how to rebate a value added tax, the English and Europeans have seemed to figure out a way to do it, as anyone who has recently traveled abroad and made significant purchases may have found out.

It will be asked whether providing for the charitable exemption under any of the proposed systems will be revenue neutral. In this connection, it may be pointed out that some assert that the charitable contribution deduction costs the Federal government $20 billion. But we believe that this is the wrong question and the point is pointless. If we never intended to have money contributed to charity in the tax base to begin with, it doesn't make sense to talk about lost revenues. The charitable tax exemption provisions are unlike provisions put into the code to stimulate investment, or encourage business or home ownership. These provisions are included for non-tax reasons and it makes good sense to say that they are a carve-out from the tax base and represent lost revenues.

But this is not the case with the charitable exemptions. We don't choose to tax everything. For example, if we wanted to we could impute the value of the efforts that individuals make when they volunteer for charities and tax the individuals on the imputed value. But nearly everyone would think that this is an illogical idea. And it is illogical because we certainly have never meant volunteer charitable efforts to be in the tax base. When you think about it for a moment you will see a close analogy between volunteer charitable efforts and the contribution of money to charities.

It should be noted that the approach to the charitable exemption I have been arguing for powerfully confirms one of the principal glories of America's nonprofit sector, namely its pluralism. Our view of what qualifies for the charitable exemption places more emphasis on the fact that no one is personally benefitting from these charitable nonprofits than on an evaluation of the nature of the goods they are providing. Thus, it is up to the founders of these organizations to decide what is in the public's interest rather than leaving the decision to the government. Letting the government define what is in the public's interest would be appropriate if the exemption is seen as a way of encouraging efforts that the government approves of.

The trouble with this latter view is that the government may change its mind. Today it favors the right to bear arms; tomorrow it doesn't. Today it favors affirmative action and encouragement of the arts; tomorrow it doesn't. On the other hand, if the exemption is seen as a tax base provision, as just mentioned, it is up to the initiators and supporters of the individual nonprofits to decide what is in the public's interest. American history has shown time and time again that nonprofits

have identified emerging social problems long before government or political parties have. Furthermore, it is commonplace wisdom that nonprofits are able to respond to problems with more flexibility and creativity than the government can. Finally, and related to the pluralism point, it is likely that many more Americans now volunteer to work for nonprofits than would be the case if the sector was defined solely by government policy and party politics.

One can believe in the worth of government while simultaneously seeing the great value to our polity of having a nonprofit sector operating independently and parallel to the government in identifying and providing public goods and services. Who can doubt that such a system offers us a wider range of public benefits, a richer palette of public goods, than would be the case if defining the public good was left exclusively to the government? But note, if we do away with the charitable tax exemption and tax nonprofits, logic inevitably dictates that the nonprofit sector will wither and the provision of public goods will more and more be left exclusively in the hands of the government. America will then have given up on one of its most significant contributions to civilization.

NONPROFIT COORDINATING COMMITTEE OF NEW YORK
Member List

100% Vote/Human Serve Fund
14th St-Union Square Local Development Corporation
42nd Street Development Corporation
AIDS & Adolescents Network of New York
Actor's Fund of America
Add Joy to Learning
Adolph & Esther Gottlieb Foundation
Advertising for Survival
Ageless Foundation
Alliance for the Arts
Alliance of Resident Theatres/New York
Alonzo Daughtry Family Life Services
Alpha Omega 1-7 Theatrical Dance Co
Alternatives to Violence Project/Metro New York Inc
Altman Foundation
Amateur Chamber Music Players Inc
American Academy of Psychoanalysis
American Bible Society
American Bureau for Medical Advancement in China
American Center for the Alexander Technique
American Civil Liberties Union
American Ditchley Foundation
American Friends of Neve Shalom/ Wahat al Salam
American Institute of Graphic Artists
American Montessori Society
American Red Cross in Greater NY
American Society of Botanical Artists Inc
American Stock Exchange
Americas Society
Amethyst House
Andrew Glover Youth Program Inc
Andy Warhol Foundation for the Visual Arts
Aquarian Center for Initiation
Arab Television of America Inc
Arts Connection Inc
Asian & Pacific Islander Coalition on HIV and AIDS
Asian American Communications Inc
Asian American Federation of New York
Asian-American Coalition for Children And Families
Association for Neighborhood & Housing Development
Association of PVO Financial Managers
Atlantic Foundation of New York
BHRAGS Inc
Barnard College
Bay Ridge Parks & Waterfront Council
Beacon of Hope House
Beekman Family Association
Bermuda Artworks Foundation
Bernhill Fund
Better Business Bureau Education and Research Foundation
Big Apple Greeter Program
Black Veterans for Social Justice Inc
Blanton-Peale Metro Counseling Center
Body Positive of New York
Boehm Foundation
Bond Street Theatre
Bridge Fund

Bridgeport Community Health Center Inc
Bristol-Myers Squibb Fund
Bronx Educational Services
Bronx Health Plan
Brooklyn Bureau of Community Service
Brooklyn Center for Independence of the Disabled
Brooklyn Center for the Urban Environment
Brooklyn Chamber of Commerce
Brooklyn In-Touch Information Center
Brooklyn Psychiatric Centers Inc
Brooklyn Society for the Prevention of Cruelty to Children
Brooklyn Waterfront Artists Coalition
Bushwick Community Service Society
Byram Hills Education Foundation
CASA Court Appointed Special Advocate
Cable Positive Inc
Cambridge University Press
Cancer Care Inc
Care for the Homeless
Caribbean Women's Health Association Inc
Carnegie Corporation of New York
Carnegie Council on Ethics and International Affairs
Catholic Big Brothers of New York
Catholic Charities Archdiocese of New York
Catholic Charities Diocese of Brooklyn
Cause Effective-Nonprofit Resource Development Center
Cdr Wm S Stuhr Scholarship Fund
Center for Anti-Violence Education/Brooklyn Women's Martial Arts
Center for Environmental Technology Cooperation Inc
Center for Family Life
Center for Law and Human Values
Center for Medical Consumers
Center for Reproductive Law & Policy
Center for Strategic Communications
Center for the Study of Philanthropy
Center for the Study of Social Administration
Center on Social Welfare Policy
Central Park Historical Society
Charles H Revson Foundation
Charles M Cappellino Foundation Inc
Children Internationally Abducted New York City Inc
Children with Attention Deficit Disorder
Children's Aid Society
Children's Express Foundation Inc
Children's Television Workshop
Chinese Development Council
Chinese-American Planning Council Inc
Church Avenue Merchants Block Association Inc
Circuit Theatre Inc
Citizen's Advice Bureau
Citizen's Committee for Children of New York
Citizens Committee for New York City
Citizens Housing and Planning Council of New York
Citizens Resource Center
City Club of New York
City Innovation
City Limits Community Information Service
City Project
City Volunteer Corps
Citymeals on Wheels
Civitas Citizens

Cluster Inc
Co-op City Nutrition Program
Co-operation Ireland Inc
Coalition for the Homeless
Coalition of Voluntary Mental Health Agencies
Columbia University
Columbia University-Office of Public Affairs
Committee for Humanitarian Assistance to IranianRefugees
Common Cents New York Inc
Commonwealth Fund
Communication for Change
Community Access
Community Bankers Association of New York State
Community Lesbian and Gay Rights Institute (CLGRI)
Community Projects & Programs
Community Resource Exchange
Community Service Society of New York
Community Training & Resource Center Inc
Composers Collaborative Inc
Concourse House
Consciousness Research & Training Project Inc
Contact Center Network
Cooper Union for the Advancement of Science and Art
Council of Literary Magazines and Presses
Council of Senior Centers and Services of NYC Inc
Council on Accreditation of Services for Families & Children
Council on Foreign Relations
Counseling-Learning Institutes
Create Inc
Creative Development Services
Crescentera
Cure for Lymphoma Foundation
DJJ Fund Inc
DOROT
DW Senior Services Inc
David G Salten Foundation
Day Care Council of New York
Deer Hill Conference Center
District 4 New York State Volunteer Ambulance and Rescue Association
Doing Art Together Inc
Domestic & Foreign Missionary Society of the Protestant Episcopal Church
Drug Policy Foundation
East Bronx Council on Aging
East Harlem Tutorial Program
East Side Community Group for Senior Services
Educational Equity Concepts
Educational Priorities Panel
Educators for Social Responsibility Metro
Edward W Hazen Foundation
End Stage Renal Disease Network of New York Inc
Environmental Action Coalition
Environmental Defense Fund
Epilepsy Society of NYC
Episcopal Church Center
Episcopal Mission Society
Eugene Zitwer Foundation
Eulenspiegel Society
Evergreen Association Inc
Exploring the Metropolis
FITA

Families First
Family Center
Fan Fox & Leslie R Samuels Foundation
Federation Employment & Guidance Service
Federation of Protestant Welfare Agencies
Fifth Avenue Committee Inc
Fifth Avenue Community Center of Harlem
Financial Women's Association of New York Educational Fund
First Chinese Presbyterian Church Community Affairs
Flushing Jewish Center
Flute Force Inc
Food First Inc
Food For Survival Food Bank
Ford Foundation
Fordham Bedford Housing
Forest Hills Community House
Forestdale Inc
Fort George Community Enrichment Center
Fort Washington Houses Services for the Elderly
Foundation for Cultural Review
Fourth Universalist Society
Fresh Air Fund
Fresh Youth Initiatives
Friends & Relatives of Institutional Aged (FRIA)
Friends of Island Academy
Friends of the Institute of Noetic Sciences Inc
Fund for Aging Services
Fund for Modern Courts
Fund for the City of New York
Funders Concerned About AIDS
GNYRSO INC
Gay Men Of African Descent
Gay Men's Health Crisis
General Board of Global Ministries-The UnitedMethodist Church
General Theological Seminary College
Gestalt Center for Psychotherapy & Training
Gilda's Club
Gillen Brewer School
Global Education Initiatives Inc
Global Information Network
Global Kids
Goddard-Riverside Community Center
Golden Family Foundation
Good Shepherd Services
Greater Sheepshead Bay Development Corp
Greenwall Foundation
HERO Inc
HIPPY USA
Hai-Lan Chinese American Cultural Society Inc
Handicapped Adults Association
Happiness is Camping Inc
Harlem Restoration Project Inc
Harold & Isabel Feld Foundation
Hatch-Billops Collection Inc
Health & Help Corp
HealthCare Chaplaincy
Hearts & Voices Inc
Henry Street Settlement
Hermanidad Hispana Nacional
Hispanic Organization of Latin Actors (HOLA)
Holiday Dinner Group

Holy Apostles Soup Kitchen
Holy Cross High School
Honor Emergency Fund NYC Fire Department
House of Emmaus
Hudson Guild
Hundred Year Association of New York
Huntington Free Library
Huntington Township Art League Inc
IOLA Fund
Illusion Productions
Incollaboration Inc/Readers Theatre Workshop
Incube Inc
Indian American Kerala Cultural and Civic Center
Information for Families Inc
Innovative Community Enterprises
Institute for Asian Studies
Institute for Urban Family Health
Institute of International Education
Institute of Public Administration
Institutes of Religion and Health
Interchurch Center
Interculture
Interlingua Institute
International Committee for Haitian Industrial Training
International Student Hospice
International Women's Health Coalition
Internet Nonprofit Center
Inwood House
Israel Matz Foundation
Italian Center of New York City
Ittleson Foundation Inc
JM Kaplan Fund
JMR Barker Foundation
JR Hansborough Jr Recreation Center Conservancy
Jamaica Service Program for Older Adults
James Lenox House Association
Jane Addams Peace Association Inc
Japan Society
Jewish Association for Services to the Aged
Jewish Board of Family and Children Services
Jewish Community Centers Association of NA
Jewish Community Council of the Rockaway Peninsula
Jewish Community Relations Council of New York Inc
Joyce Mertz-Gilmore Foundation
Junior League of the City of New York
Kingsbridge-Riverdale-Van Cortlandt Development Corp
Kosciuszko Foundation
LIFE Inc
La Mama Experimental Theatre Club Inc
Laban/Barteniff Institute for Movement Studies
Landmark Players
Landmark West!
Latin American Development Foundation Inc
Lawyers Alliance for New York
League of Women Voters of the City of New York
Leake and Watts Children's Home
Leap Inc
Learning Disabilities Association of NYC
Learning Matters Inc
Legal Outreach Inc
Leopold Schepp Foundation

Lesbian & Gay Community Services Center
Lincoln Center for the Performing Arts
Literacy Volunteers of New York City
Little Sun People
Living Waters Fellowship Inc
Liz Claiborne & Art Ortenberg Foundation
Longwood Historic District Community Association
Love People
MBD Community Housing Corp
Malankara Catholic Mission of North America Inc
Manhattan Borough Development Corporation Inc
Manhattan Boroughwide Interagency Council on Aging
Manhattan Comprehensive HDFC
Manhattan Institute for Psychoanalysis
Manhattan Neighborhood Network
Map of Africa
Marine Environmental Research Institute
Martin House/Thames River Community Service
Mary Cassatt Foundation
Maspeth Town Hall
Maternity Center Association
Medica Foundation
Medical & Health Research Association of New York
Medicare Beneficiaries Defense Fund
Melodious Accord
Met Council on Housing
Methodist Federation for Social Action
Metro International Program Services
Metropolitan Historic Structure Association
Metropolitan Museum of Art
Metropolitan New York Coordinating Council on JewishPoverty
Midwood Development Corporation
Mood Disorders Support Group Inc MDSG/NY
Morningside Area Alliance
Morningside Retirement and Health Services Inc
Motherless Daughters Inc
Mothers' Voices
Mount Hope Housing Company Inc
Mount Morris Park Community Improvement Association
Municipal Art Society
Museum of Jewish Heritage
Museum of Modern Art
NAACP Mid-Manhattan Branch Community Services Inc
Nate B & Frances Spingold Foundation
Nathan Cummings Foundation
National Artists for Mental Health
National Association for Female Executives Women's Foundation
National Association of Social Workers NYC Chapter
National Collegiate Association for the Research of Principles
National Committee for Public Education & Religious Liberty
National Council for Research on Women
National Council of Negro Women of Greater New York
National Council on Women's Health
National Executive Service Corps
National Helpers Network Inc
National Institute for the Psychotherapies
National League for Nursing
National Multiple Sclerosis Society NYC Chapter
National Society of Fundraising Executives
Natural Resources Defense Council
Neighborhood Coalition For Shelter

Neighborhood Coaltion for Shelter
Neighborhood Housing Services of NYC
Neighborhood Self-Help By Older Persons Project
Neighbors Together Inc
Network for Women's Services Inc
New Alternatives for Children
New Dance Group Arts Center
New York AIDS Coalition
New York Academy of Medicine
New York Association for New Americans (NYANA)
New York Business Group on Health
New York Cares
New York Citizens' Committee on Health Care Decisions
New York City Audubon Society
New York City Clean Air Campaign
New York City Coalition for Fairness to Veterans Inc
New York City Community of the ARE
New York City Environmental Justice Alliance
New York City Job & Career Center
New York City Outward Bound Center
New York City Partnership
New York City Police Foundation Inc
New York City Public Private Initiatives Inc
New York City School Volunteer Program
New York City Voluntary Action Center
New York Coalition of Professional Women in the Arts& Media Inc
New York Community Trust
New York Conservation Education Fund
New York Foundation
New York Foundation for the Arts Inc
New York Immigration Coalition
New York Institute for Human Development
New York International American Youth Hostel
New York Landmarks Conservancy
New York Lawyers for the Public Interest
New York Public Library
New York Quarterly Meeting of the Religious Society ofFriends
New York Rainforest Alliance
New York Regional Association of Grantmakers
New York Society of Association Executives
New York State Association for Solid WasteManagement
New York State Coalition for Choice
New York Theatre Workshop
New York Therapeutic Riding Center
New York University Robert Wagner Graduate School ofPublic Service
New York Women's Agenda
New York Women's Foundation
New York Youth at Risk Inc
New Yorkers Against Gun Violence Education Fund Inc
Nonprofit Facilities Fund
Nonprofit Management Program New School for SocialResearch
Noreen T Holland Breast Cancer Foundation
Northern Westchester Shelter
Object Relations Institute for Psychotherapy and Psychoanalysis
Odyssey House
Open Housing Center
Opera Amadeo
Opportunity Resources Inc
Origami USA
Orton Dyslexia Society NY Branch
Ossining Food Pantry

Other Theatre Inc c/o Artservices
Parents League of New York
Park Slope Neighborhood Family Center
Parodneck Foundation for Self-Help Housing & Community Development
Partnership for Responsible Drug Information Inc
Paterson Orphan Asylum Association
Pathways to Freedom Inc
Paul Rapoport Foundation
People Against Sexual Abuse
Performing Arts Resources
Phoenix House Foundation Inc
Piatigorsky Foundation
Pinkerton Foundation
Planned Community Living Inc
Planned Parenthood of New York City
Plays for Living
Population Council
Practising Law Institute
Prep for Prep
Primary Care Development Corporation
Program Development Services Inc
Program in Arts Administration
Project Renewal
Project for Psychiatric Outreach to the Homeless
Prospect Park Alliance
Psychoanalytic Quarterly
Psychonephrology Foundation
Public Affairs Information Service
Queens Botanical Gardens
Queens Child Guidance Center
Queens Women's Network
Queensboro Council for Social Welfare Inc
Radd Racers Against Drunk Driving Inc
Ramapo Anchorage Camp
Red Hook Arts
Regional EMS Council of New York City Inc
Rehabilitation Through Photography Inc
Rhombus/Amos Eno Gallery
Riverside Language Program Inc
Rockefeller University
Russell Sage Foundation
Russian Ethnic Bilingual Educational & Cultural Association
Russian Musical Arts Society of America Inc
SHARE
STRIDE
Sabater Foundation
Salvodori Education Center on the Built Environment
Samuel H Kress Foundation
School News Nationwide
Shelter and Food for the Homeless Inc
Shorefront Mental Health Board
Shorewalkers
Sidewalks of New York Productions Inc
Sivananda Yoga Vedanta Center
Smith College Club of New York
South Bronx Overall Economic Development
St John's Bread & Life Program Inc
Staten Island AIDS Task Force
Staten Island Chamber Music Players Inc
Statue of Liberty-Ellis Island Foundation
Stella and Charles Guttman Foundation

Subud New York
Suited for Success
Sunnyside Home Care Project
Support Center of New York
Support for People with Oral and Head and Neck Cancer
Support for Training & Educational Services
Symphony Space
Taconic Foundation Inc
Teaching Matters Inc
Team New York Aquatics
The ASCAP Foundation Inc
The Aaron Diamond Foundation
The Africa Fund
The American Guild of Organists
The Andrew W Mellon Foundation
The Asia Society
The Association of the Bar of the City of New YorkFund Inc
The Astraea Foundation
The Catalog for Giving
The Correctional Association of New York
The Crystal Quilt Inc
The Epidavros Project Inc
The Foundation Center
The Interactive Aging Network
The Markle Foundation
The Osborne Association
The Partnership for the Homeless
The Polish Institute of Arts and Sciences
The Ranger Corps
Theatre for a New Audience
Theatreworks/USA
Third Millennium
Times Square Business Improvement District
Tinker Foundation Inc
Toshiba America Foundation
Toussaint Institute Fund Inc
Town Hall Civic Association of Springfield Gardens Inc
Township Community on New Life
Trafica Press Inc
Training Institute of the National Psychological Association
Transactional Analysis Awareness Center
Triangle Arts Association/Triangle Artists' Workshop
Trisha Brown Company Inc
Trust for Mutual Understanding
UJA/Federation of Jewish Philanthropies
Ukrainian Institute of America
Union of American Hebrew Congregations
United Hospital Fund
United Neighborhood Houses of New York
United Neighborhood of East Midtown
United States Servas
United Way of New York City
Unity Fellowship Church in Christ NYC
Universal Temple of the Arts
University Physician Associates of New Jersey
University of Cape Town Fund Inc
Urban Assembly
Urban Policy Designs
Uris Brothers Foundation
VZV Research Foundation Inc
Valley Restoration Local Development Corp

Van Cortlandt Jewish Center
Vera Institute of Justice
Veritas Therapeutic Community Inc
Vincent Astor Foundation
Vivaldi Travelling Circus
Volunteer Consulting Group
Volunteer Lawyers for the Arts
Volunteer Referral Center
Volunteer Services for Children
Volunteers of America
Volunteers of Legal Service
WAIF Inc
Wagner Society of New York
Way of Action
Weigh Less Foundation Inc
Well Spouse Foundation
West 181st Street Beautification Project
West End Intergenerational Residence
West Side One-Stop
Westchester Community Foundation
Wieder Family Foundation
Women In Need
Women's Action Alliance
Women's City Club of New York Inc
Women's Housing & Economic Development Corporation
Women's Prison Association and Home
World Cultural Exchange Inc
World Education Services Inc
World Fund
World Hunger Year
YMCA of Greater New York
YPIS of Staten Island Inc
YWCA of Brooklyn
Yorkville Common Pantry
Young Concert Artists Inc
Youth & Family Justice Center
Youth Activities Committee Inc
Youth Association of Whitestone Inc
Youth DARES

Chairman ARCHER. Thank you, Mr. Swords.

Mr. Rosen, if you will identify yourself for the record, you may proceed.

STATEMENT OF LARRY M. ROSEN, PRESIDENT, YMCA OF METROPOLITAN LOS ANGELES; ON BEHALF OF THE YMCA OF THE USA

Mr. ROSEN. Mr. Chairman, Members of the Committee, my name is Larry Rosen. I have the honor of being the caboose of these hearings. Thank you for welcoming the opinions——

Chairman ARCHER. Only for today, Mr. Rosen.

Mr. ROSEN. Thank you. I am the president of the YMCA of Metropolitan Los Angeles, which is a community-based nonprofit charitable organization of 250,000 members, 25,000 volunteers in the greater Los Angeles area. About 130,000 of those members are children.

The Los Angeles YMCA operates 24 major full facilities plus 140 program centers throughout the Los Angeles area. Eight of these full facilities and 42 of these program centers are in the inner city of Los Angeles, involving more than 84,000 residents of those areas. They are the only facilities that were completely untouched during the civil disturbance in Los Angeles in 1992 because they are owned by the members of that community. All of these were built and supported by charitable contributions.

I am testifying today on behalf of the YMCA of the USA and the more than 2,000 local YMCAs nationwide, all of which could tell similar stories. As the Committee considers the possibility of structural alternatives to the existing Federal income tax, I commend you for taking this opportunity to focus on the implications of tax restructuring for America's charities. These implications are profound and merit careful consideration.

In considering the impact of Federal tax policy on America's charities, it is important first of all to consider the importance of charities for America. America is blessed with a charitable sector of incomparable breadth, strength, and diversity. Virtually all of us can think of charitable organizations that have profoundly touched our lives. It is not by accident that the Nation which has done the most through its tax laws to support the generous impulses of its citizens also enjoys such a large, vibrant, and effective nonprofit sector.

For millions of Americans, one of those organizations has been the YMCA. Our mission at the YMCA can be summed up in just nine words. We build strong kids, strong families, and strong communities. We accomplish that mission through a far broader range of programs than most people realize—child care, health and fitness, youth sports, camping, teen programs, and many more. Last year, YMCAs in this Nation served over 14 million Americans.

The YMCA's mission has never been more important, and the same can be said for America's charities as a whole. America's rich web of nonprofit charities are an invaluable national resource that help shape our character, enlighten our minds, knit together our communities, and sustain our democratic process.

In fact, at a time when government is being challenged in many ways to do less or is unable to do more, the nonprofit sector is

being asked to do more about pressing social, educational, and cultural concerns.

At this time, the most appropriate reform of our Tax Codes might be to seek ways to increase citizen participation in charitable concerns. The status quo will not be good enough as government continues to step back.

In the past 15 years, my experience has been that the YMCA has been invited with increasing frequency to come to the table as a partner with school districts, municipalities, county agencies, all seeking to serve with diminishing resources and to invite the nonprofit sector in partnership, an unpaid partner. The YMCA's ability to fulfill this impulse to be a partner in this regard depends very heavily on its ability to raise additional dollars.

Turning now to the tax policy issues at hand, let me say first of all that America's charities are not creatures of Federal tax law. America had a strong tradition of private initiative for the public good long before we had a Federal income tax, indeed, long before we had a Federal Government. On the other hand, from the beginning of this century, Federal tax policy has provided strong support for charities. These supportive tax policies have surely had much to do with the continued growth and dynamism of the charitable sector.

Our own board, 75 of the wealthiest, most influential citizens in Los Angeles, was in retreat with us over the weekend. I told them I was coming here and I asked them if any of them had been influenced in any way by the Tax Code to make more or larger contributions to their community. When the laughter died, they asked if anyone was seriously questioning the significant influence of the charitable deduction and the level of charitable giving. They said that, of course, they had been influenced mightily to give more and more often because the Tax Codes favored their participation.

I have had conversations like this for 26 years with individuals about their charitable activities, involving the raising of tens of millions of dollars. The story is always the same.

One gentleman, who was the beneficiary of a leveraged buyout that left him holding $5 million in appreciated securities, gave $1.5 million of that $5 million gain to charity. I asked him, what would have happened had the laws been different or had there been no incentive in the Tax Codes for his participation? He said he believes in charity—having been raised in Germany, having been in a society where no encouragement was given for such things—that even without a charitable deduction he would have given something, perhaps $200,000 but nothing close to the $5 million he actually contributed.

Four aspects of the current law are particularly important: First, a clearly defined category of tax-exempt charities; second, a broad concept of charity defined in terms of benefit to the community as a whole rather than in narrowly defined terms of relief of poverty; third, strong tax incentives for charitable giving; and finally, tax exemption for income earned from activities directly related to an organization's charitable purposes. These four key elements of current law provide clear benchmarks for evaluating the implications for charities of proposed replacements for the Federal income tax.

To appreciate how important it is to sustain these Federal tax supports for charities, just come to the Los Angeles YMCA. Talk to any of the 1,000 kids who benefit from scholarships every year to go to summer camp, the thousands of seniors who are involved because we are able to say we will turn no one away for lack of funds, the thousands of single parents who have their children in subsidized child care, the children playing in inner city soccer teams, the runaway youth and homeless families who have transitional housing at our Hollywood YMCA, or any of the hundreds of at-risk teens who we serve.

In the past 6 years, we have been able to raise $81 million, $12 million in the last year alone. Without this support, none of these programs would have been possible.

America needs its charities now as never before. This is precisely the wrong time to weaken the Federal tax policy supports for charitable giving. We hope they will be increased.

Thank you for your time and attention.

[The prepared statement follows:]

Statement by

LARRY M. ROSEN
President, YMCA of Metropolitan Los Angeles
on behalf of
THE YMCA OF THE USA

HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Room 1100, Longworth House Office Building
10:00 a.m., May 1, 1996

My name is Larry M. Rosen. I am the President of the YMCA of Metropolitan Los Angeles. I am testifying today on behalf of the YMCA of the USA and the more than 2,000 local YMCAs nationwide.

As the Committee considers the possibility of structural alternatives to the existing federal income tax, I commend the Committee for taking this opportunity to focus on the implications of tax restructuring for America's charities. As discussed below, the implications are profound, and merit careful consideration.

I. **America's Charities: A Unique National Resource**

Before considering the implications of federal tax policy for America's charities, it is important to consider the importance of charities for America. It is frequently remarked, but all to easily taken for granted, that America is blessed with a charitable sector of incomparable breadth, strength, and diversity. Virtually all of us can think of charitable organizations that have profoundly touched our lives. For millions of Americans, one of those organizations has been the YMCA.

The YMCA is one of the oldest, and largest, nonprofit community service organizations in the country. From the founding of the first American YMCA in Boston in 1851, the YMCA quickly spread across the nation. Dedicated to translating Christian values into practical action, the YMCA has responded to the needs of each new generation with a succession of innovative programs and services. Today, YMCAs serve over 14 million Americans each year -- persons of all races, religions, and income levels, half male and half female, half children and youth, and half adults.

The YMCA mission can be summed up in just eight words: *"We build strong kids, strong families, strong communities."* We accomplish that mission through a far broader range of programs than most people realize. We are America's largest provider of child care for school age children. Hundreds of thousands of children and youth participate in our youth sports and aquatics programs and attend our camps. In recent years, we have greatly expanded our programs for teens, including outreach programs for disadvantaged youth who are particularly at-risk of substance abuse, pregnancy, AIDS, and gangs. And YMCAs continue to be the national leader in providing community-based health and fitness programs for adults of all ages.

Beyond these programs, several key attributes define the essence of a YMCA. First and foremost, in everything we do, YMCAs seek to develop positive moral values -- respect, responsibility, honesty, and caring. Second, YMCAs are inclusive; our goal is to serve and bring together all elements of the community. Third, YMCAs are committed to prevention. Finally, YMCAs are rooted in, and belong to, the communities they serve. Every local YMCA is directed by a board of local volunteers, ensuring its responsiveness to local needs and concerns.

YMCAs have made a positive difference in the lives of millions of Americans, and the YMCA mission -- building strong kids, strong

families, strong communities -- has never been more important than it is today.

The same can be said for America's charitable sector as a whole. From churches and nonprofit social service agencies to private colleges and universities, from community groups promoting arts and culture to hospitals and medical research organizations, America's rich web of nonprofit charities comprise an invaluable national resource that helps to shape our character, enlighten our minds, knit together our communities, and sustain our democratic process.

Leaders of emerging democracies around the world look at America and recognize the crucial importance of America's charities. Many of these countries are working hard to nurture a U.S.-style nonprofit sector. We should be no less concerned about preserving this aspect of our tradition than they are about replicating it.

II. The Current Tax Treatment of Charities: Bench marks for Evaluating Alternative Tax Systems

America's charities are not creatures of federal tax policy. America had a strong tradition of private initiative for the public good long before we had a federal income tax -- indeed, long before we had a federal government. On the other hand, from the beginning of this century, federal tax policy has provided strong support for charities, and these supportive tax policies have surely had much to do with the continued growth and dynamism of the charitable sector.

Thus, as Congress considers the possibility of fundamental change in the federal tax system, it is important to focus on the essential elements of current federal tax policy towards charities and to consider whether it would be possible to preserve these tax supports within various structural alternatives to the income tax. Four aspects of existing federal policy are particularly important, and provide useful bench marks in evaluating the effects on charities of alternative tax systems. Specifically, these salient aspects of the current federal tax rules are:

* A clearly defined category of tax-exempt charities;
* A broad concept of charity, defined in terms of benefit to the community as a whole rather than more narrowly in terms of relief of poverty;
* Strong tax incentives for charitable giving; and
* Tax exemption for income earned from activities directly related to an organization's charitable purpose.

Each of these elements of current policy deserves brief comment.

A. A clearly defined category of tax-exempt charities

An important, and highly beneficial aspect of current law is that it clearly defines a class of organizations -- those exempt under section 501(c)(3) of the Internal Revenue Code -- that are, in effect, certified by the federal government as dedicated to public purposes and deserving of public support. The importance of section 501(c)(3) status -- to charities, to the public, and to government -- transcends the tax benefits that flow directly from it.

For the public, section 501(c)(3) status signals an organization's single-minded commitment to a public service mission. This special status, in turn, encourages individuals to

interact with the organization on a basis wholly different from their interaction with commercial entities. Instead of "buyer beware," we deal with section 501(c)(3) organizations on the basis of altruism and trust -- whether in giving our time and our money or in committing our children or our parents to such organizations' care. Our willingness to trust and to support these organizations derives from our understanding that section 501(c)(3) -- backed-up by IRS oversight -- imposes fundamental fiduciary safeguards and public purpose constraints.

Government, likewise, makes use of the section 501(c)(3) classification in a variety of contexts beyond the tax field. For example, over the years Congress has limited participation in many federal grant programs to section 501(c)(3) organizations and has given these organizations the benefit of preferred postal rates and other legal preferences. Similarly, state and local governments have made section 501(c)(3) status the basis for awarding exemptions from various taxes and regulatory requirements.

It is important that any future federal tax system preserve such a clearly defined class of public purpose organizations.

B. **A broad definition of charity**

A second key element of the current rules is their use of a broad concept of charity -- defined in terms of benefit to the community as a whole -- rather than a narrow definition limited to relief of poverty and distress. In this regard, the federal tax rules reflect the common law tradition that, at least since the Statute of Elizabeth in 1604, has embraced this broader concept of charity. Under this approach, the advancement of education, science, religion, and the arts, the promotion of health, the preservation of the environment, and similar public purposes -- as well as the relief of poverty -- are all recognized as charitable purposes, and thus as the basis for exemption under section 501(c)(3).

At a time when cuts in federal social spending focus increased attention on the need for private charities to serve the poor and disadvantaged, it is not surprising to hear calls from some quarters for a narrower legal definition of charity -- one that would require charities to focus primarily on service to the poor. As the leader of an organization that is deeply committed to serving the disadvantaged, I nonetheless believe that any move in this direction would be highly counter-productive.

The YMCA is a powerful case in point. Every community, whether in the inner city or an affluent suburb, has families under stress, kids in crisis, and persons of all ages needing and looking for a place to belong. In short, every community needs a YMCA. But even more important, the YMCA cuts across the economic, ethnic, religious, and social fault lines in a city like Los Angeles and provides a framework within which people from all walks of life can work together for the common good. People in more advantaged circumstances are challenged to come to grips with the broader needs of the community, and to give time and money to help those less fortunate than themselves. Conversely, persons from disadvantaged communities are pulled into a mainstream organization that helps them escape the social isolation of the inner city.

Let me make this very concrete. The Los Angeles YMCA has eight major facilities and 40 program centers serving the inner city; last year we devoted roughly $15 million to our inner city operations. We simply could not sustain these programs without strong volunteer leadership and financial support from the broader community, and we wouldn't have that support if YMCAs weren't actively serving the whole community.

Any future federal tax system should preserve this broad concept of charity, and with it the ability of groups like the YMCA to serve the entire community.

C. **Strong incentives for charitable giving**

A third critical element of current federal tax policy toward charities is strong incentives for charitable giving, both during life and at death. The income tax generally allows taxpayers who itemize deductions to deduct the full value of their charitable contributions, subject to certain percentage of income limitations. The estate tax, in turn, provides an unlimited charitable deduction.

While these tax benefits do not create the impulse to give, they have a profound effect on the level of giving. Under the federal income tax, individuals face marginal tax rates of up to 39.6 percent. In California and many other states, state income taxes push marginal rates still higher -- well above 40 percent for many top bracket taxpayers. This means that the after-tax cost of giving to charities is less than 60 cents on the dollar.

Based on years of fundraising experience, I can assure you that most donors are fully aware of, and highly sensitive to, this substantial difference between the pre-tax and after-tax cost of charitable giving. Just as most American homeowners buy more expensive houses than they would if mortgage interest were not deductible, many donors are far more generous than they would be -- or could afford to be -- if their charitable gifts were not deductible. Econometric studies uniformly confirm this practical experience.

The current highly favorable treatment of charitable gifts of appreciated property deserves special mention. Under current law, donors who contribute appreciated assets to charities are generally allowed to deduct the full fair market value of those assets. Further, by giving the assets to charities, donors also avoid the capital gains tax that they would otherwise incur upon sale. America's dynamic economy continually rewards successful entrepreneurs with substantial new wealth, generally in the form of highly appreciated securities. As a nation, we have a strong interest in maintaining tax policies that encourage such individuals to commit a generous portion of their wealth to charitable endeavors.

Finally, as noted above, like the income tax, the estate tax, with its 55 percent top rate and unlimited charitable deduction, also provides a strong incentive for charitable giving.

How important are these tax incentives and the charitable giving that they help stimulate? Just come to the Los Angeles YMCA and ask the hundred of kids from low-income families that went to YMCA camp last summer on scholarships; the single parents whose children receive subsidized YMCA child care; the inner city soccer teams playing at our beautiful new Field of Dreams soccer complex; the runaway youth and homeless families who have found transitional housing at our Hollywood Wilshire branch; or the hundred of at-risk teens being served through our expanded youth programs. Without the nearly $12 million in charitable contributions given to the YMCA in 1995 by literally tens of thousands of donors, few if any of these programs would have been possible.

Similar stories about the community benefits of charitable giving could be told by countless charities across America. They underscore the importance of preserving strong incentives for charitable giving as part of any future federal tax system.

D. Tax exemption for "related" income

The fourth key element of the current federal tax treatment of charities is that charities are not taxed on income earned from so-called "related" activities -- that is, activities that, in and of themselves, contribute importantly to the accomplishment of the organization's charitable purposes. Thus, for example, YMCAs are not taxed on income from day camps, child care, health and fitness programs, or swimming lessons. Likewise, colleges aren't taxed on tuition and symphonies aren't taxed on ticket sales. On the other hand, if a charity engages in an income-producing activity unrelated to its exempt purposes, it pays tax on essentially the same basis as a taxable corporation.

This distinction between related and unrelated activities -- the core of the unrelated business income tax (UBIT) -- has been central to the federal tax treatment of charities since 1950. It reflects Congress' desire, on the one hand, to prevent charities from using their tax status to compete unfairly with taxable businesses while, on the other hand, acknowledging, and affirming, charities' traditional reliance on income generated from charitable programs.

The notion that charities can properly derive income from the accomplishment of their charitable purposes follows logically from the premise, discussed above, that the proper role of charity is not limited to providing free or heavily subsidized services to the poor, but, instead, encompasses a broad range of activities intended to benefit the community as a whole. Take education for example. Advancing education is a charitable purpose, not because education directly relieves poverty, but because an educated populace benefits the community at large; because education is what economists refer to as a public good. To be sure, a school may also directly relieve poverty by providing scholarships to poor students. But the school advances its fundamental educational objective just as surely when it educates an affluent student, even if -- or, perhaps, as suggested below, particularly when -- it charges sufficient tuition to cover its costs and to yield a surplus that can subsidize other aspects of the school's program.

I noted above the important contribution YMCAs make by bringing people together across the economic, social, racial, and religious divides that so often divide us. From this perspective, it is very much in the public interest that we serve the entire community. On the other hand, given the limits on our contributed funds, it is equally in the public interest that we subsidize only those persons who cannot afford to pay, and that we expect our other members and program participants to pay for what they receive and, where their means permit, to pay a bit more to expand our ability to serve those in need.

Thus, charging fees is entirely consistent with the legal concept of a charity and, as a practical matter, enables a charity to substantially leverage its contributed funds. Like universities, symphonies, and YMCAs, many charities are heavily -- and, indeed, in many cases, primarily -- dependent on such related

income.[1] Reversing the long-standing policy embodied in the UBIT rules by taxing such related income would substantially reduce the resources available to charities to advance their exempt purposes and would be logically inconsistent with the idea that charities exist to serve the entire community.

Accordingly, it is important that any future federal tax system preserve a UBIT-type exemption from tax for charities' related income.

III. Evaluating Alternatives to the Income Tax: The Implications for Charities

The four criteria outlined above provide clear bench marks for evaluating the implications for charities of proposed replacements for the federal income tax. As the following discussion makes clear, it would generally be possible within each of the principal alternatives under consideration to preserve tax-exempt status for charitable organizations roughly comparable to that under current law. On the other hand, with the exception of the USA Tax Act, all of these alternatives, in their pure forms, would eliminate tax incentives for charitable giving, and thus would produce a major reduction in giving to charities.

A. The flat tax

Like the existing federal income tax, the flat tax -- at least as generally discussed in the current debate -- is a tax on income rather than on consumption. Its defining characteristic is a single tax rate. Further, in the current debate, this idea of a single tax rate is strongly linked to a substantial broadening of the tax base, achieved by eliminating virtually all existing deductions, including the charitable deduction. Proponents assert that this broader base would, in turn, enable a flat tax to be revenue neutral with a rate as low as 17-19 percent.

In a flat tax system, preserving three of the four key elements of the present federal tax treatment of charities would be relatively easy. Specifically, a flat tax could, and presumably would, incorporate a charitable tax exemption directly comparable to section 501(c)(3). Further, nothing inherent in the underlying policy rationale of the flat tax is inconsistent with the current broad definition of charity or with UBIT-type treatment of charities' earned income.

On the other hand, the implications of the flat tax for charitable giving are far more alarming. To broaden the tax base, a pure flat tax like that proposed by House Majority Leader Richard Armey would eliminate both the individual and corporate charitable contribution deductions, and would thus dramatically increase the after-tax cost of charitable giving. More specifically, for top bracket taxpayers, the after-tax cost of giving would increase by roughly 65 percent. Consistent with my own experience as a

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[1] In fact, most charities depend on four sources of support: (1) charitable contributions, (2) volunteers, (3) government funding, and (4) membership dues and program fees. For YMCAs nationwide, the 1995 breakdown was as follows:

	$	Percent
Charitable contributions:	424,578,000	17.2
Volunteer services:	268,000,000	10.8
Government funding:	166,021,000	6.7
Membership dues and program fees:	1,597,485,000	64.6
Other income:	18,000,000	.7
Total:	2,474,340,000	100.0

fundraiser, econometric studies uniformly conclude that such a substantial increase in the cost of giving would produce a correspondingly significant drop in the amount of giving.

Flat tax proponents argue that this negative "price effect" would be largely, if not fully, offset by a countervailing income and wealth effect -- that is, that taxpayers would have so much more disposable income and wealth under a flat tax than under the present system that they would be likely to maintain current giving levels notwithstanding the substantial increase in the after-tax cost of giving.

Two comments are in order. First, from a static perspective, a revenue neutral flat tax, by definition, would not increase taxpayers' aggregate after-tax income (though, of course, it might affect the distribution of income among taxpayers). To be sure, taxpayers would face a lower marginal tax rate, but that lower rate would be applied against a correspondingly broader definition of taxable income. The aggregate tax bill would remain the same, and thus there would be no income or wealth effect to stimulate increased giving.

Flat tax proponents reject this static analysis, arguing that lower marginal tax rates would stimulate a sufficiently large increase in economic growth to achieve revenue neutrality while reducing the aggregate percentage tax burden. They may be correct, but many respected economists are highly skeptical. Moreover, even if a flat tax did result in some increase in economic growth, and thus permit some reduction in the percentage tax burden, econometric studies of giving behavior suggest that the positive effects on giving of this increase in income and wealth would be overwhelmed by the negative effect on giving attributable to the elimination of the charitable deduction.

Finally, it should be noted that even if the charitable deduction were retained under a flat tax, the deduction's stimulative effect would be greatly reduced because the deduction would apply against a tax rate substantially lower than the top marginal rates under current law.

B. Consumption taxes

The effect on charities of replacing the income tax with a consumption tax depends on the form of the consumption tax. There are two basic types of consumption taxes -- those imposed on an annual basis on an individual's aggregate consumption expenditures, and those imposed on business transactions at the point of sale. As a general matter, while it is relatively straightforward to preserve existing tax policy support for charities within the former type of consumption tax, it is extremely difficult, if not impossible, to preserve current incentives for charitable giving within the latter.

1. Individual consumption taxes (e.g. the USA Tax Act)

As typified by the Nunn/Dominici USA Tax Act, the fundamental difference between the present income tax system and an individual consumption tax is that the latter, after determining an individual's taxable income, allows an unlimited deduction for the individual's "net savings" during the year.

Because of its structural similarity to the present income tax, an individual consumption tax could readily incorporate each of the four key elements of the current federal tax treatment of charities -- and, in particular, could preserve strong tax incentives for charitable giving. For example, the USA Tax Act would permit individuals (though not businesses) to deduct charitable contributions against a top marginal rate of 40 percent -- providing a tax incentive for giving almost identical to that

under current law. The USA Tax Act would also preserve exemptions for essentially the present range of section 501(c)(3) organizations, and would incorporate UBIT-type rules for the tax treatment of charities' earned income.

2. Point-of-sale based consumption taxes (e.g. a VAT or a national retail sales tax)

By contrast, as noted above, point-of-sale consumption taxes like a VAT or a national retail sales tax do not lend themselves to providing tax incentives for charitable giving. These taxes are imposed on business transactions rather than on individuals, and an important part of their appeal is that they would free individuals from the need to file annual tax returns. Yet, precisely by eliminating individual returns, these systems would eliminate the traditional mechanism through which individual tax liability has been adjusted to reflect charitable giving.

Tax incentives for charitable giving could be grafted onto this type of consumption tax, but the fit would probably not be a good one. The most plausible approach would be to provide, either to donors or to charities, some form of refundable tax credit for charitable contributions given or received. However, there are potentially serious drawbacks to either approach.

Granting such a credit to individuals would entail substantial administrative costs, since taxpayers seeking to claim the credit would presumably have to file a tax return. On the other hand, granting the credit to charities on the basis of gifts received would entail a significant risk that the credit would come to be seen as direct government funding, carrying with it the risk of more intrusive government regulation.

It should also be noted that replacing the charitable deduction with a credit, whether to donors or to donees, would almost certainly reduce the tax incentives for giving by upper income donors while correspondingly increasing the tax incentives for givers of more modest means (most of whom are nonitemizers, and thus receive no tax benefit for giving under current law). This change could significantly affect the distribution of giving among charities.

As for the tax treatment of charities themselves under point-of-sale consumption taxes, exemptions roughly equivalent to that under current law could be incorporated into both a VAT and a retail sales tax. Under the VAT, the preferred method would probably be so-called "zero-rating" of sales by a charity. Under this approach, the charity would not be required to collect VAT on its sales of goods or services <u>and</u> would be entitled to a refundable credit for VAT it paid to its suppliers. Consistent with preservation of both the current broad concept of charity and of UBIT-type treatment of charities' earned income, eligibility for such zero-rating could, and should, be extended to all "related" transactions by section 501(c)(3) organizations.

Under a retail sales tax, present section 501(c)(3) organizations should be exempt from tax both on items they purchase for "related" use and on sales of "related" goods and services.

IV. Conclusions

As never before, America is looking to its charities to help address a broad range of social concerns. In light of the evident need for a strong and dynamic charitable sector, this is precisely the wrong time for Congress to weaken the federal tax policy supports traditionally afforded to charities.

As Congress considers alternatives to the current income tax, it must recognize that, in their pure forms, the most widely discussed alternatives -- the flat tax, the VAT, and the national retail sales tax -- would all eliminate tax incentives for charitable giving. The result would almost certainly be a major decline in gifts to charity.

Whether effective incentives for giving can be incorporated into any or all of these tax systems is a difficult question, and one that demands careful attention before Congress moves forward with any of these potential replacements for the income tax.

Chairman ARCHER. Thank you, Mr. Rosen. My gratitude to each of you for coming, many of you from a long way away, to be able to give us the benefit of your testimony.

Mr. Tempel, you picked up a little bit on what I commented to the last panel and I am appreciative that you were out there listening. I am curious, do you have any opinion as to why, assuming that you are correct that things were different back in the late twenties and thirties as far as community giving is concerned and sharing, why has that changed?

Mr. TEMPEL. This would be opinion, although there has been some recent research by a colleague of ours who has written an article called "Bowling Alone" who attributes much of the breakdown recently to television.

But, in fact, the community I grew up in was a very close community. As Peter Drucker said:

> There was a time in America where almost every person grew up in a small community and could remember someone who grew up in a small community, and confining as that was, it was a place where you belonged, where you paid attention to others. . . .

Drucker says that as communities became larger, people no longer had that close connection. The question is how you can rebuild those close connections in a larger community, and for Drucker, that answer is not-for-profit organizations. He says in his book on managing nonprofits that, "When I talk to people in nonprofits about why they are volunteering and what they are doing," he said, "almost universally, the response is, Because here I make a difference. Here, I belong."

It is that kind of involvement and encouragement that we think the Federal Government should send a signal to in whatever it does with the Tax Codes and other programs that it enacts, because we think that it can be rebuilt by using nonprofit organizations.

Chairman ARCHER. What importance do you attach to the creation of more lavish welfare systems in the bigger cities which operated as magnets to draw people in and then they could not get out? Those programs did not exist back in the late twenties and early thirties.

Mr. TEMPEL. You are taking me into an area in which I have no expertise, so when I comment, I cannot comment as a social scientist who has studied those things. But again, I believe deeply that people who are in circumstances that are less than ideal, who do not have hope, can sometimes get hope through nonprofit organizations. That is, the quickest way to find hope for yourself is to find a way to help someone else.

One of the key things you said 1 minute ago was that you were asked to help someone less fortunate than yourself, although you were not in very good circumstances yourself, and I think that is a key to this, that we must encourage philanthropy at every level of society because those people who learn to help others learn to help themselves, learn to find meaning in life, and so forth.

So I think that programs that make people dependent are not programs that are very helpful to society as a whole, and again, I am speaking as an observer of this and not as a social scientist.

Chairman ARCHER. Thank you for your input.

Mr. Jacobs.

Mr. JACOBS. First, I should comment. Mr. Rosen, you know the Chairman believes in charitable giving and gave you an extra 4 minutes just now.

Mr. ROSEN. I apologize.

Mr. JACOBS. No, no, no, your gratitude, I should think.

Of course, Chancellor Tempel, I welcome you to the Committee. I spent my time at IU–PUI. My nephew went through IU–PUI in the law school and is doing very well. If cajoling and prayer and suggestion can have any effect, our two little boys will go to IU–PUI. I whisper it in their ears every night. Compared to Harvard, you can imagine why.

Chairman Archer knows that he is among my most respected colleagues, among those I respect the most, and he knows I count him as a dear friend, as is true of Senator Lugar from Indiana. We do part company on the sales tax. However, I was just sitting here trying to think, if the government were of a mind to substitute the Federal income tax with a national sales tax, would the government be capable of, shall we say, subsidizing charitable giving as the present Tax Code does?

The thing that crossed my mind was the so-called challenge grant. How do you suppose it would work if somebody gave $70 to the YMCA and the YMCA then were, under law, permitted to remit proof of that giving to the U.S. Government, which then would forward a matching $30? Has that crossed the minds of any of the members of the panel as some way that you might—let me just give you the one metaphor that occurs to me.

We have geothermal heat at our home and solar panels, and that is OK. That is forced air. But if you have hot water heat, the baseboard heat in your home, you have a little problem delivering air conditioning. You usually have to have a set of ducts and a separate system.

So here you go to sales tax, and that is like the hot water heat. How do you deliver the deduction? How do you deliver the government participation in giving, and that is what occurred to me. Does that make any sense to the panel members? First, the one who could flunk our kids.

Mr. TEMPEL. I could comment just briefly. First of all, matching gifts and challenge gifts are great techniques in fundraising, and we know that people respond to those when they can see that they can enhance their impact.

I do not know if this panel has given great thought to that concept. I think that in a sales tax, charitable gift incentives can be structured. If you think of gifts of philanthropy as being part of the savings plan that is investing in the future of our country, you could structure such a plan. I think Mr. Clotfelter and other economists who have studied the flat tax and the sales tax models can comment more intelligently than I can.

But I want to tell you that I have had discussions recently with some college presidents in Ireland who are trying to adapt a more Americanized version of philanthropy and promote it in Ireland. In fact, in Ireland, if you make a charitable gift deduction, the organization verifies to the government that you have made that deduction and then the government sends you some money back. It is a

system that has a lot of burdens in it because of all the requirements that one must go through.

There is something at least one could look at, but I think I will defer to others who might have a more intelligent comment on it.

Mr. CLOTFELTER. The Irish and English approach that you described is essentially the same as our deduction. But as far as could you structure an incentive similar to our deduction under a sales or value-added tax, I believe even the staff publication that you have for these hearings that I just looked at a little while ago outlines the fact that a VAT with an exemption appropriately structured for nonprofit organizations would give you a price effect that would be very similar to the current deduction.

Mr. JACOBS. I think my time has expired, essentially.

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Clotfelter, I was intrigued by one thing that you said in your testimony and I want to explore it a little bit. You said that while tax policy generally will not determine whether someone gives to charity, it can affect how much people give. Do you recall saying that?

Mr. CLOTFELTER. Yes.

Mr. MCCRERY. I am trying to determine whether you think that tax policy is a marginal consideration in the determination in someone's mind to give to charity and if you think that marginal effect can be overcome by a tax policy that may not favor charitable giving but which encourages greater economic growth, ends up giving more people more disposable income, or have you looked at that or considered that?

Mr. CLOTFELTER. Let me just answer by analogy. Imagine you were trying to think about the demand for bananas at your local grocery store. Would coupons that give you a 30-percent reduction on the price of bananas, would that be a marginal effect or not, and compare that to the effect of giving all the customers more income. More income would probably, because bananas are what we call a normal good, lead them to consume more of it.

So then it just turns out to be an empirical question. How much do these price affects affect the demand for bananas? Economists do not have much to say about something like whether it is a "marginal consideration." They would look at, what is the empirical effect.

The research that I am familiar with says that charitable giving, like bananas, is somewhat responsive to price as well as income, and both of those would have an impact.

Mr. MCCRERY. So I think what you are telling us is if we could construct a tax policy that did not give preference to charitable giving but, on the other hand, left more money in the pockets of people in the way of disposable income, you do not know what the outcome would be as far as the level of charitable giving in the country.

Mr. CLOTFELTER. One could imagine a tax system that increased it purely through income effects, but it is hard to see on a piece of paper how the Federal Government's budget would be balanced in that way, because we were doing calculations that were under

a revenue neutral assumption. So it is conceivable, but you would have that revenue problem to deal with.

Mr. McCRERY. Certainly, and that is the problem we have as policymakers. We can hire the smartest economists in the world but they all have to make assumptions to reach their conclusions and we do not know if those assumptions are good assumptions or faulty assumptions, so we are left with tough decisions sometimes.

I think all of us on this Committee want to encourage charitable contributions and make them ourselves, but we also have to think about what is in the best long-term interests of the economy as a whole and know that if we can improve economic conditions on the whole, we probably improve the level of charitable giving in this country, if we are making the proper assumption with respect to the character of the American people, and again, we do not know if we are correct in that, but those are the decisions we have to make.

Thank you all for your testimony.

Chairman ARCHER. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

I apologize for missing most of your testimony. If you have answered it, just tell me you have answered it. I have heard some say that taking away the charitable deduction from a tax viewpoint would not substantially reduce charitable giving. Do any of you agree? As I have glanced through your testimony, you seem to be saying that you need the charitable deduction. I just want to see what response you have to the several that have said to me that it would not substantially reduce charitable giving.

Mr. CLOTFELTER. I think I would disagree if "not substantially" would include 30 or 20 percent. I would say that getting rid of the deduction probably would have a noticeable effect on charitable giving. That is what the economists have found from the research they have done using a variety of different data sets and periods.

Mr. LAUGHLIN. Mr. Rosen.

Mr. ROSEN. My research is simply talking with donors over 26 years and having a family of 35,000 donors annually in our YMCA. I am unaware of any significant donor who is unaware of the tax benefits and the costs of making contributions and who does not take those into consideration in making gifts, or who has not made a larger gift because the Tax Codes made it possible.

Mr. LAUGHLIN. It is your opinion, then, Mr. Rosen, that if the tax benefit were removed, those donors, many of them would evaporate on you?

Mr. ROSEN. They would still be there at much lower levels. I do not think the Tax Code prevents people from giving one way or the other, but it certainly influences the size of the gift substantially.

Mr. LAUGHLIN. Anybody else?

Mr. TEMPEL. We do have the evidence that when the marginal tax rates were changed, that giving among donors of significant wealth dropped. The average gifts dropped. For example, the taxpayers with incomes of $1 million or more, between 1980 and 1993, their average gift dropped from $207,000 to $108,000, which is one of the studies that we have to use to talk about what impact the cost of giving has on giving. It is our experience as fundraisers on an individual case-by-case basis that major gift donors talk to us

about these tax structures when they make those large gifts. This is fairly conclusive evidence that the cost of giving has an impact, especially on large gifts.

Mr. LAUGHLIN. I noticed in the written statements that you have submitted that there is discussion of the various tax proposals. Mr. Tempel, do you feel that charitable giving is enhanced or stimulated more under one of the proposals? Under which proposal, if any, do you think charitable giving is enhanced, other than staying with the current system?

Mr. TEMPEL. I would say that Chairman Archer's proposal of a 91-percent tax rate would help us out a great deal. [Laughter.]

But in fairness, I think what we want to search for is balance. That is, under a flat tax system, for example, we think there will be an impact. Studies by Steinberg and other economists—I am sure Dr. Clotfelter would say the same thing, that the cost of giving has an impact on giving. So as the rates drop today, we see, unlike the situation that might have been in the late twenties, that giving will be challenged.

So if there is a way, for example, even to create a combination of tax credits and tax deductions to stimulate larger gifts, we think that, as Mr. Steinberg, an economist on our campus proposes, would be very helpful to charitable giving.

Mr. LAUGHLIN. Thank you very much, Mr. Chairman.

Chairman ARCHER. Let me file an immediate disclaimer that I am not proposing a 91-percent Federal income tax rate. [Laughter.]

Thank you very much, all of you, for the testimony that you have given us.

Mr. TEMPEL. Could I take a privilege to thank my Congressman from Indianapolis for being here for this hearing? Thank you, Andy.

Chairman ARCHER. Certainly.

I would like to include for the record the written statements submitted by the American Hospital Association, the Center for the Study of Economics, and the Charitable Organization Working Group on Tax Restructuring.

[The statements follow:]

American Hospital Association

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Statement
of the
American Hospital Association
before the
Committee on Ways and Means
on
The Impact on Tax-Exempt Hospitals of Replacing the Federal Income Tax

May 1, 1996

Summary

The American Hospital Association (AHA) includes in its membership 5,000 hospitals, health care systems, networks, and other providers of health care. We appreciate the opportunity to submit this statement for the record in support of tax-exemption for hospitals, health systems and integrated health networks in a reformed Federal income tax system.

Tax exemption for hospitals and other charitable health organizations under the community benefit standard is a powerful means for society to reinforce its commitment to ensuring that every American has access to health care services. The 60 percent of hospitals and health systems in America that are nongovernment, not-for-profit, tax-exempt institutions play a vital role in the delivery of health services in their communities. Tax exemption has been important in the operation of these institutions, and it should be continued in order to support them in their mission as the health care system moves toward integrated delivery systems.

The AHA supports changes in the current Federal tax system that would foster the development of tax-exempt, integrated health networks designed to lower health costs, improve quality of care, and expand access to services.

Need For Hospital Tax Exemption

AHA and its members have a longstanding commitment to meeting the health care needs of this country, and welcome the focus on how the tax code affects the tax-exempt health care delivery system.

There has been tremendous debate over the last several years about how we can improve access to health care services in this country. Federal tax policy that expands access to health care services is part of the solution. Tax exemption helps not-for-profit hospitals serve their communities by enabling them to tap resources to support their missions--resources such as tax-exempt financing and tax-deductible charitable contributions.

Qualifications for exemption are designed to ensure that exempt institutions engage in activities that support the larger public good. The community benefit standard has been, since 1969, the federal policy for awarding tax exemption. The premise underlying the community benefit standard is that a public purpose is served by promoting health in a manner that benefits the larger community. The promotion of health alone is not enough; how it is done, when, and for whom are important factors. All health care providers have a professional responsibility to provide high- quality services, but tax exemption requires more. Tax exemption requires making the needs of the community the focal point of the institution's financial resources and health services.

The community benefit test remains a sound basis for awarding tax-exempt status to hospitals. Hospital tax exemption is a key to guaranteeing access to health services for all Americans, and should be retained under a reformed Federal tax code.

Tax Exemption in the Changing Health Delivery System

The AHA believes that local, integrated health networks tailored to the needs of their communities are vital to expanding access to care, improving quality of care and containing costs. In general, integrated health delivery networks are formal affiliations of health care providers organized and operated to provide a wide range of health services. The most highly integrated networks are both clinically and financially integrated. Clinical integration means coordinated decision-making among different health care providers, supported by organized systems of information and administration. Financial integration means accepting payment centrally for a full range of health care services, and distributing payments to other providers of care consistent with clinical integration.

Current tax rules and law present several barriers to the formation of tax-exempt integrated health networks. These barriers fall into three categories: capital financing, capitation, and governance.

Capital Financing

Current law restricts to $150 million the outstanding amount of nonhospital tax-exempt bonds that a 501(c)(3) organization may have at any time. This cap works to forestall integration and consolidation of health care resources.

The formation of integrated health delivery networks often begins at the community level with the affiliation of acute inpatient hospital services and multi-specialty physician group practices and primary care physicians. In some areas, this core integrated system may merge or align with other area hospitals and physician groups.

At this point, 501(c)(3) hospitals can run into problems with the nonhospital bond cap. If two hospitals planned to merge and each had $80 million in nonhospital tax-exempt debt outstanding, they would violate the cap. The same situation exists for the merger of hospitals, outpatient surgery clinics, long-term care facilities, hospices and other nonhospital healthcare facilities. These providers are pivotal sites of service in a fully integrated network. The limit on aggregate debt can prevent merger and consolidation of these services. The development of ambulatory and primary care facilities and the information systems required to truly integrate health care also becomes more costly if tax-exempt debt financing is not available.

In addition, Congress has proposed changes to the Medicare program that encourage hospitals to merge, consolidate, and form health networks. Other purchasers of health care are demanding the same. However, the bond cap arbitrarily restricts the evolution of integrated networks by standing in the way of potential partnerships.

Recommendation: The nonhospital bond cap should be repealed.

Capitation

Capitated payment arrangements are central to the development of integrated networks. Capitation is a method of payment for health services in which an individual or institutional provider is paid a fixed amount for each person the provider assumes responsibility for serving, without regard to the actual number or nature of services provided. It is a defining feature of financial integration.

The use of capitated payment and the alignment of payment incentives is viewed by AHA and many health policy makers as key to creating incentives for the prudent use of health care dollars, and to slowing the rate of growth in health spending. Congress, for example, has passed major reforms (vetoed by President Clinton) in Medicare program payment policy to encourage the development of Medicare capitation arrangements.

Some have argued that acceptance of capitation is equivalent to engaging in the business of insurance, and is therefore a taxable activity. AHA strongly believes that mere acceptance of capitation by a tax-exempt provider or integrated network should not jeopardize that entity's tax-exempt status.

To qualify as tax-exempt, a health care provider must establish that it is organized and operated exclusively for exempt purposes. In most cases, this requirement is met by demonstrating that the provider promotes the health of the community through the provision of health care in accordance with the community benefit standard described earlier. Acceptance of capitation does not alter this fundamental purpose.

Acceptance of capitation also does not change the fundamental nature of the activity through which the provider fulfills a charitable purpose: the provision of health care services to the community. Capitation simply represents one more basis on which a provider may charge for its services. The form of payment does not, by itself, convert the underlying activity from the delivery of health services to the provision of insurance.

Recommendation: To clarify this tax law distinction between commercial insurance and capitation, Congress should establish in the tax code a specific exemption for integrated health delivery networks. This change should also impose new requirements on exempt integrated delivery networks to ensure that they are assessing and addressing the needs of the community even beyond their enrolled populations. One way to meet the community benefit standard would be a requirement that integrated health networks, with the participation of community representatives, assess the health care needs of their communities and develop plans to meet those needs.

Governance

Current Internal Revenue Service (IRS) rulings and practice restrict the participation of physicians on the governing boards of newly developing integrated delivery

systems and health networks. Recent IRS exemption determinations have limited physician and other "insider" board representation to no more than 20 percent of all board members. This is unduly restrictive.

When hospitals and physicians form integrated systems, physicians very often seek a role in governance. Physicians are a major force in making clinical and financial integration a success and hospitals welcome their participation in governance. To deny them board membership based on an arbitrary formula undermines their ability to clinically and financially integrate a network's operations.

The goal of the current restrictions on board composition--preventing insiders from using their position for self-enrichment--can be achieved in other ways. Congress has proposed, and AHA has supported, legislation granting IRS the power to impose sanctions--short of revocation of exemption--for private inurement violations. Intermediate sanctions are a far preferable alternative to loss of tax exemption, and would provide the IRS a substantial tool with which to enforce the prohibition against inappropriate board action that benefits insiders. Moreover, under existing state laws, boards of tax-exempt organizations already have well-defined duties and obligations.

Recommendation: In enacting specific tax-exemption for integrated health delivery systems, Congress should require that boards include members of the community, be obligated to comply with the requirements of the community benefit standard, and be subject to intermediate sanctions.

CONCLUSION

Hospitals and health systems believe that laws and regulations should enhance, not impede, the day-to-day, lifesaving and health improvement work they do. Reform of the federal tax system is an opportunity to build on the foundation that already exists: the provision of care by tax-exempt organizations to those in need. By shaping the tax code to retain this tax exemption and encourage the development of integrated delivery systems, Congress can help hospitals and health systems achieve their vision: a society of healthy communities, where all individuals reach their highest potential for health.

STEVEN B. CORD, President ALBERT S. HARTHEIMER, Vice President FRED KARN, JR., Treasurer JOSHUA VINCENT, Secretary

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STATEMENT BY STEVEN CORD FOR C.S.E. ON THE

IMPACT ON STATE & LOCAL GOVERNMENTS

OF REPLACING THE FEDERAL INCOME TAX

before the COMMITTEE ON WAYS & MEANS, 5/1/96

The federal government should encourage state & local governments to shift as many of their taxes as possible to the assessed value of land, for these reasons:

(1) State & local governments penalize building ownership, retail sales and income when they tax such desirable things. Such taxes hurt the economy and cause the federal government to levy high income taxes to fund government programs.

(2) State & local governments should get their revenue by taxing land assessments instead. Such a tax encourages land owners to develop their sites in order to obtain an income from the improvement which can pay the higher land value tax and can pay for the improvement also. When that is done, jobs and economic growth are created. Here is a revenue source that actually promotes economic growth at no extra tax cost to the taxpayer! Only a tax shift is involved.

In the 21st century, the repayment of the Social Security debt and the general budget debt will absolutely require such a tax, but there are ways by which the federal government can encourage state & local governments to levy such a tax now:

o H.U.D. and D.O.T. can condition state & local grants on their adoption of a land value tax.

o H.U.D. can require enterprise zones to levy a land value tax.

o H.U.D. can promote land value taxation.

o H.U.D. can establish land value tax new cities.

There are also ways by which the federal government can levy a land value tax; see C.S.E. for advice on this (there are 16 land-value-taxing cities and a school district, and we have developed experience by working with all of them). There are many studies (some of which we have done) which substantiate all the claims made above, and many well-known authorities have endorsed this proposal, including seven recent American Nobel Prize winners in economics.

Now is the time to act. Now is the time to get to the root of our taxation problem.

Written Statement
of
The *Charitable Organization Working Group on Tax Restructuring*
Submitted by Price Waterhouse LLP and
Caplin & Drysdale, Chartered

Price Waterhouse LLP and Caplin & Drysdale, Chartered, on behalf of the *Charitable Organization Working Group on Tax Restructuring* (the "*Working Group*"), appreciate the opportunity to submit this written statement concerning the impact of tax restructuring on the charitable sector and on the continuing capacity of that sector to carry out its philanthropic mission. We also appreciate the opportunity to explain briefly the *Working Group's* plans to study those subjects.

The *Working Group* consists of public charities, private foundations, and groups representing both of those classes of charities. The charitable sector spans a broad and highly diverse range of institutions - - from large national organizations like the American Heart Association and the American Cancer Society, major universities, and human service organizations like the Boy and Girl Scouts to small, local groups like food banks, homeless shelters, and community service organizations.

The *Working Group* plans to assemble relevant information about the various categories of those organizations, subject it to rigorous analysis, and examine the potential impacts of tax restructuring proposals on charitable giving, the tax exemption for charities, the cost of delivering charitable goods and services, and other aspects of the ability of charities to serve their multitude of beneficiaries throughout our society. In association with Price Waterhouse and Caplin & Drysdale, the *Working Group* intends to provide credible, useful analyses and economic studies resulting from its study to assist Congress and the public in evaluating key tax restructuring issues for the charitable sector and those it serves.

The *Working Group* commends the Committee for focusing early attention through this hearing on how a complete overhaul of our tax system could affect the sources of funds for charities and their costs of operation. This is critically important since it impacts the ability of charities to provide vital services to the American economy and society. **Careful, thorough consideration is needed of all the potential ramifications of restructuring the tax system for charities, their donors, and their beneficiaries to ensure the philanthropic sector's continued growth and well-being.**

The following are among the significant issues arising in the context of various tax restructuring proposals that demand careful study and thought:

- **Deductions for charitable giving:** The fundamental efficiency of the charitable deduction under the present income tax system as an incentive to increased charitable giving already has arisen as a key issue. While the focus to date has been on the itemized income tax deduction for individual donors, Congress also should consider the significant impact of the present-law corporate charitable deduction and the estate and gift tax charitable deduction. Further, some proposals would limit deductions for gifts of appreciated property, affecting donations of stock and other securities, gifts of wilderness land and other real estate, donations of art works and other tangible personal property, and corporate gifts of inventory (such as donations by manufacturers of computers to elementary schools).

- **Taxation of charitable organizations as entities:** Some tax restructuring proposals would modify the current-law income tax rules governing the treatment of exempt entities. For example, some presently tax-exempt organizations would be taxed on some sources of income under a new system for taxing general businesses. To the extent a charity's sources of funds other than donations are reduced through taxation, the charity's ability to serve its philanthropic functions would be diminished. This may come at the very time that government is downsizing and expecting the private sector to provide additional services that otherwise would not be funded or provided.

- **Taxation of goods and services used or provided by charitable organizations:** The impacts of imposing consumption taxes on services or goods provided by charities (such

as education and training, health and elder care, or educational materials) must be considered. If currently exempt goods or services purchased by charities were to be taxed, the charities' ability to carry out their mission would be constrained further.

- **Taxation of fringe benefits provided by charitable organizations:** Some proposals would subject charitable organizations to tax on the value of employer-provided health benefits and other nonretirement benefits. This approach, of course, would increase an organization's cost of carrying out its charitable activities.

- **Reporting, compliance, and tax administration burdens:** Charitable organizations are likely to face increased tax-related burdens under some restructuring proposals -- for example, the collection of sales tax on services or goods it provides, the record-keeping entailed by value added taxes, and the valuation of fringe benefits provided to its employees.

In urging careful study and analysis of the various ways in which tax restructuring could have important impacts on the charitable community, the *Working Group* does not disparage either the frustrations that have been expressed about the current system or the objectives of those seeking to overhaul it, such as increased savings and simplification. Rather, the *Working Group* wishes to stress that the impact on charities is not a tangential or marginal issue. **The tax overhaul debate must address -- as a core issue -- how philanthropic activities will continue to flourish and serve multi-faceted purposes throughout the American economy and society.** Adoption of otherwise attractive proposals without preserving the role of charities and protecting their beneficiaries would pose grave problems for this country and its citizens.

It is instructive that as the governments of formerly communist countries in Eastern and Central Europe struggle to develop more efficient and humane societies, they often look to the nonprofit sector in the United States for both models and inspiration. America needs to continue to demonstrate its leadership in nurturing the growth of this non-government, non-business sector, under which groups of individuals through organizations assist other individuals to help their fellow citizens.

The *Working Group* stands ready to assist the Committee in identifying and evaluating the impacts of tax restructuring proposals on the charitable community, providing needed information and analysis, and developing these issues in a positive manner.

Contacts for *Charitable Organization Working Group on Tax Restructuring*:
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Chairman ARCHER. You have helped us move along this road. It is going to be a long road, a major undertaking, but I hope we can find the right answer to benefit everybody.

Thank you very much.

The Committee is adjourned.

[Whereupon, at 3:53 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF CHIEF MASTER SERGEANT JAMES D. STATON, USAF (RET.)
AIR FORCE SERGEANTS ASSOCIATION

Mr. Chairman and distinguished committee members, I am pleased to have this opportunity to share the enlisted (non-commissioned) military perspective as it pertains to federal tax reform. Enlisted members are, of course, those who are paid the least (among military members) and do the majority of the hands-on work such as maintaining aircraft, providing security, walking perimeters, and acting as those that most directly deal with hand-to-hand combat. AFSA represents the millions of active and retired enlisted members of the Air Force, Air National Guard and Air Force Reserve, and their family members and survivors.

While I will not go into comparing one tax plan over another, I ask that, during your deliberations, you consider the plight of the enlisted military members serving daily around the world, at great sacrifice and often separated from the ones they love, and especially for those who manage to serve a full career. Whatever reforms are adopted should incorporate income tax relief for these service members and their families.

While tax reform is important to all Americans, it is especially important to enlisted military members because of their low pay scale. Many active duty airmen must get second jobs to supplement their income. The vast majority of enlisted military retirees must work to economically survive. Thus, the more of their lower income that they are allowed to keep, the more comfortable their lives would be. AFSA asks that whatever plan this committee recommends, you consider tax relief for enlisted active duty and retired members.

The enlisted military lifestyle is not conducive to saving for education or retirement. The frequent reassignments (with many costs borne by the member) make it next to impossible for the spouses of military members to achieve seniority or obtain other than low-paying employment. Over two-thirds of enlisted families have both parents working or are single parents. Many enlisted families live from paycheck to paycheck. Those who serve a full career enter the job market in middle age, usually without the benefit of a degree; therefore, the quality of their job prospects is not good. Tax relief could open the possibility of saving for important life events, e.g., emergencies, children's education, surviving the transition to civilian life, etc. All too often these life events are neglected due to a lack of funds.

In addition to their low pay levels, compared to commissioned officers, enlisted military pay in general is estimated to be 13 percent below that of comparable civilian pay. Reflective of this is the fact that $24.6 million worth of food stamps was cashed in at military commissaries in 1995.

One side benefit of tax relief would be to enhance recruitment by creating a major incentive for members to join the Armed Forces as enlisted members. While not paying them more directly, tax relief would be viewed as a benefit.

Mr. Chairman, from this association's perspective, the most important point of tax reform is that it not add to the enlisted tax burden and that it protect as much of their lower income as possible. Whatever relief can be considered would be appreciated. Many sacrifices -- including low income -- are inherent in an enlisted military career. The government should do all it can to *ease* that burden. If reform of the federal income tax system will do so, then AFSA supports it wholeheartedly. We appreciate your attention and ask that you keep the enlisted members of our Armed Forces in mind as you formulate recommendations for tax reform. Of course, as always, AFSA is ready to support you on matters of mutual concern.

STATEMENT OF AMERICAN ARTS ALLIANCE

INTRODUCTION

Mr. Chairman and distinguished members of the committee, the American Arts Alliance is grateful for this opportunity to submit testimony on behalf of our 2,600 nonprofit professional, performing, exhibiting and presenting arts organizations nationwide. This testimony is intended to highlight the critical role of nonprofits in local communities and the necessity of continued favorable tax treatment of the charitable deduction while Congress examines fundamental tax reform. In the growing national discussion on tax reform, little has been mentioned of the effect any changes would have on the important tax-exempt sector of our economy. This testimony serves to address this important issue.

In addition to the committee's focus on tangible financial data, it should also be aware of the philanthropic environment it fosters with its tax policies. Historically, the arts have relied primarily on the generosity of the private sector for support. Whatever plan is ultimately adopted should maintain or increase the current incentives for private giving which have so successfully bolstered a spirit of American altruism.

ECONOMIC BENEFITS OF THE ARTS

Nonprofit arts organizations are directly responsible not only for bettering the quality of cultural life in America, but are also a significant contributor to the national economy. Any changes to the basic financial structure of arts entities, such as a comprehensive tax reform plan, will have profound ramifications for the viability of every single nonprofit arts organization and the economic and cultural health of the communities which they serve.

Nonprofit arts organizations create nearly $37 billion in economic activity in the United States every year and support 1.3 million American jobs. This activity generates $3.4 billion for the federal government through income taxes, as well as an additional $1.2 billion in tax revenue at the state and local levels. If the commercial arts sector is included, the annual contribution of the arts to the American economy is $314 billion.

In addition to tax revenue, the arts stimulate business development, spur urban renewal, and attract tourists. In 1994, international visitors alone spent $78 billion in the U.S. According to an in-flight survey conducted by the U.S. Travel and Tourism Administration, 23% of these international tourists visited museums or art galleries while in the country, and another 16% attended concerts or plays.

FUNDING STRUCTURE OF NONPROFIT ARTS ORGANIZATIONS

Over the years, the government has slowly fostered a three-tiered system of arts support that relies mainly on the private sector. These three tiers are: private sector contributions, government funding, and earned income. This funding structure demands that each of its features be in place for the arts community to continue to flourish. Any elimination, or even alteration, of just one of these funding supports would jeopardize the survival of the arts in America.

This three-tiered funding structure has set off an explosion of American artistic activity. Due to the current public-private partnership that supports the arts, a significant increase in the growth of arts institutions has occurred since the 1960's with respect to the creation of nonprofit theaters, orchestras, and opera and dance companies.

However, each essential component of the triple-tiered arts funding structure is currently under stress: NEA funding was cut 40% in FY 1996 and is threatened with full elimination after FY 1997, private giving has leveled off, and major donors readily admit that their resources are already stretched to the limit. Earned income cannot be increased without running the risk of making the arts the sole province of the well-to-do. In light of this precarious situation for the future funding of the arts, the enactment of any fundamental tax reform which would eliminate the charitable deduction would be devastating.

Private Sector Contributions

The deductibility of *individual contributions* has its genesis in the War Revenue Act of 1917, which sharply increased tax rates to finance World War I. Motivated by a concern that higher taxes would be paid with money formerly used for philanthropy, Congress allowed a deduction for "contributions or gifts...for religious, charitable, scientific or educational purposes..." Since that time, Congress has affirmed the importance of the individual charitable deduction by passing numerous additional bills that have continually raised the limit on charitable contributions from a low of 15 percent to the current level of 50 percent of adjusted gross income.

Arts organizations also depend heavily on *corporate contributions* facilitated by the charitable deduction. In 1935, Congress allowed charitable deductions of up to five percent of a corporation's net profit. This was subsequently raised to ten percent of a corporation's taxable income.

Arts organizations rely on *foundation grants* as well. Congressional revisions in 1984 removed most controls on grant-making foundations, which have subsequently become more important than ever to arts organizations.

Current Status of Private Sector Contributions

With their commitment to keeping admission prices affordable to all, it should be no surprise that the economic health of American nonprofit arts organizations depends in large measure on the generosity of the private sector and enlightened federal tax policies. According to a Duke University study, cultural organizations and private contributions account for 36% of total revenue as compared with only 14% for education and research, 27% for social services, and 10% for the whole nonprofit sector. In 1994, the estimate of private donations to arts, culture and the humanities was $9.3 billion, roughly $8.5 billion of which came from individuals. 77% of arts contributions come from individuals.

Private giving to the arts is simply not keeping up with the rate of inflation. According to 1995 Giving USA, a publication released by the American Association of Fund-Raising Counsel Trust for Philanthropy, when adjusted for inflation, private giving to the arts, culture and humanities *decreased* in 1994.

A recent study by the President's Committee on the Arts and the Humanities, entitled "Looking Ahead: Private Sector Giving to the Arts and Humanities," reports that most private sources of funding have, in fact, already reached their limit:

- The average size of an individual's donation to the arts has fallen 47% from $260 in 1987 to $139 in 1993.
- Increased giving by foundations to human service causes has driven the arts' share of foundation dollars down from 14% to 12.7% in the 1990's.
- The data for corporate funding show that corporate giving is up slightly. However, corporations represent only 4.7% of total giving to nonprofits. In addition, arts organizations cannot rely principally on corporate funding since it fluctuates greatly depending on current economic conditions.

At a time when the federal government is turning to the private sector with increasing frequency to compensate for decreased federal support, private funding sources are responding to multiple requests from *all* sectors of the nonprofit community. In order to respond to these requests, 24% of businesses report an expectation that they will decrease giving to the arts.

Government Funding

Clearly, government support for the arts lies in this country's great tradition of private philanthropy. Even the National Endowment for the Arts (NEA)--founded in 1965 to provide a measure of federal funding for the arts--acts mainly as a catalyst to generate additional private funding for the arts. Although government funding amounts to only a small percentage of total income for nonprofit arts organizations, grants from the NEA, and to a lesser extent the state and local arts councils, not only provide vital funds in and of themselves, but the leveraging effect of these grants, which, in the case of the NEA, require at least as much as a three or four-to-one match, stimulates private giving many times over the required match.

Earned Income

Earned income is also crucial to the financial well-being of nonprofit arts organizations, especially in the performing arts field. Earnings from performance and ticket/admissions sales are particularly important to the operating budgets of the fields of dance, opera, orchestras and theatre as well as presenting organizations.

Current Status of Earned Income

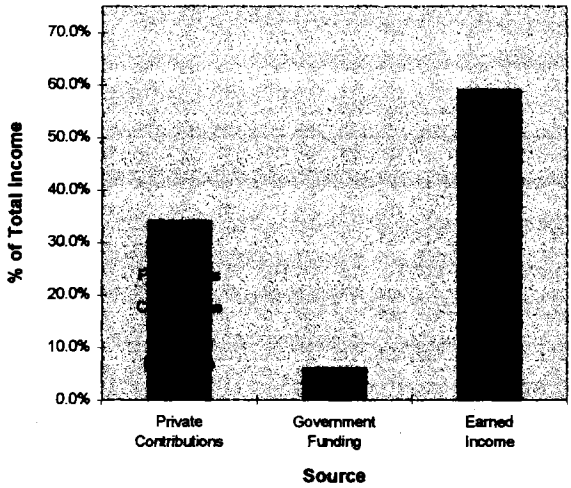
Nonprofit arts institutions are dedicated to their mission of providing excellent artistic programming and making their programs widely available to all members of the community. Our members also feel a strong responsibility to provide other services such as extensive and innovative educational and cultural outreach for school children, at-risk youth, senior citizens, and the physically challenged.

In so doing, arts groups work to make their programs and services affordable to all. To accomplish these objectives, they must obtain significant amounts of financial support beyond ticket sales, admission fees, and other earned income. Revenue from earned income constitutes only about one-half to two-thirds of the total revenue of art museums, presenters, orchestras, and dance, opera and theatre companies. *Ticket sales and other earned income do not and cannot fully subsidize arts organizations.* Symphony orchestras, for example, must raise an average of $26 per seat per performance over and above the ticket prices just to break even. While earned income is crucial to the financial well-being of nonprofit arts organizations, these groups could not survive without the support of both the public and private sectors.

The following charts illustrate the importance of individual contributions and provide a picture of the financial structure of art museums, orchestras, presenters, dance, opera and theatre:

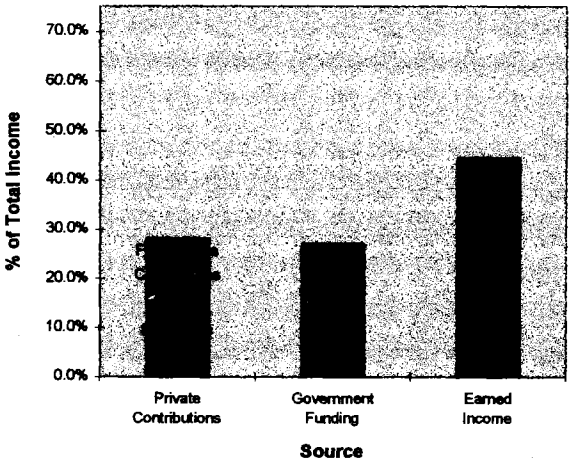
SOURCES OF FUNDING FOR THE ARTS

Symphony Orchestras (for 1995)



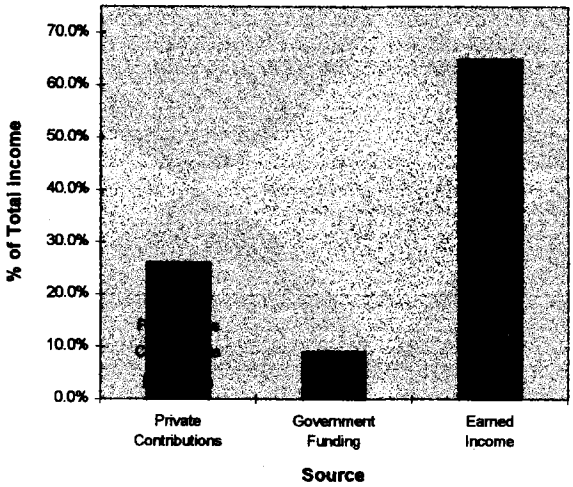
* United arts funds, volunteers, gifts from special events.

Art Museums (for 1994)



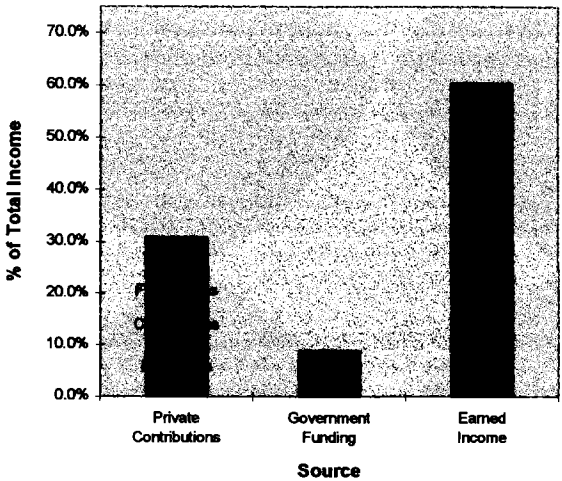
SOURCES OF FUNDING FOR THE ARTS

Presenters (for 1993)



* Endowment income, and support from private and public host institutions.

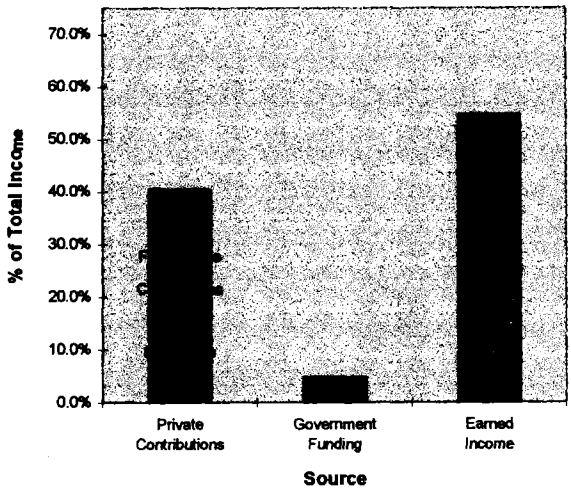
Dance (for 1994)



* United arts funds, guild/volunteer organizations, special fundraising events.

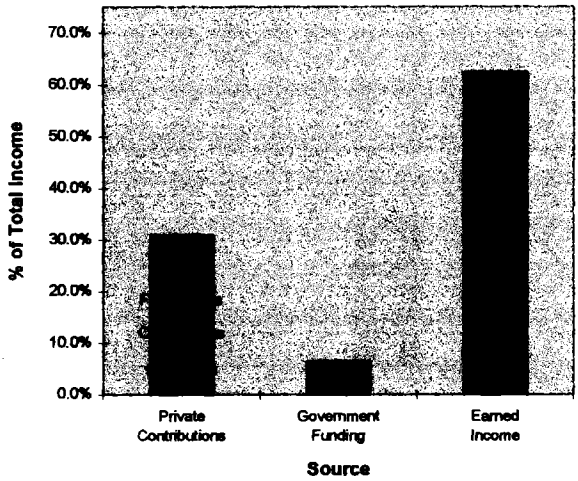
SOURCES OF FUNDING FOR THE ARTS

Opera (for 1994)



* United arts funds, revenue projects, volunteer associations, in-kind donations.

Theatre (for 1995)



* United arts funds, fundraising events/guilds, in-kind donations.

CONSEQUENCES RESULTING FROM ELIMINATING THE CHARITABLE DEDUCTION

The elimination of the charitable deduction would have a profoundly negative impact on nonprofit arts organizations at a time when their financial underpinnings are already strained. As Congressional leaders speak about the need to decrease the role of the federal government and increase private participation in the American economy, it is important to note that altering or eliminating the charitable deduction would have precisely the opposite effect. The accounting firm of Price Waterhouse estimates that if the charitable deduction were eliminated, the level of charitable contributions would drop by about $20 billion annually. In addition, according to a new study by Duke University, nonprofits may lose up to 29% of the revenue currently generated through private contributions.

Many of the tax reform plans being discussed would decrease rather than increase the incentive to give. The most prominent plans would eliminate the charitable deduction or would create a deduction for savings that would make charitable giving no more tax-favored than investing. At a time when nonprofit arts organizations need an increase in charitable giving to offset cuts in the public sector, the tax reform debate should focus on how to enhance the charitable tax deduction, not whether it should be retained. Non-itemizers lost their ability to deduct charitable contributions in 1986. In 1990, upper-income taxpayers watched the value of their deductions, including the charitable deduction, decline as a result of the 3% floor. The American Arts Alliance opposed both these measures and continues to support restoration of the full deductibility of charitable contributions.

Nonprofit arts organizations would be particularly at risk if the charitable deduction is eliminated because they depend in large part on contributions from individuals at high average income levels (over $59,000 in 1991 and over $56,500 in 1993). The giving behavior in this group is much more likely to be influenced by changes in the tax law than the population as a whole.

The tax law changes of the 1980's demonstrated that such changes have their greatest effect on the wealthiest taxpayers. Wealthy donors decreased their gifts noticeably after tax changes in 1981 and 1986 reduced their rates. Some high income groups never returned to their previous giving levels. Median giving by people with pre-tax incomes of $1 million dropped from $18,569 in 1981 to $9,264 in 1990 in inflation adjusted dollars. Moreover, lead gifts, important fundraising catalysts, would dry up as they would no longer be economically advantageous.

Many nonprofit arts organizations are currently operating with a deficit. For many arts groups, there are no economies of scale. There is no fat left to cut. An opera company, for example, cannot decrease essentials like the size of its chorus or the size of the orchestra to reduce costs. Nonprofit arts organizations cannot afford the reduction in their levels of private support that would be the result of eliminating the charitable deduction.

Whether or not arts organizations would be better off in the long term as the result of fundamental tax reform depends on what plan is ultimately adopted. Proponents of the flat tax, for example, assume that if the average taxpayer has more after-tax income, that taxpayer will use a portion of that income to increase the amount of his/her charitable contribution. Such assumptions are speculative at best. There is no factual or historical data to support such conclusions since charitable contributions have always been tax deductible. On the contrary, a recent poll of 1,015 adults conducted by Opinion Research Corporation for the Nonprofit Times revealed that "76% of those polled said that they would contribute the same amount as pre-flat tax and 15% said they would contribute less."

Unless careful consideration is given to nonprofit organizations, the transition from one tax system to another will result in many nonprofit groups having to shut down. A vast majority of the groups forced to shut their doors would be from rural and inner-city areas with populations which historically have been under-served by the arts. While many of the bigger companies, museums, orchestras and presenters would survive, they would have to cut their

ducation and outreach programs. This is anathema to their missions as community rganizations.

'HE EDUCATIONAL ROLE OF NONPROFIT ARTS ORGANIZATIONS AND TAX 'OLICY

Often overlooked, the educational benefits of the arts are true testament to their value as a ational priority. For example, according to the College Entrance Examination Board, students f the arts continue to outperform their non-arts peers on the Scholastic Assessment Test (SAT). ı 1995, SAT scores for students who studied the arts more than four years were 59 points higher n the verbal portion and 44 points higher on the math portion than students who had no xperience in the arts.

Because of the mounting evidence linking the arts to basic learning, some researchers :fer to the arts as "The Fourth R." "Eloquent Evidence: Arts at the Core of Learning" is a ompilation of results of studies conducted all across the country. These studies show dramatic :sults as to the value of the arts in educating our children. Teachers from every part of the ountry reported that arts education in the curriculum resulted in students writing better essays, aving a greater conceptual understanding of core subjects, improved reading and vocabulary omprehension, increased creativity, more interactive classroom discussions, better analytical kills, greater self-esteem, self-acceptance and acceptance of others. For instance, the "Learning) Read Through the Arts" program in New York City resulted in students improving an average f one or two months in reading for each month they participated in the program.

Arts programs are also effective in promoting character development of America's youth. is no surprise that a recent national study found that organized youth activities can deter high-sk behavior in adolescents. The study concluded that students who participated in various arts-:lated activities (orchestra, chorus, drama, etc.) were significantly less likely than onparticipants to drop out of school, be arrested, use drugs, or engage in binge drinking.

Moreover, the United States government has historically recognized the educational value f nonprofit arts organizations, and has always acknowledged that America draws great spiritual enefit from the arts. The arts illuminate the human condition, our history, contemporary issues ıd our future.

MPACT OF TAX POLICY ON NONPROFIT ARTS ORGANIZATIONS: THE CASE)F APPRECIATED PROPERTY

While private philanthropy would continue in the absence of the charitable contributions eduction, there can be little doubt that Federal tax policies have a major impact on giving. hanges in the tax treatment for gifts of appreciated property provide a particularly clear xample.

Nonprofit arts organizations, especially art museums, saw a tremendous decline in gifts of ppreciated property after enactment of the Tax Reform Act of 1986. Surveys conducted by the ssociation of Art Museum Directors (AAMD) covering the years 1986 through 1990 reveal a ramatic 63% drop in the number of donations to museums. During this same period, acquisition osts increased by 62%, causing the actual number of acquisitions to decrease by 75%. Many iuseums suffered tremendous declines in giving. The Walker Art Center in Minneapolis ıffered a precipitous 80% drop in the value of artworks received during that four year period. he Brandywine River Museum in Chadds Ford, Pennsylvania experienced a devastating 76% ecrease in the value of art donated from 1989 to 1990.

In the Fall of 1990, Congress amended the Internal Revenue Code to allow benefactors to ıke deductions for gifts of appreciated tangible personal property in 1991. This action gave rise) an explosion of gifts during that year. An AAMD sample survey of its membership revealed ıat during 1991 the number of objects donated increased by 159% from 1990, and that the value

of these donations increased by 367%. Many benefactors specifically stated to museums that they were making their donations in 1991 because of the tax window.

In 1993, Congress made permanent the deduction for appreciated property and nonprofit arts organizations have seen their contributions of such property return to healthy, pre-1986 levels.

SUMMARY

Nonprofit arts organizations contribute significantly to the cultural and economic well-being of America. Although arts organizations have flourished since the 1960's, they continue to face unprecedented financial hardship in the 1990's. Stagnating private contributions, combined with huge cuts in federal arts funding, have left arts groups to stretch their resources to the limit, and beyond.

The American Arts Alliance understands that changes to some parts of the federal tax code could improve the current system. However, we urge the committee to be sensitive to the needs of nonprofit arts organizations in evaluating the merits of such proposed changes. We particularly request that Congress retain the charitable deduction in whatever tax reform plan is adopted so that current incentives for private giving are maintained or increased, and a smooth transition from one system to another is ensured. Arts organizations depend on this deduction to provide an incentive for individuals and corporations to continue contributing to the arts, especially during these economically difficult times. Its elimination would have devastating effects on the nonprofit arts community.

We urge the committee to consider the essential role of the charitable deduction in the funding structure of nonprofit arts organizations when evaluating tax reform proposals. These groups serve national goals in education, economic development, and community outreach, especially in rural and inner-city areas. Arts and cultural organizations are a vital component of community life allowing everyone to appreciate our nation's culture and heritage through excellent artistic programming, extensive educational and social outreach activities, and efforts to bring diverse groups together.

The charitable deduction is an investment that realizes significant returns, both measurable and intangible, and is well worth preserving.

STATEMENT OF AMERICAN HEART ASSOCIATION

The American Heart Association (AHA) is pleased to submit the following statement to the Committee on Ways and Means regarding the impact on tax-exempt entities of replacing the Federal Income Tax.

The American Heart Association is a non-profit, voluntary health organization funded by private contributions. The mission of the Association is to reduce disability and death from cardiovascular diseases and stroke. Cardiovascular diseases cause almost as many deaths as all other causes of death combined, at an estimated cost in 1994 of nearly $128 billion in medical expenses and lost productivity. To combat and prevent more deaths from cardiovascular diseases, the AHA places a special emphasis on cardiovascular research, cardiovascular education and revenue generation. It is in these areas that the AHA invests its resources.

In 1994-95, the AHA raised $317.9 million. Of that total, $256.5 million came from public support. Public support includes income from contributions, special events, legacies and bequests, and other funds received indirectly from fund-raising agencies. The AHA receives no direct funding from the federal government.

To support its mission the AHA has contributed almost $1.4 billion dollars to cardiovascular research since 1949, and has developed educational programs designed to promote health, and to prevent and reduce the risk of heart disease and stroke. In 1994-95, the AHA spent $93.9 million on research; $61.2 million on public health education; $37.8 million on professional education; and $43.4 million on community services. With those funds, the AHA

informed 47.7 million Americans about what they can do to prevent heart disease and stroke. The AHA also serves as the public's unwavering advocate in the fight against heart attack and stroke. More than four million volunteers are active in the work of the AHA.

Data shows that the amount of charitable giving is clearly related to the deductibility of the contribution. For example, charitable contributions by nonitemizers increased by 40 percent from 1985 to 1986 when the percentage deductibility of such contributions rose from 50 to 100 percent. A few examples of patterns of giving make a strong case for deductibility. Itemizers earning $30,000 - $39,999 contributed 3.0% of income, compared to 1.1% for nonitemizers. For those earning $75,000 - $99,000, the ratio was 2.2 to 1. Overall, the average annual amount contributed by itemizers is $1,313, compared to $509 for nonitemizers.

In 1990, Congress enacted a three percent floor on the amount of certain deductions, including those for charitable contributions. Although this was supposed to be a temporary measure, Congress eventually made the charitable deduction limit permanent. This change to the tax code continues to pose a great threat to the nonprofit sector. The three percent floor provision applies to itemized tax deductions for individuals and families with incomes over $100,000, and limits the amount that can be deducted for charitable gifts. While the provision does not significantly impact charitable giving, it continues to concern the AHA in that the potential exists that the three percent figure could easily be raised in order to generate more federal revenue. Overall, it sets a

bad precedent, it's inequitable and it's an added complication to the average taxpayer.

Congress has a long history of encouraging charitable deductions through the tax code. Currently, those subject to the top federal income tax rate have an after-tax cost of only about 60 cents on the dollar. We are worried over a series of recent tax reform plans which could impact negatively on charitable giving. For example, a number of "flat tax" proposals would completely eliminate the charitable deduction.

According to Independent Sector, approximately 32 million itemizers reported $63 billion in charitable contributions in 1992. If the deductibility of contributions were eliminated, the level of giving would have dropped by $20 billion annually. Organizations like the American Heart Association would be hit hard. Further, the American public supports the continuation of the charitable deduction. According to a Time/CNN poll, more than 6 in 10 Americans would not be in favor of a flat tax with no charitable deduction.

Studies also show that the increase in disposable income for certain taxpayers which might result from the lower rate of taxation contained in some tax reform proposals are dwarfed by the loss of the charitable deduction incentive. According to the Internal Revenue Service, average gifts to charities by individuals with incomes over $1 million annually dropped nearly 50 percent when the top rates fell from 70 percent to 39.6 percent. This is the result of a change in the "price of giving." Using the above rates, the price of giving rose from 30 cents on the dollar to 60.4 cents on the dollar. Studies show that a

change in the price of giving is inversely proportional to the amount of giving by a factor of 1.13.

The balanced budget debate of the 104th Congress has highlighted the very real possibility of major cuts in federal funding for health, education and social welfare. The nonprofit sector will be called upon like never before to fill the void with programs and services. Rather to create disincentives to charitable giving, Congress should secure passage of legislation like H.R. 1493, sponsored by Representatives Crane, Cox and Rangel, which would reinstate a limited version of the charitable deduction for non-itemizers and terminate the 3 percent floor for charitable giving. We believe it is an appropriate time for the Congress to pass legislation to provide incentives to charitable giving.

As a matter of public policy, our government has long endorsed the notion that nonprofit entities, which serve the public good, should be encouraged and supported. Since 1917, the tax code has been used to further this aim through the charitable contribution deduction. However, as we discussed earlier,recent developments in tax law have limited the ability of contributors to deduct charitable contributions. Members of the non-profit sector urges the Congress to carefully consider the needs and benefits of charitable organizations during its consideration of possibly restructuring of the tax code.

STATEMENT OF THE AMERICAN RED CROSS
TO THE HOUSE COMMITTEE ON WAYS AND MEANS
ON
IMPACT OF REPLACING THE FEDERAL INCOME TAX

MAY 15, 1996

PRESENTED BY
JENNIFER DUNLAP
VICE PRESIDENT FOR DEVELOPMENT
AMERICAN RED CROSS

On behalf of the American Red Cross, I want to thank Chairman Archer and the Ways and Means Committee for providing the opportunity to present testimony on the effects on our organization of fundamentally revising the current income tax system.

I am sure I speak for many of the 1.4 million volunteers and staff of the nearly 2,000 operating units of the Red Cross in expressing periodic frustration with the complexities of the current tax code. While the current tax system may benefit from some well-considered reforms, the public support of the American Red Cross is very tax-sensitive, and could be significantly and adversely impacted by certain proposals to redefine the tax base. The removal of tax incentives to give to the American Red Cross would significantly threaten its ability to adequately provide assistance to its clients.

Since Clara Barton founded the American Red Cross in 1881, the Red Cross has become the trusted symbol of immediate response to emergencies. Indeed, the American Red Cross was chartered by the Congress in 1905. It performs a number of services which otherwise might have to be assumed by the government. For instance, the Red Cross is the only non-governmental organization charged with undertaking a role mandated by the Federal Emergency Response Plan - providing emergency mass care during natural disasters.

With chapters across the country, in communities large and small, urban, suburban and rural, wealthy and poor, the Red Cross is almost always among the first to respond when a disaster strikes. After the Oklahoma City bombing in April 1995, for instance, the Red Cross was there within minutes, assisting victims and comforting concerned families. Because of the localized nature of most emergencies, disaster fund-raising is a requirement of all Red Cross chapters. Red Cross policy dictates that chapters raise funds to meet the cost of disaster relief operations within their jurisdiction, with national headquarters becoming involved when disasters are of significant magnitude. This decentralized responsibility for service delivery, combined with centralized policy and guidance, enables the Red Cross to give prompt, efficient assistance. However, this assistance requires an adequate funding base.

The American Red Cross relies primarily on the financial support of the American people through donations of money and time. Americans are a generous people, a fact which is especially clear during times of catastrophic disaster. However, in other years, such as fiscal 1994-1995 when there were many non-catastrophic disasters that failed to attract enough media attention to make them memorable, total public support can fall dramatically. While fiscal '94-'95 saw contributions fall almost 8% from the previous year, it also stood second only to the year Hurricane Andrew struck south Florida as the most expensive year for disaster service costs in Red Cross history.

For example, Tropical Storm Alberto ripped through Alabama and Georgia in July 1994, causing extensive flooding - total cost of assistance to victims, $17.9 million. In October 1994, torrential rains pelted Houston, Texas - total cost of assistance to victims, $14.2 million. These are the types of disasters that affect people who are served each day by the Red Cross, compassionately and competently, without much fanfare, which nonetheless add up to hundreds of millions of dollars of assistance each year.

The Red Cross is taking the necessary steps to bring its budget into balance and the charitable contribution deduction is a vital tool in its fund-raising efforts. Charles Clotfelter and Richard Schmalbeck of Duke University have estimated that the elimination of the charitable deduction, as envisioned in such proposals as the flat, retail sales or value added taxes, would result in a 10 to 22 percent reduction in charitable giving. Based on the contributions received during the last fiscal year, if these estimates are correct, such a change could result in an annual loss of revenue to the American Red Cross of some $46 million to $102 million. Other economists, including those at the firm of Price Waterhouse, have indicated that the loss of the deduction could result in a fall-off of contributions of up to 30 percent, which could conceivably cost the Red Cross over $130 million per year. Needless to say, such an impact on the funding base of the American Red Cross would have devastating consequences on its ability to respond to local and national disasters, not to mention its efforts to support military families in crisis and ease human suffering around the world.

While the charitable deduction is perhaps the issue of greatest concern to the Red Cross and the charitable community, it is by no means the only charitable incentive that could be endangered by a fundamental tax restructuring. Congress has granted tax-exempt status to public charitable organizations described in Section 501(c)(3) of the Internal Revenue Code. This tax-exempt status is critical to enable the Red Cross to carry out its congressionally-chartered purposes. Section 501(c)(3) allows an interaction with the Red Cross based on a spirit of altruism and an understanding that we function on a not-for-profit basis, entrusted with public purposes and barred by law from private gain. A pure retail sales tax or a value added tax could eliminate this fundamental tenet of charitable status and greatly increase operating costs.

The estate tax, with its current unlimited charitable deduction, provides a strong incentive to charitable giving. The Red Cross has benefited increasingly from donations in the form of trusts and bequests, which have been crucial to its ability to compensate for declining funding from other sources. Similarly, its corporate funding base, an increasingly important target of its fund-raising efforts, could be sharply depleted by the loss of a charitable deduction for businesses. Another key issue is tax-exempt bond interest. Charitable organizations, including the American Red Cross, rely on access to tax-exempt bond financing to provide needed capital. All these incentives to charitable giving would be threatened by the imposition of a pure consumption tax.

The purpose of many tax reform proposals is to stimulate individual savings and investment which in turn would spur economic growth. This is certainly an admirable goal in that economic growth always has a number of tangible and intangible benefits to society. However, individual savings and investment incentives should not come at the expense of charitable giving incentives. The charitable deduction represents more than simply a monetary incentive to give. It represents a policy of government support for charitable giving which has existed since 1917. The charitable deduction is relatively easy for taxpayers to understand and its costs to the Treasury are minimal compared to the advantages it provides to society.

Perhaps most importantly, the charitable deduction empowers individual taxpayers. When a taxpayer makes a contribution, he or she selects what public purposes to support, rather than having the government make that determination. The American Red Cross is grateful that so many taxpayers choose to support it and is hopeful that our nation's tax laws will allow this tradition with the American people to continue.

In summary, the unique relationship of the American Red Cross with the Federal Government not only encourages, but requires it to provide services to Americans facing emergencies. It is an organization with heart, but also with an obligation. The American people depend on the American Red Cross and its dedicated volunteers to bring compassionate support and practical assistance to those who have nowhere else to turn. The Red Cross can no more control what its financial obligations may be in a given year than it can control the weather. In granting it a charter in 1905, Congress recognized its role and responsibilities and it has successfully endeavored ever since to perform this mission. The Red Cross relies on the American people who give to it out of a sense of altruism and community. However, altruism does not exist independently of the laws of economics. Tax incentives are a major determinant in how much people give to charity. The American Red Cross realizes it is healthy to periodically reexamine the assumptions behind our tax policy. To eliminate the charitable contribution deduction and other philanthropic tax incentives, however, would compromise its ability to help Americans translate their caring and concern for others into immediate action.

STATEMENT OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES TO THE COMMITTEE ON WAYS AND MEANS OF THE UNITED STATES HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY FOR HEARINGS ON THE IMPACT ON TAX-EXEMPT ORGANIZATIONS OF REPLACING THE FEDERAL INCOME TAX
MAY 1, 1996 (date of hearing)

R. William Taylor, CAE
President
American Society of Association Executives
1575 I Street, N.W.
Washington, D.C. 20005

I am president of the American Society of Association Executives (ASAE), a not-for-profit, tax-exempt, umbrella organization organized to serve and represent association executives and associations. Its membership includes approximately 23,500 association executives and staff, as well as suppliers of goods and services to the association community. Approximately one-third of the association executives and staff manage charitable and philanthropic organizations; the remaining two-thirds manage professional societies and trade associations. The more than 10,700 organizations managed by ASAE members include international, national, regional, state, and local groups, as well as multi-tiered federations and coalitions. ASAE is submitting this testimony on behalf of the organizations it represents, all of whom have a strong interest in this issue.

ASAE applauds the work of this Committee in its efforts to simplify the tax code. We are grateful for the opportunity to submit this testimony.

I. Tax Reform and Associations

The various tax reform proposals being considered by this Committee raise serious questions about the ultimate effect reform will have on the continuing viability of associations. Specifically, ASAE has identified three areas that might adversely affect associations and their members. First, though many of the proposals are short on specifics at present, it appears that at least some plans consider the removal of the tax exemption for associations. Second, the business tax deduction for dues payments to associations may be in jeopardy. Third, ASAE is concerned about proposals to remove the tax incentives for charitable giving.

A. The Association Tax Exemption

ASAE opposes any effort to erode the current tax exemption for 501(c)(6) and 501(c)(3) organizations unless the end result maintains the current effect of nonprofit tax principles and policies. Any net damage to nonprofits will result in a diminution in the benefits associations provide to American society, especially in the areas of standard-setting, education, self-regulation, codes of ethics, philanthropy, research and development, and advocacy.

Education

Given the important work that associations do, and the effects that such work has on the federal budget, any increase in tax revenue derived from discontinuing the tax exemption for trade associations will likely be small compared to the services that will be lost. Associations, which employ more than 500,000 Americans, are the primary source of continuing adult education. A recent ASAE study found that 90 percent of associations offer educational programs to their members and the public, spending more on continuing or specialized education than any state, except for California. Such education enhances the knowledge, productivity and professionalism of the American work force.

Safety and Professionalism

Associations are also very much involved in standard-setting, acting to ensure the safety of every light socket, hair dryer, high chair and electrical outlet. Without associations, much of this activity would likely become the federal government's responsibility. Association codes of ethics and professional standards govern professions such as law, medicine, banking, and manufacturing. According to a study of associations conducted by the Hudson Institute, associations spent almost $300 million on safety standards in 1989.

Research and Statistics

That same study also found that two-thirds of all associations engage in research or statistical gathering that businesses and government rely upon for their statistical information. Groups like the Juvenile Diabetes Foundation and the American Cancer Society conduct medical research that is helpful to countless Americans.

It is impossible to predict how many associations would dissolve absent a tax exemption, and how severely they will scale back their educational, standard-setting and research activities when faced with steeper tax bills. But it is clear that such an increased tax burden on associations would place a number of these beneficial programs in jeopardy.

Paying Taxes Already

It should also be pointed out that associations are currently tax-paying organizations. The tax on business activities not related to organizations' tax-exempt functions accounted for more than $372 million in federal tax revenue in 1994. The unrelated business income tax prevents abuse of the tax exemption, levels the playing field for small businesses and provides a significant amount of revenue for the federal government. ASAE does not oppose those tax reform proposals which retain a tax on unrelated business conducted by exempt organizations.

B. The Business Tax Deduction for Membership Dues Payments

At least some association members are currently able to deduct at least a portion of their dues payments as ordinary and necessary business expenses. ASAE supports this deduction as consistent with the traditional definition of taxable income (gross income less the cost of doing business). As a primary source of education and information on industry practices and standards, association membership is clearly an ordinary and necessary expense for doing business.

There are also strong policy reasons for maintaining some form of business tax deduction for association member dues. Encouraging people to join associations through this tax incentive will help ensure that safety standards are widely promulgated, and that the American work force is well-educated.

C. The Tax Deduction for Charitable Giving

A number of other organizations have commented recently about the importance of retaining the tax deduction for giving to organizations exempt under Section 501(c)(3) of the *Internal Revenue Code*. ASAE agrees with these past commentators that this deduction is a significant enticement to make donations. Retaining this deduction will allow charitable and education organizations to continue to do their good deeds — activities that, without the efforts of these organizations, would likely have to be conducted by the government.

II. The Impact of Specific Plans On Associations

Though the plans being considered by this Committee vary in specificity, listed below are ASAE's general impressions on how each proposal will affect tax-exempt associations.

A. The Armey/Shelby Flat Tax

The Armey/Shelby flat tax would apply a flat 17 percent rate (20 percent in the first two years) to wages and salaries and pension distributions received by individuals. All current-law deductions, including those for mortgage interest and charitable contributions, would be eliminated. No deduction would be allowed for interest expenses, most taxes, employee fringe benefits, or charitable contributions. The Armey proposal would maintain a deduction for employee wages and qualified pension contributions.

Tax-exempt organizations apparently would not be subject to the business activities tax, but would be subject to a tax on the amount of remuneration for services of an employee other than wages. The bills would also expand the availability of qualified retirement plans. The tax on remuneration other than wages will not likely have a significant effect on tax-exempt organizations, providing that the other activities of an association would not be subject to the business tax. The proposal to increase the availability of qualified retirement plans would significantly enhance associations' ability to attract top quality staff, since many associations are currently barred from offering 401(k) plans to their employees, because of shortsighted congressional meddling in 1986. ASAE wants all employees of nonprofits to be able to participate in 401(k) retirement programs.

The Armey/Shelby plan's elimination of a tax deduction for corporate and individual charitable contributions, and the elimination of a business tax deduction for association member dues raise serious concerns. A significant incentive to join associations and to give to charities would be removed, resulting in less donations and fewer association members. The ultimate result will be that private sector organizations will have to scale back their programs that help people, educate American workers, and ensure safety.

B. National Sales Tax

The "National Retail Sales Tax Act of 1996" (H.R. 3039) would impose a tax on gross payments for the use, consumption or enjoyment of any taxable property or service. Dues, contributions and payments to a qualified nonprofit organization generally would not be subject to tax. The plan retains a provision that is similar to the current unrelated business income tax, providing that the 15 percent sales tax will apply to transactions that are not substantially related to the exempt purpose of the organization or is commercially available. To the extent that this categorization of unrelated business is similar to the current tax code definition, ASAE does not oppose it.

Also, the exemption of 501(c)(3), (4), (5), (6), (8), and (10) organizations from paying the sales tax for services or goods purchased is a welcome provision.

The National Retail Sales Tax Act would provide no incentive for charitable giving or for joining associations — with no tax on income, there can be no concomitant income tax deductions. Absent the incentives for charitable giving and association membership, the net effect on nonprofit organizations will likely be a downturn in the amount of donations they receive and on the number of members joining associations.

It should be noted that, though making a transition in any of these reform plans will present problems, adapting to a national sales tax will likely be the most difficult. For nonprofit organizations, getting an exemption from the sales tax would require application for a certificate from the tax administrators of each state.

C. Value-Added Tax

It is not clear what impact the imposition of either a credit-invoice method or subtraction method value-added tax will have on nonprofit organizations. In general, it appears that the tax exemption for associations and other nonprofits may be retained in such a system, though it would be a complex maneuver to do so, since the value added-

tax is imposed at every stage of the production and distribution process of goods and services. Also, as with the national sales tax, there is no room for charitable and business tax deductions.

D. USA Tax Act of 1995 (S. 722)

The USA ("Unlimited Savings Allowance") Tax Act would maintain progressive tax rates (up to 40 percent) for individuals, but would tax only consumption; and it would impose a flat, low-rate (11 percent) tax for business on a base similar to that of a subtraction method value-added tax.

The USA Tax Act would exempt from the business tax only a limited subset of presently tax-exempt nonprofit organizations. Several types of organizations would lose their exemption, including most trade and professional associations. Organizations exempt from the business tax would continue to be subject to tax on their unrelated business income.

The USA Tax plan's exclusion of trade and professional associations from its list of tax-exempt organization presents a serious problem that could have a net effect of costing the government more than it gains by imposing the tax on associations. As nonprofit, tax-exempt organizations, associations now play a significant role in training, education, and safety. Currently, associations that conduct activities that are not consistent with their tax-exempt purpose are taxed on the revenue from those activities. Removal of the tax exemption for associations will have the effect of discontinuing valuable education, safety and research program, causing some associations to dissolve and others to cut programs. The removal of these programs will result in a void that — at least in some instances — will have to be filled by government.

The USA Tax on individuals would: (1) maintain a deduction for most charitable contributions; (2) restrict the deduction for most contributions of property to the lesser of the donor's original cost basis or fair market value; and (3) maintain the exclusion from income for tax-exempt bond interest. It would also create a new deduction for up to $8,000 of qualified education expenses annually. These measures are not expected to have a strong effect on charitable giving.

III. Conclusion

When the Committee considers these proposals for structural tax reform, Members should keep in mind that associations continue to serve as a valuable, cost-effective alternative to the government — providing education to its members, ensuring safety in the American work place, and supplying government with detailed statistical research. The tax exemption, the business tax deduction for member dues payments, and the deduction for charitable contributions are a small price to pay for the efficiency-improving and safety-enhancing work done by associations.

Statement for the Record

Dorothy S. Ridings
President and CEO
Council on Foundations

HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am Dorothy Ridings, President and CEO of the Council on Foundations. The Council is a nonprofit, charitable membership association of grantmaking foundations and corporations. Our members now number over 1,400. Together they hold the bulk of the assets of the foundation community and make the majority of that community's charitable grants each year.

I am pleased to have the opportunity to testify today about the impact of tax restructuring on America's charities, particularly private foundations. The Council on Foundations is seriously concerned about this subject and will be devoting substantial time and energy to studying it in depth during the coming months. In the meantime, let me begin by offering the Council as a source of information about grantmaking foundations (private, community and corporate) and the important work they do. I look forward to working with Congress as it undertakes this significant reassessment of our tax system. And I commend this Committee for focusing early on the implications of tax restructuring for America's charitable organizations.

I. Private Foundations: a key resource for America's charities

Any tax reform that Congress enacts must be crafted to protect and support our nation's charitable organizations. America's charities hold a special place in our democratic society. Organized for public purposes yet independent of government, charitable organizations constitute an important bulwark for our pluralistic system of social organization. Schools, churches, hospitals, youth groups, arts organizations, and a host of other nonprofit charities all work to provide services that are crucial to the health of our national community and our democratic process. Both through the services they provide and the opportunities they create for the rest of us to participate in helping others, charities shape our character, expand our horizons, and help us bridge the divisions that too often separate us.

Grantmaking foundations play a key role in maintaining the vitality of America's charities. This year we predict foundations will contribute more than $12 billion to charitable organizations. These grants fund a vast array of charitable activities including scientific and medical research, strengthening the American educational system, and assistance for the disadvantaged – to name only a few of the multitude of charitable purposes foundations support. Foundation grants have, for example, been responsible for

- The Salk polio vaccine,
- The pap smear,
- The cure for yellow fever,
- The development of the modern hospice movement,
- Expansion of America's system of junior and community colleges,

- Sesame Street, and
- The Emergency 911 response system.[1]

The importance of foundation grants to America's charities cannot, however, be measured by a list of the highly successful grants or even by the total dollars provided to charities each year. Compared with total U.S. charitable giving of more than $120 billion, foundation grants might seem a relatively small portion of the overall support charities receive. This comparison, however, grossly understates the significance of foundation support. Because their funds are generally not committed to annual operating budgets, foundations are uniquely flexible institutions that can quickly readjust their funding priorities to adapt to changing circumstances. Hence, foundations greatly increase the ability of the charitable sector to respond dynamically to evolving social needs.

The elements of flexibility and dynamism foundations provide are becoming ever more important to the charitable sector as it adapts to reduced levels of government support. Current and anticipated reductions in government programs as well as reduced federal payments to charitable organizations will force many charities to reassess their capacity to provide badly needed services and put additional pressure on their ability to raise funds from private sources. During this period of transition, foundations can provide essential assistance. Because of their independence, foundations can provide the "research and development" funds for new and more efficient modes of coping with the problems charities will confront as government funds decrease. Moreover, through the mechanism of matching grants, foundations are able to leverage their funds to greatly increase the total benefit of their grantmaking for operating charities.

Equally important, foundations have already proved themselves adept at working with government to streamline service delivery and discover cost-effective alternatives to traditional approaches. Foundations have, for example, supported successful public-private partnerships in urban economic development and sponsored important research on how to make our health care delivery system more efficient. Through targeted grantmaking of this kind, foundations are able to generate synergies among government, private experts, national charities, and local groups working to develop innovative solutions to longstanding problems. The heightened budgetary pressures on government will much increase the need for such cooperation.

In 1965, after a thorough and searching evaluation of the foundation field, the U.S. Treasury Department concluded that private foundations "constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity." That assessment remains true today, and it will become dramatically more important that foundations continue to play this role in the years ahead as they are called upon to help charities adapt to reduced government funding and increased need for charitable services.

II. Congress should increase incentives for charitable giving to private foundations

As Congress considers alternative structures for our system of taxation, it must bear in mind an additional factor that makes this a decisive moment for the future health of the charitable sector. The concentration of new wealth in hands of high income individuals has increased sharply. During the 1980's and early

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[1] I have attached a document we call Philanthropy's Great Grants which tells the story of these and several other important foundation grants.

nineties, entrepreneurs and investors developed significantly enlarged financial resources, causing the ranks of potentially significant charitable givers to grow to proportions virtually without precedent during this century. In 1980, there were roughly 4,000 millionaires in this country. Today, there are approximately 64,000. Much -- perhaps most -- of this new capital is held in the form of highly appreciated stock.

These recent accumulations of considerable private capital, coupled with the major increase in the need for charitable services caused by reduced government spending, highlight the pressing need to create and maintain strong incentives for charitable giving. Such incentives will help ensure that an appropriate portion of this new capital flows into the charitable sector at a time when it is seriously needed for public purposes.

Tax incentives for giving to foundations should play a particularly important part in encouraging charitable gifts in this context. During the 1980s, a large number of enterprising business people founded new companies, many of which have flourished, leaving the founders with highly appreciated corporate stock. Historically, foundations have been the traditional object of such individuals' charitable giving. Hence, this should be a period of significant foundation growth.

Unfortunately, the tax law currently contains a critical impediment to giving to private foundations -- one that will greatly reduce the transfer of new capital to the charitable sector. Specifically, the tax law limits, to cost basis, the deduction donors may claim for gifts of appreciated property to private foundations. First enacted as part of the Tax Reform Act of 1969, this limitation has had a grave effect on lifetime giving to private foundations. The available data indicate that such giving, proceeding at a brisk pace before 1969, dropped to near to zero in 1970 and did not rebound significantly until the basis limitation was lifted in 1984 for gifts of publicly traded stock.

A bit of history is helpful here. The basis limitation for gifts of appreciated property to foundations came into the tax law as part of comprehensive 1969 legislation enacted to address Congressional concerns about abuses by a minority of private foundations. In the years before 1969, some foundations had been criticized for engaging in self-dealing, enabling families to control businesses, and delaying contributions to operating charities. In response to these criticisms, Congress enacted both complex limitations on the deductibility of gifts to private foundations and a series of stringent, targeted measures designed to control the specific abuses. The success of the anti-abuse measures has been repeatedly documented by the Internal Revenue Service. After broadscale audits of foundations, the IRS has consistently reported high levels of foundation compliance with these rules.[2]

In 1984, recognizing that the 1969 Act had effectively eliminated the source of its original concerns, and that the basis limitation had virtually ended lifetime giving to private

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[2] In the five years succeeding the 1969 legislation, the IRS audited virtually every foundation in the country and concluded that there was "a high level of compliance" with the new provisions. See Statement of James Owens, Assistant Commissioner of Internal Revenue for Employee Plans and Exempt Organizations, Oversight Subcommittee of the House Ways and Means Committee, 98th Cong., 1st Sess. 56 (1983). Since the conclusion of that project, the IRS has maintained an active foundation audit program, and it has without exception found similarly high rates of compliance. See Private Foundation Grant-Making Administrative Expense Study, IRS, 14 (1990).

foundations, Congress restored the market value deduction for gifts of publicly traded stock. By limiting the availability of the full deduction to stock traded on an established securities market, Congress avoided the concerns about the valuation of donated property which had, in part, motivated the adoption of the basis limitation in 1969.

Not surprisingly, restoration of the full deduction for this critically important category of property triggered a dramatic resurgence of lifetime giving to private foundations. The number of new foundations created increased markedly after 1984. According to The Foundation Center, from 1985 to 1994 the number of foundations grew by 48 percent. One state – Michigan – has identified more than 50 new foundations formed in 1992 and 1993 alone with publicly traded stock valued at a total of $82 million. The impact of the restored deduction could hardly have been clearer.

For ten years, the deduction encouraged donors to endow foundations during their lifetimes -- without any suggestion of abuse from the IRS, Congressional Oversight Committees, or anyone else. Nevertheless, while the Senate's restoration of the deduction had been permanent in 1984, a political compromise when the measure reached Conference resulted in a ten-year sunset rule; and the deduction expired at the end of 1994. Initial indications received by the Council from tax planners and other professionals familiar with the formation of new foundations are that the return of the basis limitation is having the same seriously damaging consequences as in 1969. Once again, this critically important class of charitable giving appears to have withered.

The effects of this cessation in lifetime giving to private foundations will surely be significant, and could not come at a worse time. Experience shows that major bequests to charity are typically preceded by active involvement in philanthropy during the donor's life. In particular, absent the experience of direct participation in supporting charitable works through their own foundations, many high income individuals simply forgo making significant charitable bequests. Hence, limiting deductions for lifetime gifts to foundations does more than delay giving to foundations; it very likely results in major gifts not being made at all. At a time when reductions in government support are increasing the need for foundations, that is precisely the wrong behavior for the tax laws to encourage.

Congress need not wonder about the effectiveness of the market value deduction for gifts of publicly traded stock as a stimulus to charitable giving. When Congress eliminated the deduction in 1969, lifetime giving to foundations dropped to near zero; when the deduction was restored in 1984, such gifts increased dramatically; and when it expired in 1994, such giving appears once again to have virtually disappeared. Therefore, a crucial, minimum requirement for any income tax reform concerning charities must be the permanent restoration of the market value deduction for gifts of publicly traded stock to private foundations.

III. Conclusion

As Congress considers restructuring the tax system, maintaining support for America's charities should be a prime criterion against which proposals are judged. At a time when charities are being asked to do more because government must do less, it is vitally important that the tax laws encourage charitable giving. In assessing the impact of tax reform on charities, special attention must also be paid to the role private foundations can play in helping operating charities adapt to an era of reduced government support. In this context, restoring the charitable deduction for gifts of publicly traded stock to private foundations presents a rare opportunity to transform very substantial wealth now held for personal purposes to a major resource permanently dedicated to the support of sound and creative charitable works.

Testimony of Professor Meade Emory

Professor of Law & Director, Graduate Program in Taxation
University of Washington School of Law

before the

Ways and Means Committee,
U.S. House of Representatives

April 24, 1996

Chairman Archer, I welcome the opportunity to provide your Committee with some thoughts concerning the current tax debate. I think that the debate currently going on in this country concerning our tax system is a healthy sign. Scrutiny of how we live as a society, especially of the financial burden which we collectively impose on ourselves to support necessary government functions, is an important exercise. Even as we do this, however, we should not forget Justice Holmes' admonition that is cast over the main door of the IRS building in Washington--"Taxes are what we pay for a civilized society." It does not profit us as a functioning society if we undermine our present system through a drumbeat of disparagement which can only have the effect of encouraging disrespect for our tax system, a disrespect which cannot help but adversely affect what is the finest self-assessment tax system in the world.

This does not mean, however, that change in the system--even significant change--may not be warranted. Certainly, the system is complex--too complex. I would observe, though, that the complexity does not arise to any significant extent, as Steve Forbes asserted on the campaign trail, out of special interest provisions inserted in the tax code at the behest of campaign contributors or others seeking special favors. Although there are certainly provisions in the tax code of limited application, I can say, as one who has been in many drafting sessions in the House Legislative Counsel's Office of the U. S. House of Representatives, that most of the complexity arises out of a desire to provide for uniform and equitable application of the law. Senator Russell Long, longtime chair of the Senate Finance Committee said "most of it (complexity) is there in the effort to do more perfect justice."

Frankly, with equitable and fair application of our tax law as an objective, our tax system can support considerable complexity. We live in a complex world and transactions in modern society, especially at the business level and between affluent individuals, are very often far from simple. And yet, I am not troubled too much by the complexity of, for example, the tax-free corporate reorganization provisions since a taxpayer participating in that kind of transaction is almost always--probably always--counseled by expert advisors whose business it is to walk their clients through the transaction in as trouble free a manner as possible. I am, though, concerned about needless complexity in areas of the tax law that have broad application to a wide number of taxpayers, most of whom have no regular professional advice and who often become frustrated in trying to determine the application of a given provision to their situation. For example, there should be a concerted effort to stamp out complexity in such areas as the EITC, deductions that apply to large numbers of individuals like personal exemptions, moving expenses, home mortgage interest and the like.

A Flat Tax?

I am aware, of course, that many of the proposals generally linked under the rubric of "flat tax" would go far in limiting deductions generally and that the goal of simplicity is a central objective of most, probably all, flat tax proposals. This, therefore, seems to be an appropriate place to discuss some features of so-called flat tax proposals.

Simplicity

It would be foolhardy to believe that an untried and untested system such as a consumption-based flat tax (which most of the flat tax proposals are) would strike a big blow for simplicity. First, complexity does not arise from the application of the rate to the tax base--it arises, rather, from defining the base which is to be subject to the tax. Calculating the tax using one applicable rate will be no speedier, nor less burdensome, than use of the present tax

tables. Second, although the prospect of "postcard" reporting may be attractive, we should not overlook the fact that millions of taxpayer today report on the equivalent of a postcard, using, as they do, either the Form 1040A or the 1040-EZ.

Third, we can't overlook the fact that the accumulated wisdom cultivated over the life of the present system allows us to obtain, fairly readily, solutions to all but the most novel questions. That will not be the case if this country adopts a completely new tax system as unfamiliar and untried as those being proposed. Let me describe, as examples, some of the thorny issues that even those most close to the consumption-based flat tax have not yet resolved nor perhaps even thought about. For example, since the consumption-based flat tax excludes altogether from the tax base the investment income of individuals while at the same time includes all business income under the business tax, the proposed system assigns much more importance than current law to the characterization of an activity as "business" or "investment." Current law includes all of a person's income, whether derived from business or investment. Making this a crucial distinction will be a significant source of complexity.

Along the same line, on the expenditure side, business inputs are fully deductible while investment expenditures are not, thus prompting taxpayers to have exactly the opposite motivation on the expenditure side than on the receipt side, i.e., as respects expenditures, their objective will be to classify the outlay as business thus allowing them to shelter business income with "investments" made by that activity. What treatment will be accorded financial interests, for example, commodities futures held by a business person? If the business person can deduct the hedging transaction it is necessary to ask whether the individual on the other side of the contract will be allowed to exclude his gross revenue as investment income. One can readily see that complex rules for the identification of these transactions will be necessary.

What about mixed business and personal assets? Fairly sophisticated rules now exist for differentiating between the business and personal use of so-called mixed-use assets such as a vacation home. Will they be any the less complex under a flat tax regime where a taxpayer, for example, rents out a portion of a residence? How much may such a taxpayer deduct as a business input when there was in that particular year no actual outlay? Further, all of the timing issues present under current law will persist in magnified form. While the placing of all business taxpayers on the cash basis is intended to eliminate accounting arbitrage, it will be imperative to develop rules (which will by no means be "simple") assuring that the seller's receipt is reported consistently with the buyer's claimed input (which is an offset).

The opportunities for structuring transactions which will result in deductibility by the payor but not in inclusion by the recipient would seem to be increased. As an example, assume that Taxpayer A wins a promotional prize. While the business transferring the prize would deduct it as a business input, Taxpayer A would escape taxation since the amount was not wages or retirement benefits. This asymmetry doesn't exist under current law where the prize would be includible in income but the potential for it in a flat tax world would encourage businesses to find and exploit that kind of opportunity. Similarly, the exclusion from an employee's tax base employer-provided fringes (such as meals and automobile use) will motivate many businesses to compensate employees in that manner (since the business will get an offset and the employee will not include).

The above represents a mere scratching of the surface of the complexity that inevitably would be a part of a completely new tax system. It is naive to think that high-priced professional advisors (or even the medium-priced kind) would not be necessary to guide large (and small too!) taxpayers through this new terrain. It is even more naive to think that the lobbying business which has grown up around the federal tax law will suddenly fold its tent and seek another line of work. The same pressures that have built up around the current tax law and contributed to what it is today will most surely be applied with even greater fervor, given the novelty of the issues presented, to the new system.

Tax Burden

A threshold question raised by any consumption tax proposal is whether, despite the laudable goals of promoting simplicity and encouraging growth and efficiency, a system which exempts unconsumed capital and income from capital can be said to represent a fair tax system and one which is tied a our populace's ability to pay. As a student of the tax law I remember the outrage which greeted Secretary Barr's 1969 disclosure that 154 taxpayers with adjusted

gross income of more than $200,000 paid no income taxes. Frankly, if Congress had not scheduled hearings in response to that announcement and moved to do something about it there would have been a "revolution" of some kind or another. Even now nothing arouses public consternation as much as claims that the "rich" are not paying their fair share of tax. Although driving a dagger into the heart of the tax shelter business, which Congress effectively accomplished in 1986, was a significant step in quieting taxpayer unrest concerning the system, knowledge that a wealthy citizen living off dividends and interest would write no checks to the U.S. Treasury would awaken a hostility toward our tax system that would, I submit, be unprecedented in modern times.

I think we need go back no further than the recent primaries when there was still some doubt concerning who would be the Republican nominee for President in 1996. Except for Steve Forbes, and we saw what happened to him, the other candidates couldn't run faster and farther away from the notion of a consumption-based flat tax. Considering how soundly the concept got beaten about the head and ears in those primary battles, it is surprising it still has any life at all. Shouldn't it be clear that while the electorate (surprise, surprise!) doesn't like to pay taxes, and may even hate the IRS, it will not countenance a tax system under which large segments of income, typically those held largely by the most affluent individuals, are not subject to tax in their hands. One can talk flat tax purity all one wants--that a consumption-based tax "integrates" business and individual taxes in the sense that income from each component is taxed only once--but there will be no political stability for a system that permits large portions of individual wealth to escape taxation in the hands of our most affluent people. In the last analysis the combination of a single rate, and the exemption from tax of income from capital, redistributes the tax-burden from high-income families to those with low- and middle-incomes and the question has to be asked whether, when the facts become known, there will be any public support for such a system.

I find it anomalous that this debate is taking place against the backdrop of two decades of increasing economic inequality. One need go no further than the daily newspaper--or for that matter, our city streets--to know that the gulf between rich and poor is widening to a point that, if it is not soon arrested, we will no longer be able to call our nation a true society. Taxes were not a major cause of this inequality but it would be terribly unfortunate were we to adopt a tax system that exacerbated it.

Revenue

I am surprised by the manner in which proponents of the flat tax cavalierly side-step the revenue generation issue. (The Armey flat tax proposal, for example, has been estimated to fall $138 billion short of current revenue production.) Most of the proponents will say that they want any resulting enactment to be "revenue neutral" but when revenue estimates show that it will fall billions short of that produced by the current system, they seem to have no real reply except to state that unleashing the savings promoted by the system will promote unprecedented investment thereby producing increased tax revenues. Even though there is no direct evidence to support this conclusion, the point must also be made that despite a strong feeling in the majority of the newly-elected current Congress, a specific decision was made not to use so-called "dynamic scoring." The main reason, of course, is that any predictions regarding growth are purely guesswork. It is difficult, therefore, to see how economic growth could be factored into any estimate made by the Congress' Joint Committee on Taxation. The revenue estimating methods urged by flat tax proponents have consistently overestimated economic growth caused by tax cuts and underestimated revenue growth from tax increases. What would make it any different this time?

One further thought. It would seem fair to ask whether the predicted increase in savings would, in fact, dampen consumption and thereby reduce demand, a scenario which would obviously throw everything off as far as estimating revenue impact is concerned.

Savings/Double Taxation

There are already in the present system considerable incentives for savings. A great portion of current savings is fostered by such tax-preferred vehicles as IRAs, 401(k) plans, Keoghs, and qualified pensions. These amounts already receive the same treatment that they would receive under a consumption tax. It would seem that there should be concern that pensions would lose their tax-advantaged status relative to other forms of saving. Query, whether the

expensive regulation to which such plans are subject would lead to a fall in pension coverage which could adversely affect society in the long-term.

The need to rid the system of double taxation lies at the forefront of the flat tax approach. There are really only two major income segments that are arguably subject to tax twice--dividends and capital gains on corporate investments. With respect to the former, the corporate tax system is not airtight, since a large share of dividends is paid to nontaxable recipients and a big chunk of it is not distributed at all. As for gain on the sale of stock, it demands a realization of the gain through sale or other disposition before it is taxed, and when realized, it is taxed preferentially as capital gain. If the stock is not sold (and this will certainly be the case as respects most small business interests) the gain will be forgiven at the death of the shareholder.

Painting our present system as marked by double taxation only goes so far. There are major income or wealth categories that are clearly taxed only once and some not at all. For example, pension income--a major portion of any individual's wealth--is subject to tax only once and then on a preferential deferred basis. Residences, again a major component of every homeowner's holdings, is not taxed at all--either while it is occupied by the taxpayer or even, in almost all instances, when it is sold. Further, life insurance, also a significant wealth component, goes untaxed, and when the insured turns in the policy during his or her lifetime in return for its then cash surrender value, the previously untaxed inside build-up currently escapes the tax.

Estate & Gift Taxes

Most of those proposing a flat tax also urge the simultaneous repeal of the estate and gift tax system. Death taxes have, of course, been one of the most universally accepted forms of taxation in history. The United States enacted its first death tax in 1797. While an old tax is not necessarily a good tax, any radical departure from our current system must be carefully considered in light of the historic goals of the transfer tax system.

Revenue

The estate and gift tax produces over 15 billion dollars annually, slightly over 1% of total federal tax revenue. While this represents a small portion of the entire federal revenue, in light of current budgetary pressures, Congress should not, and could not, lightly dismiss this revenue source.

Some advocates of the elimination of the estate tax have suggested that lost estate tax revenue will be offset by increased income tax revenue. Proponents of this view argue that with no estate tax, wealthier taxpayers will retain income-producing property rather than give such property to charity or taxpayers subject to lower marginal rates. These estimates are very speculative. First, transfer taxes reach property based on value, not income production. Transferred property may or may not produce income sufficient to offset the lost transfer tax revenue. Second, factors such as affection or income shifting might motivate wealthy taxpayers to give to charities or taxpayers with lower rates regardless of the existence or non-existence of an estate tax. In fact most estate planners will tell you that their clients regularly want to transfer more to the natural objects of their bounty but may be prevented from doing so by the inability to make large transfers tax-free.

Additionally, even if this theory is correct, the elimination of the estate tax could be catastrophic for charities. While a good deal of lifetime giving, especially to churches, would take place without the incentive of an income tax deduction, it is a fact that transfer tax reduction is a prime motivator for the making of deathtime gifts to charitable organizations. The removal of this incentive would have a significant downward impact on the amount of dollars moving to foundations and endowments maintained by hospitals, schools, etc., which receive the bulk of their donations from gifts made at death.

Wealth Leveling

A second goal of the transfer tax system is to curb, at least to some degree, large concentrations in wealth. The passing of large fortunes from generation to generation conflicts with core American beliefs in hard work and equality of opportunity. To be sure, the comments

of President Theodore Roosevelt and Andrew Carnegie, and the like, to the effect that a graduated death tax is the wisest form of taxation since the transfer of huge wealth may dampen the initiative of those receiving the transfer, may seem, today, somewhat archaic. Nevertheless, we now see the impending intergenerational transfer of unprecedented wealth in the next decade, or two.

One of the most pressing concerns in society is the growing disparity in wealth and income between the wealthiest Americans and the lower and middle classes. William McDonough, President of the Federal Reserve Bank of New York, has warned that growing disparities in income and wealth are raising issues of equity and social cohesion that force us "to face the question of whether we will be able to go forward together as a unified society...." While disparities in wealth may be a sign of a healthy capitalist economic system, grave disparities threaten to drive a wedge between the upper and middle classes which will ultimately hinder prosperity for all.

The data illustrate that a small fraction of the American populace is controlling vast amounts of wealth. Over 68% of America's net worth is held by Americans in the wealthiest 10 percentile. Over 56% is held by the top 5 percentile. This contrasts with under 3% of net worth held by the Americans with wealth below the median. To permit large concentrations of wealth to pass free of a transfer tax, further widening the gulf between the rich and the poor, cannot be considered sound public policy.

In light of the high concentration of wealth in the hands of the wealthiest Americans, the modest, albeit insufficient, attempt by the estate and gift taxes to equalize wealth seems appropriate.

Fairness

The transfer tax system serves the important goal of making the overall tax system more fair and progressive by taxing those with the highest levels of wealth. Transfer tax credits, deductions, and exclusions mean that only a fraction (about 1% of decedents) of the population consisting of the wealthiest individuals will face any transfer tax liability. In 1995, the IRS estimates only 85,100 estate tax returns will be filed. This compares with an expected 117,198,600 individual income tax returns. Further, there is nothing inherent in a consumption-based flat tax world which demands repeal of transfer taxation. Obviously, large estates will be accumulated by people who chose not to consume. A consumption tax is a tax on one's standard of living whereas the income tax puts its focus on ability to pay. Retention of the present transfer tax regime within the framework of a consumption tax would emphasize the important consideration of ability to pay.

Hardship on Small Business?

Notwithstanding current rhetoric, the transfer tax system is not a hardship to most farmers or small business owners. When businesses are valued at death, applicable methods of valuation accord valuation discounts (for liquidity, fractional interests, etc.) to such property which combine to reduce substantially the valuation of the property for tax purposes. Further, the Internal Revenue Code already has numerous provisions in place to protect small businesses and farms from the hardship of transfer tax liability. For example, 95% of all farms can be transferred under the present system without any transfer tax. Among the most important provisions:

(1) Unified credit of $192,800 ($600,000 deduction equivalent);

(2) Annual gift tax exclusion of $10,000 per year per donee;

(3) Unlimited marital deduction;

(4) Section 303 provides for what can be a tax-free distribution from a corporation for the payment of estate tax liabilities;

(5) Section 2032A allows special valuation of farm and small business real property which can potentially reduce an estate by up to $750,000;

(6) Section 6166 allows the estates of small business owners to defer the payment of estate tax liability for 5 years and then to pay the liability in installments over the next 10 years, often at a substantially reduced interest rate.

Congress should remedy any remaining hardship by reforming the current transfer tax system, not by discarding it. For example, Congress may consider indexing the unified credit and annual exclusion to ease erosion by inflation. Further, Congress could aid continuing small businesses by making the installment payment of estate tax liability more attractive (e.g., by decreasing the requirement that the business interest be 35% of the decedent's estate to a 20% level).

Economic Disincentive?

No evidence exists that transfer taxes create economic disincentives. It is equally plausible that the transfer tax system acts as an incentive for individuals to generate larger estates in order to maintain their desired level of after tax transfers.

History suggests that a the transfer tax system does little to dampen the entrepreneurial spirit. Andrew Carnegie, a prime example of spirited entrepreneurship, thought death taxes operated "without interfering in the least with the forces which tend to the development of the country through the production of wealth." During the economic boom of the 1940s and 1950s estate and gift tax rates were higher than they are now--top marginal rates of 77% and 57.75%, respectively--yet these were among the golden years of business and economic growth. In more recent times, one doubts that Bill Gates ever paused to consider the death tax consequences of turning his small business into a colossus. This can certainly be said, as well, of much smaller entrepreneurs--in the flush of enthusiasm and vigor of starting and building a business, one is simply not caught up in thoughts of a prospective transfer tax impact.

Thank you, again, Chairman Archer for the opportunity to appear before you today and to share my thoughts with you.

TESTIMONY OF
THE HEALTHCARE FINANCING STUDY GROUP
FOR HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS
REGARDING THE IMPACT OF TAX REFORM ON TAX-EXEMPT ENTITIES
MAY 1, 1996

Introduction

The Healthcare Financing Study Group ("HFSG") is pleased to submit this testimony to the House Ways and Means Committee regarding the impact of tax reform on tax-exempt organizations. The HFSG is a national trade association of investment bankers, bond counsel, bond insurers and other firms that serve the needs of non-profit healthcare institutions for capital to finance the efficient delivery of healthcare services throughout the United States. Thus, our testimony will focus on the impact of tax restructuring on the capital financing needs of tax-exempt healthcare providers.

The Mission and Role of Tax-Exempt Health Providers

Non-profit institutions play a large and vital role in providing healthcare and related services throughout the United States, often operating under the sponsorship of religious organizations, fraternal societies, charitable foundations, and community groups. In fact, the vast majority of the nation's hospitals (86%) are not-for-profit. Unlike for-profit entities, non-profit healthcare providers must elevate their patients' interests over profit-making objectives. The motive to maximize profits may cause for-profit providers to avoid locating in a particular geographic area or avoid providing certain benefits, because to do so would be unprofitable. By contrast, non-profits generally are obligated to serve all persons in the community regardless of ability to pay. Non-profits typically bear the responsibility of providing services in very rural or inner-city areas where the costs of providing care are especially high.

These institutions also provide the bulk of those healthcare and related services that are especially costly to operate and rarely provide commensurate return on the investment. Non-profits, for example, conduct the majority of medical research and education in the United States. It is non-profits that typically offer high-cost specialized care units such as burn and trauma centers. Similarly, the children's hospitals in the United States are non-profit. These facilities, again, provide relatively high-cost, low-return services for the nation and their communities such as pediatric intensive care units, infant intensive care units, neonatal units, and tertiary care, including treatment for congenital defects, pediatric nephrology, and pediatric hematology/oncology. Non-profits add to the quality of their services, and subsidize the cost, by developing volunteer networks within the community to help serve patients.

Increasingly, non-profit hospitals and nursing homes are expanding their services to the community through a growing variety of outreach services and outpatient clinics. One example is the Children's Hospital and Medical Center of Seattle. Among the numerous community outreach programs operated by this non-profit hospital are: a Children's Resource Center, which provides child and teen health information through community education programs and a newsletter; a Parent Resource Center, which offers information and education about children's health; and the Odessa Brown Children's Clinic, which provides medical, dental and counseling services to children in inner-city Seattle with programs that include a sickle-cell disease clinic, foster care medical case management, a dental clinic, health education, and nutrition counseling. Another example is the Evangelical Lutheran Good Samaritan Society, which provides nursing home services in 26 states (Arizona, Arkansas, California, Colorado, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Minnesota, Missouri, Montana, Nebraska, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Texas, Washington, West Virginia, and Wisconsin), and now operates over 100 separate outreach programs, ranging from Meals on Wheels to senior companionship, that help elderly persons live independently in their own homes and communities.

Changes in Health Service Delivery

In recent years HFSG members and their health provider clients have had to confront radical changes in healthcare service delivery. During the 1990's, policymakers, health providers and consumers developed an increasing consensus about the need for reform of our healthcare system. Most have agreed that changes in our healthcare system were needed in order to expand access to care to the uninsured and underinsured, and to increase the overall efficiency of health services delivery so that the cost of these services consume a smaller proportion of household and national resources. Legislators have responded to the needs for expanded access and greater efficiency by developing legislation to increase availability and portability of health coverage in the private market (the pending Kennedy-Kassebaum bill). Regulators and legislators have responded by attempting to expand the availability of managed care options in both the Medicare and Medicaid programs, and by broadening the reach of capitated payment systems, such as prospective payment, that encourage provider efficiency. Above all, the marketplace has responded to these needs by shifting service sites away from the more expensive acute care setting to less expensive ambulatory and sub-acute settings; by improving and expanding preventive care; and, of course, by developing an increasing variety of managed care delivery systems.

As we are all aware, these changes, which are continuing and accelerating even now, have had tremendous impact on the way in which healthcare providers deliver their services. Reform is shifting resources away from tax-exempt acute care and extended care facilities into the primary and preventive care arenas. The various pressures for cost containment from government and the marketplace have created ever more powerful imperatives for efficiency in operations and facilities. Existing institutions are being merged or otherwise converted into facilities that are more responsive to the changing healthcare marketplace, old facilities are being sold or torn down, and new facilities have to be constructed. Most recently, the managed care explosion is driving non-profit providers to form networks or other alliances to provide a complete continuum of care and compete with insurance-based managed care providers. Typically, these networks are local and community-based. They are necessarily integrated in a clinical fashion, so that the healthcare providers within the network utilize common information, administrative, and decision-making systems to provide the most appropriate and cost-effective care to patients. An increasing number of such networks are integrated financially as well.

Another growing trend confronting non-profit healthcare providers in the United States is the growing demand for long term care services as the population continues to age. In 1995, an estimated 21 million households were headed by Americans over 65. As the number of frail elderly (those over 75) continues to rise, the need for long term care, whether in residential facilities or in the community, and related outreach services will continue to increase. And cost-driven changes in medical practice during the last ten years have led to earlier and earlier hospital discharges, with the result that care which once would have been furnished in a hospital is now provided by a nursing facility. In fact, many long term care facilities already have long waiting lists.

All of these changes in the healthcare system have significantly expanded the capital financing needs of non-profit hospitals and other healthcare providers.

Role of Tax Exemption for Healthcare Facilities

The United States has long maintained a public policy commitment to the charitable and community role of tax-exempts through provisions in the tax system. Even before the first corporate income tax was enacted in 1894, non-profit entities were exempt from the specific business activity levies such as custom duties and excise taxes. From the beginning of the corporate income tax, Congress established a broad-based exemption for non-profit religious, charitable and educational organizations and certain other non-profit organizations. When the Sixteenth Amendment to the Constitution was ratified, the exemption continued. Since the early part of this century, it has provided an important mechanism by which non-profits can address the capital needs associated with their community and charitable mission.

Tax exemption supports the capital financing needs of non-profit healthcare providers in three ways. First, it allows such providers to reserve retained earnings to support capital needs that may arise in the future. Second, the deduction for charitable contributions gives tax-exempts access to a key source of such earnings. Third, the exclusion of interest on tax-exempt bonds from federal taxation provides a critical source of capital financing for hospitals, universities and other non-profit healthcare providers. Being not-for-profit, such institutions cannot raise equity capital for improvements and structural changes; therefore, they have only two sources of financing, retained earnings and debt. Tax-exempt debt financing lowers the cost of capital and may be passed on to public reimbursement systems, particularly Medicaid.

It is important to note that Congress and the Internal Revenue Service ("IRS") have established requirements for tax-exempt status that ensure that non-profit healthcare providers adhere closely to community needs, community direction, and charity care. Unless this community and charitable mission is fulfilled, a tax-exempt provider will not retain this status. Measures such as the "intermediate sanctions" provision included in the House-passed taxpayer rights bill, H.R. 2337, strengthen such protections by exposing non-profit providers to penalty excise taxes if they engage in "excess benefit" transactions with organization insiders. In short, the tax code includes carefully crafted restrictions to ensure that non-profit entities adhere to the charitable mission which is the foundation for the benefits that tax-exempt status confers.

Impact of Tax Reform on Capital Financing For Tax-Exempt Healthcare Providers

We believe that tax reform -- whether a complete replacement of the current tax code or more limited tax restructuring -- should do two things with regard to provisions affecting capital financing for non-profit healthcare providers. First, the system should maintain the benefits of tax exemption that permit non-profits to fulfill their role as community health providers, suppliers of charity care, and investors in research and innovation. Second, the tax code should be cleansed of an existing provision, the tax-exempt "bond cap," that creates an increasing obstacle to the changes non-profit healthcare providers must make to form integrated networks and otherwise respond to the rapidly changing healthcare marketplace. We discuss each of these concerns separately below.

Pending tax reform proposals generally eliminate the existing tax on interest income and would thus do away with the role of tax-exempt bonds. Consequently, non-profit healthcare organizations would have to finance their capital improvements and structural changes using taxable debt at higher interest rates than they currently pay. For undertakings of any significant size, the difference may equate to millions of dollars. Many non-profit healthcare organizations could be limited in their ability to obtain debt financing altogether. The problem of eliminating preferred treatment for tax-exempt bonds exists in three of the four major tax reform approaches, the "flat tax," the retail sales tax, and the Value Added Tax ("VAT"). Likewise, these three reform approaches would significantly reduce charitable contributions by ending the current deduction for such contributions. One tax reform approach, an income-based tax system containing an unlimited deduction for savings, would maintain both of these important foundations of capital financing for non-profit healthcare providers.

As noted above, the continuing needs for non-profit healthcare providers to obtain capital financing to support their unique mission make it imperative that the availability of tax-exempt bonds and incentives for charitable donations be maintained under any reformed tax system.

At the same time, any reformed or restructured system should do away with an outmoded obstacle, the "bond cap." The Tax Reform Act of 1986 imposed a limit of $150 million on the aggregate amount of outstanding qualified Section 501(c)(3) bonds, *other than hospital bonds*, from which any 501(c)(3) organization may benefit. In determining whether the $150 million limitation has been exceeded, advance refundings are taken into account. Historically, hospitals were viewed as the appropriate beneficiaries of tax-exempt financing, and this view justified an exception to the $150 million limitation for qualified Section 501(c)(3) hospital bonds. Because health reform, under almost any plan, will propel a shift from acute care to primary and preventive care, and because the population is aging, there will be increased demand across the country for non-hospital long-term care and managed care entities. At the same time, the

existence of excess capacity in the acute care sector may require restructurings of acute care facilities, or renovations of such facilities to become providers of primary, preventive, or other non-acute care services. Such renovations will necessarily increase overall efficiency and reduce costs in the healthcare system. Yet because the resulting entities will not be "hospitals" under the current, narrow statutory exception, such beneficial restructurings will subject non-profit providers to the $150 million cap.

The $150 million cap creates a powerful disincentive for the creation of the new delivery systems necessitated by legislative and market changes. While traditional non-profit hospitals may need to shift resources into areas such as neighborhood diagnostic and treatment facilities, long-term residential care facilities, medical equipment acquisition entities and the like, the $150 million cap restricts their ability to modify their services in the interests of efficiency and cost-effective care. The cap also restricts the ability of non-profit long term care providers to meet the demand for their services. Finally, the cap prevents many non-profit health providers that are now paying relatively high interest rates from lowering their costs of capital through advance refundings of their bonds, because the original bonds are still considered to be outstanding for purposes of the cap. Because of the cap, the dramatic drop in interest rates that occurred in the early 1990's has passed many of these institutions by.

The federal government shares in such unnecessarily high financing costs in more ways than one. Whenever a non-profit institution is the recipient of research funding from the National Institutes of Health, the increased financing cost requires a larger grant than would otherwise be the case. The Medicaid program, which uses a cost-reimbursement system, absorbs increased financing costs incurred by long term care facilities, which must raise their per diem rates to cover the additional financing costs. The same increases in per diem rates, of course, also fall on private pay residents in long term care facilities -- and accelerate the point at which such private pay residents become dependent on Medicaid.

Specific examples of the problems caused by the cap abound. One New York institution represented by an HFSG member had to turn to the higher-cost taxable bond market for a necessary project because the institution had already reached the $150 million limitation. Another non-profit organization, a 26-state provider of nursing homes that has been at the cap since 1986, has been forced to do the same. A Chicago-area health provider seeking to form a network to serve the city and its suburbs was blocked from integrating by the cap. Many other facilities have chosen to forego expansion or reconstruction of outdated facilities in lieu of pursuing taxable bond financing. Other healthcare, educational and research systems have faced similar prospects. A major Washington State clinic that wished to refund existing bonds and to merge with another local facility -- steps intended to increase operating efficiency and reduce costs -- could do neither as a result of the cap. A large cancer research center in the same state was prevented from refunding to obtain lower interest rates because, for cap purposes, it was considered a "non-hospital" institution.

A possible solution to some of these problems might be to pay down non-hospital debt with cash in order to stay below the cap. However, there are numerous obstacles to such a solution, even where the cash is available. Because current law imposes a limit of one advance refunding for debt on bonds issued after 1986, debt retirement may not be an option. Additionally, a competing demand for cash comes from the need for working capital for the delivery of healthcare. Additionally, cash availability is important to bond ratings and institutional liquidity. And finally, paying down non-hospital debt with cash may violate bond covenants. For all of these reasons, there is no ready solution for institutions that need to finance structural changes but find themselves today at or near the $150 million bond cap.

The new emphasis on non-hospital care and the fact that non-profit healthcare institutions must increasingly provide whole continuums of care makes a bond cap exception limited to "hospitals" obsolete. A logical solution to these problems would be to expand the exception to the $150 million limit to cover not only hospitals, but also non-hospital healthcare facilities, including nursing homes, ambulatory care centers, primary care clinics, and others. Alternatively, the $150 million cap should be lifted in its entirety.

Market Disruptions and Transition Provisions

As we have said, any new tax system that eliminates or diminishes the preferred status of tax-exempt bonds and charitable contributions will have a mammoth effect on the nation's tax-exempt healthcare providers. Given that 86% of U.S. hospitals are now tax-exempt, such changes would obviously have a great adverse impact on the healthcare delivery system in this country. At a minimum, therefore, any such tax reform system should be implemented with a transition of sufficient length to allow tax-exempt healthcare providers to plan and adjust to the changes. However, such changes would also have an enormous adverse effect on holders of the billions of dollars in outstanding tax-exempt healthcare bonds. It is highly possible that this impact could not be adequately mitigated by a transition of any length. For these reasons as well as those discussed above, therefore, the HFSG urges the Committee to preserve current-law treatment of tax-exempt bonds and charitable contributions.

Conclusion

There is much in the current tax system that is counterproductive and ill-suited to the healthcare market of today. We welcome and applaud the Committee's commitment to tackling the immense job of revamping the system. We particularly urge the Committee to finally remove the outmoded bond cap as a part of this effort. At the same time, however, we believe that the charitable contributions deduction and the preferred status of tax-exempt bonds are essential to capital formation for U.S. non-profit healthcare providers and should be retained in any reformed tax system.

Comments on the
Effect of Tax Reform on State and Local Governments

Submitted by
The Tax Reform Study Group
within the Council on Tax & Fiscal Policy
An Initiative of Joint Venture: Silicon Valley Network

These comments are submitted pursuant to the House Ways & Means announcement of April 15, 1996. They are submitted for inclusion in the printed record of the hearing held on May 1, 1996 on the impact of fundamental tax reform on state and local governments and tax-exempt entities. The following comments focus only on state and local government considerations and issues. The comments are intended to *list* areas for which Congress must interact with state and local legislators and tax administrators in order for effective reform of the federal tax system to occur. The Tax Reform Study Group is working on a more comprehensive comment letter to submit to the tax writing committees at a later date.

Background on the Tax Reform Study Group

The Tax Reform Study Group was formed in October 1995 and consists of individuals from business, state and local government, and academia who are interested in studying the proposals for reform of the federal and state tax systems and tax reform in general and the impact to Silicon Valley. The Group provides objective forums for people in Silicon Valley to learn about tax reform and how it affects them and their employers. The Group maintains a Web page where interested people can obtain objective information on tax reform:

http://www.svi.org/jointventure/tax/tax_fed.html

Joint Venture: Silicon Valley Network is a dynamic model of regional rejuvenation with a vision to build a community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to act on regional issues affecting economic vitality and quality of life. One of its initiatives is the Council on Tax & Fiscal Policy.

Drafting: The views expressed in the comment letter represent the collective views of the Tax Reform Study Group within the Council on Tax & Fiscal Policy of Joint Venture: Silicon Valley Network, and not necessarily the views of any individual members of the Study Group, the Council or of Joint Venture. The primary draftsperson of these comments was Annette Nellen, Associate Professor, San Jose State University; substantive contributions and review were provided by William C. Barrett, Director: Tax, Export & Customs, Applied Materials, Inc.; Alf Brandt, Counsel to the Chairman, California State Board of Equalization; Dan Kostenbauder, General Tax Counsel, Hewlett-Packard Company; Larry R. Langdon, Vice President - Tax, Licensing & Customs, Hewlett-Packard Company; Suzanne Luttman, Assistant Professor, Santa Clara University; David W. Mitchell, Hoge, Fenton, Jones & Appel, Inc.; Jerry Nightingale, Financial Advisor, Royal Alliance; Donald J. Scott, Director: Tax Compliance, Oracle Corporation; John Thomson, Adjunct Fellow, Tax Foundation; and Arthur Troyer, Principal Analyst, Santa Clara County.

Factors Relevant to State and Local Governments That Must Be Included in The Federal Tax Reform Debate

State and local taxes are intertwined with federal taxes in a number of ways and it would not be possible for effective federal tax reform to occur without consideration of state and local tax implications. For example, one of the key goals touted for reform of the federal tax system is simplification. However, because most state income tax systems have some basis in the federal income tax structure, if states do not or cannot conform to federal changes, the goal of simplification will not be obtained for most taxpayers. This and other concerns that we believe must be included in the federal tax reform debate are listed and briefly explained below.

State and local governments rely on various federal income tax features:

State and local governments have come to rely on a large number of features of the federal income tax system. Repeal of any of these features could adversely impact state and local governments. Also, should the federal income tax system be repealed and replaced with another type of tax, state and local governments would need some amount of lead time to be able to set up their own systems or make other adjustments. Some of the areas of state and local government reliance include:

1) *State income tax conformity to federal income tax.* Most states with an income tax system in place rely on the federal income tax law in defining their own rules, in drafting state tax forms, and in their use of federal reporting forms, such as W-2s and 1099s. In addition, many states rely on the results of federal income tax examinations to make adjustments to state income tax

returns. A recent Joint Committee on Taxation report notes the following conformity information from the U.S. Advisory Commission on Intergovernmental Relations:[1]

States with income taxes based on federal adjusted gross income (27):
Arizona, California, Connecticut, Delaware, District of Columbia, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Oregon, Virginia, West Virginia, Wisconsin.

States with income taxes based on federal taxable income (7):
Colorado, Hawaii, Idaho, Minnesota, North Carolina, South Carolina, Utah.

States with income taxes calculated as a percentage of federal tax liability (3):
North Dakota, Rhode Island, Vermont.

States that only tax certain interest and dividends (2):
New Hampshire, Tennessee.

States that do not conform to federal income taxes (5):
Alabama, Arkansas, Mississippi, New Jersey, Pennsylvania.

States without an income tax (7):
Alaska, Florida, Nevada, South Dakota, Texas, Washington, Wyoming.

2) *Exclusion of interest on state and local bonds.* State and local governments have relied on the tax advantage provided for state and local bonds under the federal income tax which excludes interest from such bonds from federal income taxation.[2] (See further discussion later.)

3) *Tax benefits of home ownership.* State and local governments have relied on the federal tax benefits provided to individuals who own a principal residence, namely the home mortgage interest and property tax itemized deductions. These benefits likely affect the value of homes. Any decline to the value of homes from a change in the federal income tax rules could have a negative impact on state and local government revenues from the resulting decline in the property tax base.

4) *Tax benefits of charitable giving.* All levels of government derive some amount of benefit from services performed by charitable organizations. Without these organizations, governments would likely have to provide these services. A study should be conducted on the impact to each level of government from the elimination of the deduction for charitable contributions (as would occur under the consumption tax proposals[3]). This study should focus on whether the levels of charitable giving under the current tax rules would be adversely affected under the consumption tax proposals.

5) *Consumption taxes are the domain of state and local governments.* State and local sales and use taxes are the major consumption taxes in the U.S. today. In 1994, such taxes represented 33% of the state government tax collections for the 50 states combined.[4] A benefit to state and local governments of relying to some extent on a consumption tax is that it can offset the inability to use the income tax as the sole revenue source (this is particularly important when federal income tax rates are high). A change from an income tax to a consumption tax at the federal level would limit revenue choices for state and local governments.

State and local government financing concerns:

State and local governments could be financially impacted by federal tax reform in the following ways.

1) *New costs for state and local governments.* Some of the current tax proposals will subject state and local governments (and the federal government) to new tax burdens. For example, under the Armey flat tax, governments (and tax-exempt entities) would be subject to tax at 17% (20% for the first two years) on fringe benefits provided to employees. A report by the

[1] Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems*, (JCS-1-96), March 14, 1996, page 82.

[2] The exclusion for interest on state and local bonds has been part of the federal income tax law from the beginning, having been enacted as part of the Revenue Act of 1913.

[3] Only the USA tax proposal continues the charitable contribution deduction, but only for individuals; S. 722, 104th Cong., 1st Sess., §8 and §11.

[4] U.S. Census Bureau, http://www.census.gov/, under Government data; the 33% figure excludes sales taxes collected directly by local governments. Data for 1992 show that general sales taxes represented 10.8% of tax revenues for federal, state and local governments combined and 23.6% of tax revenues for state and local governments combined. Source: U.S. Dept. of Commerce, *Statistical Abstract of the United States 1995*, 115th Ed., Table No. 475. All Governments - Detailed Finances: 1992.

California Franchise Tax Board concluded that the annual cost of this tax could be about $375 million for the State of California and about $2.2 billion for local governments in California.[5] The Gibbons subtraction method value-added tax (VAT) proposal does not suggest any exemptions for governments.[6] Similarly, H.R. 3039, the National Retail Sales Tax proposal, does not suggest any special exemptions for governments.[7] State and local governments would likely have to raise taxes on their own residents and/or reduce the level of government services in order to deal with these new tax burdens.

2) *Government bond market.* The National League of Cities (NLC) estimates that the removal of the exemption for interest on municipal bonds could cause an increase in capital improvement and borrowing costs of up to 30%.[8] The California Franchise Tax Board estimates that if the interest rate on municipal bonds increased by one-half of a percentage point due to removal of the federal exclusion for interest, the increased first-year debt service cost to California state and local governments would be about $100 million.[9] How would state and local governments deal with such an outcome? How might the federal government offer an alternative means of support for such financing?

While replacement of the federal income tax with a consumption tax could lead to improved savings and economic growth, further study is needed as to how this potential benefit compares to the potential increased capital costs that state and local governments could face under the consumption tax proposals.

"Ripple" impacts to state and local governments from federal tax reform:

State and local governments could also be impacted indirectly by various changes in the federal income tax law.

1) *Adverse effects of a proposal that is not revenue neutral.* If a new federal tax system is not revenue neutral, but instead does not raise as much revenue as the income tax, budget deficits and the national debt would increase. This can negatively impact the states by reducing the amount of federal funds provided to state and local governments and increasing interest rates for everyone.

2) *Impact from removal of federal incentives that benefit state and local governments.* Under most reform proposals, special deductions and credits, such as the targeted jobs tax credit and enterprise zone benefits, would be eliminated. While the direct benefits of these incentives are to taxpayers, state and local governments are indirect beneficiaries of them and could be adversely impacted by their removal.[10]

3) *Impact of removal of deduction for fringe benefits.* Under the consumption tax proposals, businesses could no longer deduct fringe benefits provided to employees. One possible reaction to this change is that businesses may eliminate or reduce the fringe benefits, such as health insurance, that they provide to workers.[11] If workers do not or cannot obtain their own health insurance, local governments are likely to see their health care costs, such as at county hospitals and clinics, increase.

4) *Impact on tax evasion from some proposed federal tax reforms.* One of the current federal proposals is to replace the federal income tax with a national retail sales tax of 15%.[12] For the 46 states and the District of Columbia that currently have sales and use taxes,[13] adding a

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[5] California Franchise Tax Board - Economics and Statistical Research Bureau, *The Impact of the Flat Tax on California*, December 1995, pages 63-64; based on an assumed 22.9% tax rate.

[6] "Sales of goods and services to governments would be included in the system. Governments should not be exempt from the tax for their sales of goods and services." Congressman Gibbons, *The Value-Added Tax - A Revenue System for America's Future*, March 27, 1996, page 11.

[7] "Nothing in this subtitle shall be construed to exempt any Federal, State, or local governmental unit or political subdivision from paying any tax imposed by this subtitle on any sale, purchase, use, consumption or enjoyment by such a unit." H.R. 3039, 104th Cong., 2d Sess., §3(a).

[8] NLC, *Nation's Cities Weekly*, January 22, 1996.

[9] FTB Report, *supra*, page 63.

[10] This potential problem has already been noted by the NLC in *Nation's Cities Weekly*, January 22, 1996.

[11] The Armey proposal maintains a business deduction for employee wages, but not fringe benefits. Under such a regime, businesses might be encouraged to eliminate fringe benefits, but to replace all or part of that cost with increased wages for its workers. However, unless workers can and do use the extra wage income to purchase health insurance, the impact noted here would still occur.

[12] Under the sales tax proposal, H.R. 3039, the *effective* tax rate is about 17.6% because the stated rate of 15% is applied to the tax-inclusive price for taxable property and services. H.R. 3039, *supra*, §1(a) and §21(b).

[13] Delaware, Montana, New Hampshire and Oregon do not have a sales tax. Alaska does not have a sales tax at the state level, but it is used at the local level. Due and Mikesell, *Sales Taxation - State and Local Structure and Administration*, 2d ed., Urban Institute Press, 1994, page 3.

federal level sales tax on top of the state and local taxes would lead to combined rates of 20% or more in many states. At such a high rate, evasion is more likely and would adversely affect not only federal tax collections, but also state and local tax collections. Some tax administrators and researchers have suggested that at sales tax rates of 10% and above, evasion becomes more attractive.[14]

5) *Impact of tax reform on industries that are not "winners" under reform proposals.* Tax reform will create winners and losers. That is, some taxpayers will see their tax liabilities go down while others will face increases. State and local governments that have a higher proportion of "losers" in their jurisdiction will likely suffer ripple effects of declines in business and tax collections, and possibly job losses. For example, a 1995 report by the California Franchise Tax Board noted that C corporations in all industries would face a tax increase under a flat tax (using a flat tax rate of 22.9%). The report noted that services, trade, construction and mining would fare worse under the flat tax than other industries.[15]

Factors affecting whether or not states can or should conform to federal changes:

The federal tax reform debate should also consider whether states can and should conform to any federal changes. If states do not or cannot conform, some of the goals touted for federal reform will not occur. For example, if states do not conform to a new federal tax system, simplification will not be achieved for most taxpayers. This scenario would certainly raise the question of whether the federal government should have even gone through the difficult and risky effort of changing its tax system. Also, if state and local governments are considering any reforms of their own tax systems, it may be more efficient and beneficial to taxpayers if the reforms at all government levels were coordinated. Some of the specific factors to consider in the area of state conformity to federal changes include the following.

1) *Potential double consumption tax for states.* If a state were to abolish its income/franchise tax system in response to repeal of the federal income tax and adopt a version of the new federal consumption tax in its place, most states would then have two consumption tax systems in place - the new one and the sales tax. Most of the current federal proposals call for some type of a subtraction method VAT which, in effect, is a mechanism for collecting a sales and use tax. If a state were to have a subtraction method VAT *and* a sales tax, it would have increased the regressivity of its overall tax system, have duplicative, but separate tax systems, and would have eliminated one possible form of relief, namely, exemptions and credits available through the income tax system (an income tax system also helps to identify who is a "low-income" taxpayer).

2) *Potential for increased regressivity of the tax system.* One benefit of an income tax at the state level is that it helps to offset the regressivity of the state's sales tax. If a state were to conform to a federal consumption tax, that benefit would be lost and a new mechanism would likely be needed at the state and local level to alleviate the regressivity of the tax system on low-income taxpayers. The likelihood of increased regressivity of the tax system and the need for a new mechanism to alleviate it could be a factor that discourages states from conforming to a new federal consumption tax. However, states that chose to maintain their income tax systems to alleviate regressivity would face obstacles, including the non-existence of information returns, such as Forms 1099 to report investment income, because they would be eliminated under a federal consumption tax.

3) *Differing state tax mixes.* States have different tax mixes which can affect whether or not they can or should conform to a new federal tax system. This factor also means that states have differing concerns with federal tax law changes. For example, if a state currently has no income tax, it citizens will have no need to pressure the state to conform its system to a new federal tax system. Thus, in considering state government concerns in the federal tax reform debate, some state concerns must be considered at the individual state levels, not just under a broad category of concerns affecting all states similarly. The following chart illustrates how the mix of taxes can vary among states.

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[14] Tait, *Value Added Tax - International Practice and Problems*, International Monetary Fund, 1988, page 18. Mr. Tait suggests that at a sales tax rate of 10%, evasion is "more attractive, and at 15 - 20 percent, becomes extremely tempting." Also see: General Accounting Office (GAO), *State Tax Officials Have Concerns About a Federal Consumption Tax*, GAO/GGD-90-50, March 1990, page 40; and Joint Economic Committee (JEC), *Consequences of Replacing Federal Taxes With a Sales Tax*, August 1995, page 8.

[15] California Franchise Tax Board - Economics and Statistical Research Bureau, *The Impact of the Flat Tax on California*, December 1995, pages 59 - 60.

State government tax collections for all 50 states combined and selected states -1994

(in millions of dollars)

Type of tax	All 50 states[3]	%	Calif.	%	New York	%	Texas	%
Property taxes	$8,386	2.2	$3,000	6.0	$0	0	$0	0
General sales tax	$123,298	33.0	$16,872	34.0	$6,365	19.4	$9,926	51.0
Selective sales tax[1]	$62,540	16.7	$4,594	9.2	$5,231	15.9	$5,941	30.5
License taxes[2]	$24,203	6.5	$2,471	5.0	$941	2.9	$2,526	13.0
Individual income tax	$117,726	31.5	$17,548	35.3	$16,034	48.9	$0	0
Corporate income tax	$25,498	6.8	$4,633	9.3	$3,120	9.5	$0	0
Death and gift	$5,042	1.4	531	1.1	$799	2.4	$153	0.8
Documentary & Stock transfer	$2,539	0.7	$0	0	$327	1.0	$0	0
Severance	$4,298	1.1	$46	0.1	$0	0	$919	4.7
Other	$279	0.1	$0	0	$0	0	$0	0
Total	$373,809	100	$49,695	100	$32,817	100	$19,465	100

[1] Includes alcoholic beverage, amusement, insurance premium, motor fuels, pari-mutuel, public utilities and tobacco sales taxes.

[2] Includes alcoholic beverage, amusement, corporation, hunting & fishing, motor vehicle, motor vehicle operators, public utility and occupation & business licenses.

[3] Excludes the District of Columbia and local governments; thus, taxes that are collected at the local level, such as perhaps, property taxes, are not included in the chart.

Note: The chart does not reflect wage assessments for retirement and social insurance programs and unemployment compensation taxes.

Source: U.S. Census Bureau, http://www.census.gov/, under Government data.

4) *Possible pressure from taxpayers for conformity.* If the federal government were to replace the income tax system with a simpler system, individuals in states with income tax systems that conformed to the repealed federal income tax would likely put pressure on state legislators to repeal the state income tax. Because it may not be in the best interests of the state to conform, if state legislators are not able to convince taxpayers of that fact, taxpayer revolt could lead states to make difficult changes. On the other hand, if state legislators are able to convince their citizens that conformity would not be good for the state, a backlash against the federal tax law change could result when taxpayers realize that their compliance burdens have actually increased (because their federal and state filing obligations are now quite different).

The possibility that taxpayers will pressure states *not* to conform should also be considered, particularly under a plan such as the national retail sales tax where the federal government would want the states to conform and to administer the federal tax. Under H.R. 3039, the national retail sales tax proposal, a tax of 15% is levied on gross payments for the use, consumption or enjoyment of taxable property or services. Gross payments are defined as the product of the pre-tax factor and the price of the goods or services. The pre-tax factor is 1 divided by 1 less the federal rate of 15% *and* the state tax rate if it is imposed in conformity with the federal system. Under this calculation, if a state has a conforming sales tax, its citizens will pay a higher federal tax rate.[16] Under these circumstances, consumers will *not* want their state to conform. This would be in opposition to what the federal government desires. These types of concerns must be addressed during the tax reform debate.

5) *State reliance on a diverse tax mix.* States may not find it in their best interests to conform to the extent they rely on a diverse tax mix to provide steady and predictable revenues. Property, sales and income taxes behave differently at various stages of the business cycle and under various economic conditions. This fact can be important to states in balancing state budgets on a yearly basis.

[16] For example, assume that H.R. 3039 is enacted and an individual purchases a $20,000 car in a non-conforming state. The federal sales tax owed on this purchase would be 15% x [1 + (1 - .15)] x $20,000 = $3,529. Now assume that the individual lives in a conforming state with a rate of 7%. The federal sales tax calculation now becomes: 15% x [1 + (1 - .15 - .07)] x $20,000 = $3,846. Thus, the federal tax liability has increased by $317 if the individual resides in a state that conforms its tax system to the federal sales tax.

6) *Transition time.* States that want to conform to federal changes may need more time to get ready than the federal government needs.[17] Also, due to differences in fiscal years between the federal government and most state governments, transitional periods may need special coordination in order to prevent confusion for taxpayers, possible abuses by taxpayers and needlessly complex federal-state tax reconciliations by taxpayers.

Concerns of state and local *taxpayers*:

1) *Updating of P.L. 86-272.* If the federal government replaces its income tax system with a consumption tax and all or some states conform, businesses would likely want to see P.L. 86-272 updated to include the new tax (such as a subtraction method VAT) in order to retain interstate protections provided by P.L. 86-272.

P.L. 86-272 (15 U.S.C. §381)[18] enacted in 1959, provides the minimum standards that must be met in order for one state to tax the operations of a foreign (out-of-state) business. The law prohibits a state from taxing a foreign business's net income derived from activities within the state if the activities consist merely of solicitation of orders that are approved, filled and shipped from outside the state. This law only applies to *net income taxes* and transactions involving the sale of tangible personal property. Whether the protections of P.L. 86-272 apply to a VAT has already been tested in *Gillette Co. v. Dept. of Treasury*[19] which involved Michigan's single business tax (SBT), a form of addition method VAT. The court held that because the SBT was neither a tax imposed on net income nor a tax measured by net income, P.L. 86-272 did not apply to the tax. Thus, whether Michigan could subject an out-of-state taxpayer to the SBT had to be determined under the Due Process and Commerce Clause provisions of the U.S. Constitution. Because some or all states might consider conforming to a new federal tax, revision of P.L. 86-272 should be included in the federal debate.

Any state that changes its income and franchise taxes to a VAT (assuming that is what the federal government does), might also want to revisit apportionment formulas for determining what portion of a multistate company's taxable base is taxable in a particular state. The standard 3-factor apportionment formula (sales, property, and payroll) is used in Michigan for its SBT and the constitutionality of its use has been upheld by the U.S. Supreme Court.[20] However, should other states also replace net income taxes with a VAT, perhaps consideration should be given to what is the best apportionment technique to determine a multistate business's taxable business activity within a particular state. Alternatively, the new federal system may warrant that states consider whether it is most appropriate to apply the system on an origin or a destination basis and how this could be coordinated with the federal system such that simplification would be attained and business income would not be double taxed by the states. Again, time would be needed for this aspect of state taxation to be analyzed, debated and implemented.

The possible need to update P.L. 86-272 and revisit apportionment and/or sourcing standards is an area that will require discussion among state and federal governments, as well as businesses, and must be included in the federal tax reform debate.

2) *Can reform alleviate both federal and state tax burdens?* Much of the federal tax reform discussions to date have focused on the complexity of the federal income tax as a reason to change it. However, federal taxes are not the sole compliance burden faced by businesses. A survey conducted by researchers at the University of Michigan in 1993 noted the following "most frequent" suggestions from respondents for simplifying compliance:

- increase uniformity between federal and state rules

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[17] For example, states may need more time to enact legislation, train tax personnel, change computer systems, and make a revenue estimate in order to set a tax rate. The availability of personnel and resources may not be equivalent at the state level to what it is at the federal level; and to some extent, the federal government has obtained a "head start" in the reform process.

[18] 15 U.S.C. §381 Imposition of net income tax

(a) Minimum standards. No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

[19] *Gillette Co. v. Dept. of Treasury*, 497 N.W.2d 595 (Mich. App. 1993), cert denied, 115 S.Ct. 779 (1995); also see *Guardian Industries Corp. v. Dept. of Treasury*, 499 N.W.2d 349 (Mich. App. 1993).

[20] *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358 (1991).

- eliminate, simplify and/or change the AMT rules
- increase book-tax conformity
- a uniform formula for apportioning state taxes[21]

The current consumption tax proposals would only alleviate the AMT compliance burden for businesses. The suggestion to increase uniformity between federal and state rules cannot be met if states are not included in the federal tax reform debate. Also, state apportionment is not part of the current debate (although tax simplification *is* part of the debate).

To best address what would truly be simplification for businesses and individuals, the debate must include whether state and local governments can or should conform to the proposed new federal tax system, what are the true compliance concerns of business and individual taxpayers and how both federal and state compliance burdens can be alleviated in one reform effort.

Can state and local tax issues be included in the federal tax reform debate?

State and local governments presently face several taxation issues, such as nexus determinations, how to collect sales and use tax on purchases made by mail order or over the Internet from non-present retailers, how to deal with eroding tax bases, and increasing pressure to offer various business tax incentives. Many of these issues stem from changes in the economy, such as expansion of the services sector and decline of the manufacturing sector. In addition, changes in ways of doing business, and the increased importance of difficult to tax items, such as services and intangible assets, have made portions of federal, state and local tax systems outdated and sometimes, ineffective. While these are complex issues and situations, consideration of how federal tax reforms can or should help state and local governments address these areas would be a beneficial addition to the debate for all parties involved.

The federal debate should also consider the flat tax proposals that some states have already proposed, such as in California (ACA 29), Arizona (SB 1407) and Iowa (HF 2492). These proposals and the reaction of taxpayers to them and how they differ from each other and from federal proposals would be an interesting addition to the federal tax reform debate.

Perhaps the federal reform process should include creation of a model state tax act that would address state tax concerns and aid states that want to conform to the new federal system. Such a model would be helpful to states in calculating what a revenue neutral rate would be for them. It would also help taxpayers to more effectively evaluate the potential impact of tax reform at the federal and state levels.[22]

Federalism:

Proposals to shift tax collection responsibility raise issues of federalism and the balance of power between federal and state governments. A proposal to require the states to collect a national sales tax, for example, could shift the balance of taxation power to the individual states and lead to federal-state conflicts. Under such a system, the federal government would depend on states to remit their "national" tax revenues. What remedies would exist if a state withheld its revenues to compel the federal government to modify some federal policy, or if the federal government was not in favor of some technique used by a state in administering the tax? Conversely, if a tax reform proposal involved federal collection of state revenues, would state governments lose their independence in tax administration and adjudication matters? Similarly, would removal of the current income tax rules, in light of the fact that the majority of states rely on some portion of these rules, be equivalent to the federal government imposing its new system on the states? Again, what is the appropriate division between federal and state governments with respect to taxes?

The tax reform debate should include a study of the appropriate balance between federal, state and local governments in enacting and administering taxes, as well as the role of the judiciary. For example, where states act as collectors of a federal sales tax, in which courts should disputes be handled? The tax reform debate should involve a constitutional discussion of federalism and taxation, how to balance this issue with taxpayer desires for simplification (such as increased uniformity between federal and state rules), and how changes in the economy and the nature of business transactions that have occurred since the federal income tax was adopted in 1913[23] impact the balance of taxation matters between each level of government.

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[21] As reported in JCS-1-96, *supra*, page 77, based on study by Joel Slemrod and Marsha Blumenthal, "Income Tax Compliance Cost of Big Business," Univ. of Michigan Working Paper No. 93-11, 1993.

[22] Such a model need not be created by Congress; it might instead be written through a combined effort of the various organizations that presently exist that represent state and local governments. Several of these organizations are noted in the next section of this comment letter.

[23] For example, our economy of today has a more global focus, as opposed to a local or national focus. Also, transactions have changed to a point where in many instances, borders are not transactionally important, such as for transactions involving the Internet and satellite transmissions.

Existing Input From State and Local Tax Administrators and Legislatures

In 1990, the GAO conducted a survey of state tax administrators to gather their views on a federal consumption tax. This data should be updated and included in the debate. This study found that 81% of state policymakers opposed a federal retail sales tax and 68% opposed a VAT. Instead, most favored using existing tax systems to reduce the federal budget deficit.[24] Per the report:

> Policymakers are concerned that a federal consumption tax could (1) limit the states' ability to raise additional revenue from state sales taxes, (2) pressure the states to alter their tax bases to conform with the federal tax base, and (3) confuse taxpayers about the distinction between state and federal consumption taxes.[25]

In addition, the National League of Cities has adopted an action agenda dealing with federal tax reform issues. A key concern of the NLC is the lack of attention being given to local government concerns in the federal debate. The 1996 Action Agenda adopted by the NLC Board of Directors in March 1996 states that they support:

- a system based on ability to pay;
- keeping the income tax as the primary federal tax base;
- the deductibility of state and local taxes;
- keeping municipal bond interest exempt from tax;
- a federal tax system which produces sufficient revenues for ongoing government services;
- changing current rules that favor consumption over savings, rather than moving to a pure consumption tax;
- broadening the tax base; and
- "a phasing-in of any major tax changes and recognition of the interrelationship of the federal, state, and local tax systems."[26]

Because the items on the NLC agenda are in conflict with most of the federal tax reform proposals, there is a clear need for open dialogue and debate on the difficult issues raised by federal tax reform and how they impact state and local governments.

Additionally, a report of the National Conference of State Legislatures discusses revenue and taxation issues and concerns presently faced by states. Information from this report should be useful in considering state and local tax systems and issues and how they might be hindered or helped in the process of reforming the federal tax system.[27]

Conclusion

We encourage Congress to include the state and local government items listed above in the federal tax reform debate so that effective reform can occur for all taxpayers and all levels of governments and without unnecessary adverse impact to state and local governments.

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[24] General Accounting Office, *Tax Policy: State Tax Officials Have Concerns About a Federal Consumption Tax*, GAO/GGD-90-50, March 21, 1990, page 31.

[25] GAO/GGD-90-50, *supra*, page 4.

[26] "1996 Action Agenda" of the National League of Cities, adopted March 9, 1996.

[27] *Financing State Government in the 1990s*, February 1994, ed. Snell, prepared by the staffs of the National Conference of State Legislatures, National Governors' Association, Federation of Tax Administrators, Multistate Tax Commission, and the National Association of State Budget Officers.

STATEMENT OF THE LARGE PUBLIC POWER COUNCIL
ON
THE IMPACT ON STATE AND LOCAL GOVERNMENTS AND
TAX-EXEMPT ENTITIES OF REPLACING THE FEDERAL INCOME TAX

The Large Public Power Council ("LPPC") is pleased to present the following statement of its views on the impact on state and local governments and tax-exempt entities of replacing the federal income tax.

The LPPC is, as its name implies, an organization of the nation's largest public power systems. Our members serve some of the nation's largest metropolitan areas, including Los Angeles, Phoenix, Jacksonville, Seattle, Orlando, and Austin, as well as smaller communities in rural America. In total, we serve over six million customers directly with electric power, and our members' revenues total over $12 billion. We own and operate many large electric generating stations and thousands of miles of high-voltage bulk power transmission lines. These electric systems require large capital investments, and our members rely on the tax-exempt bond market for extensive financing needs that cannot be provided directly from customer rates. LPPC members have over $30 billion of tax-exempt bonds outstanding.

The LPPC supports reasonable changes to the national tax system that promote economic efficiency and lead to a less complex and burdensome tax regime. Tax reform of this sort should be comprehensive and not create disproportionate burdens on any one sector of the economy.

The objective of LPPC members is to provide their customers with reliable energy at a competitive price. The electric power industry is currently undergoing significant change and moving to a much more competitive and less regulated environment. LPPC members would be particularly concerned about major changes in tax law which increase their costs relative to competing organizations. Increased costs for electric power would be passed on to customers. Many of our industrial and commercial customers compete in competitive global markets and are acutely sensitive to increased costs of any sort.

We particularly encourage careful review of any tax proposals that would impact the preference for tax-exempt bonds. The impacts of such changes will be hard to predict and diverse, and state and local governments should be asked to provide input. On the other hand, it is clear that tax reforms that simplify the rules and reduce the administrative burden in the areas of arbitrage rebate and private activity would be beneficial to issuers of tax-exempt bonds.

The LPPC stands prepared to provide you and your staff with any necessary technical assistance and comments, and appreciates the opportunity to voice its concerns.

Thank you for your consideration.

COMMITTEE ON WAYS AND MEANS

HEARING ON TAX REFORM

APRIL 24, 1996

WRITTEN STATEMENT OF THE NATIONAL ASSOCIATION OF BEVERAGE RETAILERS (NABR)

The following written testimony is submitted on behalf of the National Association of Beverage Retailers (NABR), a national association comprised of state associations of both "off-premise" and "on-premise" licensees. NABR's off-premise retail members, formerly represented by the National Liquor Stores Association, operate businesses in the "license" or "open" states.

NABR welcomes the opportunity to submit written testimony which supports Chairman Archer's belief that any reform of the tax system of the United States of America should result in a simplified approach to taxation, does not increase the tax burden on either private or corporate citizens, fosters competitiveness on both the domestic and international marketplace, and encourages savings and investment.

In particular, NABR stands in opposition to any measures which would increase the Federal Excise Tax (FET) or Value Added Taxes (VAT) on any alcohol beverage product due to the negative consequences such an impact will have on the beverage alcohol industry, consumers, and local, state and national economic stability.

Should alcohol beverage products become the target of increased taxation, and should the increases be implemented, the alcohol beverage industry -- the nation's most taxed and highly regulated industry -- will be expected to accept the additional burden of curing the nation's economic woes.

While NABR supports -- without reservation -- our Congress' efforts to reform the nation's tax system while at the same time addressing the U.S. budget deficit, we must wholeheartedly object to increased or additional taxes on alcohol beverage products on a number of grounds.

The alcohol beverage industry has been targeted by some for heavy taxation on the basis of so-called negative externalities and the "social costs" that are derived from the consumption of our products. Higher prices will only deter responsible consumption of alcohol. Higher prices through higher taxes will not deter the abusive consumer from purchasing alcohol beverages. It must be noted that alcohol abusers are but a small number as compared with the 90 million+ responsible and moderate consumers who would be discouraged from enjoying their right to responsibly, moderately and lawfully consume alcohol beverage products.

It is not only the consumer who will be hurt. The alcohol beverage industry, its employees, related service and agricultural industries, and the nation and its economy will be harmed by increases or additional alcohol beverage taxes. The alcohol beverage industry is on a financial decline, therefore it is the wrong time to impose further taxes.

Alcohol beverages are the most highly taxed and regulated consumer product in the nation. Nearly one-half the cost of a bottle of spirits, for example, is earmarked for excise or sales taxes. However, the heavy taxation of our products has actually had a negative impact with respect to U. S. tax collection efforts. Evidence: despite the 8 percent FET increase on distilled spirits in 1991, the U. S. Government actually collected $91 million less than the year prior to the increase.

Beer retailers, distributors and manufacturers faced a similar dilemma when in 1991, a 100 percent increase in the federal excise tax on beer went into effect. The tax increase directly resulted in a decline in sales of 91 million cases. The fallout has been 31,000 lost jobs in the brewing, wholesaling and retail industry tiers and resultant lost wages totalling millions of dollars among brewers, distributors and on- and off-premise retailers. Millions of dollars were also lost in selected reductions of direct purchases such as packaging and agricultural products which were neither needed nor purchased. And most ironic, nearly $310 million in state and federal revenues were lost as a result of declining sales and lost wages and tax and social security revenue.

The wine industry in the U. S. experienced its largest drop in sales in over 40 years following the huge federal excise tax increase in 1991. Depressed wine sales adversely affected the farm economy due to a lower level of production. Estimates are such that the newly proposed tax increase will result in a loss of 15 - 20,000 acres of grapes grown in the U. S. Lower wine sales will translate into a drop in economic activity and job loss. California -- where 90 percent of U. S. wine is produced -- is still in a deep depression. Unemployment is critically high in that state and will only increase with higher taxes.

Excise taxes are heavily regressive and will result in a negative economic impact. Both at current and increased levels, excise taxes hit the low and middle class especially hard and have a burdensome impact on the national, state and local economies. As taxes and costs rise for the consumer, purchasing and consumption will drop sharply, taking with it the precious tax revenues which government at all levels has come to rely upon.

Should a new layer of tax be implemented, such as a national sales tax, the FET on alcohol beverage products should be repealed in light of the facts stated previously about the economic burdens on industry, citizens as well as the federal, state and local governments.

In summary, we hope that you will consider the following critical points:

1. Increasing federal excise taxes or adding additional taxes on alcohol beverages will destroy jobs.

2. Increasing federal excise taxes on alcohol beverages are regressive and will increase taxes on middle and low income Americans.

3. Increasing federal excise taxes on alcohol beverages will reduce state sales and excise taxes and will result in increased unemployment benefit claims.

4. Higher excise taxes on alcohol beverages punish both the responsible drinker and the non-drinker through lost jobs and wages.

5. The alcohol beverage industry already pays its fair share burden.

6. Higher taxes do not reduce alcohol abuse as price is not a concern to those who abuse alcohol.

In conclusion, NABR supports Congressional efforts to streamline and improve the efficiency of the nation's tax system. However, narrowly focused taxes such as excise and value added taxes, which proves costly to our nation's businesses and economy, should be replaced by broad-based, equitable income or consumption taxes.

As part of this streamlining effort, the Congress should seriously consider abolishing excise taxes. The regressive nature of the excise tax is counterproductive in terms of its negative impact on citizens' ability to pay.

STATEMENT OF NATIONAL ASSOCIATION OF BOND LAWYERS

This testimony is submitted to the Committee on Ways and Means pursuant to its request for comment on The Impact on State and Local Governments and Tax-Exempt Entities of Replacing the Federal Income Tax by the National Association of Bond Lawyers, a non-profit association of municipal finance lawyers organized for the purpose of improving the law relating to state and municipal obligations by among other things educating its members and providing advice and comment with regard to state and municipal obligations with respect to legislation, regulations, rulings and other actions or proposals affecting state and municipal obligations. The National Association of Bond Lawyers (NABL) is incorporated in the State of Illinois. NABL has over 2,800 members practicing in fifty states.

We begin our testimony by associating ourselves with the comments made by Arthur Lynch on behalf of the Government Finance Officers Association and the eighteen other state and local government organizations endorsing the GFOA testimony. We believe the concerns raised by the GFOA testimony are accurate and rather than repeat them, we endorse that testimony and will address certain other issues raised by the analysis done by the Joint Committee on Taxation Staff Description on Impact of Tax Reform Changes on State and Local Governments (the JCT Description) in the area of municipal bonds.

As our concerns evidence below, we concur with the JCT Description's conclusion that adoption of any of the proposed tax reform recommendations would dramatically affect both the outstanding $1.2 trillion of municipal bonds, and future investment in municipal

bonds and the public infrastructure for which the borrowing is made. The tax structures of state and local governments would have to be completely overhauled at great cost and effort to state and local governments if any of the proposals were enacted. We also are concerned that were tax-exemption removed from the Internal Revenue Code (the Code), it could jeopardize exemption analysis for obligations issued by state and local governments under the Securities Act of 1933. Attention to protection of that exemption is necessary if any of the proposals are adopted. For purposes of this testimony we assume such protection would be provided and therefore will not address the potential costs of the loss of the registration exemption that would be incurred were such protection not provided.

Adverse Credit Implications

As municipal finance lawyers, we are particularly worried about the changes in the security for or the perception of the strength of the security behind outstanding as well as future bond issues. The implication in the JCT Description is that there will be no transition relief provided for outstanding tax-exempt bonds under the proposals except for the USA Tax. This causes us concern for three reasons, all of which relate to the adverse security implications which arise from adoption of any of the proposals set forth in the JCT Description. First, one fundamental reason people complain about the Code and its unfairness and complexity is their belief that Congress is perpetually changing the Code to benefit someone else and potentially to their detriment. To deflate the value of outstanding bonds will enhance their skepticism about the Code, not diminish it.

Second, for the Congress to break the contract between municipalities and their bondholders by eliminating the benefit bondholders received when they bargained for tax-exemption undermines bondholders' belief in the security for those bonds (and in fact the actual security) and the fundamental premise of the contract between the bondholder and the borrower. Outstanding debt would be drastically devalued to the detriment of the purchasers relative to other investments they might have made had they known their tax advantage would be eliminated. The implication for future borrowers is that purchasers cannot count on the non-impairment of the contract made by governmental issuers because of the possibility that Congress would again interfere with the bargain they might make and therefore, issuers will not only see increases in interest rates due to taxability but also due to a risk premium.

Should Congress decide to provide transitional relief for outstanding obligations, it would be recognizing the sanctity of that contract and protecting the existing bondholders from a change they could not have foreseen when they purchased the bonds, a change that may be fundamental to their long-term financial planning like their retirement plans. Purchasers who assumed that these were safe tax-advantaged investments made to provide for their retirement needs will under consumption tax proposals be devastated and under other options find their investment made illiquid or subject to sale at a loss.

The third concern relates to creditworthiness -- these proposals, as suggested in the GFOA testimony and the JCT Description, will dramatically change the structure of state and

local taxation. To the extent that property values drop as the result of changes in mortgage deductions and the deductibility of property taxes, the fundamental security underlying the repayment of these long term fixed-rate bonds will have been undermined, thereby calling into question the issuer's ability to repay the debt. Replacement of the lost debt service could be achieved through tax increases at the local level to make up the difference due to the impairment of the security underlying the bonds. However, this will only further call into question the ability of issuers to raise taxes to meet outstanding debt requirements -- their creditworthiness -- and thereby reduce their ability to make future infrastructure investments.

State and local government creditworthiness is premised on an issuer's overall debt capacity, that is, what amount of debt the local tax base can bear. The JCT Description states that there has been no direct correlation proven between interest rates and infrastructure investment but does not address the impact of debt capacity on infrastructure investment. If issuers are required to pay higher taxes to service outstanding debt and higher rates to borrow in the future due to loss of tax exemption, then additional incremental debt will come with a higher risk factor, which means additional expense. This means the issuers quickly reach their debt capacity, the level at which either they can no longer afford to raise taxes to pay for future borrowings or the market will no longer trust their ability to repay that debt. Such changes as a result of the tax reform proposals would be happening at a time when the federal government is decreasing its investment in infrastructure and is turning responsibility over to state and local governments for infrastructure investment as well as

other federally mandated programs. State and local governments will not be able to enhance their share of investment in infrastructure, given their other new responsibilities under the 1996 and proposed 1997 budgets. This must be considered carefully when analyzing the expected economic growth attributed to these various tax reform proposals because the economy's ability to expand is subject to the physical constraints of its infrastructure.

Cost and Efficiency

Two of the criticisms of tax exemption in the JCT Description are "inefficiency" and therefore "unfairness." The criticism mistakenly focuses on the incorrect perception that tax-exemption benefits only higher bracket taxpayers. The inefficiency criticism misses the mark in at least two ways. First, since interest rate obligations are set by marketing efforts to all investors, including many lower bracket taxpayers investing in tax-exempt mutual funds and especially the elderly who rely on tax-exempt income during their retirement, the rate for particular obligations represents the blended equivalent, in after-tax dollars, of comparable quality taxable investments made by similar buyers. Market efficiency should produce rates for local government reflective of the aggregate investor tax savings and benefits to higher income bracket taxpayers should be off-set by lower bracket taxpayers.

Second, if higher bracket taxpayers are now major investors in tax-exempt bonds, it is because bonds are now relatively more favored than other tax-exempt investments. In prior years when tax rates were higher, the percentage of individuals holding state and local government bonds were lower because there were other more attractive investment

possibilities. There will always be some things in the Code more highly favored than others and that fact should not be taken as proof that the program underlying the tax treatment should be terminated. The program should be evaluated on its own merits as to whether or not it is meeting a governmental purpose. Furthermore, the reality is that capital will find another tax-advantaged investment vehicle in the new tax regime and not, as calculated in the JCT Description efficiency argument, an "efficient" taxable investment.

If the Committee really wants to deal with inefficiencies related to tax-exemption, it would eliminate many of the complexities in the Code relating to tax-exempt financing so that the federal benefit would go into infrastructure reducing the cost of Code compliance or Code inefficiencies like the Alternative Minimum Tax on tax-exempt bonds. Another example of Code created needless inefficiency is the costly, duplicative requirements of yield restriction and rebate. Elimination of yield restriction would simplify municipal finance transactions, and reduce compliance costs without providing opportunity for abuse due to the existence of rebate.

To address the fairness question one has to evaluate who benefits from investment in public infrastructure and whether their relative enjoyment is comparable to what they are paying for it -- at the federal and local level. Higher bracket taxpayers may benefit more from the investment in tax-exempt bonds than lower income investors, but lower income investors similarly pay a lower tax burden for the cost of government, including infrastructure investment. It is hard to evaluate the commensurate share attributable to an

individual taxpayer from an investment in a road or municipal transit system. It would depend on whether the taxpayer was a truck driver, the owner of a trucking company, a mass transit commuter, a student in a local public or state financed school system, a user of public parks, a mortgage revenue bond borrower, or a low income housing tenant. The tax equity argument cannot be calculated purely on the basis of tax efficiency but has to be calculated on the actual beneficiaries of the infrastructure investment. Arguably lower income taxpayers benefit more from investment in those projects than do higher income investors by virtue of the relative number of taxpayers in each category and the proportional responsibility for state income and property taxes dedicated to repay the debt. The numbers would suggest that equity analysis places a higher benefit to infrastructure investment in the public generally than in specific segments of the economy and in a broader base of the public than pure analysis of investor benefit would suggest.

Allocation of Capital

The JCT Description suggests that tax-exemption somehow skews investment in favor of tax-exempt projects over allocation of capital to other projects. It is a fundamental purpose of government to allocate its resources whether through the Code or through direct appropriations. Tax-exemption is an appropriate allocation of capital to infrastructure investment which since 1968 has been reviewed and refined by Congress to assure it is appropriately meeting its public purpose. Additionally, it is required to be approved at the issuer level of government, further assuring its governmental purpose. Tax-exemption is an alternative and not an additional tax advantage or "allocation of capital". Whereas, the

corporate sector gets the benefit of the allocation of tax expenditures to their capital investment through depreciation, governments get tax-exemption and no depreciation benefits. State and local governments are not getting additional tax benefits.

Inter-Governmental Comity or Reciprocal Immunity

Finally, the analysis of the impact on the Federal Treasury and the relationship between state and local governments and the federal government needs to recognize the concept of comity or reciprocal immunity. State and local bonds are federally tax-exempt and federal debt is tax-exempt at the state level. According to the JCT Description, households held $1.087 trillion in federal government debt (excluding $145.2 billion in large time deposits and $353.1 billion in money market shares) that is tax-exempt at the state level due to federally proscribed state tax-exemption of federal debt. If state and local obligations are to become taxable, then fairness should dictate that federal debt would become taxable at the state and local level, thereby increasing federal borrowing costs.

As bond lawyers we constantly confront the fact that state, local and federal taxpayers are one and the same. Any changes in the federal system must consider the implication for the taxpayer and not just the level of government applying the tax. If a federal tax cut harms the revenue base and increases the demands for revenues at the state and local level, taxpayers will not be happy with a federal tax cut that merely shifts their tax burden to a different level of government. Thank you for the opportunity to address the Committee on these important issues.

William H. McBride
Hunton & Williams
President, National Association
of Bond Lawyers
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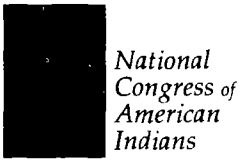

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Statement of W. Ron Allen, President
National Congress of American Indians

Before the House Committee on Ways and Means

Regarding Potential Changes in the Internal Revenue Code and Impacts On States, Local Governments, Indian Tribes, and Non-Profit Organizations

15 May 1996

INTRODUCTION

Good morning Chairman Archer, Congressman Gibbons, and distinguished members of the Committee. I am W. Ron Allen, Chairman of the Jamestown S'Klallam Tribe of Washington State and President of the National Congress of American Indians (the "National Congress" or "NCAI"). On behalf of the National Congress and our 206 member tribes, I am pleased to present to the Committee this statement regarding revenue generating measures currently contained in the Internal Revenue Code (the "Code"), possible alternatives to these measures, and the likely impacts of such alternatives on Indian tribal governments.

As the oldest, largest, and most representative Indian advocacy organization in the United States, the National Congress is dedicated to the exercise of tribal sovereignty and the continued viability of tribal governments.

FUNDAMENTALS OF FEDERAL INDIAN LAW AND POLICY

Since the earliest days of our republic, Indian tribes have been accorded sovereign status, which brings with it not only the well-established right to regulate and tax persons and activities within the boundaries of the sovereign, but also the well-settled principle that sovereigns do not possess the authority to tax other sovereigns. It is this dual nature of tribal sovereign existence that is critical to any discussion of the current Code provisions and how tribes would be affected by changes in the Code.

Along with states and the federal government, tribal governments are 1 of 3 sovereign entities mentioned in the U.S. Constitution. Though the constantly changing balance of power in our federalist system has never adequately recognized Indian tribal governments as sovereigns, the U.S. has consistently held Indian tribes, like states, sovereign and non-taxable. Treating tribes as non-taxable entities reflects the legal and political reality that tribal sovereignty itself predates

the U.S. Constitution and is inherent rather than delegated as some would believe and would have this Committee believe. [1] Indian tribes, therefore, enjoy all those characteristics and attributes of sovereignty not explicitly withdrawn by treaty or statute.

THE INTERNAL REVENUE CODE AND INDIAN TRIBES

The current Code includes authority to tax 3 types of "taxable entities": individuals, estates and trusts, and corporations. (See Code Secs. 1(a) - (d); 1(e); and 11(a) respectively). By its own terms therefore, the Code does not provide for the taxation of Indian tribes at the federal level. As I noted above, Indian tribal governments are not considered "taxable entities" and are therefore immune from the federal tax. [2] As a general rule, agencies and enterprises of a tribe retain the non-taxable character of the tribe. For instance, proposals to levy a federal tax on the revenues generated by a tribal government gaming facility fail to recognize the fact that the activity is governmental in nature, not commercial or for-profit, and is akin to state lotteries which enjoy tax-immunity. I want to make this point clear: these activities are not commercial or for-profit, nor are they undertaken by a tax-exempt organization because tribal governments are not "tax-exempt" but rather are tax-immune --- like the several states themselves.

Similarly, there have been efforts made over the years to levy a federal tax on corporations organized under tribal charters. Ironically, as tribes have attempted to bring value-added activities and jobs to our reservations the states with tribal populations have proven eager to regulate and tax those activities. These initiatives will not only frustrate tribal efforts, but represent a significant deviation from past practice and well-settled law. It has long been held by the Department of Treasury's Internal Revenue Service that federally-recognized Indian tribes are not subject to the federal tax, even on income that appears to be "clearly commercial". [3] The IRS has also held that tribal corporations organized pursuant to a federal charter under the federal Indian Reorganization Act ("IRA") [4] are similarly non-taxable. Tribally-owned corporations

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[1] I would, without going further, like to thank Chairwoman Debra Doxtator, of the Oneida Tribe of Indian Wisconsin, for her testimony made to this Committee on 1 May, and would like to associate myself with her remarks.

[2] "Indian tribes are not taxable entities under the income tax provision of the Internal Revenue Code. The Code taxes the income of every 'individual'; 'estate and trust'; and 'corporation'. These terms do not include Indian tribes which are 'unique aggregations' like no other legal entities. The fact that tribes retain sovereign powers of government strengthens the conclusion, because the federal income tax does not apply to other units of government." Felix Cohen, *Handbook of Federal Indian Law* (1982 ed.) P. 390.

[3] *See* Rev. Rul. 67-284, and Rev. Rul. 94-16.

[4] 25 USC Sec. 477; *see also* Rev. Rul. 81-295, holding that a "federally chartered Indian tribal corporation shares the same tax status as the Indian tribe and is not taxable on income from activities carried on within the boundaries of the reservation."

organized under federal law are not considered "taxable". [5]

I would like to put to rest one of the fundamental misconceptions about Indian tribes and Indian people that unfortunately continues to cloud every Indian issue. Items of income earned by Indian tribal governments are *not* subject to federal taxation, [6] and as noted above tribal agencies and enterprises are similarly non-taxable. However, unless an express exemption is provided by treaty or statute, any items of income earned by individual Indians, however, are subject to the federal income tax. [7]

TRIBAL INCOME FUNDS TRIBAL GOVERNMENT SERVICES

The items of income earned by Indian tribes across the U.S. fund a comprehensive list of tribal government services to tribal and non-tribal members that very much mirrors the services provided by states to state citizens: schools, day care centers, hospitals and elderly care units, housing rehabilitation and maintenance, road construction and repair, water system and infrastructure financing, and a host of others. These programs and services, it should be pointed out, are provided to Indian and non-Indian residents alike.

Just as states and local governments are reliant on their own array of property, sales, and use taxes, tribal governments are reliant on their own activities in an attempt to deliver these services and satisfy the needs of those living within their boundaries. I will not cite the litany of dramatically poor economic, health, housing, and other indicators from Indian country. Suffice it to say that in terms of these and other statistics, Indian people rank at or near the bottom in every category. The poverty of Indian people nationwide is not relative, but is abject and more akin to Third World countries than the largest, most productive democracy in the world today.

The unemployment rate in Indian country averages over 40%, and exceeds 80% on some reservations. Safe, decent, and affordable housing is scarce and most existing Indian housing lacks the fundamental amenities most Americans take for granted such as plumbing, electricity, telephone service, and other basics. In 1990, 51% of all reservation Indians lived below the poverty line --- compared with 45% in 1980. These figures are drawn from the U.S. Census

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[5] *See* Rev. Rul. 67-284, 1967-2 C.B. 55; and Rev. Rul. 81-295, 1981-2 C.B. 15; see also B. Bittker and L. Lokken, stating that "(a)s quasi-sovereign bodies, Indian tribes are not taxable entities." Federal Taxation, Income, Estates, and Gifts, 2d ed. 1989.

[6] *See* Rev. Rul. 67-284.

[7] Two such exemptions do exist: Congress has granted a statutory exemption in accord with the Just Compensation Clause of the Fifth Amendment's prohibition against takings of property; and has also exempted all income earned directly from an Indian's trust allotment. *See Squire v. Capoeman*, 351 U.S. 1 (1956).

Bureau's decennial counts, as well as the Bureau's intercensal and other statistical efforts, and given the historic undercount in Indian country, these figures are apt to be even higher.

In addition, alcoholism, suicide, tuberculosis, diabetes, and a whole host of social problems traceable to poverty and underdevelopment also form part of the fabric of Indian society today.

TAX CODE RESTRUCTURING AND INDIAN TRIBES

It is critical that the Congress have a fundamental understanding of both federal Indian law and policy, and a grounding in the very real problems faced by most Indian tribes today. Any alternatives should be implemented with an eye toward strengthening tribal economies, bringing solid value-added activities to the reservation, and improving the standards of living of Indian people. Achieving these same goals on a national level, it would seem, are the paramount concerns of those proposing the changes in the first instance.

A. The Flat Tax: there have been a number of flat tax proposals put forth to replace the current individual, estate, and corporate income tax system. Legislation introduced by Majority Leader Dick Armey (HR 2060, with companion legislation introduced by Sen. Richard Shelby, S. 1050) does contain a blanket exemption from the "business tax" for any activity of a government entity, but it is not clear how Indian tribal governments would be treated under the Armey proposal. Presumably, all income would be exempted because an activity undertaken by an Indian tribe is, by definition, a governmental activity. The uncertainty in the Armey proposal is definitional: it is not clear whether Indian tribal governments would be treated as governmental entities or as non-profit organizations. Clearly, Indian tribes should be treated as governmental entities and therefore subject to the blanket exemption.

With regard to individual Indians, the Armey proposal plans a flat 17% rate (20% in the first two years) to wages and pension distributions; deductions for mortgage interest and charitable contributions would be eliminated. The proposed "family living allowance" --- $21,4000 for a married couple, and $5,000 for each child --- would shield much income from the flat tax. Because income rates tend to be lower across Indian country, and other things remaining equal, a flat tax could prove beneficial to Indian people. Further study and analysis is necessary to fully determine the impact of a flat tax on Indian tribes and Indian people.

B. National Sales Taxes: under national retail sales tax proposals that have been put forward, disincentives would be created to consume goods and services as they would be subject to a 15% tax. Indian tribes, because they are government entities, should be held immune from such a tax. Similarly, under the current proposals Indian tribes, like states and local governments, would not be exempt from such a tax and could suffer disproportionately because of that fact. Because Indian tribal governments spend huge percentages of their income to address the needs of their members, a sales tax would leave them with proportionately less after-tax revenues than other governments. Any effort to tax sovereign Indian tribal governments would likewise be

contrary to well-established law and policy regarding tribes and other government entities.

Most distressing, the current proposals call upon the states to enforce the sales tax, which would seemingly involve state jurisdiction over reservation activities. This would be universally opposed in Indian country because of the history of state-tribal relations and because it would violate core tenets of tribal sovereignty. Alternatives could, theoretically, be worked out including tribal collection of the sales tax within the boundaries of their reservations pursuant to compacts.

C. Consumption-Based Taxes: currently there are proposals designed to encourage savings and penalize consumption such as S. 722, introduced by Sen. Pete Domenici. This bill would tax income that is consumed (with a maximum rate of 40%), and would encourage savings by making all money saved non-taxable. Again, this bill provides no exemption for tribal governments. Encouraging savings is a laudable goal, but unless the details of the USA tax, as S. 722 has come to be known, can be worked out with regard to the taxation of tribal governments, it is not known what the real impacts of the bill on tribal governments and tribal people will be.

CONCLUSION

On behalf of the National Congress I appreciate the opportunity to submit this preliminary statement with regard to possible changes in the tax code and impacts on tribal governments. In the months ahead, we look forward to receiving details of the proposed legislative changes and to appearing before you to comment on those proposals. Obviously, the legislation that has been introduced thus far has yet to be fleshed out and until that time it is difficult to relate what the impacts on tribes and Indian people will be.

Whatever proposals are considered in the months ahead, I strongly urge that the well-settled federal laws and policies regarding the taxability of Indian tribal governments and Indian people be favorably looked upon in reaching any conclusion regarding tax code amendments. The National Congress encourages the Committee to continue to respect tribal governments as sovereign entities, and to respect the government-to-government nature that characterizes the U.S.-tribal relationship.

In addition, I would hope that if further hearings are held by the Committee, that Indian tribes from across the nation be afforded the opportunity to provide comments and testimony on any proposed changes in the tax code.

Thank you.

* * *

National
Council of
State
Housing
Agencies

May 15, 1996

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Phil:

The National Council of State Housing Agencies (NCSHA) appreciates this opportunity to comment on the impact on state and local governments and tax-exempt entities of replacing the federal income tax.

NCSHA is a national, nonprofit organization created in 1970 to assist its members in advancing the interests of lower income people through the financing, development, and preservation of affordable housing. NCSHA's members are Housing Finance Agencies (HFAs) with statewide authority. NCSHA's member agencies operate in every state and the District of Columbia, Puerto Rico, and the United States Virgin Islands.

At the center of HFA activities within the states and NCSHA's work in Washington are three federally authorized tools: authority for states to issue tax-exempt Mortgage Revenue Bonds (MRBs) and multifamily housing bonds; the Low Income Housing Tax Credit (Housing Credit); and the HOME Investment Partnerships (HOME) program. NCSHA is the principal advocate for MRBs, multifamily housing bonds, and the Housing Credit, and the principal state advocate for the HOME program.

Using these tools, HFAs have crafted hundreds of housing programs – from homeownership to rental to all types of special needs housing. Many HFAs also administer other state and federal housing assistance programs.

We are deeply concerned that any potential replacement for the federal income tax preserve the incentives which it now provides to encourage investment in housing affordable, because of those incentives, to low and lower income citizens.

The states have used the MRB program to help more than 2.1 million lower income families buy their first home. MRBs make mortgage money available in areas where it is in short supply. They also help lower income families through home repair and energy efficiency programs, which improve the housing stock and make neighborhoods better places to live.

MRBs are used with lease purchase programs, which allow rent payments to count toward downpayments; reverse equity programs, which keep seniors in their homes longer; and counseling programs to help first-time buyers be responsible owners.

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MRB mortgages typically go to families earning much less and buying homes costing much less than MRB program limits. Average MRB homebuyers make only about 77 percent of the national median income, just 70 percent of an average conventionally financed first-time buyer's income and 60 percent of an average conventional buyer's. Average MRB-financed homes cost only 68 percent of average conventionally financed first-time homes and 54 percent of all average conventionally financed homes.

The states have used multifamily housing bonds to make possible nearly three quarter of a million affordable apartments for low income families. In 1994 alone, the states issued more than $2 billion in multifamily housing bonds to finance almost 35,000 affordable apartments.

The Housing Credit has helped finance more than 800,000 new and rehabilitated apartments since its inception in 1986. The 100,000 affordable apartments the program makes possible each year barely make up for the almost equal number lost annually to demolition, abandonment, or conversion to market rate use.

The program accounts for nearly every apartment created for low income people and a substantial part of all new apartments constructed nationwide. Housing Credit developments also boost local tax bases and help stabilize neighborhoods. The program has leveraged $12 billion in private investment in affordable housing and generates more than 90,000 jobs, $3.1 billion in wages and $1.5 billion in taxes every year. Increasingly, HFAs are combining Housing Credits and multifamily housing bonds to serve families earning even less than the individual programs require.

Administered at the state level, with minimum bureaucracy, MRBs, multifamily housing bonds, and the Housing Credit are models for empowering states to deliver limited federal resources to those who need them most.

We look forward to commenting in more detail on the impact of replacing the federal income tax on MRBs, multifamily housing bonds, and the Housing Credit later this year when the Committee holds hearings on how such action would affect homeownership and real estate.

Sincerely,

Barbara J. Thompson
Director of Policy and
Government Affairs

STATEMENT OF NATIONAL EDUCATION ASSOCIATION

Mr. Chairman and Members of the Committee:

The National Education Association (NEA), which represents 2.2 million education employees in our nation's public elementary, secondary, vocational, and postsecondary schools, appreciates the opportunity to submit this statement opposing any legislation to replace the current federal income tax with a federal flat tax. NEA supports meaningful tax reform provided it assures basic fairness for all taxpayers, economic security, and adequate funding for education and other critical public services.

NEA believes, however, that a flat tax system would adversely impact education, children from middle-income and poor families, and the economy.

None of the flat tax proposals are at a rate that would generate sufficient revenues to meet the needs now met by our federal government. A flat tax system would drastically reduce federal aid of all kinds to states and localities. As the largest single expenditure in most state budgets, K-12 public education would become a necessary target for budget cuts at a time of escalating school enrollments, growing student needs, and efforts to improve America's schools.

Decreased federal revenues will gut federal education programs that support strong, local schools and high educational standards. Among the programs that would most likely be cut are those that support local school reform, safe and drug-free schools, Title I programs for teaching basic skills, school-to-work programs, professional development for teachers, technology assistance to schools, and college grants and loans. States would be unable to pick up the slack as they struggle to allocate fewer resources caused by decreased federal revenues to states.

Decreased federal revenues would require deep cuts in other programs that support families and children, hampering efforts to assure that all children come to school ready to learn. Federal standards for services that states now consider basic necessities for children would be forced into the category of "unfunded mandates," including school breakfast and lunch programs, other nutrition and infant feeding programs, Head Start services, Aid to Families With Dependent Children (AFDC), and inoculation and other preventive health programs.

Under a flat tax system, funding mechanisms for financing education would impact unfairly on lower income households and impede the ability of communities to raise money for school construction. A decrease in state aid to schools would force increases in local property taxes and state and local sales taxes to fund education. Property and sales taxes are regressive and would fall hardest on the poorest families and their schools. Bonds for school building construction currently are exempt from taxes. Under a flat tax system this exemption would be lost and the incentive for investment in school and municipal building bonds would be eliminated.

Despite the seeming fairness of applying the same tax rate to all income, a flat tax would in reality shift the federal tax burden away from high income groups onto middle income families. Currently, dividend income from the purchase of stocks and bonds is taxed once in connection with the corporations who must report it on their taxes as income and once when the corporation distributes the money to individual investors, who must report it as income on their federal and state tax returns. A flat tax would unfairly shift the tax burden from investment dividends to wage earners.

Further, the flat tax would make it more difficult to reduce the deficit or stimulate savings, which are the purported rationales for reforming the current tax system. None of the flat tax proposals have been at a rate that would be required to keep the federal government from incurring further deficit. Raising the flat tax rate to a range that could stem the deficit would place the tax burden disproportionately onto moderate and low-income households.

A flat tax or consumption tax would eliminate the current tax preference for pension savings plans and raise health care costs. Without an incentive to invest in pension savings plans, current pension plans will be weakened by reduced participation and an accompanying reduction in assets. Further, employers will have no incentive to establish new pension plans, causing a reduction in individual savings since pension plans are the single, largest source of individual savings in the United States. Health care costs would rise since a flat or consumption tax would increase the cost of health insurance premiums by eliminating the deductibility of health care costs.

Flat tax proposals are based on failed economic policies implemented in the 1980s that are responsible for the extraordinary deficits our country now faces. Advocates claim the flat tax would lower everyone's taxes and stimulate individual savings, which in turn would cause interest rates to fall and thereby increase business investment. But a flat tax would cause retirement savings to lose their tax preference status and eliminate the mortgage interest deduction, both of which would have a negative impact on individual savings. Instead of productive investment or economic growth, the likely result of a flat tax would be a repeat of the policies during the 1980s that resulted in the worst deficits in U.S. history.

Forty-three states now piggyback their state income tax on the federal income tax, some who do so by simply charging a percentage of the federal tax. Under a federal flat tax, states would have to dismantle their current system and incur substantial costs to establish their own separate income tax system. A transition to a new state tax system no longer based on federal definitions would be complex and jeopardize short-term state and local government funding. Students and teachers would be adversely affected by this halt in adequate funding, which could become a permanent disruption in funding.

NEA strongly supports any federal tax reform measures that promote equity and fairness among taxpayers and that assure continued funding for the services the federal government now provides. A federal flat tax would not provide these assurances.

SMME

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April 29, 1996

Honorable Charlie Norwood
Congressman, 10th District, Georgia
Congress of the United States
House of representatives
1707 Longworth Building
Washington, DC 20515

Dear Congressman Norwood:

I am writing to you concerning the upcoming Ways and Means Committee Hearing concerning change to the income tax system and alternative methods of taxation. Though the notice is short to prepare a complete presentation, my message is clear-

"Is the tax system broke or can we fix it?"

I realize the complexities of the tax system. Congress and the Internal Revenue Service **share the blame** for its complexity. This position paper will give by example some of those complexities created by Legislation or administered by Congress. **Congress can make the Tax Code simpler but the political process may not allow it to be honest with the taxpayers!!** It may therefore be easier to attack the system than to fix it.

I submit material that can be published or submitted to various Committees of Congress. You know me as not only a CPA who speaks out for my profession as a whole, but one who has been able to speak out on the practicality of ideas and their ability to be implemented. As I speak to small CPA practices around the country, I represent their ideas as well as mine.

I submit as my beginning a quote from "West Publishing Company-1987; Ch. 1, pg 3-4"...

> "What is taxation? In simple terms, taxation is the process of extracting revenue from citizens to finance governmental activities. In a modern technological society, such as that of the United States, taxation comprises an interaction among several disciplines. The tax system is derived from law, accounting, economics, political science, and sociology. Principles of economics, sociology, and political science provide the environment for the tax system, while law and accounting precepts are applied in a typical tax practice."
>
> "Tax policy questions concerning, for instance, the effects that a specified tax law change will bring about relative to economic growth, the effects of projected inflation on the implementation of the tax law and vice versa, and the effects of the tax law on the United States' balance of payments, are addressed by economists. Political scientists, economists, and sociologists, alternatively, examine issues such as identifying those who bear the ultimate burden of a tax, determining how a tax bill becomes law (including practical effects of the legislative process), measuring the social equity of a tax, and specifying whether a tax is discriminatory against certain taxpayers. Attorneys interpret (and, often, create) the extant taxation statutes, and accountants apply the tax laws to specific prevailing or prospective economic transactions."

The tax code is made complicated because business has become more complex and global. Many of the financial transactions that exist today did not exist in such proportion 20 years ago. Laws are more complex because professionals are paid to reduce the impact on their clients. To think one would be able to pass laws politically that professionals may not be able to reduce their impact for their clients is optimistically "Camelot".

1. "Exhibit 1" is a schedule for a client. Three percent (3%) of adjusted Gross Income is subtracted (after exceeding an inflation adjusted amount) from itemized deductions. The purpose

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of this calculation was to raise taxes one percent (1%) (3% of the top bracket of 31%). This especially hurts those who have Capital Gains and large State Income Taxes. This can partially negate other rates publicly stated such as the Capital Gain rate.

2. "Exhibit 2" is an example of a client who had only Earned Income and no itemized deductions. Note that this person is subject to the Alternative Minimum Tax because personal exemptions are not included as a deduction in Alternative Tax Method.

3. "Exhibit 3" is an example of a client whose main preference was traveling on the road as a Salesman. Because he had to pay his own expenses in lieu of his Company paying them and reducing his Salary, this taxpayer had fifty percent (50%) of his meals disallowed and was subject to Alternative Minimum Tax.

4. "Exhibit 4" shows the old ten percent (10%) Investment Credit Form. Notice the taxpayer does not receive ten percent (10%) as an actual ITC and also note the complexity of the form in relationship to the purpose of the act in spurring investment.

The Committee is interested in effects of taxes on Small Business's ability to run with less bureaucracy from the Government. This is a noble venture and taxes are a small part. I find that Small Business is more concerned with OSHA, ADA, EPA, EOOC, etc., than with taxes. Taxes have a good "political ring", but they are not what chokes Small Business and provokes fear of the unknown. Most of my clients, who have been audited by the IRS, have a "no change". Fear strikes them when OSHA, EPA, etc., examine them for as anyone, honest and willing, may be subject to fines.

To understand the effect on Small Business, one must define Small Business. During the last large debate on "Tax Relief", Small Business had a definition all across the board.

1. A "S Corporation"
2. Number of Shareholders
3. Income under $1,000,000
4. Income under $100,000
5. Gross Sales under $50,000,000
6. Assets under $10,000,000

Before designing relief from Small Business a specific guideline of its definition must be articulated to the Business Community and to the public. This would discourage arguments that miss the definition.

In 1969, the last great revision of the Tax Code was passed, (almost every year since we have had a revision.) In 1986, the major change of the system was passed. A majority of the Senators pledged not to vote for major tax changes for five (5) years.

Small Business wants an efficient Tax Law that will stick for 5-10 years in concept. It does not want to make business decisions as it did in 1985 to see it reasoning wiped out by the 1986 Tax Law as Real Estate had happen to it. It does not want to borrow on its house to start up a business to discover that interest is no longer deductible as some flat taxes may do. It does not want to see its State raise taxes to see such taxes as not deductible because of a Flat Tax or Alternative Minimum Tax.

When congress passes new tax laws, it does not realize their complexity or ambiguity. Does the new law comply with the Paper-work Reduction Act? At the same time, Congress is reducing the overall budget of the Treasury and Internal Revenue Service. What happens when this combination occurs? The Small Businessman loses.

1. Regulations and rulings needed to aid the Small businessman in interpreting the laws can take 3-8 years, such as what is happening with the 1986 Tax Law.

2. A reduction of funds is allocated to the local IRS offices. Taxpayers are not allowed anymore to tax their notices of change to discuss with a "Human Being" the problems. In our tax practice, we can save the taxpayer 2-4 letters, as well as time for the IRS, if we can take our information directly to an agent and discuss the matter with that Employee in lieu of a letter writing campaign. In fact, if Congress is serious about reducing the uncollected taxes they would allocate money directly to this activity in lieu of less productive, (Revenue nonproducing), activities.

If Congress is going to change the Tax System, they should anticipate the problems of a transition. The reason a Capital Gains Tax is a tax raiser is that people rush to close transactions with lower rates before they change. Very little activity takes place in the interim. If the Income Tax system is changed materially (rates or abandoned) the transition would cripple the economic system of this country. **I have seen no studies on the transition but only on alternative tax systems.** If the patient dies before surgery, one does not need the surgery.

I appreciate this opportunity to address you on this matter. You and your fellow Republicans have made great strides in attacking government waste and inefficiency so I challenge you not to create the same by substitution.

Sincerely,

Abram J. Serotta, President
Serotta Maddocks Evans & Co., CPA's

AJS/dtd

attachments

701 Greene Street, Suite 200 / Augusta, Georgia 30901-2322 Telephone (706) 722-5337 Telefax (706) 724-FAXX (3299)

Form **1040** — Department of the Treasury – Internal Revenue Service

U.S. Individual Income Tax Return 1995

IRS Use Only – Do not write or staple in this space

For the year Jan. 1 – Dec. 31, 1995, or other tax year beginning , 1995, ending , 19 — OMB No. 1545-0074

Label (See instructions on page 11.) Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial — Last name — Your social security number

If a joint return, spouse's first name and initial — Last name — Spouse's social security number

Home address (number and street). If you have a P.O. box, see page 11. — Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, see page 11.

For Privacy Act and Paperwork Reduction Act Notice, see page 7.

Presidential Election Campaign (See page 11.)

	Yes	No
Do you want $3 to go to this fund?		X
If a joint return, does your spouse want $3 to go to this fund?		X

Note: Checking "Yes" will not change your tax or reduce your refund.

Filing Status (See page 11.) Check only one box.

1 [ ] Single
2 [X] Married filing joint return (even if only one had income)
3 [ ] Married filing separate return. Enter spouse's soc. sec. no. above & full name here ▶
4 [ ] Head of household (with qualifying person). (See page 12.) If the qualifying person is a child but not your dependent, enter this child's name here ▶
5 [ ] Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 12.)

Exemptions (See page 12.)

6a [X] Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a. But be sure to check the box on line 33b on page 2.
b [X] Spouse

No. of boxes checked on 6a and 6b: 2

c Dependents:

(1) First Name Last name	(2) Dependent's social security number, if born in 1995, see page 12.	(3) Dependent's relationship to you	(4) No. of mos. lived in your home in 1995

If more than six dependents, see page 13.

No. of your children on 6c who: ● lived with you ; ● didn't live with you due to divorce or separation (see page 14) ; Dependents on 6c not entered above

d If your child didn't live with you but is claimed as your dep. under pre-1985 agreement, check ▶ [ ]
e Total number of exemptions claimed — Add numbers entered on lines above ▶ 2

Income — Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	197,014
8a	Taxable interest income (see page 15). Attach Schedule B if over $400	8a	4,564
b	Tax-exempt interest (see page 15). DON'T include on line 8a. St. . 2 . 8b 2		
9	Dividend income. Attach Schedule B if over $400	9	9,940
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 15)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). If required, attach Schedule D	13	642,118
14	Other gains or (losses). Attach Form 4797	14	
15a	Total IRA distributions . 15a — b Taxable amount (pg. 16)	15b	
16a	Total pensions and annuities . 16a — b Taxable amount (pg. 16)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation (see page 17)	19	
20a	Social security benefits . 20a — b Taxable amount (pg. 18)	20b	
21	Other income.	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	853,636

If you did not get a W-2, see page 14. Enclose, but do not attach, your payment and payment voucher. See page 33.

Adjustments to Income

23a	Your IRA deduction (see page 19)	23a	
b	Spouse's IRA deduction (see page 19)	23b	
24	Moving expenses. Attach Form 3903 or 3903-F	24	
25	One-half of self-employment tax	25	
26	Self-employed health insurance deduction (see page 21)	26	
27	Keogh & self-employed SEP plans. If SEP, check ▶ [ ]	27	
28	Penalty on early withdrawal of savings	28	
29	Alimony paid. Recipient's SSN ▶	29	
30	Add lines 23a through 29. These are your **total adjustments** ▶	30	0

Adjusted Gross Income

31	Subtract line 30 from line 22. This is your **adjusted gross income**. If less than $26,673 and a child lived with you (less than $9,230 if child didn't live with you), see "Earned Income Credit" on pg. 27. ▶	31	853,636

KFA — Form **1040** (1995)

"EXHIBIT 1"

Form 1040 (1995) Page 2

Tax Computation (See page 23.)	32 Amount from line 31 (adjusted gross income)	32	853,636
	33 a Check if: ☐ You were 65 or older, ☐ Blind; ☐ Spouse was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 33a		
	b If your parent (or someone else) can claim you as a dependent, check here ▶ 33b ☐		
	c If you are married filing separately and your spouse itemizes deductions or you are a dual-status alien, see page 23 and check here ▶ 33c ☐		
	34 Enter the larger of your: Itemized deductions from Schedule A, line 28, OR Standard deduction shown below for your filing status. But if you checked any box on line 33a or b, go to page 23 to find your standard deduction. If you checked box 33c, your standard deduction is zero. ● Single – $3,900 ● Married filing jointly or Qualifying widow(er) – $6,550 ● Head of household – $5,750 ● Married filing separately – $3,275	34	34,527
	35 Subtract line 34 from line 32	35	819,109
	36 If line 32 is $86,025 or less, multiply $2,500 by the total number of exemptions claimed on line 6e. If line 32 is over $86,025, see the worksheet on page 24 for the amount to enter	36	0
	37 Taxable income. Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	819,109
If you want the IRS to figure your tax, see page 35.	38 Tax. Check if from a ☐ Tax Table, b ☐ Tax Rate Schedules, c ☒ Capital Gain Tax Worksheet, or d ☐ Form 8615 (see page 24). Amount from Form(s) 8814 ▶ e	38	232,457
	39 Additional taxes. Check if from a ☐ Form 4970 b ☐ Form 4972	39	
	40 Add lines 38 and 39 ▶	40	232,457
Credits (See page 24.)	41 Credit for child and dependent care expenses. Att. Form 2441 — 41		
	42 Credit for the elderly or the disabled. Attach Schedule R — 42		
	43 Foreign tax credit. Attach Form 1116 — 43: 112		
	44 Other credits (see page 25). Check if from a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form — 44		
	45 Add lines 41 through 44	45	112
	46 Subtract line 45 from line 40. If line 45 is more than line 40, enter -0- ▶	46	232,345
Other Taxes (See page 25.)	47 Self-employment tax. Att. Sch. SE	47	
	48 Alternative minimum tax. Attach Form 6251	48	
	49 Recapture taxes. Check if from a ☐ Form 4255 b ☐ Form 8611 c ☐ Form 8828	49	
	50 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	50	
	51 Tax on qualified retirement plans, including IRAs. If required, attach Form 5329	51	
	52 Advance earned income credit payments from Form W-2	52	
	53 Household employment taxes. Attach Schedule H	53	
	54 Add lines 46 through 53. This is your total tax ▶	54	232,345
Payments Attach Forms W-2, W-2G, and 1099-R on the front.	55 Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐ — 55: 56,403		
	56 1995 estimated tax payments and amount applied from 1994 return — 56: 142,000		
	57 Earned income credit. Attach Schedule EIC if you have a qualifying child. Nontaxable earned income: amount ▶ and type ▶ NO — 57		
	58 Amount paid with Form 4868 (extension request) — 58		
	59 Excess social security and RRTA tax withheld (see page 32) — 59		
	60 Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136 — 60		
	61 Add lines 55 through 60. These are your total payments ▶	61	198,403
Refund or Amount You Owe	62 If line 61 is more than line 54, subtract line 54 from line 61. This is the amount you OVERPAID	62	
	63 Amount of line 62 you want REFUNDED TO YOU ▶	63	
	64 Amount of line 62 you want APPLIED TO 1996 ESTIMATED TAX ▶ 64		
	65 If line 54 is more than line 61, subtract line 61 from line 54. This is the AMOUNT YOU OWE. For details on how to pay and use Form 1040-V, Payment Voucher, see page 33 ▶	65	33,942
	66 Estimated tax penalty (see page 33). Also include on line 65 — 66		

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Keep a copy of this return for your records.

Your signature ▶ Date Your occupation: ACCOUNTANT

Spouse's signature. If a joint return, BOTH must sign. ▶ Date Spouse's occupation: BUYER

Paid Preparer's Use Only

Preparer's signature ▶ Abram J. Serotta, CPA Date Check if self-employed ☐ Preparer's social security no. 254-70-5976

Firm's name (or yours if self-employed) and address ▶ Serotta Maddocks Evans & Co., 701 Greene Street, Suite 200, Augusta, GA 30901 E.I. No. 58-1107697 ZIP code

SCHEDULES A&B (Form 1040)
Department of the Treasury Internal Revenue Service

Schedule A–Itemized Deductions

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
1995
Attachment Sequence No. 07

Name(s) shown on Form 1040 | Your social security number

Medical and Dental Expenses		Caution: Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A–1)	1			
	2	Enter amount from Form 1040, line 32 2				
	3	Multiply line 2 above by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter –0–			4	0
Taxes You Paid	5	State and local income taxes	5	33,938		
	6	Real estate taxes (see page A–2)	6	5,749		
	7	Personal property taxes	7	202		
(See page A–1.)	8	Other taxes – List type and amount ▶	8			
	9	Add lines 5 through 8			9	39,889
Interest You Paid	10	Home mortgage interest and points reported on Form 1098 . St . 3 . . .	10	5,776		
(See page A–2.)	11	Home mortgage interest not reported on Form 1098. If paid to the person from whom you bought the home, see page A–3 & show that person's name, ID no. & address ▶ SOUND PARTNERS 2ND HOME	11	1,135		
Note: Personal interest is not deductible.	12	Points not reported on Form 1098. See page A–3	12			
	13	Investment interest. If required, attach Form 4952. (See page A–3) . . . . . See . Statement . 4 .	13	4,925		
	14	Add lines 10 through 13			14	11,836
Gifts to Charity	15	Gifts by cash or check. If any gift of $250 or more, see pg. A–3 St . 5 .	15	3,565		
If you made a gift and got a benefit for it, see page A–3.	16	Other than by cash or check. If any gift of $250 or more, see page A–3. If over $500, you MUST attach Form 8283	16	1,405		
	17	Carryover from prior year	17			
	18	Add lines 15 through 17			18	4,970
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A–4.)			19	0
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses – job travel, union dues, job education, etc. If required, you MUST attach Form 2106 or 2106–EZ. (See page A–5.) ▶	20			
	21	Tax preparation fees	21			
(See page A–5 for expenses to deduct here.)	22	Other expenses – investment, safe deposit box, etc. List type and amount ▶	22			
	23	Add lines 20 through 22	23			
	24	Enter amount from Form 1040, line 32 24				
	25	Multiply line 24 above by 2% (.02)	25			
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter –0–			26	0
Other Miscellaneous Deductions	27	Other – from list on page A–5. List type and amount ▶			27	0
Total Itemized Deductions	28	Is Form 1040, line 32, over $114,700 (over $57,350 if married filing separately)? NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also enter on Form 1040, line 34, the larger of this amount or your standard deduction. YES. Your deduction may be limited. See page A–5 for the amount to enter.			28	34,527

NFA For Paperwork Reduction Act Notice, see Form 1040 Instructions. Schedule A (Form 1040) 1995

TOTAL 56691

Client

Deduction for Exemptions Worksheet (Form 1040)

1. $2,500 per exemption on Form 1040, 6e		5,000
2. Enter amount from Form 1040, line 32	853,636	
3. Threshold for your filing status	172,050	
4. Subtract line 3 from line 2	681,586	
NOTE: If line 4 is more than $122,500 ($61,250 if married filing separately), STOP HERE; you may not take a deduction for exemptions.		
5. Divide line 4 by $2,500 ($1,250 if MFS)	0	
6. Multiply line 5 by 2% (.02)		
7. Multiply line 1 by line 6		0
8. Deduction for Exemptions (Subtract line 7 from line 1)		0

Itemized Deductions Worksheet (Schedule A)

1. Add amounts on Schedule A, lines 4, 9, 14, 18, 19, 26, and 27		56,695
2. Add amounts on Schedule A, lines 4, 13, & 19, plus any gambling losses on line 27		4,925
3. Subtract line 2 from line 1		51,770
4. Multiply line 3 above by 80% (.80)	41,416	
5. Enter amount from Form 1040, line 32	853,636	
6. Enter $114,700 ($57,350 if MFS)	114,700	
7. Subtract line 6 from line 5	738,936	
8. Multiply line 7 above by 3% (.03)	22,168	
9. Enter the smaller of line 4 or line 8		22,168
10. Total Itemized Deductions (Subtract line 9 from line 1)		34,527

Client

Schedule D Tax Worksheet

1. Enter the amount from Form 1040, line 37.			819,109
2. Net capital gain. If filing Schedule D, enter the smaller of Schedule D line 17 or line 18. Otherwise, enter capital gain distributions from Form 1040, line 13.	591,817		
3. If you are filing Form 4952, enter the amount from Form 4952, line 4e.		0	
4. Subtract line 3 from line 2. If zero or less, stop here.			591,817
5. Subtract line 4 from line 1.			227,292
6. Enter: $23,350 if single; $39,000 if married filing jointly or qualifying widower; $19,500 if married filing separately; or $31,250 if head of household.			39,000
7. Enter the greater of line 5 or line 6.			227,292
8. Subtract line 7 from line 1.			591,817
9. Figure the tax on the amount on line 7. Use the Tax Table or Tax Rate Schedules.			66,748
10. Multiply line 8 by 28% (.28).			165,709
11. Add lines 9 and 10.			232,457
12. Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules.			300,056
13. Tax. Enter the smaller of line 11 or line 12 here and on Form 1040, line 38.			232,457

Gross Investment Income (Form 4952)

Interest Income	4,564
Dividend Income	9,940
Child's Investment Income - Form 8814	0
Gross Investment Income - Schedule C	0
Gross Investment Income - Schedule E	0
Publicly Traded Partnership Income	0
Other Net Investment Income - K-1	0
Gross Investment Income Adjustment	0

	14,504

Form 1040 (1995) JOE PUBLIC 999-99-9999 Page 2

Tax Computation (See page 23.)

32	Amount from line 31 (adjusted gross income)	32	45,000
33	a Check if: ☐ You were 65 or older, ☐ Blind; ☐ Spouse was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 33a		
	b If your parent (or someone else) can claim you as a dependent, check here ▶ 33b ☐		
	c If you are married filing separately and your spouse itemizes deductions or you are a dual-status alien, see page 23 and check here ▶ 33c ☐		
34	Enter the larger of your: **Itemized deductions** from Schedule A, line 28, OR **Standard deduction** shown below for your filing status. **But if you checked any box on line 33a or b**, go to page 23 to find your standard deduction. **If you checked box 33c**, your standard deduction is zero. ● Single – $3,900 ● Married filing jointly or Qualifying widow(er) – $6,550 ● Head of household – $5,750 ● Married filing separately – $3,275	34	3,275
35	Subtract line 34 from line 32	35	41,725
36	If line 32 is $86,025 or less, multiply $2,500 by the total number of exemptions claimed on line 6e. If line 32 is over $86,025, see the worksheet on page 24 for the amount to enter	36	22,500
37	**Taxable Income.** Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	19,225
38	Tax. Check if from a ☒ Tax Table, b ☐ Tax Rate Schedules, c ☐ Capital Gain Tax Worksheet, or d ☐ Form 8615 (see page 24). Amount from Form(s) 8814 ▶ e	38	2,884
39	Additional taxes. Check if from a ☐ Form 4970 b ☐ Form 4972	39	
40	Add lines 38 and 39 ▶	40	2,884

If you want the IRS to figure your tax, see page 35.

Credits (See page 24.)

41	Credit for child and dependent care expenses. Att. Form 2441	41			
42	Credit for the elderly or the disabled. Attach Schedule R	42			
43	Foreign tax credit. Attach Form 1116	43			
44	Other credits (see page 25). Check if from a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form	44			
45	Add lines 41 through 44			45	
46	Subtract line 45 from line 40. If line 45 is more than line 40, enter -0- ▶			46	2,884

Other Taxes (See page 25.)

47	Self-employment tax. Att. Sch. SE			47	
48	Alternative minimum tax. Attach Form 6251			48	2,966
49	Recapture taxes. Check if from a ☐ Form 4255 b ☐ Form 8611 c ☐ Form 8828			49	
50	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137			50	
51	Tax on qualified retirement plans, including IRAs. If required, attach Form 5329			51	
52	Advance earned income credit payments from Form W-2			52	
53	Household employment taxes. Attach Schedule H			53	
54	Add lines 46 through 53. This is your **total tax** ▶			54	5,850

Payments

Attach Forms W-2, W-2G, and 1099-R on the front.

55	Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐	55	5,500		
56	1995 estimated tax payments and amount applied from 1994 return	56			
57	**Earned income credit.** Attach Schedule EIC if you have a qualifying child. Nontaxable earned income: amount ▶ and type ▶	57			
58	Amount paid with Form 4868 (extension request)	58			
59	Excess social security and RRTA tax withheld (see page 32)	59			
60	Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136	60			
61	Add lines 55 through 60. These are your **total payments** ▶			61	5,500

Refund or Amount You Owe

62	If line 61 is more than line 54, subtract line 54 from line 61. This is the amount you **OVERPAID**			62	
63	Amount of line 62 you want **REFUNDED TO YOU** ▶			63	
64	Amount of line 62 you want **APPLIED TO 1996 ESTIMATED TAX** ▶	64			
65	If line 54 is more than line 61, subtract line 61 from line 54. This is the **AMOUNT YOU OWE.** For details on how to pay and use Form 1040-V, Payment Voucher, see page 33 ▶			65	350
66	Estimated tax penalty (see page 33). Also include on line 65	66			

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

(Keep a copy of this return for your records.)

Your signature	Date	Your occupation
		CLERGY
Spouse's signature. If a joint return, BOTH must sign.	Date	Spouse's occupation

Paid Preparer's Use Only

Preparer's signature ▶ Abram J. Serotta, CPA	Date	Check if self-employed ☐	Preparer's social security no. 254-70-5976
Firm's name (or yours if self-employed) and address ▶ Serotta Maddocks Evans & Co. 701 Greene Street, Suite 200 Augusta, GA		E.I. No. 58-1107697	ZIP code 30901

Form 1040 (1995) JOE PUBLIC 999-99-9999 Page 2

Tax Computation (See page 23.)	32 Amount from line 31 (adjusted gross income)	32	45,000
	33 a Check if: ☐ You were 65 or older, ☐ Blind; ☐ Spouse was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 33a		
	b If your parent (or someone else) can claim you as a dependent, check here ▶ 33b ☐		
	c If you are married filing separately and your spouse itemizes deductions or you are a dual-status alien, see page 23 and check here ▶ 33c ☐		
	34 Enter the larger of your: Itemized deductions from Schedule A, line 28, OR Standard deduction shown below for your filing status. But if you checked any box on line 33a or b, go to page 23 to find your standard deduction. If you checked box 33c, your standard deduction is zero. ● Single – $3,900 ● Married filing jointly or Qualifying widow(er) – $6,550 ● Head of household – $5,750 ● Married filing separately – $3,275	34	3,275
	35 Subtract line 34 from line 32	35	41,725
	36 If line 32 is $86,025 or less, multiply $2,500 by the total number of exemptions claimed on line 6e. If line 32 is over $86,025, see the worksheet on page 24 for the amount to enter	36	22,500
	37 Taxable income. Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	19,225
If you want the IRS to figure your tax, see page 35.	38 Tax. Check if from a ☒ Tax Table, b ☐ Tax Rate Schedules, c ☐ Capital Gain Tax Worksheet, or d ☐ Form 8615 (see page 24). Amount from Form(s) 8814 ▶ e	38	2,884
	39 Additional taxes. Check if from a ☐ Form 4970 b ☐ Form 4972	39	
	40 Add lines 38 and 39 ▶	40	2,884
Credits (See page 24.)	41 Credit for child and dependent care expenses. Att. Form 2441 — 41		
	42 Credit for the elderly or the disabled. Attach Schedule R — 42		
	43 Foreign tax credit. Attach Form 1116 — 43		
	44 Other credits (see page 25). Check if from a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form — 44		
	45 Add lines 41 through 44	45	
	46 Subtract line 45 from line 40. If line 45 is more than line 40, enter -0- ▶	46	2,884
Other Taxes (See page 25.)	47 Self-employment tax. Att. Sch. SE	47	
	48 Alternative minimum tax. Attach Form 6251	48	2,966
	49 Recapture taxes. Check if from a ☐ Form 4255 b ☐ Form 8611 c ☐ Form 8828	49	
	50 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	50	
	51 Tax on qualified retirement plans, including IRAs. If required, attach Form 5329	51	
	52 Advance earned income credit payments from Form W-2	52	
	53 Household employment taxes. Attach Schedule H	53	
	54 Add lines 46 through 53. This is your total tax ▶	54	5,850
Payments Attach Forms W-2, W-2G, and 1099-R on the front.	55 Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐ — 55 5,500		
	56 1995 estimated tax payments and amount applied from 1994 return — 56		
	57 Earned income credit. Attach Schedule EIC if you have a qualifying child. Nontaxable earned income: amount ▶ and type ▶ — 57		
	58 Amount paid with Form 4868 (extension request) — 58		
	59 Excess social security and RRTA tax withheld (see page 32) — 59		
	60 Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136 — 60		
	61 Add lines 55 through 60. These are your total payments ▶	61	5,500
Refund or Amount You Owe	62 If line 61 is more than line 54, subtract line 54 from line 61. This is the amount you OVERPAID	62	
	63 Amount of line 62 you want REFUNDED TO YOU ▶	63	
	64 Amount of line 62 you want APPLIED TO 1996 ESTIMATED TAX ▶ 64		
	65 If line 54 is more than line 61, subtract line 61 from line 54. This is the AMOUNT YOU OWE. For details on how to pay and use Form 1040-V, Payment Voucher, see page 33 ▶	65	350
	66 Estimated tax penalty (see page 33). Also include on line 65 — 66		

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature ▶ | Date | Your occupation: CLERGY

Keep a copy of this return for your records

Spouse's signature, if a joint return, BOTH must sign. | Date | Spouse's occupation

Paid Preparer's Use Only

Preparer's signature ▶ Abram J. Serotta, CPA | Date | Check if self-employed ☐ | Preparer's social security no. 254-70-5976

Firm's name (or yours if self-employed) and address ▶ Serotta Maddocks Evans & Co., 701 Greene Street, Suite 200, Augusta, GA | E.I. No. 58-1107697 | ZIP code 30901 *

Form 6251

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax – Individuals

▶ See separate instructions.
▶ Attach to Form 1040, Form 1040NR, or Form 1040-T.

OMB No 1545-0227

1995

Attachment Sequence No. 32

Name(s) shown on Form 1040: JOE PUBLIC

Your social security number: 999-99-9999

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040) (or you entered the amount from Form 1040-T, Section B, line t, on Form 1040-T, line 20), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 34 (or Form 1040-T, line 20), and go to line 6	1	3,275
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 or 2 1/2% of Form 1040, line 32 (Form 1040-T filers, enter the smaller of Section B, line c or 2 1/2% of Form 1040-T, line 16)	2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9 (or the total of lines d through g of Form 1040-T, Section B)	3	
4	Certain interest on a home mortgage not used to buy, build, or improve your home	4	
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26 (or Form 1040-T, Section B, line r)	5	
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	( )
7	Investment interest. Enter difference between regular tax and AMT deduction	7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 8	12	
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item and enter the total on line 14.		
	a Charitable contributions		
	b Circulation expenditures		
	c Depletion		
	d Depreciation (pre-1987)		
	e Installment sales		
	f Intangible drilling costs		
	g Long-term contracts		
	h Loss limitations		
	i Mining costs		
	j Patrons adjustment		
	k Pollution control facilities		
	l Research and experimental		
	m Tax shelter farm activities		
	n Related adjustments	14	
15	Total Adjustments and Preferences. Combine lines 1 through 14 ▶	15	3,275

Part II Alternative Minimum Taxable Income

16	Enter the amount from Form 1040, line 35 (or Form 1040-T, line 21). If less than zero, enter as a (loss) ▶	16	41,725
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 32 (or Form 1040-T, line 16), is over $114,700 (over $57,350 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28 (or line 9 of the worksheet for Section B, line t, of Form 1040-T)	18	( )
19	Combine lines 15 through 18 ▶	19	45,000
20	Alternative tax net operating loss deduction. See page 5 of the instructions	20	
21	Alternative Minimum Taxable Income. Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 5 of the instructions.) ▶	21	45,000

Part III Exemption Amount and Alternative Minimum Tax

22 Exemption Amount. (If this form is for a child under age 14, see page 6 of the instructions.)

If your filing status is:	And line 21 is not over:	Enter on line 22:
Single or head of household	$112,500	$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

If line 21 is over the amount shown above for your filing status, see page 6 of the instructions.

22		22	22,500
23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 ▶	23	22,500
24	If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result	24	5,850
25	Alternative minimum tax foreign tax credit. See page 6 of the instructions	25	
26	Tentative minimum tax. Subtract line 25 from line 24 ▶	26	5,850
27	Enter your tax from Form 1040, line 38 (plus any amount from Form 4970 included on Form 1040, line 39), minus any foreign tax credit from Form 1040, line 43 (Form 1040-T filers, enter the amount from Form 1040-T, line 26)	27	2,884
28	Alternative Minimum Tax. (If this form is for a child under age 14, see page 7 of the instructions.) Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 46 (or Form 1040-T, line 31) ▶	28	2,966

A For Paperwork Reduction Act Notice, see separate instructions.

1995	Federal Statements	Page 1
Client 1	JOE PUBLIC	999-99-9999

Statement 1
Form 1040
Wages

Wages Taxpayer - Employer	Wages	Federal W/H	FICA	Medi Care	State W/H	Local W/H
ANYJOB	45,000	5,500				
Totals	45,000	5,500	0	0	0	0

Statement 2
Form 1040, Line 6c
Dependents

DEMO

Dependent's Name	Soc Sec #	Relationship	Months
AMY PUBLIC	888-88-8889		12
BARRY PUBLIC	888-88-8887		12
CAROL PUBLIC	888-88-8886		12
DAVID PUBLIC	888-88-8885		12
EVAN PUBLIC	888-88-8884		12
FRANK PUBLIC	888-88-8883		12
GUY PUBLIC	888-88-8883		12
HANK PUBLIC	888-88-8882		12

FORM **1040** Department of the Treasury – Internal Revenue Service

U.S. Individual Income Tax Return 1995

IRS Use Only – Do not write or staple in this space.

For the year Jan. 1 – Dec. 31, 1995, or other tax year beginning , 1995, ending , 19 OMB No. 1545-0074

Label (See instructions on page 11.) Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial: JOE PUBLIC — Last name:

Your social security number: 999-99-9999

If a joint return, spouse's first name and initial: — Last name:

Spouse's social security number: 888-88-8888

Home address (number and street). If you have a P.O. box, see page 11. — Apt. no.: 1 ANYSTREET

City, town or post office, state, and ZIP code. If you have a foreign address, see page 11.: AUGUSTA, GA 30901

For Privacy Act and Paperwork Reduction Act Notice, see page 7.

Presidential Election Campaign (See page 11.)

	Yes	No
Do you want $3 to go to this fund?		X
If a joint return, does your spouse want $3 to go to this fund?		

Note: Checking "Yes" will not change your tax or reduce your refund.

Filing Status (See page 11.) Check only one box.

1 [ ] Single

2 [ ] Married filing joint return (even if only one had income)

3 [X] Married filing separate return. Enter spouse's soc. sec. no. above & full name here ▶ QUIET PUBLIC

4 [ ] Head of household (with qualifying person). (See page 12.) If the qualifying person is a child but not your dependent, enter this child's name here ▶

5 [ ] Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 12.)

Exemptions (See page 12.)

6a [X] **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a. But be sure to check the box on line 33b on page 2.

b [ ] **Spouse**

No. of boxes checked on 6a and 6b: 1

c **Dependents:**

(1) First Name Last Name	(2) Dependent's social security number. If born in 1996, see page 13.	(3) Dependent's relationship to you	(4) No. of mos. lived in your home in 1995
AMY PUBLIC	888-88-8889		12
BARRY PUBLIC	888-88-8887		12
CAROL PUBLIC	888-88-8886		12
DAVID PUBLIC	888-88-8885		12

If more than six dependents, see page 13.

No. of your children on 6c who:
- lived with you: 4
- didn't live with you due to divorce or separation (see page 14)

Dependents on 6c not entered above

d If your child didn't live with you but is claimed as your dep. under pre-1985 agreement, check ▶ [ ]

e Total number of exemptions claimed

Add numbers entered on lines above ▶ 5

Income

Attach copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see page 14.

Enclose, but do not attach, your payment and payment voucher. See page 33.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	45,000
8a	Taxable interest income (see page 15). Attach Schedule B if over $400	8a	
b	Tax-exempt interest (see page 15). DON'T include on line 8a. 8b		
9	Dividend income. Attach Schedule B if over $400	9	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 15)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). If required, attach Schedule D	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	Total IRA distributions 15a — b Taxable amount (pg. 16)	15b	
16a	Total pensions and annuities 16a — b Taxable amount (pg. 16)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation (see page 17)	19	
20a	Social security benefits 20a — b Taxable amount (pg. 18)	20b	
21	Other income	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	45,000

Adjustments to Income

23a	Your IRA deduction (see page 19)	23a		
b	Spouse's IRA deduction (see page 19)	23b		
24	Moving expenses. Attach Form 3903 or 3903-F	24		
25	One-half of self-employment tax	25		
26	Self-employed health insurance deduction (see page 21)	26		
27	Keogh & self-employed SEP plans. If SEP, check ▶ [ ]	27		
28	Penalty on early withdrawal of savings	28		
29	Alimony paid. Recipient's SSN ▶	29		
30	Add lines 23a through 29. These are your **total adjustments** ▶		30	0

Adjusted Gross Income

31	Subtract line 30 from line 22. This is your **adjusted gross income**. If less than $26,673 and a child lived with you (less than $9,230 if child didn't live with you), see "Earned Income Credit" on pg. 27. ▶	31	45,000

Form 1040 (1995) JOE PUBLIC 999-99-9999 Page 2

Tax Computation (See page 23.)

32	Amount from line 31 (adjusted gross income)	32	45,000
33	a Check if: ☐ You were 65 or older, ☐ Blind; ☐ Spouse was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 33a		
	b If your parent (or someone else) can claim you as a dependent, check here ▶ 33b ☐		
	c If you are married filing separately and your spouse itemizes deductions or you are a dual-status alien, see page 23 and check here ▶ 33c ☐		
34	Enter the larger of your: Itemized deductions from Schedule A, line 28, OR Standard deduction shown below for your filing status. But if you checked any box on line 33a or b, go to page 23 to find your standard deduction. If you checked box 33c, your standard deduction is zero. ● Single - $3,900 ● Married filing jointly or Qualifying widow(er) - $6,550 ● Head of household - $5,750 ● Married filing separately - $3,275	34	3,275
35	Subtract line 34 from line 32	35	41,725
36	If line 32 is $86,025 or less, multiply $2,500 by the total number of exemptions claimed on line 6e. If line 32 is over $86,025, see the worksheet on page 24 for the amount to enter	36	12,500
37	**Taxable income.** Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	29,225
38	Tax. Check if from a ☒ Tax Table, b ☐ Tax Rate Schedules, c ☐ Capital Gain Tax Worksheet, or d ☐ Form 8615 (see page 24). Amount from Form(s) 8814 ▶ e	38	5,648
39	Additional taxes. Check if from a ☐ Form 4970 b ☐ Form 4972	39	
40	Add lines 38 and 39 ▶	40	5,648

If you want the IRS to figure your tax, see page 35.

Credits (See page 24.)

41	Credit for child and dependent care expenses. Att. Form 2441	41		
42	Credit for the elderly or the disabled. Attach Schedule R	42		
43	Foreign tax credit. Attach Form 1116	43		
44	Other credits (see page 26). Check if from a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form	44		
45	Add lines 41 through 44		45	
46	Subtract line 45 from line 40. If line 45 is more than line 40, enter -0- ▶		46	5,648

Other Taxes (See page 25.)

47	Self-employment tax. Att. Sch. SE	47	
48	Alternative minimum tax. Attach Form 6251	48	202
49	Recapture taxes. Check if from a ☐ Form 4255 b ☐ Form 8611 c ☐ Form 8828	49	
50	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	50	
51	Tax on qualified retirement plans, including IRAs. If required, attach Form 5329	51	
52	Advance earned income credit payments from Form W-2	52	
53	Household employment taxes. Attach Schedule H	53	
54	Add lines 46 through 53. This is your **total tax** ▶	54	5,850

Payments

Attach Forms W-2, W-2G, and 1099-R on the front.

55	Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐	55	2,500	
56	1995 estimated tax payments and amount applied from 1994 return	56		
57	**Earned income credit.** Attach Schedule EIC if you have a qualifying child. Nontaxable earned income: amount ▶ and type ▶	57		
58	Amount paid with Form 4868 (extension request)	58		
59	Excess social security and RRTA tax withheld (see page 32)	59		
60	Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136	60		
61	Add lines 55 through 60. These are your **total payments** ▶		61	2,500

Refund or Amount You Owe

62	If line 61 is more than line 54, subtract line 54 from line 61. This is the amount you **OVERPAID**	62	
63	Amount of line 62 you want **REFUNDED TO YOU** ▶	63	
64	Amount of line 62 you want **APPLIED TO 1996 ESTIMATED TAX** ▶ 64		
65	If line 54 is more than line 61, subtract line 61 from line 54. This is the **AMOUNT YOU OWE.** For details on how to pay and use Form 1040-V, Payment Voucher, see page 33 ▶	65	3,518
66	**Estimated tax penalty** (see page 33). Also include on line 65 66 168		

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Keep a copy of this return for your records.

Your signature	Date	Your occupation
		CLERGY
Spouse's signature. If a joint return, BOTH must sign.	Date	Spouse's occupation

Paid Preparer's Use Only

Preparer's signature ▶ Abram J. Serotta, CPA	Date	Check if self-employed ☐	Preparer's social security no. 254-70-5976
Firm's name (or yours if self-employed) and address ▶ Serotta Maddocks Evans & Co. 701 Greene Street, Suite 200 Augusta, GA		E.I. No. 58-1107697	ZIP code 30901 *

Form **6251** — Department of the Treasury, Internal Revenue Service

Alternative Minimum Tax – Individuals

▶ See separate instructions.
▶ Attach to Form 1040, Form 1040NR, or Form 1040-T.

OMB No. 1545-0227
1995
Attachment Sequence No. **32**

Name(s) shown on Form 1040: JOE PUBLIC

Your social security number: 999-99-9999

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040) (or you entered the amount from Form 1040-T, Section B, line 1, on Form 1040-T, line 20), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 34 (or Form 1040-T, line 20), and go to line 6	1	3,275
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 or 2 1/2% of Form 1040, line 32 (Form 1040-T filers, enter the smaller of Section B, line c or 2 1/2% of Form 1040-T, line 16)	2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9 (or the total of lines d through g of Form 1040-T, Section B)	3	
4	Certain interest on a home mortgage not used to buy, build, or improve your home	4	
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26 (or Form 1040-T, Section B, line r)	5	
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	( )
7	Investment interest. Enter difference between regular tax and AMT deduction	7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 5	12	
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item and enter the total on line 14. a Charitable contributions b Circulation expenditures c Depletion d Depreciation (pre-1987) e Installment sales f Intangible drilling costs g Long-term contracts h Loss limitations i Mining costs j Patrons adjustment k Pollution control facilities l Research and experimental m Tax shelter farm activities n Related adjustments	14	
15	**Total Adjustments and Preferences.** Combine lines 1 through 14 ▶	15	3,275

Part II Alternative Minimum Taxable Income

16	Enter the amount from Form 1040, line 35 (or Form 1040-T, line 21). If less than zero, enter as a (loss) ▶	16	41,725
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 32 (or Form 1040-T, line 16), is over $114,700 (over $57,350 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28 (or line 9 of the worksheet for Section B, line l, of Form 1040-T)	18	( )
19	Combine lines 15 through 18 ▶	19	45,000
20	Alternative tax net operating loss deduction. See page 5 of the instructions	20	
21	**Alternative Minimum Taxable Income.** Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 5 of the instructions.) ▶	21	45,000

Part III Exemption Amount and Alternative Minimum Tax

22 **Exemption Amount.** (If this form is for a child under age 14, see page 6 of the instructions.)

If your filing status is:	And line 21 is not over:	Enter on line 22:
Single or head of household	$112,500	$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

If line 21 is over the amount shown above for your filing status, see page 6 of the instructions. — 22: 22,500

23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 ▶	23	22,500
24	If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result	24	5,850
25	Alternative minimum tax foreign tax credit. See page 6 of the instructions	25	
26	Tentative minimum tax. Subtract line 25 from line 24 ▶	26	5,850
27	Enter your tax from Form 1040, line 38 (plus any amount from Form 4970 included on Form 1040, line 39), minus any foreign tax credit from Form 1040, line 43 (Form 1040-T filers, enter the amount from Form 1040-T, line 26)	27	5,648
28	**Alternative Minimum Tax.** (If this form is for a child under age 14, see page 7 of the instructions.) Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 48 (or Form 1040-T, line 31) ▶	28	202

FA **For Paperwork Reduction Act Notice, see separate instructions.**

Form **6251** (1995)

Client 1 JOE PUBLIC 999-99-9999

Statement 1
Form 1040
Wages

Wages Taxpayer - Employer	Wages	Federal W/H	FICA	Medi Care	State W/H	Local W/H
ANYJOB	45,000	2,500				
Totals	45,000	2,500	0	0	0	0

DEMO

FORM **1040** Department of the Treasury - Internal Revenue Service
U.S. Individual Income Tax Return 1995

IRS Use Only - Do not write or staple in this space.

For the year Jan. 1 - Dec. 31, 1995, or other tax year beginning , 1995, ending , 19 OMB No. 1545-0074

Label (See instructions on page 11.) Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial | Last name | Your social security number

If a joint return, spouse's first name and initial | Last name | Spouse's social security number

Home address (number and street). If you have a P.O. box, see page 11. | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, see page 11.

For Privacy Act and Paperwork Reduction Act Notice, see page 7.

Presidential Election Campaign (See page 11.)

	Yes	No
Do you want $3 to go to this fund?		X
If a joint return, does your spouse want $3 to go to this fund?		X

Note: Checking "Yes" will not change your tax or reduce your refund.

Filing Status (See page 11.) Check only one box.

1 [ ] Single
2 [X] Married filing joint return (even if only one had income)
3 [ ] Married filing separate return. Enter spouse's soc. sec. no. above & full name here ▶
4 [ ] Head of household (with qualifying person). (See page 12.) If the qualifying person is a child but not your dependent, enter this child's name here ▶
5 [ ] Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 12.)

Exemptions (See page 12.)

6a [X] Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, do not check box 6a. But be sure to check the box on line 33b on page 2.
b [X] Spouse

No. of boxes checked on 6a and 6b: 2

c Dependents:

(1) First name Last name	(2) Dependent's social security number. If born in 1995, see page 13.	(3) Dependent's relationship to you	(4) No. of mos. lived in your home in 1995
		Child	12
		Child	12

If more than six dependents, see page 13.

No. of your children on 6c who:
● lived with you: 2
● didn't live with you due to divorce or separation (see page 14):
Dependents on 6c not entered above:

d If your child didn't live with you but is claimed as your dep. under pre-1985 agreement, check ▶ [ ]
e Total number of exemptions claimed. Add numbers entered on lines above ▶ 4

Income

Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see page 14.

Enclose, but do not attach, your payment and payment voucher. See page 33.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	93,870
8a	Taxable interest income (see page 15). Attach Schedule B if over $400		8a	271
b	Tax-exempt interest (see page 15). DON'T include on line 8a. St. . 2 .	8b 5,611		
9	Dividend income. Attach Schedule B if over $400		9	959
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 15)		10	3,130
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). If required, attach Schedule D		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	Total IRA distributions	15a	b Taxable amount (pg. 16)	15b
16a	Total pensions and annuities	16a	b Taxable amount (pg. 16)	16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation (see page 17)		19	
20a	Social security benefits	20a	b Taxable amount (pg. 18)	20b
21	Other income.		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	98,230

Adjustments to Income

23a	Your IRA deduction (see page 19)	23a		
b	Spouse's IRA deduction (see page 19)	23b		
24	Moving expenses. Attach Form 3903 or 3903-F	24		
25	One-half of self-employment tax	25		
26	Self-employed health insurance deduction (see page 21)	26		
27	Keogh & self-employed SEP plans. If SEP, check ▶ [ ]	27		
28	Penalty on early withdrawal of savings	28		
29	Alimony paid. Recipient's SSN ▶	29		
30	Add lines 23a through 29. These are your **total adjustments** ▶		30	0

Adjusted Gross Income

31	Subtract line 30 from line 22. This is your **adjusted gross income**. If less than $26,673 and a child lived with you (less than $9,230 if child didn't live with you), see "Earned Income Credit" on pg. 27. ▶	31	98,230

KFA

"EXHIBIT 3"

Form 1040 (1995) Page 2

Tax, Computation (See page 23.)	32 Amount from line 31 (adjusted gross income)	32	98,230
	33 a Check if: ☐ You were 65 or older, ☐ Blind; ☐ Spouse was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 33a		
	b If your parent (or someone else) can claim you as a dependent, check here ▶ 33b ☐		
	c If you are married filing separately and your spouse itemizes deductions or you are a dual-status alien, see page 23 and check here ▶ 33c ☐		
	34 Enter the larger of your: Itemized deductions from Schedule A, line 28, OR Standard deduction shown below for your filing status. But if you checked any box on line 33a or b, go to page 23 to find your standard deduction. If you checked box 33c, your standard deduction is zero. ● Single – $3,900 ● Married filing jointly or Qualifying widow(er) – $6,550 ● Head of household – $5,750 ● Married filing separately – $3,275	34	42,654
	35 Subtract line 34 from line 32	35	55,576
	36 If line 32 is $88,025 or less, multiply $2,500 by the total number of exemptions claimed on line 6e. If line 32 is over $88,025, see the worksheet on page 24 for the amount to enter	36	10,000
	37 Taxable income. Subtract line 36 from line 35. If line 36 is more than line 35, enter -0-	37	45,576
If you want the IRS to figure your tax, see page 25.	38 Tax. Check if from a ☒ Tax Table, b ☐ Tax Rate Schedules, c ☐ Capital Gain Tax Worksheet, or d ☐ Form 8615 (see page 24). Amount from Form(s) 8814 ▶ e	38	7,691
	39 Additional taxes. Check if from a ☐ Form 4970 b ☐ Form 4972	39	
	40 Add lines 38 and 39 ▶	40	7,691
Credits (See page 24.)	41 Credit for child and dependent care expenses. Att. Form 2441 — 41		
	42 Credit for the elderly or the disabled. Attach Schedule R — 42		
	43 Foreign tax credit. Attach Form 1116 — 43		
	44 Other credits (see page 25). Check if from a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form ____ — 44		
	45 Add lines 41 through 44	45	
	46 Subtract line 45 from line 40. If line 45 is more than line 40, enter -0- ▶	46	7,691
Other Taxes (See page 25.)	47 Self-employment tax. Att. Sch. SE	47	
	48 Alternative minimum tax. Attach Form 6251	48	1,982
	49 Recapture taxes. Check if from a ☐ Form 4255 b ☐ Form 8611 c ☐ Form 8828	49	
	50 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	50	
	51 Tax on qualified retirement plans, including IRAs. If required, attach Form 5329	51	
	52 Advance earned income credit payments from Form W-2	52	
	53 Household employment taxes. Attach Schedule H	53	
	54 Add lines 46 through 53. This is your total tax ▶	54	9,673
Payments Attach Forms W-2, W-2G, and 1099-R on the front.	55 Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐ — 55: 17,944		
	56 1995 estimated tax payments and amount applied from 1994 return — 56		
	57 Earned income credit. Attach Schedule EIC if you have a qualifying child. Nontaxable earned income: amount ▶ ____ and type ▶ NO — 57		
	58 Amount paid with Form 4868 (extension request) — 58		
	59 Excess social security and RRTA tax withheld (see page 32) — 59		
	60 Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136 — 60		
	61 Add lines 55 through 60. These are your total payments ▶	61	17,944
Refund or Amount You Owe	62 If line 61 is more than line 54, subtract line 54 from line 61. This is the amount you OVERPAID	62	8,271
	63 Amount of line 62 you want REFUNDED TO YOU ▶	63	8,271
	64 Amount of line 62 you want APPLIED TO 1996 ESTIMATED TAX ▶ 64		
	65 If line 54 is more than line 61, subtract line 61 from line 54. This is the AMOUNT YOU OWE. For details on how to pay and use Form 1040-V, Payment Voucher, see page 33 ▶	65	
	66 Estimated tax penalty (see page 33). Also include on line 65 — 66		

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Keep a copy of this return for your records.

Your signature	Date	Your occupation
▶		SERVICE-INS
Spouse's signature. If a joint return, BOTH must sign.	Date	Spouse's occupation
▶		HOUSEWIFE

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's social security no.
▶ Abram J. Serotta, CPA			254-70-5976
Firm's name (or yours if self-employed) and address ▶ Serotta Maddocks Evans & Co. 701 Greene Street, Suite 200 Augusta, GA		E.I. No. 58-1107697	ZIP code 30901

SCHEDULES A&B (Form 1040)
Department of the Treasury
Internal Revenue Service

Schedule A–Itemized Deductions

▶ Attach to Form 1040. ▶ See instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
1995
Attachment Sequence No. 07

Name(s) shown on Form 1040 | Your social security number

Medical and Dental Expenses		Caution: Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A–1)	1			
	2	Enter amount from Form 1040, line 32 2				
	3	Multiply line 2 above by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter –0–			4	0
Taxes You Paid (See page A–1.)	5	State and local income taxes	5	5,923		
	6	Real estate taxes (see page A–2)	6	1,736		
	7	Personal property taxes	7	1,459		
	8	Other taxes – List type and amount ▶	8			
	9	Add lines 5 through 8			9	9,118
Interest You Paid (See page A–2.) Note: Personal interest is not deductible	10	Home mortgage interest and points reported on Form 1098 . . St . 3 . . .	10	7,413		
	11	Home mortgage interest not reported on Form 1098. If paid to the person from whom you bought the home, see page A–3 & show that person's name, ID no. & address ▶ SARA AND JOSEPH STRAUSS NOT SELEER FINANCED MTG	11			
	12	Points not reported on Form 1098. See page A–3	12			
	13	Investment interest. If required, attach Form 4952. (See page A–3)	13			
	14	Add lines 10 through 13			14	7,413
Gifts to Charity If you made a gift and got a benefit for it, see page A–3.	15	Gifts by cash or check. If any gift of $250 or more, see pg. A–3 St . 4 .	15	5,297		
	16	Other than by cash or check. If any gift of $250 or more, see page A–3. If over $500, you MUST attach Form 8283 See . Stmt . 5	16	185		
	17	Carryover from prior year	17			
	18	Add lines 15 through 17			18	5,482
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A–4.)			19	0
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses – job travel, union dues, job education, etc. If required, you MUST attach Form 2106 or 2106–EZ. (See page A–5.) ▶ Form 2106 (Taxpayer) 22,136	20	22,136		
	21	Tax preparation fees	21	300		
(See page A–5 for expenses to deduct here.)	22	Other expenses – investment, safe deposit box, etc. List type and amount ▶ INVESTMENT EXPENSES 115; Safe Deposit Box Rental 55	22	170		
	23	Add lines 20 through 22	23	22,606		
	24	Enter amount from Form 1040, line 32 . . . . 24 98,230				
	25	Multiply line 24 above by 2% (.02)	25	1,965		
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter –0–			26	20,641
Other Miscellaneous Deductions	27	Other – from list on page A–5. List type and amount ▶			27	0
Total Itemized Deductions	28	Is Form 1040, line 32, over $114,700 (over $57,350 if married filing separately)? NO. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also enter on Form 1040, line 34, the larger of this amount or your standard deduction. YES. Your deduction may be limited. See page A–5 for the amount to enter.			28	42,654

Form **6251**

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax – Individuals

▶ See separate instructions.
▶ Attach to Form 1040, Form 1040NR, or Form 1040-T.

OMB No. 1545-0227

1995

Attachment Sequence No. **32**

Name(s) shown on Form 1040 | Your social security number

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040) (or you entered the amount from Form 1040-T, Section B, line t, on Form 1040-T, line 20), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 34 (or Form 1040-T, line 20), and go to line 6	1	
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 or 2 1/2% of Form 1040, line 32 (Form 1040-T filers, enter the smaller of Section B, line c or 2 1/2% of Form 1040-T, line 16)	2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9 (or the total of lines d through g of Form 1040-T, Section B)	3	9,118
4	Certain interest on a home mortgage not used to buy, build, or improve your home	4	
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26 (or Form 1040-T, Section B, line r)	5	20,641
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	(3,130)
7	Investment interest. Enter difference between regular tax and AMT deduction	7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 8	12	
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item and enter the total on line 14.		
	a Charitable contributions; b Circulation expenditures; c Depletion; d Depreciation (pre-1987); e Installment sales; f Intangible drilling costs; g Long-term contracts; h Loss limitations; i Mining costs; j Patron's adjustment; k Pollution control facilities; l Research and experimental; m Tax shelter farm activities; n Related adjustments	14	
15	**Total Adjustments and Preferences.** Combine lines 1 through 14 ▶	15	26,629

Part II Alternative Minimum Taxable Income

16	Enter the amount from Form 1040, line 35 (or Form 1040-T, line 21). If less than zero, enter as a (loss) ▶	16	55,576
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 32 (or Form 1040-T, line 16), is over $114,700 (over $57,350 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28 (or line 9 of the worksheet for Section B, line l, of Form 1040-T)	18	( )
19	Combine lines 16 through 18 ▶	19	82,205
20	Alternative tax net operating loss deduction. See page 5 of the instructions	20	
21	**Alternative Minimum Taxable Income.** Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 5 of the instructions.) ▶	21	82,205

Part III Exemption Amount and Alternative Minimum Tax

22	**Exemption Amount.** (If this form is for a child under age 14, see page 6 of the instructions.)		
	If your filing status is: / **And line 21 is not over:** / **Enter on line 22:**		
	Single or head of household: $112,500 / $33,750		
	Married filing jointly or qualifying widow(er): 150,000 / 45,000	22	45,000
	Married filing separately: 75,000 / 22,500		
	If line 21 is over the amount shown above for your filing status, see page 6 of the instructions.		
23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 29 ▶	23	37,205
24	If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result	24	9,673
25	Alternative minimum tax foreign tax credit. See page 6 of the instructions	25	
26	Tentative minimum tax. Subtract line 25 from line 24 ▶	26	9,673
27	Enter your tax from Form 1040, line 38 (plus any amount from Form 4970 included on Form 1040, line 39), minus any foreign tax credit from Form 1040, line 43 (Form 1040-T filers, enter the amount from Form 1040-T, line 26)	27	7,691
28	**Alternative Minimum Tax.** (If this form is for a child under age 14, see page 7 of the instructions.) Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 48 (or Form 1040-T, line 31) ▶	28	1,982

KFA **For Paperwork Reduction Act Notice, see separate instructions.**

Form **2106**

Department of the Treasury
Internal Revenue Service (99)

Employee Business Expenses

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1040–T.

OMB No. 1545-0139

1995

Attachment Sequence No. **54**

Your name	Social security number	Occupation in which expenses were incurred
		SALES -OUTSIDE

Part I **Employee Business Expenses and Reimbursements**

STEP 1 Enter Your Expenses		Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29	1	12,786	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel	2	110	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	2,367	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment. See Stmt 6	4	4,765	
5 Meals and entertainment expenses (see instructions)	5		4,216
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6	20,028	4,216

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

STEP 2 Enter Amounts Your Employer Gave You for Expenses Listed in STEP 1

7 Enter amounts your employer gave you that were not reported to you in box 1 of Form W-2. Include any amount reported under code "L" in box 13 of your Form W-2 (see instructions)	7		

STEP 3 Figure Expenses To Deduct on Schedule A (Form 1040) or Form 1040–T, Section B

8 Subtract line 7 from line 6	8	20,028	4,216
Note: If both columns of line 8 are zero, stop here. If Column A is less than zero, report the amount as income on Form 1040, line 7, or Form 1040–T, line 1.			
9 In Column A, enter the amount from line 8. (If zero or less, enter –0–). In Column B, multiply the amount on line 8 by 50% (.50)	9	20,028	2,108
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 20, or Form 1040–T, Section B, line n. (Qualified performing artists and individuals with disabilities, see the instructions for special rules on where to enter the total.) ▶	10		22,136

For Paperwork Reduction Act Notice, see instructions.

Form **2106** (1995)

Part II **Vehicle Expenses** (See instructions to find out which sections to complete.)

Section A. – General Information

			(a) Vehicle 1	(b) Vehicle 2
11	Enter the date vehicle was placed in service	11	4/01/90	
12	Total miles vehicle was driven during 1995	12	39,103 miles	miles
13	Business miles included on line 12	13	36,745 miles	miles
14	Percent of business use. Divide line 13 by line 12	14	93.97 %	%
15	Average daily round trip commuting distance	15	miles	miles
16	Commuting miles included on line 12	16	miles	miles
17	Other personal miles. Add lines 13 and 16 and subtract the total from line 12	17	2,358 miles	miles

18 Do you (or your spouse) have another vehicle available for personal purposes? ☒ Yes ☐ No

19 If your employer provided you with a vehicle, is personal use during off-duty hours permitted? ☐ Yes ☐ No ☒ Not applicable

20 Do you have evidence to support your deduction? ☒ Yes ☐ No

21 If "Yes," is the evidence written? ☒ Yes ☐ No

Section B. – Standard Mileage Rate (Use this section only if you own the vehicle.)

22 Multiply line 13 by $0.30 (.30). Enter the result here and on line 1. (Rural mail carriers, see instructions.) 22

Section C. – Actual Expenses

		(a) Vehicle 1		(b) Vehicle 2	
23 Gasoline, oil, repairs, vehicle insurance, etc.	23		4,541		
24a Vehicle rentals	24a	9,545			
b Inclusion amount (see instructions)	24b	480			
c Subtract line 24b from line 24a	24c		9,065		
25 Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2 – see instrs.)	25				
26 Add lines 23, 24c, and 25	26		13,606		
27 Multiply line 26 by the percentage on line 14	27		12,786		
28 Depreciation. Enter amount from line 38 below	28				
29 Add lines 27 and 28. Enter total here and on line 1	29		12,786		

Section D. – Depreciation of Vehicles (Use this section only if you own the vehicle.)

		(a) Vehicle 1		(b) Vehicle 2	
30 Enter cost or other basis (see instructions)	30				
31 Enter amount of section 179 deduction (see instructions)	31				
32 Multiply line 30 by line 14 (see instructions if you elected the section 179 deduction)	32				
33 Enter depreciation method and percentage (see instructions)	33				
34 Multiply line 32 by the percentage on line 33 (see instructions)	34				
35 Add lines 31 and 34	35				
36 Enter the limitation amount from the table in the line 36 instructions	36				
37 Multiply line 36 by the percentage on line 14	37				
38 Enter the smaller of line 35 or line 37. Also, enter this amount on line 28 above	38				

Form **8801**

Department of the Treasury
Internal Revenue Service

Credit For Prior Year Minimum Tax– Individuals, Estates, and Trusts

▶ Attach to your tax return.

OMB No. 1545-1073

1995

Attachment Sequence No. 74

Name(s) shown on return | Identifying number

Part I Net Minimum Tax on Exclusion Items

1	Combine lines 16 through 18 of your 1994 Form 6251. Estates and trusts, see instructions	1	55,653
2	Enter adjustments and preferences treated as exclusion items. See instructions	2	35,062
3	Minimum tax credit net operating loss deduction. See instructions	3	( )
4	Combine lines 1, 2, and 3. If zero or less, enter –0– here and on line 15 and go to Part II. If more than $165,000 and you were married filing separately for 1994, see instructions	4	90,715
5	Enter $45,000 ($33,750 if single or head of household for 1994, $22,500 if married filing separately for 1994). Estates and trusts, enter $22,500	5	45,000
6	Enter $150,000 ($112,500 if single or head of household for 1994, $75,000 if married filing separately for 1994). Estates and trusts, enter $75,000	6	150,000
7	Subtract line 6 from line 4. If zero or less, enter –0– here and on line 8 and go to line 9	7	0
8	Multiply line 7 by 25% (.25)	8	
9	Subtract line 8 from line 5. If zero or less, enter –0–. If this form is for a child under age 14, see instructions	9	45,000
10	Subtract line 9 from line 4. If zero or less, enter –0– here and on line 15, and go to Part II. Form 1040NR filers, see instructions	10	45,715
11	If line 10 is $175,000 or less ($87,500 or less if married filing separately for 1994), multiply line 10 by 26% (.26). Otherwise, multiply line 10 by 28% (.28), and subtract $3,500 ($1,750 if married filing separately for 1994) from the result	11	11,886
12	Minimum tax foreign tax credit on exclusion items. See instructions	12	
13	Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13	11,886
14	Enter the amount from your 1994 Form 6251, line 27, or Form 1041, Schedule H, line 38c	14	7,905
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter –0–	15	3,981

Part II Minimum Tax Credit and Carryforward to 1996

16	Enter the amount from your 1994 Form 6251, line 28, or Form 1041, Schedule H, line 39	16	3,981
17	Enter the amount from line 15 above	17	3,981
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	
19	**1994 minimum tax credit carryforward.** Enter the amount from your 1994 Form 8801, line 26	19	
20	Enter the total of your 1994 unallowed orphan drug credit, 1994 unallowed nonconventional source fuel credit, and 1994 unallowed qualified electric vehicle credit. See instructions	20	
21	Combine lines 18, 19, and 20. If zero or less, **stop here** and see instructions	21	
22	Enter your 1995 regular income tax liability minus allowable credits. See instructions	22	
23	Enter the amount from your 1995 Form 6251, line 28, or Form 1041, Schedule I, line 37	23	
24	Subtract line 23 from line 22. If zero or less, enter –0–	24	0
25	**Minimum tax credit.** Enter the smaller of line 21 or line 24. Also enter this amount on the appropriate line of your 1995 tax return. See instructions	25	
26	**Minimum tax credit carryforward to 1996.** Subtract line 25 from line 21. See instructions	26	

Form **3468**

Department of the Treasury
Internal Revenue Service (X)

Computation of Investment Credit

▶ Attach to your tax return.
▶ Schedule B (Business Energy Investment Credit) on back.

OMB No. 1545-0155

1985
24

Name(s) as shown on return | Identifying number

Part I Elections (Check the box(es) below that apply to you (See Instruction D).)

A I elect to increase my qualified investment to 100% for certain commuter highway vehicles placed in service before January 1, 1986 (section 46(c)(6)) ☐

B I elect to increase my qualified investment by all qualified progress expenditures made this and all later tax years ☐
Enter total qualified progress expenditures included in column (4), Part II ▶

C I claim full credit on certain ships under section 46(g)(3) (See Instruction B for details.) ☐

Part II Qualified Investment (See instructions for rules on automobiles and other property with any personal use)

1 Recovery Property		Line	(1) Class of Property	(2) Cost or Other Basis	(3) Applicable Percentage	(4) Qualified Investment (Column 2 x column 3)
Regular Percentage	New Property	(a)	3-year		60	
		(b)	Other		100	
	Used Property	(c)	3-year		60	
		(d)	Other		100	
Section 48(q) Election to Reduce Credit (instead of adjusting basis)	New Property	(e)	3-year		40	
		(f)	Other		80	
	Used Property	(g)	3-year		40	
		(h)	Other		80	

2	Nonrecovery property—Enter total qualified investment (See instructions for line 2)	2	
3	New commuter highway vehicle—Enter total qualified investment (See Instruction D(1))	3	
4	Used commuter highway vehicle—Enter total qualified investment (See instruction D(1))	4	
5	Total qualified investment in 10% property—Add lines 1(a) through 1(h), 2, 3, and 4 (See instructions for special limits)	5	
6	Qualified rehabilitation expenditures—Enter total qualified investment for:		
	a 30-year-old buildings	6a	
	b 40-year-old buildings	6b	
	c Certified historic structures (You must attach NPS certification—see instructions)	6c	

Part III Tentative Regular Investment Credit

7	10% of line 5	7	
8	15% of line 6a	8	
9	20% of line 6b	9	
10	25% of line 6c	10	
11	Credit from cooperatives—Enter regular investment credit from cooperatives	11	
12	Regular investment credit—Add lines 7 through 11	12	
13	Business energy investment credit—From line 11 of Schedule B (see back of this form)	13	
14	Current year investment credit—Add lines 12 and 13	14	

Note: If you have a 1985 jobs credit (Form 5884), credit for alcohol used as fuel (Form 6478), or employee stock ownership plan (ESOP) credit (Form 8007) in addition to your 1985 investment credit, or if you have a carryback or carryforward of any general business credit, stop here and go to Form 3800, General Business Credit, to claim your 1985 investment credit. If you have only a 1985 investment credit (which may include business energy investment credit), you may continue with lines 15 through 20 to claim your credit.

Part IV Tax Liability Limitations

15	a Individuals—From Form 1040, enter amount from line 46		
	b Corporations—From Form 1120, Schedule J, enter tax from line 3 (or Form 1120-A, Part I, line 1)	15	
	c Other filers—Enter income tax before credits from return		
16	a Individuals—From Form 1040, enter credit from line 47, plus any orphan drug, nonconventional source fuel, and research credits included on line 49		
	b Corporations—From Form 1120, Schedule J, enter credits from lines 4(a) through 4(e) (Form 1120-A filers, enter zero)	16	
	c Other filers—See instructions for line 16c		
17	Income tax liability as adjusted (subtract line 16 from line 15)	17	
18	a Enter smaller of line 17 or $25,000. (See instructions for line 18)	18a	
	b If line 17 is more than $25,000—Enter 85% of the excess	18b	
19	Investment credit limitation—Add lines 18a and 18b	19	
20	Total allowed credit—Enter the smaller of line 14 or line 19. This is your General Business Credit for 1985. Enter here and on Form 1040, line 48; Form 1120, Schedule J, line 4(f); Form 1120-A, Part I, line 2; or the proper line of other returns	20	

For Paperwork Reduction Act Notice, see separate instructions.

Form 3468 (1985)

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"EXHIBIT 4"

Schedule B.—Business Energy Investment Credit

1 Enter on lines 1(a) through 1(e) your qualified investment in business energy property that is the kind listed in the instructions for line 1, column (2)

Type of Property	Line	(1) Class of Property or Life Years	(2) Code	(3) Basis	(4) Applicable Percentage	(5) Qualified Investment (Column 3 x column 4)
Recovery	(a)	3-year			60	
	(b)	Other			100	
Nonrecovery	(c)	3 or more but less than 5			33 ⅓	
	(d)	5 or more but less than 7			66 ⅔	
	(e)	7 or more			100	

2 Total 10% energy investment property—Add lines 1(a) through 1(e), column (5) 2

3 Enter on lines 3(a) through 3(e) the basis in qualified hydroelectric generating property. Enter nameplate capacity of the property (See instructions for line 3.) ▶

Recovery	(a)	3-year			60	
	(b)	Other			100	
Nonrecovery	(c)	3 or more but less than 5			33 ⅓	
	(d)	5 or more but less than 7			66 ⅔	
	(e)	7 or more			100	

4 Total 11% energy investment property—Add lines 3(a) through 3(e), column (5) 4

5 Enter on lines 5(a) through 5(e) the basis in energy property that is solar equipment, wind equipment, ocean thermal equipment, or geothermal equipment. (See instructions for line 5, column (2).)

Recovery	(a)	3-year			60	
	(b)	Other			100	
Nonrecovery	(c)	3 or more but less than 5			33 ⅓	
	(d)	5 or more but less than 7			66 ⅔	
	(e)	7 or more			100	

6 Total 15% energy investment property—Add lines 5(a) through 5(e), column (5) 6

7 Enter 10% of line 2 7

8 Enter 11% of line 4 8

9 Enter 15% of line 6 9

10 Cooperative credit—Enter business energy investment credit from cooperatives 10

11 Tentative business energy investment credit—Add lines 7 through 10. Enter here and on line 13 of page 1 11

Fiscal Year Filers

The business energy investment credits shown on this page may be claimed only for energy property placed in service by December 31, 1985 (except for certain hydroelectric generating property, which may be placed in service by December 31, 1988).

At the time we printed this form it was uncertain whether Congress would extend this deadline. We will use news media and other means available to provide you with information and instructions on any change.

Instructions for Schedule B (Form 3468)

Energy property must meet the same requirements as regular investment credit property, except that the provisions of sections 48(a)(1) and 48(a)(3) do not apply. See the separate instructions for Form 3468 for definitions and rules regarding regular investment credit property.

Energy property must be acquired new. See sections 46(b)(2) and 48(l)(1) through (17) for details.

See section 48(l)(17) for special rules on public utility property, and section 48(l)(11) (as amended by the Crude Oil Windfall Profit Tax Act of 1980) for special rules on property financed by Industrial Development Bonds.

Specific Instructions

One Credit Only.—If property qualifies as more than one kind of energy property, you may take only one credit for the property.

Lines 1, 3, and 5—Type of Property.—For definition of recovery and nonrecovery property, see the separate instructions for Form 3468.

Line 1—Column (2).—Use the code letters from the following list to indicate the kind of property for which you are claiming a credit. If you enter more than one kind of property on a line, enter the code letter for each kind of property in column (2) and the code letter and dollar amount of each kind of property in the right hand margin.

The code letters are:

a. Biomass property

b. Qualified intercity buses (see section 48(l)(16)(C) for the limitation on qualified investment for intercity buses based on the increase in operating seating capacity)

Line 3.—Figure your qualified investment in hydroelectric generating property. If the installed capacity is more than 25 megawatts, the 11% energy credit is allowed for only part of the qualified investment. See section 48(l)(13)(C).

In the space provided in line 3, enter the megawatts capacity of the generator as shown on the nameplate of the generator.

Line 5—Column (2).—Use the code letters from the following list to indicate the kind of property for which you are claiming a credit. Be sure to put the code or codes on the line for the correct recovery period or life years as explained in the instructions for line 1, column (2).

c. Solar equipment (but not passive solar equipment)

d. Wind equipment

e. Ocean thermal equipment

f. Geothermal equipment

See sections 48(l)(4) and 48(l)(3)(A)(viii) and (ix) for definitions and special rules that apply to these kinds of property.