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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

Serial 104–51

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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

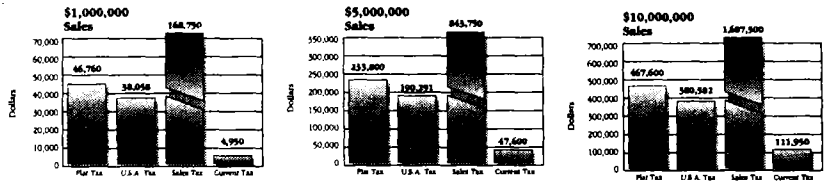
As is evident, these three proposals are similar, particularly in their provisions for business taxes. While it is premature to determine which tax is best for the printing industry, it seems obvious that the sales tax approach is beneficial from the pure simplicity of it. The Flat Tax appeals, because 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.

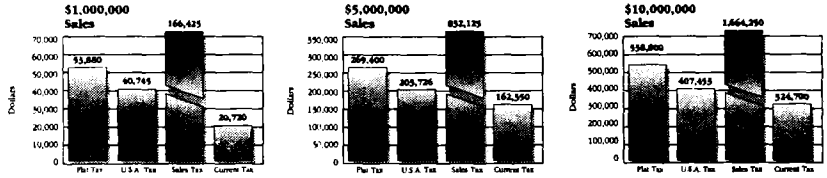
Impact of Tax Reform on All Firms, Profit Leaders and Individuals

All Firms



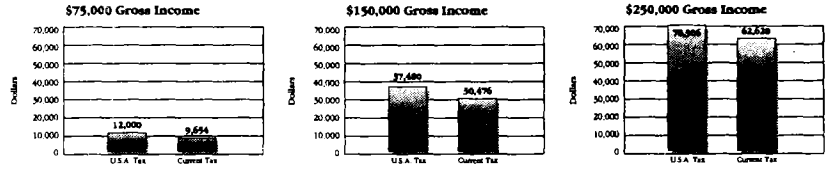
Tax Impact on All Firms: Estimated payments for companies in the All Firms category of the PIA Ratios, assuming sales of $1 million, $5 million and $10 million. In this example, capital expenditures were assumed to be 150% of depreciation for the Armey-Shelby and USA Tax proposals. Current taxes do not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

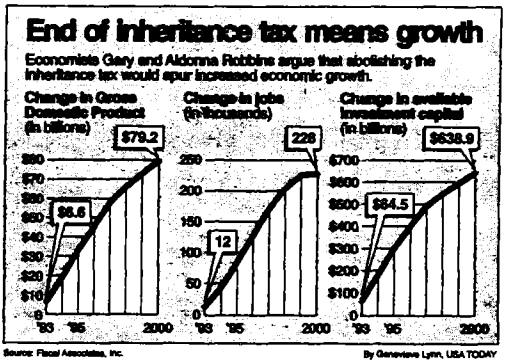
The present federal inheritance tax ranges from 37% to 55% of estates of more than $600,000. Since the $600,000 exemption, passed in 1981, was not indexed for inflation, it is now worth only $377,000 in 1981 dollars. Every year, inflation brings more and more Americans' estates into the grip of the federal 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"

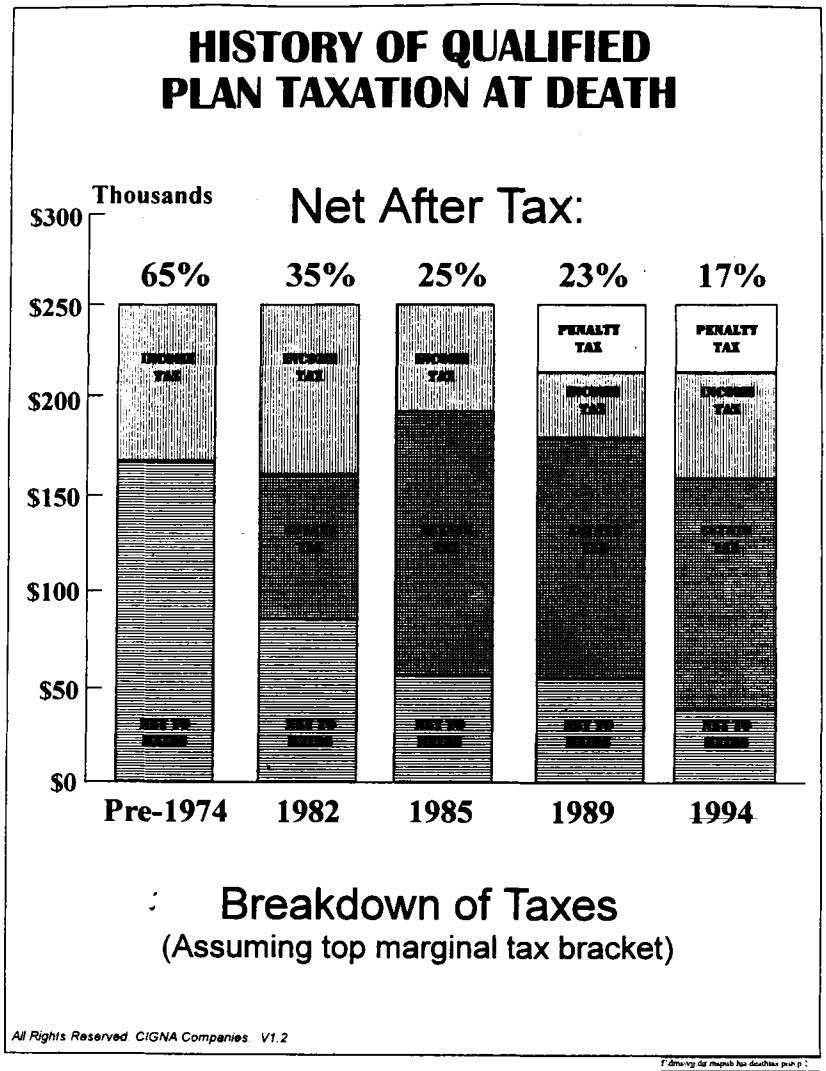

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EXHIBIT "E"

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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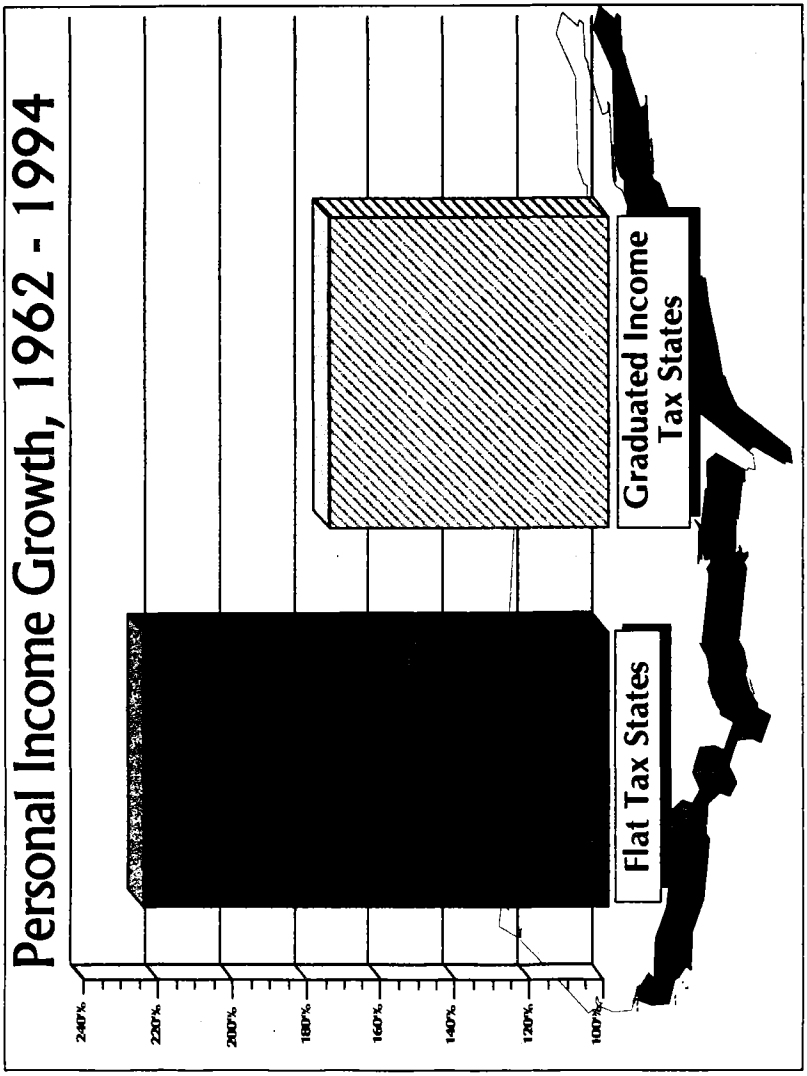
[1]Alternatively, deduction of state and local taxes can be maintained so long as all state and local taxes are deductible. In order to maintain a low tax rate and high exempt amount, the cost of this deduction would have to be paid for elsewhere.

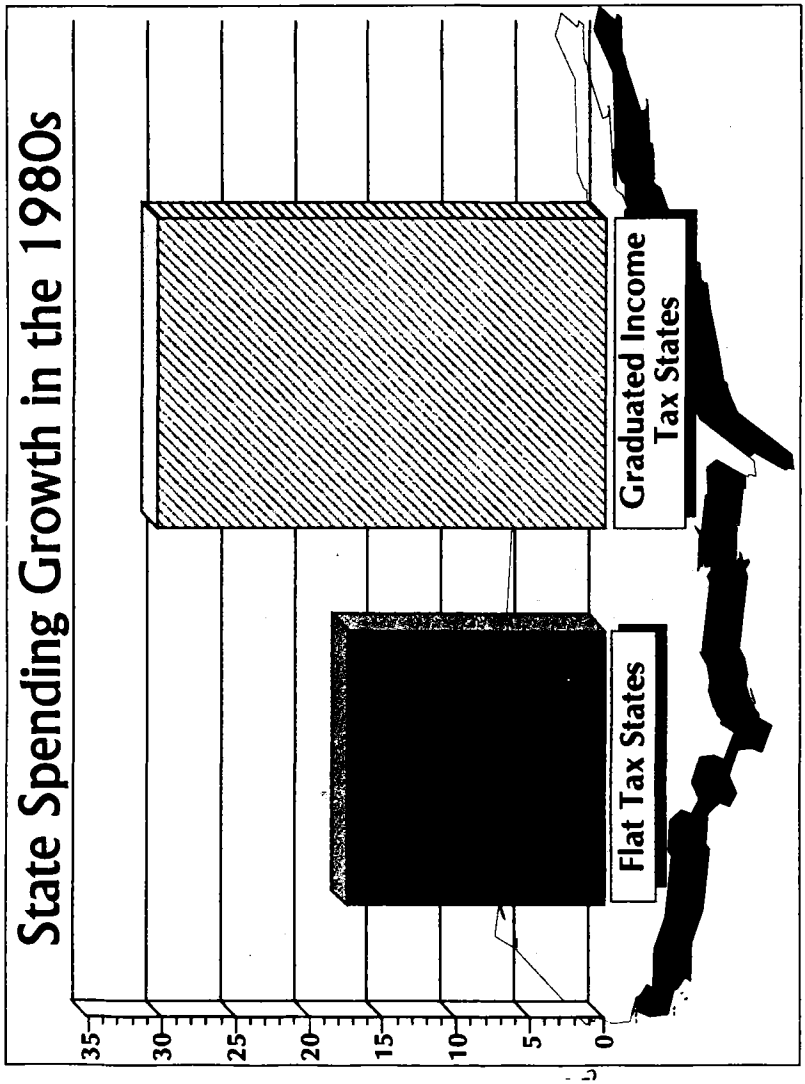
for the people's government -- at all levels.

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
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15
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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 _____

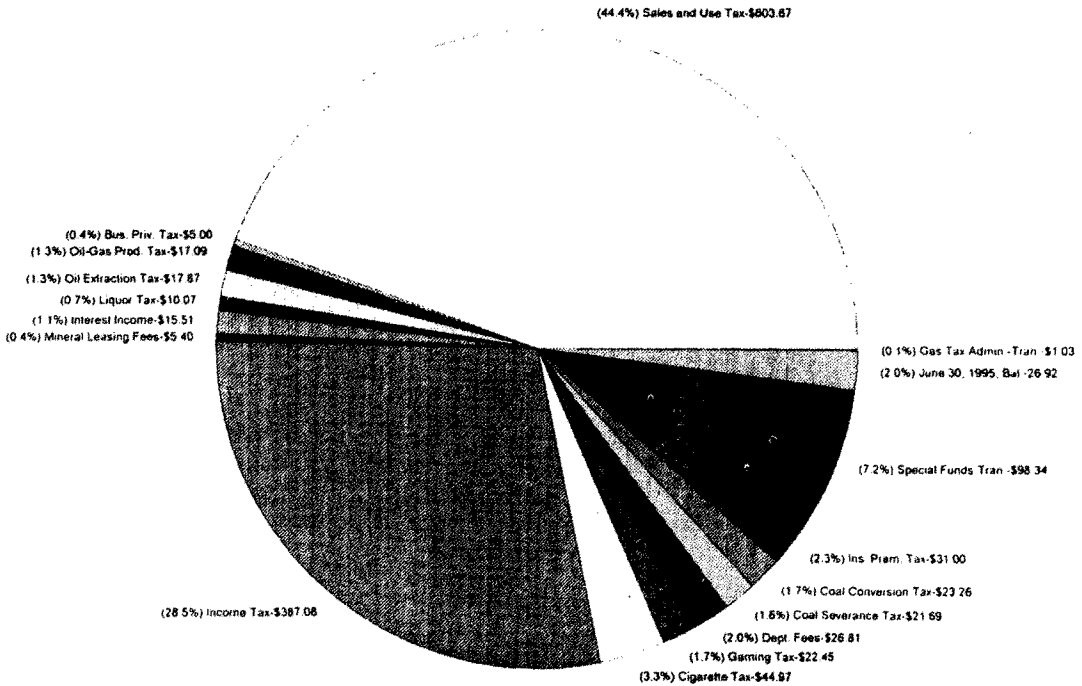
28700

☐ 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

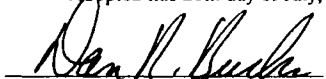
BE IT FURTHER RESOLVED, that the staff of the Multistate Tax Commission will analyze all of the major proposals for comprehensive reform of the federal tax system that are offered during the next several years and advise the Member States with regard to their impact on the ability and cost to the States 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

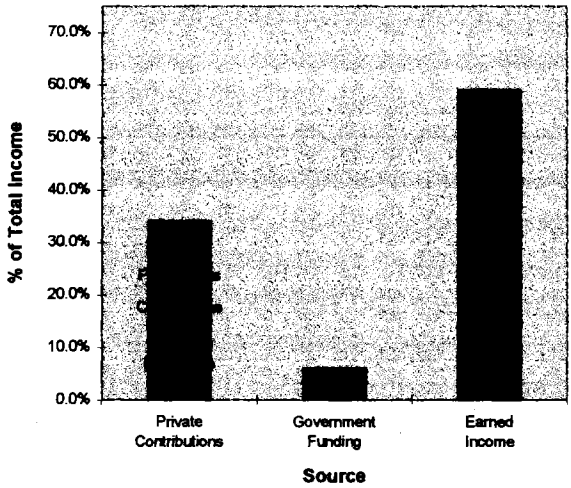
Nonprofit arts institutions are dedicated to their mission of providing excellent artistic programming and making their programs widely available to all members of the community. Our members also feel a strong responsibility to provide other services such as extensive and innovative educational and cultural 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:

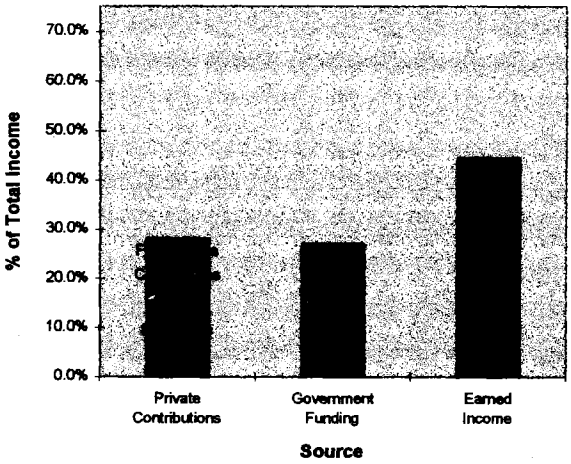
SOURCES OF FUNDING FOR THE ARTS

Symphony Orchestras (for 1995)



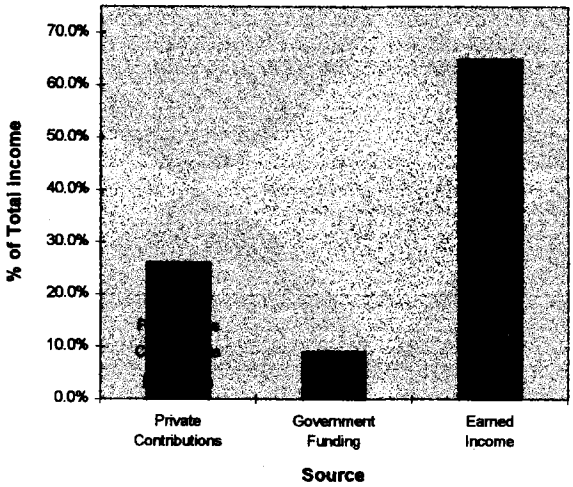
* United arts funds, volunteers, gifts from special events.

Art Museums (for 1994)



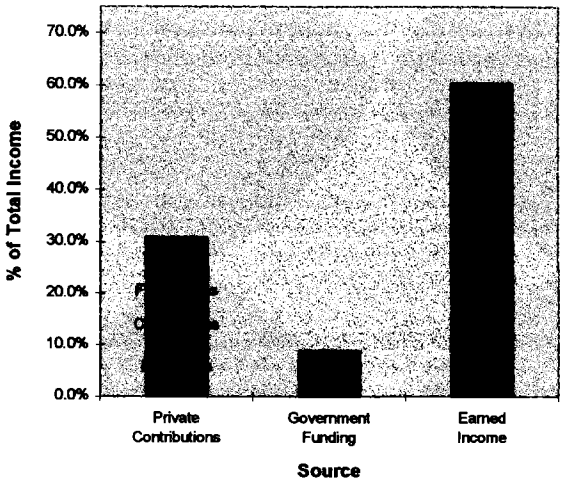
SOURCES OF FUNDING FOR THE ARTS

Presenters (for 1993)



* Endowment income, and support from private and public host institutions.

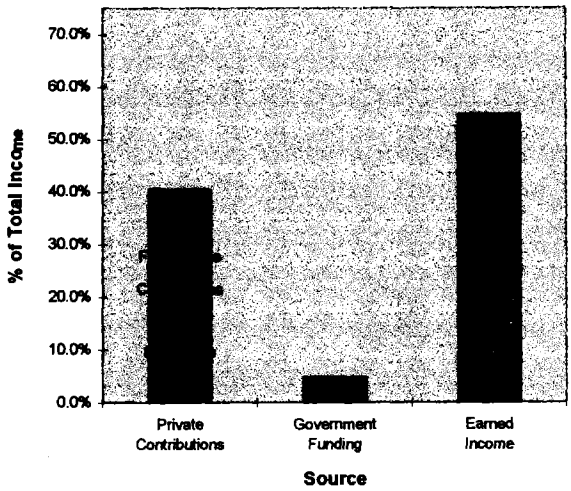
Dance (for 1994)



* United arts funds, guild/volunteer organizations, special fundraising events.

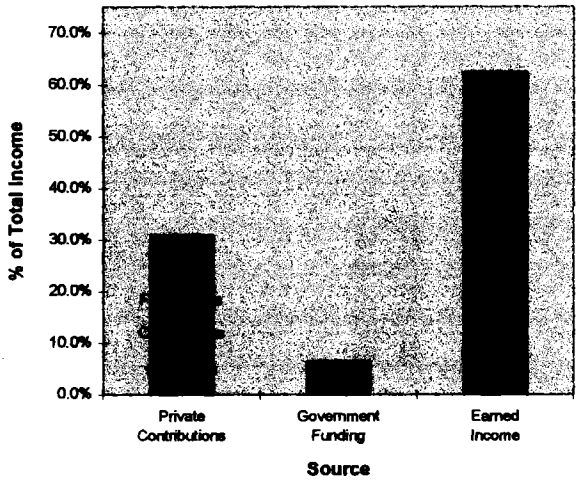
SOURCES OF FUNDING FOR THE ARTS

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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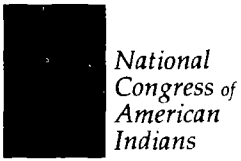

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Statement of W. Ron Allen, President
National Congress of American Indians

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.

EXAMINING THE IMPACT OF THE 1993 TAX INCREASE ON TRANSPORTATION FUELS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

MAY 8, 1996

Serial 104–61

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EXAMINING THE IMPACT OF THE 1993 TAX INCREASE ON TRANSPORTATION FUELS

WEDNESDAY, MAY 8, 1996

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

The Committee met, pursuant to notice, at 10:09 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
May 1, 1996
No. FC-16

CONTACT: (202) 225-1721

Archer Announces Hearing to Examine the Impact of the 1993 Tax Increase on Transportation Fuels

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 effects of the 4.3 cents per gallon tax on transportation fuels imposed by the Omnibus Budget Reconciliation Act of 1993. **The hearing will take place on Wednesday, May 8, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony for this hearing will be heard from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Omnibus Budget Reconciliation Act of 1993 imposed a 4.3 cents per gallon tax on gasoline and other transportation fuels. Revenues from this tax are deposited in the General Fund of the U.S. Treasury rather than dedicated to the Highway Trust Fund or similar trust funds.

In announcing the hearing, Chairman Archer stated, "The recent increase in gasoline prices has renewed public attention to the 1993 tax on transportation fuels. This regressive tax increase hit American families directly in their pocketbooks. Accordingly, the Committee should examine the impact of this tax increase and explore its repeal."

FOCUS:

The focus of this hearing will be to examine the effects of the 4.3 cents per gallon tax on transportation fuels on American families and businesses.

DETAILS FOR SUBMISSIONS OF WRITTEN COMMENTS:

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 300 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 as soon as everyone has taken seats and we can discourage extraneous audible conversation. The Committee will begin its hearing.

Today's hearing has been called to examine the impact of the 1993 tax increase on gasoline and transportation fuels. This $4.8 billion annual gas tax increase was passed as part of a bill that raised taxes by $268 billion over 5 years. That tax bill, which passed without a single Republican vote, was the largest tax increase in the history of this country.

The issue of taxes, particularly the gas tax, is a very important one for our Nation. Some believe that it was, and still is, important to raise taxes to reduce the deficit. Others, myself included, believe that when politicians raise taxes, they do not save money, they spend it, and 1992 is a good example.

The year prior to the gas tax increase, the Federal Government spent $1.38 trillion. According to the President's budget request, the government this year will spend $1.57 trillion, an increase in government spending of over $190 billion.

Let us take welfare as a specific example. In 1992 the Federal Government spent $208 billion on welfare. In 1993 Congress raised taxes. By 1995 welfare spending has increased to $262 billion, a jump of $54 billion.

The more taxes go up, the more spending goes up, and that is the heart of the problem. That is why we, as Republicans, believe very strongly that it is better to cut spending to reduce the deficit. We should not raise taxes, especially gas taxes, that hit lower and middle-income Americans the most, adding to the middle-class squeeze that we are experiencing.

I am pleased to note there is a growing bipartisan support for this position. Speaking to a group of his campaign contributors in my hometown last October, President Clinton said that he "raised taxes too much." I could not agree with the President more. He did raise taxes too much and we can help him by beginning to roll back those tax increases, starting with the gas tax. We would like to make this a bipartisan effort, and the President's wise words in Houston may help show us the way.

Beyond the gas tax, we should continue to roll back the 1993 tax increases by providing middle-income Americans with a $500 per child tax credit; and we can create more high-paying jobs by reducing the tax rate on capital gains. I hope the President will join us in this effort and make this bipartisan.

Today, we will hear testimony of several experts who will discuss the impact of the gasoline tax increase. I look forward to hearing their thoughts about this tax hike, and I now yield to the gentleman from Florida for any statement that he might like to make. Prior to yielding to him, without objection, all Members will have the opportunity to insert any written statements in the record.

[The opening statement of Mr. Christensen follows:]

JON CHRISTENSEN
2D DISTRICT, NEBRASKA

COMMITTEE:
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SUBCOMMITTEES:
HEALTH
SOCIAL SECURITY

REPUBLICAN TASK FORCE
ON LEGAL REFORM

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CHIEF OF STAFF

BILL PROTEXTER
DISTRICT DIRECTOR

Congress of the United States
House of Representatives
Washington, DC 20515–2702

OPENING STATEMENT
BY
REP. JON CHRISTENSEN

On
Repealing the Clinton Gas Tax Increase

Before the Committee on Ways and Means
May 8, 1996

Today we are once again keeping our promise to give tax relief to American families.

As you know, the 1993 Clinton budget levied an additional 4.3 cents-per-gallon tax on gasoline and other motor fuels. Not a single Republican voted for the package -- the largest tax increase in American history. Now gas prices are going up, and it's clear again how painful the Clinton tax hike is. The gas tax is one of the most regressive we have, hitting middle- and lower-class working families especially hard. In fact, the poorest 20 percent of families spend *four times* as much of their income on gasoline than the richest 20 percent.

The gas tax is especially burdensome on the people I represent in Nebraska. State and federal gas taxes in Nebraska add up to a dizzying 44 cents-per-gallon, giving the Cornhusker State the fourth highest total gas tax in the country. That means the average Nebraska family pays the government $6.60 for an average tank of gas, money that could instead be invested in their family's future.

It is interesting to note that traditionally federal gas tax revenue has been used for the construction and maintenance of roads and highways. But the $4.8 billion-a-year Clinton gas tax hike instead is being funneled into more big government social programs, proving that Washington is the world's worst gas-guzzler.

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I'm excited that we are holding hearings and hopefully will soon vote on the immediate repeal of the 4.3 cents-per-gallon gas tax hike through the end of 1996. This repeal would benefit 175 million Americans and will provide those who earn less than $10,000 a year with a 3.6 percent tax cut. That's a good way to help our working families who are struggling to make ends meet.

Also, I hope that we can seize this opportunity to address the inequity the 1993 Clinton tax hike placed on railroads, forcing the railroads to pay 1.25 cents-per-gallon more than other modes of transportation. This additional tax increases the cost of all products shipped via rail, eventually raising the cost for American consumers.

Working to reduce our nation's tax burden is a long, long road. I'm glad we've come this far. I applaud Chairman Archer and Senator Dole for their leadership on this issue and hope to work with them as we once again keep our promise to give tax relief to hard-working Americans.

Thank you.

Chairman ARCHER. Mr. Gibbons.

Mr. RANGEL. Parliamentary inquiry, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. In the interest of promoting bipartisanship on this tax bill, on the witness list, did the Republican leadership provide any witnesses that oppose the repeal of this tax? I cannot tell by the names, but it would not——

Chairman ARCHER. I would say to the gentleman that that is not a parliamentary inquiry.

Mr. RANGEL. This has to do with the hearing.

Chairman ARCHER. This does not relate to the procedure under which this Committee operates.

Mr. RANGEL. I am terribly sorry. I apologize. I will withdraw the question.

Chairman ARCHER. Mr. Gibbons.

Mr. GIBBONS. Mr. Chairman, I guess that we ought to be grateful we only have Presidential elections once every 4 years in this country. I do not think the country could afford it if we had them more often than that. Maybe we ought to have just a 1-year term limit on Presidents to cut out some of the political pandering that is going on here.

If anybody believes that the consumer will get any benefit out of this gas tax reduction, I have to say that, based upon my experience, they are dreaming. The big seven oil companies and their cohorts will find ways in which the consumer will never see a penny of this gas tax. Believe me, I have dealt with them for 35 years and I know them. They are good business people and they are doing what all business people do and should do. They are always trying to raise prices, and any excuse they get to raise prices, they will raise prices. So the consumer is not going to see this money.

Second, the runup in gas prices is perfectly explainable by the actions we have taken. We have had a cold winter, nothing any of us could do anything about, but in cold winters, the refineries have always run long on fuel oil and that means short on gasoline in the summertime.

Gasoline prices for all of my life have always raised in the summertime because there is more driving and they respond to the marketplace.

In California, where Mr. Royce comes from, the State of California changed their clean air laws and required modification of their refineries with a concomitant runup in cost that was going to happen to gasoline prices.

But it is an election year and we expect politicians to at least pay attention to the voters' wills and needs, but pander to them, my gosh, this is the worst pandering I have seen in my 76 years at election time.

If anybody thinks the infrastructure of this country is overbuilt, they have not traveled on most of it. I know that this portion of the gas tax does not, for political reasons, go into the infrastructure trust fund, but it should, and at the appropriate time, I hope to present an amendment to the legislation that will put this gasoline tax and all future gasoline taxes in the infrastructure trust fund.

We, I guess, ought to get on with our business. I do not believe the money is going to be passed through to the consumer. I think

the only way you could do that is put on a windfall profits tax, and I know that would be very difficult and very unpopular and probably not very productive, but at least it would have guaranteed the consumer got the benefit of this tax break.

That is all I have to add at this time, Mr. Chairman.

Mr. MATSUI. Mr. Chairman, may I make a parliamentary inquiry?

Chairman ARCHER. Mr. Matsui.

Mr. MATSUI. I do not know if this is appropriate at this time, but in view of the fact we are going to be questioning witnesses today, perhaps we can know the structure of the legislation we may adopt tomorrow, because when we take this matter to the floor, we will need a revenue offset on the $2.8 billion. I know there will be an attempt to do that. Does the Chairman believe that will come from this Committee?

Chairman ARCHER. The gentleman, I assume, was not here, during my preliminary comments.

Mr. MATSUI. I apologize.

Chairman ARCHER. I stated that the offsets will not come through this Committee and whatever the "pay fors" are, therefore, really are not an appropriate subject for deliberation in our hearings today.

Mr. MATSUI. Thank you.

Chairman ARCHER. Our first witness is Congressman Edward Royce of California, a State that has been especially hard hit by an increase in gasoline prices. We are glad to have you with us today.

Mr. Royce, your entire statement can be printed and entered into the record without objection. We hope that you will summarize in your oral testimony, and you may proceed.

STATEMENT OF HON. ED ROYCE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. ROYCE. I appreciate that, Mr. Chairman, and I will do so. I want to thank you, Mr. Chairman, for holding this hearing.

I do want to point out that in California last month, the price of gasoline did reach, in some parts of the State, $2 a gallon. The price increase is the result of many factors. There is some question about what we will be doing about these increases, but there is one factor I think this Congress is partially responsible for, and I think government is partially responsible for, and the American public understand, and that is the cost in taxation.

On a gallon of gas in California right now, it is 47.4 cents on the gallon. I think that is something the American people understand we could do something about if we wanted to, and that is exactly what this bill of mine, H.R. 3375, does. It repeals the 4.3-cent-per-gallon Federal gasoline tax imposed by this administration and by the prior Congress on the American public.

At a time when we in Congress are trying to put money back into the pockets of American families and recharge the Nation's economy, gasoline excise taxes are at an all-time high. In the last 10 years, the Federal gasoline tax more than doubled, from 9 cents to 18.3 cents per gallon, and the same happened at the State level.

I have shared with you California's figures, 47.4 cents on every gallon. According to the Tax Foundation, that tax burden works out

for the American family to $422 out of their household budget every year, and Mr. Chairman, that is a significant amount of money for most families.

I think it is also important to clarify the 4.3 cents per gallon is actually closer to 4.7 cents at the pump because State sales tax is levied on top of the 4.3-cent pump increase.

It is important for the American people to understand this tax is not a user fee, unlike the other taxes levied on gasoline. This does not go into the transportation fund to pay for Federal highway repairs. It is a tax, pure and simple, and it goes into the general Treasury.

While 4.3 cents may not seem like a lot to those in DOE, the Department of Energy, I think you will agree, this proposal will provide real relief to real people trying to make ends meet in a stagnant California economy. The tax has a significant impact on the national economy.

I will just share with you, the cost to the State of California out of this tax is $550 million a year. While the administration's gas tax increase hits all Americans hard, it is especially harmful to lower income families. According to the Joint Economic Committee, the lowest income families in America pay four times as much of their disposable income on gasoline than the highest 20 percent of income earners.

Further, the tax is costing our economy jobs. According to the Tax Foundation, the 1993 tax is responsible for the loss of 8,000 jobs in California and the loss of 69,000 jobs nationwide. By repealing the tax, this legislation will help restore those jobs and restore the economy, both in California and nationwide.

Recognizing that the fuel tax will result in a loss of revenue of approximately $30 billion over 7 years, I propose to offset this loss by reducing funds for the Department of Energy. This legislation is based on the work of a House Task Force on Energy, findings of the General Accounting Office, former Energy Department officials, including two Energy Secretaries.

Specifically, the bill cuts the annual budget of the Department of Energy by about 30 percent. As you know, the Department of Energy was created by President Carter following the Arab oil embargo to solve the fossil fuel energy shortage. They have not solved the problem. The problem is still with us and so is the Department of Energy.

The Department has grown into a massive $15 billion bureaucracy with multiple missions and questionable priorities. Once the energy crisis of the seventies passed, the Department was without a clear mission. As a result, it began a 15-year empire-building process in which its mission has changed several times. I am going to share with you the General Accounting Office's criticism. They called upon Congress to reevaluate the Department.

In February 1995 the GAO stated that the DOE "has a long history of management problems" and that the DOE "is not an effective or successful cabinet department." The GAO cites the following problems: Inability of the Department of Energy to overcome management weaknesses, lack of any credibility, eroding public support, and a diminishing sense of purpose.

For these reasons, Mr. Chairman, I am proposing the termination of unnecessary programs, the consolidation of programs duplicative of other departments or agencies, the transfer of programs serving a valid purpose, and the privatization of programs that could be better performed outside the government.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Representative Ed Royce

Statement on Repealing the Fuel Tax

Before the House Committee on Ways and Means

May 8, 1996

Thank you. I would like to thank you Mr. Chairman for holding this hearing on an issue of great importance to all Americans. Whether or not one owns or operates a motor vehicle, each and every consumer is affected by the skyrocketing gasoline prices that are literally stopping traffic on our nation's highways. Last month, the price of a gallon of gasoline in my home state of California reached $2.00 in some areas. This price is the result of a market shortage of crude oil, new state regulations on formulation of gasoline - and higher gasoline taxes. While we may not be able to control all of these factors, we can provide consumers with some immediate relief from the burdensome transportation taxes levied on them by the Federal government. For this reason, last week I introduced legislation, H.R. 3375, to repeal the 4.3 cents-per-gallon federal gasoline tax imposed by the Administration in 1993.

At a time when we in Congress are trying to put money back in the pockets of American families and recharge the nation's economy, gasoline excise taxes are at an all-time high. In the last ten years the federal gasoline tax more than doubled from 9 cents to 18.4 cents per gallon. In California, the total gasoline tax has increased to 47.4 cents per gallon. According the Tax Foundation, this tax burden takes $422 out of the average American family's household budget per year -- $422. Mr. Chairman, that is a significant amount of money to most families.

So, the question is, what can we in Congress do to provide some relief to these families? And the answer is simple -- we can repeal some of these taxes. And that is what my legislation does.

I think it is important, at this point, to clarify the nature of this 4.3 cent tax, which is actually closer to 4.7 cents at the pump because state sales tax is levied on top of this 4.3 increase. It is important for the American people to understand that this tax is NOT a user fee. Unlike the other taxes levied on gasoline and diesel fuels, this 4.3 cent per gallon tax does not go into the transportation trust fund to pay for federal highway repairs and improvements. IT IS A TAX, pure and simple, that goes into the general Treasury. The revenues from this tax go directly into the general Treasury, just as income taxes do.

While 4.3 cents may not seem like a lot to those in the Department of Energy, I think you will agree this proposal will provide real relief to real people trying to make ends meet in a stagnant California economy. This tax has a significant impact on the national economy -- with my home state of California bearing the brunt of this tax. The total cost of the Administration's gas tax increase to Californians is $550 million a year.

While the Administration's gas tax increase hits all Americans hard, it is especially harmful to lower income families. According to the Joint Economic Committee, the lowest income families in America pay four times as much of their disposable income on gasoline than the highest twenty percent of income earners. Further, this 4.3 cent tax is costing our economy jobs. According to the Tax Foundation, the '93 tax is responsible for the loss of 8,000 jobs in California alone, and 69,000 jobs nationwide. By repealing the 4.3 cents per gallon tax, my legislation will help to restore these jobs and restore the economy both in California and nationwide.

Recognizing that repealing the fuel tax will result in a loss of revenue of approximately $28 billion over seven years, I propose to offset this loss by reducing funds for the Department of Energy. This legislation is based on the work of a House Task Force on Energy, findings of the General Accounting Office, former Energy Department officials, and industry representatives.

Specifically, H.R. 3375 cuts the annual budget of the Department of Energy by about 30 percent. As you know, the Department of Energy was created by President Jimmy Carter following the Arab oil embargo to solve the fossil fuel energy shortage. They have not solved the problem....it is still with us, and so is the Department of Energy.

The Department of Energy has grown into a massive $15 billion bureaucracy with multiple missions and questionable priorities. Once the "energy crisis" of the 1970's passed, the Department was without a clear mission. As a result, it began a fifteen year empire-building process, in which it's mission changed several times. The General Accounting Office has criticized the Department of Energy, and called upon Congress to reevaluate the Department and its mission. In a February, 1995 report, the GAO stated that the DOE "has a long history of management problems." Specifically, the GAO concluded that the "DOE is not an effective or successful Cabinet department." The GAO cites a number of problems, including the inability of DOE to overcome management weaknesses, lack of any credibility, eroding public support, and a diminishing sense of purpose.

For these reasons, I am proposing the termination of unnecessary programs, the consolidation of programs duplicative of other departments or agencies, the transfer of programs serving a valid purpose, and the privatization of programs that could be better performed outside the government.

Chairman ARCHER. Thank you, Mr. Royce.

Are there questions from the Members?

Mr. Gibbons.

Mr. GIBBONS. Mr. Royce, you say the California gasoline tax is 29.1 cents per gallon, something like that?

Mr. ROYCE. State and sales, yes.

Mr. GIBBONS. The State gasoline tax. Have you done anything to try to get California to reduce its gasoline tax?

Mr. ROYCE. Yes, I have, Mr. Chairman. As a matter of fact, I talked with the new speaker of our State assembly and he has introduced a bill in the State legislature to try to roll back a recent increase in the California State tax, as well, yes.

Mr. GIBBONS. At least you are consistent. Do you really think the oil companies are going to pass this savings through to the consumer?

Mr. ROYCE. Mr. Chairman, I had a conversation with a constituent of mine the other day and he said, "You know, I remember when gasoline prices were 50 cents a gallon," he said, "but I guess it is going to be pretty difficult to get prices down that low again if the price we are paying in Federal and State taxes is 47.5 cents a gallon."

What I want to focus on here, and what I want to remind you——

Mr. GIBBONS. Your constituent gave that information to you?

Mr. ROYCE [continuing]. Is the total assessment that the Federal Government is taking out of the pockets of taxpayers with respect to how high these taxes really are.

Mr. GIBBONS. No, the gasoline tax has always been considered to be a user fee to help finance the infrastructure of this country. Unfortunately, the last time the gasoline tax was raised—and the gasoline tax is inflation adjusted, probably about where it was in the thirties when I used to pump gas—we had to put it in the general revenue fund.

I want to put it back in the trust fund. That is where it should have been 2 years ago. That is where it ought to be now. Anybody that thinks the infrastructure of this country is overbuilt, as I say, just has not been using it. Do you have too much infrastructure in California, too many highways, too few potholes, too few crumbling bridges?

Mr. ROYCE. But I am just pointing out, Mr. Chairman, the increase I am trying to reduce here, the tax from 1993 does not go into solving any of those problems. It goes into the general fund.

Mr. GIBBONS. It ought to be put in the trust fund, and I am going to have an amendment before this Committee to put it in there.

Mr. ROYCE. I am pointing out, Mr. Chairman, if you look at the increases in our Department of Energy, if you look at the General Accounting Office report, I think it is very credible that we look at reducing that agency, that government agency, to pay, so that the American people will have this reduction at the pump.

Mr. GIBBONS. I am not going to argue with you about the Department of Energy. I am not an expert on it and do not pretend to be. But I do know the infrastructure of this country is falling apart all around us. It is costing us a lot of money because it is falling apart.

Mr. ROYCE. Yes, sir.

Mr. GIBBONS. The transportation is a very important part of the well-functioning economic system this country has or should have. We cannot neglect it any further. We have neglected it far enough. The Airway Trust Fund which finances the safety and everything else on the airlines and the airports has been expired here for, what, 4 months, and we have not lifted a finger to do anything about that.

We are letting this country fall apart, all pandering so we can tell the consumers the oil companies are gratuitously going to give them this tax when we repeal it. That is just a bunch of wishful thinking, Mr. Royce.

Thank you.

Mr. SHAW. Mr. Chairman.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. Mr. Chairman, I would like to remind my friend from Florida that the argument he has just made is a very good argument and I wish he had made it or listened to it back in 1993. We were making that exact argument back when this tax was put on. This was breaking precedent with the past, that the taxes were all going to the construction of infrastructure. It was a user tax, and that is the way it should be.

What we are trying to do here is right a wrong. It was wrong in 1993 to make this a revenue raiser for the general fund. We are simply going to reverse that and go back to pre-1993 law, which did precisely what the gentleman has been arguing.

I would hope you would join with us in supporting this and then, at a later date, if it is necessary to go back and talk about raising taxes for the construction of infrastructure, that we do that. But this should not be a way of raising revenue for the Federal Government. I totally agree with the gentleman's argument and support him on it.

However, what we are doing now is reversing a serious error that originated in this Committee without one single vote from the Republican side. We are coming back, now that we are in the majority, and reversing that very, very bad decision that was made by this Committee.

I yield back.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Royce, do you know what the price of gasoline has risen to in California? How high has it gone in the last couple months from what it was per gallon?

Mr. ROYCE. It has gone up significantly.

Mr. CARDIN. How much per gallon, do you have any idea?

Mr. ROYCE. At my local station, I would say it has gone up over 20 cents a gallon.

Mr. CARDIN. Over 20 cents? You indicated that the 4-cent increase cost California 8,000 jobs?

Mr. ROYCE. Yes, that is correct, the 4.3-cent increase did.

Mr. CARDIN. So is it fair to say that in the last month or so, you have found there has been another, what, four times that, 30,000 lost jobs because of the price increase?

Mr. ROYCE. There is definitely going to be a job loss due to the higher energy costs. When energy costs go up, yes, Americans are laid off.

Mr. CARDIN. So in the last month or so, we have lost four or five times as many jobs as what your analysis of what happened in 1993 shows?

Mr. ROYCE. Job loss will occur as energy costs go up, that is true.

Mr. CARDIN. I am trying to figure this nationwide. I guess it is 300,000, 400,000, 500,000 jobs have been lost in the last 30 to 60 days as a result of energy. I wonder if you have any documentation that we have lost between 300,000 and 500,000 jobs in this country during the last month. Gasoline prices do fluctuate a little bit. I do not really recall a big jump in gas prices in 1993. I must tell you, I am not aware of any impact on our economy, on jobs, in 1993 with the gas tax.

But you refer to the Tax Foundation, and I guess we will be getting the information from them. I am just curious as to what your analysis would be. Should we try to control the price of gas in order to stabilize jobs in our community? Is that what you are suggesting?

Mr. ROYCE. I am suggesting we not do things which obviously will boost the price of gas, and increasing taxes the way we have boosts prices. I know we would like to get away from that fact, but the reality is that when you tax a gallon of gas at 47.4 cents on the gallon, you are increasing prices significantly. That is going to translate through the market.

Mr. CARDIN. I would appreciate if you could try to respond to the question. If, in fact, we reduced this tax by 4.3 cents, and if, in fact, there is no reduction at the pump, then I take it, as you are suggesting, it will have no positive impact in your analysis on job growth. I am curious as to whether you would support an amendment to this legislation to guarantee that the consumer gets a 4.3-cent reduction in the price of gasoline. Would you support an amendment to this legislation so that we are at least assured it does not go to the oil companies, that it goes to the consumers?

Mr. ROYCE. I would be happy to talk with you about an amendment.

Mr. CARDIN. Good.

Mr. ROYCE. But the reality is, and the point I want to make is that I think those of us in government at times try to get away from the fact that as we raise taxes, those taxes are going to be passed on to the American public. The reality is that tax increases are passed on when you tax goods and services. But no, I would be happy to talk with you about that amendment.

Mr. CARDIN. You have said that before. We have been told many times that tax reductions to companies are not necessarily passed on to consumers. That point has also been made by economists and groups before, that there is not the same passthrough necessarily of a tax reduction.

What you are suggesting is that the consumer is going to feel and understand a 4-cent increase in a gasoline price and act accordingly, and I must tell you, I find that very difficult to believe, because as I drive down the streets in Baltimore, there is more than a 4-cent differential between one gas station across the street

from the other on the same quality of gasoline. So I am not so sure a 4-cent reduction is going to have any impact on consumers, and I am concerned about whether this cut will really get to the consumer, whether they will really feel it.

I appreciate your willingness to work with us to make sure the consumer gets the benefit of it, and I hope the Committee will follow that suggestion and will make sure that any reduction that we make in the gasoline tax, the consumer actually gets the benefits, because I doubt it will happen.

Mr. ENGLISH. Mr. Chairman.

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. Royce, you have made a very powerful argument here today for the repeal and I want to thank you for it. I think you have been one of the most consistent advocates of rolling back fuel taxes in Congress.

Let me ask you, in your research, and specific to California, which sectors of the economy have you found have been most sensitive to fuel taxes, and is small business disproportionately affected by these increases?

Mr. ROYCE. I think small business and I think, basically, the motoring public is the most impacted. I have shared with you that $422 is paid in taxes, gas taxes alone, by the average family, by the average motorist. So when they fill up the tank, this additional tax which we are trying to repeal, that alone is 75 cents every time they fill up at the pump.

Mr. ENGLISH. In your study of it, particularly in your area, what do you find are the distributional effects of these fuel taxes? Do they fall disproportionately on lower income families, on middle-class families?

Mr. ROYCE. I think the studies show that there is four times—in terms of the budget, the household budget, it weighs very heavily on lower income families, disproportionately. In terms of the impact on low-income households, it is a 4-to-1 ratio.

Mrs. KENNELLY. Would the gentleman yield?

Mr. ENGLISH. Certainly.

Mrs. KENNELLY. Thank you, Phil.

We have two issues in front of us. One is the minimum wage and the other one is the gas tax. In my readings on the minimum wage, it shows your low-income worker who earns the minimum wage, the gas tax savings will only be $17.

Mr. ENGLISH. I would be very interested. Reclaiming my time, I know that that factor which my distinguished colleague from Connecticut referenced also varies considerably based on geography.

Mr. Royce, do you represent a suburban district, rural district, or a mix of both?

Mr. ROYCE. The 39th District is suburban, Mr. English.

Mr. ENGLISH. Do you find that particularly people who have limited access to mass transit and people in rural areas and places like California tend to pay the tax more than people who are of a comparable income in an urban area?

Mr. ROYCE. Our particular area is a commuter area. Southern California, as you know, has that reputation, and it is, indeed, true

that Californians drive more than people in New England. So yes, it has a disproportionate effect on the west coast.

Mr. ENGLISH. Thank you very much, Mr. Royce. Again, we appreciate your coming before the Committee and sharing your obvious expertise in this area. It has been most helpful to us.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Mr. Royce, welcome. You mentioned that the Federal tax went up in the last decade from 9 cents, I think, to 18.3 cents?

Mr. ROYCE. That is correct.

Mr. LEVIN. Could you tell me why you stop at 4.3? Why do you not then move to strike the rest of the Federal increase, if we are really concerned about the consumer?

Mr. ROYCE. Congressman, this particular latest increase in the gasoline tax does not go as a user fee. It goes into the general fund. It in no way is used for highway maintenance or road repair or anything connected with the use and the expenditure of that tax by the motorist. So I think it logical that we begin with a tax recently imposed, imposed by the last Congress and by this administration, on the American people, and I think this is something that is doable.

Mr. LEVIN. Let me ask you, what was the increase, the Federal gas tax increase before the 1993 increase?

Mr. ROYCE. I was not here prior to that time as a Member of this institution.

Mr. LEVIN. But you are an alleged expert on this. You do not know when——

Mr. ROYCE. I have shared with you the increase.

Mr. LEVIN. No, how about before 1993? When was the previous one, do you know, before 1993?

Mr. ROYCE. I would be happy to have a consultant with the Committee give us the year, if you would like.

Mr. LEVIN. To give us what?

Mr. ROYCE. The year. I would be happy to do that.

Mr. LEVIN. I think it was 1990. There was a gas tax increase in 1990. Did all of that go to the trust fund?

Mr. ROYCE. As I have shared with you, Congressman, I was not a Member of either this Committee or this House prior to that point in time.

Mr. LEVIN. Let me ask you this, then. If any of the 1990 gas tax increase went for deficit reduction, would you favor its repeal?

Mr. ROYCE. I have looked at the figures for what has been raised, Congressman, in terms of revenues from gasoline taxes and what has been expended, and you are familiar, as well, I know, with the debate about whether or not we have raised more or spent more on transportation up until this latest increase in the gasoline tax, if we have raised more or spent more in the trust fund. We hear arguments from both sides.

Mr. LEVIN. Maybe my question was not clear. If any part of the previous tax increase, gas tax increase, did not go into the trust fund, would you favor its repeal, and would you add it to the 4.3 cents?

Mr. ROYCE. I think, Congressman, I put together a bill which is logical, which reduces the bureaucracy of the Department of En-

ergy to pay for a recent tax increase that you and I both agree goes not into paying for maintenance of the highways but instead goes into the general fund.

Mr. LEVIN. I understand that.

Mr. ROYCE. So I think, in concept, we have a good bill here.

Mr. LEVIN. By the way, Mr. Chairman, when we were talking about the Energy Department, that is not within our jurisdiction. We are not supposed to be talking about that.

I am asking you if any part of the gas tax increases before 1993 did not go for highway maintenance, would you favor adding that to the 4.3 cents?

Mr. ROYCE. I think the sensible thing to do is to move this bill as it stands.

Mr. LEVIN. I do not know why you will not answer. It may be because the Majority Leader in 1990 supported an increase in the gas tax. I think we had better go back and check whether all of that went for highway maintenance and see if there is any consistency on your side here or whether this is a political ploy without any assurance that the consumer will benefit.

So I will finish by asking you this. You said you would support an amendment that would assure the consumer benefited from this repeal. Do you have any idea how we might do that?

Mr. ROYCE. No, I do not.

Mr. LEVIN. So why do you support something if you have no idea the consumer will benefit?

Mr. ROYCE. Could I share with you, Congressman, that I would be happy to work with you or to try to work out such an amendment, but I think the point here, to go back to the point you are making, is that none of this tax increase went into maintenance of the highways in any way, and therefore I think it very clear why there should not be an increase paid by the motoring public that does not end up in any way benefiting them through use on the highways.

So to try to answer both your questions, I think it very clear this tax should be repealed and I would be happy to work with you.

Mr. LEVIN. Let us see if we can find a way. You do not have one at the moment that would assure the consumer would benefit, so you are just kind of poking in the dark.

Thank you.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman.

I very much appreciate, Mr. Royce, your making these points on behalf of the consumer. I agree with you that if we can get rid of the 4.3-cent gas increase that came from the 1993 Clinton budget, that we will benefit employers, job holders, and consumers in general.

You talked about folks who own cars, motorcycles, or trucks being relieved of a burden that was put on the cost of gasoline in 1993, but I think we also have to consider some other very important costs that through support of your bill would be given back to the taxpayer and those are the indirect costs.

I live in a State that is very trade oriented, and so this cost of fuel is paid by truckowners and the aviation industry and is paid by every consumer who purchases an item that has been made in

some out-of-area spot and brought into the district, the community, and these consumers' homes. So we in Washington State get apples from eastern Washington or wheat or corn and we get goods from the central part of the United States and those are all trucked to us or flown to us. Every single dollar that is spent as a result of an increase in the fuels tax affects every consumer, and this would be a great relief along that line.

I will also tell you that because I come from a district that contains the highest number of Boeing workers in the Nation, for example, there is a direct cost to jobs. The aviation industry on October 1 began paying the jet fuels tax of 4.3 cents per gallon. Everybody who flies is now paying that, but because it is very tough and there is very little elasticity right now in the aviation industry, this is costing the aviation industry a great deal that they are having to absorb on their own.

What that translates to for me and for the folks who work for Boeing in my district is there is not as much money left to the aviation industry to buy Boeing jets. My folks are the ones that build those jets.

So I thank you, Mr. Royce, for bringing this issue to us, for giving us an item, a 4.3-cent gas tax cut that may be symbolic in the sense that it is the tip of the iceberg, but I think it projects what our team wants to do in terms of taxes generally, so that is much to your credit.

Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. I do not know when I am going to go wrong here, but I assume that there has been a dramatic increase in demand of petroleum. This is a result of winter being over and people getting ready to get their cars out of the garage and to make these trips. Then politically, we see a dramatic increase in gasoline prices at the pump. Politically, this disturbs everybody who is up for reelection, whether they are Republican or Democrat. We have to do something about it.

So while there is some question about how and why, at one time, we saw that dramatic increase. There is no question in my mind that the political solution appears to be to dramatically remove the 4-cent excise tax on gasoline.

I thought I heard you say, and this is basically my first question, that if you reduce the tax on gasoline, then you reduce the price of gasoline. Did you say that?

Mr. ROYCE. I think what I said was, and I was sharing an observation by a constituent of mine, he said, it is hard to figure out how we are going to get back to gas at 50 cents a gallon if 47.4 cents a gallon is what is paid in taxes to the government, and that was his point.

Mr. RANGEL. Congressman, I need your thoughts because I cannot bring my constituents' thoughts here, because the Chair would be embarrassed. But notwithstanding that, my President supports, I think, what you are saying, and I want to support my President. So my question to you is, Did you say that if you decrease the taxes, reduce the taxes, that the consumers will see a decrease in prices? That is all I am asking. Do you believe that?

Mr. ROYCE. What I indicated is that when government—and I think these were my words—when government increases taxes on a product or on a service, it is logical to believe the costs to the consumer are going to go up, and especially when government has imposed taxes to the tune of 47.5 cents a gallon, it is going to have an effect.

Mr. RANGEL. Forget what you said then. Let me ask a question of you now.

Mr. ROYCE. All right.

Mr. RANGEL. Do you believe if we knock off 4 cents a gallon of taxes right now, the consumer would receive any decrease in the cost of gasoline at the pump? Do you believe that will happen?

Mr. ROYCE. I think it will help drive down the costs if we help drive down the taxes.

Mr. RANGEL. I do not know what you mean by "help," but do you expect as a result of this repeal, this nonpartisan Republican Majority-Presidential agreement, that political year type of thing. Do you believe that once that is done, we should have reason to believe or do we believe that the consumer is going to pay less than he is paying today?

Mr. ROYCE. We have reason to believe that lowering taxes on a product will lower the cost to the consumer.

Mr. RANGEL. Would you support mandating the price at the pump be decreased by the same amount as we are decreasing the tax on gasoline? Would you support that we mandate it? Since we are all guessing and we want to please the consumer, we would not want anyone just to increase their profits by this and say that something else increased or we did not know about this or the President put too much.

Would you support the concept that, and if we cannot do it by law, we can certainly get language in here that we can expect this repeal be passed through to the consumer? This is election year type of talk, and I am prepared to join with you in a bipartisan way, that with any decrease we have in taxes, the cost at the pump be decreased by that amount.

Mr. ROYCE. Yes, I am happy to work with you on an amendment, to try to work out an amendment.

Mr. HANCOCK. Would the gentleman yield?

Mr. RANGEL. I will yield.

Mr. HANCOCK. Are you advocating price controls?

Mr. RANGEL. I am advocating reducing the price of gasoline at the pump to the American consumer as they get ready to embark on their spring and summer vacations.

Mr. HANCOCK. Are you advocating telling the oil companies that this is the price you are going to have to charge?

Mr. RANGEL. Between now and election, Mel, I want to reduce the price of gasoline at the pump and I want to do it any way that we can, and I do not want people to guess. I would hate to see that as we——

Mr. HANCOCK. You do not think that the marketplace will have any bearing on it?

Mr. RANGEL. Mel, please. I would hate to see——

Mr. HANCOCK. Thank you.

Mr. RANGEL. You are welcome—that we move forward and reduce the taxes and find some kind of way that we are embarrassed—not all, but those who support it—an increase in taxes at the pump. We do not want that, and I hope that we can agree we are going to mandate that if we reduce the taxes, they will reduce the price.

Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman's time has expired.

Mrs. Kennelly for a parliamentary inquiry.

Mrs. KENNELLY. Mr. Chairman, it is more of a procedural question. You mentioned to Mr. Matsui, I guess in your opening remarks, that we were not going to address a "pay for" for the repeal.

Chairman ARCHER. They are not expected to come out of this Committee's jurisdiction.

Mrs. KENNELLY. So may I ask the question, Mr. Chairman, tomorrow, or if it is not tomorrow, the day that we mark up, Will we be asked to vote for repeal without knowing how it was going to be paid for?

Chairman ARCHER. The gentlelady can rest assured that the Budget Act will be complied with and that whatever we do will be revenue neutral. But the offset will not come from this Committee.

Mrs. KENNELLY. Mr. Chairman, I just would like to remind you, twice during the organization meeting this year, I tried to have the traditional way, as when we pass a tax reduction, we have to pay for it in this Committee, and we did not get that rule passed. But I just wonder how we can possibly vote for repeal, not knowing how it is going to be paid for. I hope that does not happen.

Chairman ARCHER. I would simply say to the gentlelady that the same argument was made, as you recall, last year when we got into the Contract With America and assurances were given both to the Members of this Committee and to the public at large that whatever we did would be paid for and it was paid for because the Budget Act requires that.

Mrs. KENNELLY. Is there a possibility——

Chairman ARCHER. I would give the same assurances to the gentlelady this year that were given last year, and the proof of it is that it did occur, and before the bill is voted on the floor of the House, it will be joined with a "pay for" so that the Budget Act will be complied with.

Mrs. KENNELLY. Mr. Chairman, that is my concern. Will we be asked to vote in Committee for the repeal before we know what the "pay for" is?

Chairman ARCHER. Yes, because you would not have any opportunity to change the "pay for" in this Committee, irrespective of what it is. It is not within the jurisdiction of this Committee, and any effort to change it would be nongermane.

Mr. NUSSLE. Mr. Chairman.

Chairman ARCHER. Mr. Nussle.

Mrs. KENNELLY. It is like voting for a pig in the poke, Mr. Chairman.

Chairman ARCHER. Mr. Nussle.

Mr. NUSSLE. Thank you, Mr. Chairman.

It is just remarkable to listen to the defenders of big government squirm and get all excited about this here today. In fact, listening

to the gentleman from Michigan, I thought we were on the "Jeopardy" program and pretty soon he was going to ask for "Tax Increases for $500, please, Alex." That is not what happened, luckily, because if it did, we would have had to go into the history of this tax increase a little bit, so let me do that briefly, and then I have a question for you, Mr. Royce.

My understanding of how we got to this point is that the Democrats in 1993, as their way to "solve the deficit," was to increase taxes a lot, increase spending quite a bit but maybe not as much as they increased taxes, and as a result, they were going to solve the deficit. The righteous indignation we hear today about how this either worked or went to the solution does not recognize that, in fact, that solution in 1993 did fail and, in fact, it did not bring down the deficit. There have been deficits proposed and projected for years as a result of that 1993 deal.

Now they are running from their vote. The gentleman from Florida suggested that. He sure wanted that to go to the trust fund and he did not have any control over it. Of course, he was a Member of this Committee and in the leadership, but he did not have any control over that fact. Now, of course, they want to rewrite history and have amendments so that it goes toward the trust fund. But, in fact, it did not go to the trust fund. It went to fund bigger government.

Now Mr. Royce comes forward today with what I think is a reasonable proposal, one that suggests a way to pay for this by reducing the size of government. Maybe it means Hazel O'Leary is going to have to park her plane in the airport a little bit more than she is used to, and that is probably a good thing for all of us. But it means the cost of government is going to go down, and that is really the issue here today.

The President himself indicated he raised taxes too much and he did a mea culpa down in Texas about 1 year ago, suggesting and apologizing to the American people that he raised taxes too much. This is our opportunity to help him out by, whether it is Mr. Royce's proposal or another proposal, reducing the size of government so that we can, in fact, give back to the people, the American people, a little bit of what they earn, and that is really what this is all about.

There are some that suggest this is pandering. Obviously, they have never heard of the minimum wage. This is pandering? You have never heard of the minimum wage, obviously.

This is not pandering. It is putting back in the pockets of the American people that which they earned so they can spend it more wisely. They say there is no impact. Obviously, they have not talked to working families, maybe somebody who has their very first job, maybe on minimum wage, who have to pay more in taxes in order to get to work.

They say there is no impact on seniors that are living on a fixed income. They have forgotten about seniors now, all of a sudden. There is no impact, they say. They say, let us just continue this tax and let us just fund more government. Their answer is price controls. I do not think that is the answer.

Mr. Royce, what I would like to know from you, and this comes up quite often and I think Republicans are painted this way and

it is really not true, I know I am not antigovernment. I know I am not antitaxes. I just believe that government ought to be at the right level, that taxes ought to be at a reasonable level to fund the right level of government, and that is at the local level. I do not think increasing taxes and increasing spending at the same time is going to solve our problems.

We brought to the table in 1993 the solution of cut spending first. That was almost a battle cry to my constituents. What do your constituents say? Is this really about gas tax, the 4.3 cents? There are some that say this has no impact. Or is this a bigger issue about bigger government and more taxes?

Mr. ROYCE. In terms of the impact to California, the impact is $550 million a year as a result of this tax. But in terms of what the thrust of this legislation is, we look at a Department of Energy that has grown to some $16 billion a year in its costs. The cost of repeal of this tax increase is about $5 billion a year. So what we are saying is, let us look at a government agency where the General Accounting Office has already told us they cannot overcome their management weaknesses, it has a lack of credibility, eroding public support, a diminishing sense of purpose. Let us cut that back. Let us do that instead of imposing the fees on the American people.

Chairman ARCHER. The gentleman's time has expired.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

Mr. Chairman, it has been very instructive listening to all the chatter this morning, but let me start by responding to my good friend, Mr. Nussle, when he talks about senior citizens and the gas tax. I checked my mail before coming down here and I have yet to receive any correspondence from seniors in my district, and I have a very large population. However, I have bags full of letters decrying your Medicare cuts, so maybe you should check your mail to see what the seniors in your district are writing about.

Mr. Nussle indicates that in 1993, there were some tax increases. The bulk went to those who could afford to pay more. But like Paul Harvey says, And now the rest of the story. That same bill in 1993 did provide over $250 million in tax cuts. We find that the annual deficit when this President came to office was some $290 billion. That has been reduced today to about $140 billion, a decrease of almost one-half. So if you are going to start portraying what happened in 1993, I think it is incumbent to tell the whole story and not just one-half of the story.

My good friend, Mr. English, indicated to Mr. Royce that he has made a powerful argument, but I say to you, after looking at the statistics as to where California is as far as a State gasoline tax versus where the Federal Government is, I think, Mr. Royce, your argument today should be made in Sacramento, California, imploring Governor Wilson to join with you in helping your consumers out by radically decreasing the gas tax in California.

Again, let me state, the gas tax in California, the State tax in California on gas is 30 cents a gallon versus 18 cents on the Federal level. So you are taking more—and you served in the State Senate for 10 years—you are taking more in the State from your consumers than the Federal levy is.

Mr. Chairman, I think we all know what is going on around here today. What you are attempting to do, and your colleagues, is to jump start the Dole campaign. If, in fact, the consumers are going to benefit while you do that, I will be supportive. But I have to join my colleagues in voicing a lot of apprehension that the consumers are not going to benefit at all from our action.

In fact, over the next few weeks, I will be watching very closely select stations not only in my district but out here to see whether or not even 1 cent went into the consumers' pocket. I do not think it is going to happen. I think what we are going to see a few months from now is the tax changes from our action will go to the pockets of the oil refineries and the consumers be damned. As I look over the last 1½ years, the consumers have not benefited at all by any of the Republican Congress action. All of a sudden, it is 6 weeks before the campaign or the election and now consumers have catapulted to the top of your list.

Let me ask, Mr. Royce, clearly, this has been identified as a 4-cent Clinton gas tax. Let me ask you, sir, if you would join me in increasing this tax decrease to the tune of 14 cents, the other 10-cent reduction reflecting the Senator Dole gas tax increase. I think if it is good for the goose, it should be good for the gander, and if you are so concerned about consumers, I think a 14-cent reduction in the gas tax is a lot more beneficial than 4 cents, so I will give you the 4-cent Clinton tax if you join with me and help me to repeal the 10-cent Dole tax. I think that is a fair proposal. Would you join me in that, sir?

Mr. ROYCE. What we are trying to do is get a bill through this Committee——

Mr. KLECZKA. No, no, no. Just answer the question.

Mr. ROYCE [continuing]. And onto the President's desk and signed. We are discussing——

Mr. KLECZKA. Reclaiming my time——

Mr. ROYCE. Could I just answer?

Mr. KLECZKA. If you are stating before the Committee that you are proconsumer, you have to agree that a 14-cent cut in the gas tax is a lot better than 4 cents, so let us join hands in a bipartisan way and let us go and repeal the 4-cent Clinton tax and the 10-cent Dole tax and I think we will have a deal then.

Thank you very much, Mr. Chairman.

Mr. ROYCE. Can I respond, Mr. Chairman? I would like the opportunity, if I could.

Mr. KLECZKA. Please do.

Mr. ROYCE. First of all, I am happy to support rolling back taxes. There is a time when I get a little suspicious as to the agenda——

Mr. KLECZKA. If a 4-cent Clinton tax is bad, then a——

Mr. ROYCE. I am going to try to respond, if I can.

Mr. CHRISTENSEN. Mr. Chairman, regular order.

Chairman ARCHER. The gentleman will suspend.

Mr. ROYCE. We have here a tax increase——

Chairman ARCHER. The gentleman will suspend.

Mr. KLECZKA. OK, Mr. Chairman.

Chairman ARCHER. I would like to give you the opportunity to respond, but the time is under the control of the gentleman from

Wisconsin. I believe he has yielded back the balance of his time, is that correct?

Mr. KLECZKA. No, Mr. Chairman, I think I ran out of time, but I would ask unanimous consent——

Chairman ARCHER. You are out of time now, so we will move on to the next questioner, Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

I would like to inform the gentleman from California, my colleague, that I will allow him a chance to respond. I found it a bit humorous, listening to the previous discussion. It was humorous because of the points that were made. We heard something about a Medicare cut. I do not know if the gentleman from Wisconsin was referring to the increase that we had in our budget from $4,800 per Medicare recipient to $7,200. Is that the cut that the gentleman was referring to?

The gentleman from California also mentioned he does not hear anything from his district. Mr. Royce, we are in the same State. My district is about 500 miles north of yours and very different than yours. You are in an urban district. I am in a very rural, agricultural district. Some of our major industries are wood products, paper and wood production. The area of my district is larger than the 10 smallest States geographically, larger than the 5 smallest States combined, and we do not have mass transit. We do not have the choice of not driving to work. We must drive. It is not a luxury to use an automobile, it is an absolute necessity.

You mentioned that the cost of the Clinton tax was $422 per person. President Clintons' tax increase was the largest tax increase in our Nation's history. Let us take this particular 4.3 cents, and let us put this in perspective. As you mentioned, it is not a user fee. It goes directly into a growing government bureaucracy here in Washington. I want to commend my colleague, the gentleman from California, Mr. Royce, for attempting to roll this back. It is about time.

I think we need to make sure we do not get lost in the rhetoric of the big Democrat lie of saying there are cuts when there are no cuts. We need to know what is really going on. We need to get down to the point that we are talking about which is real people and real families, Mr. Kleczka. I do not know if anyone has said anything to you or if people are telling you——

Mr. KLECZKA. Would the gentleman yield?

Mr. HERGER. No, I will not yield now, but I want to mention to you——

Mr. KLECZKA. Since you mentioned my name, it would be kind to yield.

Mr. HERGER. Maybe they do not care in Wisconsin that their taxes are going up so dramatically, but I can tell you——

Mr. KLECZKA. Wally, your State tax is 30 cents.

Mr. HERGER. All I hear——

Mr. KLECZKA. Your State tax is 30 cents, Wally. What have you done?

Mr. CHRISTENSEN. Mr. Chairman, regular order.

Chairman ARCHER. The gentleman from Wisconsin is out of order and he knows it. The time belongs to the gentleman from California.

Mr. HERGER. I have been home every weekend for the last 5 weeks and all I hear is the fact that our gasoline prices are going up. That is all I am hearing, so this is a major problem. I do not know if it is a major problem everywhere, but it certainly is in my district.

Again, I want to commend the gentleman for his legislation. I certainly support it very strongly, and everyone I talk to supports it. We are also in the process—my own State legislators are in the process—of rolling back some taxes there in California and changing the Air Resource Board, which is another environmental problem we have there.

Mr. ROYCE. That is a point. The California prices are over 18 cents, the State excise tax, and on top of that there are sales taxes in California. I have spoken to the new speaker of the California legislature and he is attempting to reduce those State taxes in California. As a matter of fact, he introduced a bill to do that, Mr. Herger.

Mr. HERGER. Thank you. I yield back the remainder of my time.

Chairman ARCHER. Mr. Stark.

Mr. STARK. I will yield to Mr. Matsui, Mr. Chairman, if I may.

Mr. MATSUI. Thank you, Mr. Stark. I appreciate it.

Thank you, Mr. Chairman.

Ed, could you tell me, when did you introduce your bill?

Mr. ROYCE. I introduced this bill 1 week ago.

Mr. MATSUI. During the energy increase? I thought maybe you had introduced it before. Could you tell me why you believe the price of gasoline, in some cases, as you say, has gone up 20 cents? I have seen it go up 30 cents in some areas in the Washington area. Perhaps you can give me your rationale as to why this price increase has occurred over the last 30 days or so.

Mr. ROYCE. I think there are a number of factors and I do not have the answer, but I do know one component that is a major part of the price of gas, and as I have shared with you, it is the government taxes on gasoline, 47.5 cents. So that is something we can do something about. I think we should do what we can about the other factors. I agree with you on that.

Mr. MATSUI. But do you know what these other factors are?

Mr. ROYCE. I have read the same stories and I have been in the same briefings, I think, you have been in. This has been shared with us.

Mr. MATSUI. Would you like to relate them to us? I think that is why we are all here today.

Mr. ROYCE. We have discussed the different aspects. Admittedly, we have a couple refineries down in California. We do have some problems with expectation that we could have oil coming on the market out of Iraq. That did not happen. We have questions about what is happening in the gross margin at the refineries. We have questions about what is happening with the oil situation in Russia coming on the market.

Mr. MATSUI. Maybe you could break it down.

Mr. ROYCE. There are a lot of factors.

Mr. MATSUI. I will give 4.3 cents out of the 30 cents, so we are down to 26, 25.7 cents. Where does the 25.7-cent increase come from over the last 30 days? Can you break it up for me? We are

trying to make a deliberative decision here. Obviously, we have to make the same case on the floor and I would like some help. You are coming here as a Member who introduced a bill to reduce the gas tax and perhaps you can help us understand how we can bring the consumer back to what it was 30, 40, 50, or 60 days ago when it was $1.30 instead of $1.60.

Mr. ROYCE. And we are in the process——

Mr. MATSUI. If you could give us your rationale, that would help.

Mr. ROYCE [continuing]. We are in the process here of discussing some of the market forces which are being debated, are being investigated. The Air Resources Board in California is looking into this now.

Mr. MATSUI. But what about Washington? They do not have an Air Resources Board. Explain to me how that——

Mr. ROYCE. As you know, in California, one of the issues is we went over to a new type of fuel, a new type of petroleum.

Mr. MATSUI. But what about Washington?

Mr. ROYCE. That is somewhere close to 8 cents, or around 8 cents, I guess, a gallon. We have a situation with a couple of refineries in California that have been down.

Mr. MATSUI. So that affected the entire Nation, those two refineries?

Mr. ROYCE. And we have a refinery, I guess, down in Louisiana. We have a question on the gross margin on the refineries. We have a question in terms of expectation that we are going to have arrangements with Iraq that we are going to bring oil on the market. In the meanwhile, supposedly, everyone depleted their reserves. There are all these different factors that are being pointed to.

My point, though, is that there is one factor we directly influence and control and that is the cost of taxation on a gallon of gas.

Mr. MATSUI. Who are the experts you are talking to, because I would like to talk to them, too. Are you talking to any individual experts on this theory?

Mr. ROYCE. I think we are getting our information both out of the newspaper and——

Mr. MATSUI. Is that where you are getting yours out of?

Mr. ROYCE. That is where we are getting a lot of our information, and from our consultants on the Committees, yes.

Mr. MATSUI. I really appreciate this. This expertise that you are providing us on why the gas prices have gone up 30 cents a gallon has been very, very helpful, and I appreciate this.

I yield back my time.

Chairman ARCHER. Mr. Thomas. It was Mr. Stark's time. Does Mr. Stark yield back his time? I assume he does.

Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

I tell the gentleman from California, I have only been on this Committee 13 years now, so I do not have a long history of what has gone on, but it is a pleasure to announce to you that you probably have been asked more questions based upon your testimony than any other Member of Congress that has appeared before this Committee. I do not know what talent you possess, but you certainly have the ability to engage the attention of the Members of this Committee.

I want to thank you, one, for your legislation. I was somewhat amused by the gentleman from Wisconsin's reference to the rest of the story. Frankly, I did not think any Democrat would want to engage in the rest of the story dealing with the 1993 tax increase. This is only one aspect of the grab bag approach to try and find revenue to claim that they are beginning to reduce the deficit. Even the President said he raised taxes too much.

I am not going to focus on how much, because, clearly, it was too much, but rather on where they got it. This tax is an example of how they tried to piecemeal together the money to make it look good. They went after the seniors, increasing tax on Social Security above a stated income from 50 to 85 percent, the first ever shift from those sources of funds to try to cover up the continuing hemorrhaging in the trust fund in Medicare.

Even more ironic than that, where there was a cap on the amount of payroll subject to the hospital insurance tax increase, the Democrats in 1993 blew the lid off of that cap, arguing that that change would then provide sufficient revenue to protect the trust fund all the way into the middle of the first decade of the 21st century. And lo and behold, last week, CBO said the President's Board of Trustees in 1995 said, in 2002, we will be in the black by $5 billion on the Medicare Trust Fund. It turns out CBO is now telling us we will be $86 billion in the red.

The point is, on that tax, which they tried to gimmick to fix a problem, they are hemorrhaging. On taking money from the seniors, it was outrageous. And on the gimmick in terms of the tax on gasoline to make them look good as a response to the deficit, it was not a good idea, either.

I, frankly, am pleased that whatever the causes, the multiple causes of the need to focus on this kind of gimmickry has occurred, allows us to take a look at the way in which the Democrats said they fixed the problem, compare their attempt to fix the problem in 1993 with gimmicks like this to the current Majority, and the Chairman of this Committee's honest beginning of a fundamental assessment of the revenue that this government needs and how it is going to be extracted from its people.

I just want to tell my friend and colleague from California, this is not normal. You are the focal point for a number of frustrations because I think you are the one that has focused on the unraveling of this carefully knit political sweater that the Democrats did in 1993. You are the focal point; you are not the cause. If my colleagues spend more time than usual either trying to get you to claim you are an expert, and we have several panels to follow who certainly will provide us with far more expert opinion, you are an expert on your constituents. Your constituents are concerned and upset.

There are a number of other levels where there is taxation on gasoline. We hope those other levels address it. We are the Federal level. They did impose a 4.3-percent tax on gasoline. We can do something about that today, and I want to thank the gentleman for his legislation.

Mr. ROYCE. Thank you, Mr. Thomas.

Chairman ARCHER. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman.

Mr. Chairman, first of all, I would like to respond to my good friend, Mr. Nussle. I notice he is not here right now, but you should understand this tax was enacted into law in 1993 to help reduce the Federal deficit. This effort reduced the deficit by more than $500 billion. Republicans have passed into law no legislation to reduce our long-term national deficit. Now they want to pass a law whose effect will be to increase our deficit by more than $30 billion. Will the Republicans enact any laws that reduce the deficit or only ones that increase it? That is the question facing this Committee and all of us today.

Mr. Royce, let me ask you, sir, you know and I know that 1996, this year is an election year and that is why we are holding this hearing. I think my good friend and colleague from Wisconsin is right. This is an attempt, a deliberate, open, blatant attempt to start a stranded, delayed Dole campaign. If this was not an election year, this Committee would have the common sense not to consider a bill that will repeal a tax for 7 months. Do you really think in your heart it is wise to repeal a tax for 7 months?

Mr. ROYCE. I came here in 1992 and I watched as this tax was increased on the House floor. I did not vote for the increase. Neither did my colleagues on my side of the aisle. My point is that when we repeal this tax, we should do it by what should have been our focus then in 1993, cutting excessive government bureaucracies and agencies that have grown at a horrendous, horrendous pace. We look at the Department of Energy and the growth rate there and the comments by the General Accounting Office, it is time to pare back some of these agencies.

No, there is no effect if we offset this tax reduction on the American people with a reduction in government expenses for bloated Federal bureaucracies like the Department of Energy. Then there is no impact, and Congressman Lewis, that is the approach I want to take in this legislation.

Mr. LEWIS. Let me ask you, do you think it would make more economic sense to repeal the tax until the first week of November, until after the election is over?

Mr. ROYCE. Pardon.

Mr. LEWIS. Do you think it would make more economic sense to repeal the tax until the first week in November, just until the first week in November, just until November 5?

Mr. ROYCE. No. It makes the most sense to cut the Department of Energy now and reduce the taxes now. That is what makes the most sense to me, and that is what I propose to do in this bill. I do not want to delay this. I want to implement it and I want to get some reductions over there in the Department of Energy.

Mr. LEWIS. I know you are from the State of California. I come from the State of Georgia. I have environmental concerns about repealing the gas tax. Unfortunately, there are no environmental groups here today to testify. My home district, the city of Atlanta, is a nonattainment area for ozone and other pollutants under the Clean Air Act.

Congestion and urban sprawl are two of the greatest problems facing our city and our landscape today, and we are so dependent on cars because gasoline is so cheap. The taxes we place on gasoline do not pay for the roads, the bridges that the government

builds, the problems caused by pollution, health problems. I must tell you I am somewhat disappointed that as a Congress and as a Committee, this body is taking such a short-sided approach to our Nation's transportation policy.

Let me ask you the question, sir, Do you think reducing the price of gasoline undermines our efforts to encourage mass transit, reduce gridlock, and improve the health and environment of our Nation? What type of Nation are we going to leave for our unborn generation if we do not do something about urban sprawl and congestion?

Mr. ROYCE. Let me share with you, the taxes imposed by government on a gallon of gas across the United States are already over 40 cents a gallon. So, I think what we are doing by reducing this latest levy on the taxpayers is just making it more affordable for them, putting dollars back in their pockets that should have been left in their pockets to begin with.

I think a most important aspect of this is that when we look at what we have spent on the Department of Energy since President Carter created that agency, we look at the $15 billion a year we spend there, is it not time that we left more money with the taxpayer and got a rein on the costs of increase in the government agencies?

Mr. LEWIS. Mr. Royce, I do not think you are really dealing with the question I am trying to ask here. Do you think by reducing——

Chairman ARCHER. The gentleman's time has expired.

Mr. ROYCE. No, I do not. I really do not. I think it is a good move for the American consumer.

Mr. LEWIS. Do you not have some concern about the environment, about the future?

Mr. ROYCE. I do, and I——

Mr. LEWIS. Do you not think we should lose the love affair with the automobile?

Mr. ROYCE. We should lose the automobile?

Chairman ARCHER. The gentleman's time has expired.

Mr. Hayes.

Mr. HAYES. Thank you, Mr. Chairman. I knew the day would come when I also wanted to thank you for helping me to get on this Committee.

I am not going to embroil myself in any of the political observations about the 1996 election because I think it is too important. Instead, I will talk about 1993. I was a Member of the Democratic party. I was a member of one of six or so Democrats who voted against the 1993 tax increase.

If there are those in this room who are bemoaning the difficulties they are now seeing from citizens who are not happy with the increase in gas prices, I now understand, because, my goodness, if they had passed that BTU tax that was the original proposal of Mr. Gore, they would not have to worry about calls and letters. They would have to worry about drive-by shootings. If you combine what happened in the Northeast this winter with the irate level of public concern, you would be sitting here today hoping you had enough National Guardsmen to surround this hearing.

I also understand now for the first time why Al Gore proposed a BTU tax. It was an environmental concern, and the gentleman

from Georgia has expressed it. In other words, if you can find a way to make energy costs so high that no one can travel anywhere, you can force them to sit in cities they do not otherwise want to have to live in because their tax structure has become so incredibly high that it has forced business out. It is tax versus tax, and instead of considering lowering a tax, you figure out how to make one so incredibly high that just a high tax looks attractive in comparison.

Mr. LEWIS. Will the gentleman from Louisiana yield?

Mr. HAYES. No. I am just getting started. This is great.

Mr. LEWIS. You are a candidate for the Senate, that is why.

Mr. HAYES. First of all, if we will go back and take a look, in other words, it does not matter that over one-half of our oil products come from other countries. It does not matter they are imported here, that we now depend upon countries in the Middle East to give us products. It does not matter that our refining capacity has diminished over the last decade. It does not matter that we have environmental practices, many of which, John, I agree with you, are very good. But it does not matter that they exist. We are not willing to say they are going to have a cost impact. It does not matter. All of this is the result of pure politics, if you want to believe the opponents.

You had a harsh winter that nobody could do politically. You have refining capacity down that is not a political decision. You are lucky you ducked the bullet of the BTU tax, and instead, what you ought to do is what you can do.

Our solution in this Committee is to repeal a tax that should have never been passed, a tax that was coupled with 56 to 58 billion dollars' worth of giveaway programs to entice people to vote for the tax that passed by a single vote. And finally, the only alternative we have from the executive branch is to take an oldtime reservoir created in Elk Hills with about 30 minutes' worth of gasoline after it is produced and say, that, instead, is our alternative.

I know it is awfully hard to lower a tax, especially if you are in the Democratic party. It is extremely difficult to lower one, because then you start having to explain how it got raised there in the first place.

If old Isaac Newton was on our next panel, he would be absolutely astonished by some of the physics and economics he has heard here today. What we have heard is when a tax goes up, it is good. When it comes down, it does untold damage. Newton's third law of motion would apply. It applies to politics, too. For every action, there is an opposite and equal reaction. President Clinton was right when he said he made a mistake raising this tax. We should support him now and repeal it, because the opposite and equal reaction is from an irate group of American citizens who have been taxed to death.

Thanks, Mr. Chairman. I knew I would like serving here.

Chairman ARCHER. Mr. Matsui, do you still claim some time for yourself?

Mr. MATSUI. No.

Chairman ARCHER. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman.

Mr. Lewis, being from Michigan, I would vote no on losing our love affair with the automobile.

This $268 billion tax increase which was passed in 1993, of which my colleague correctly pointed out initially there was going to be a BTU tax, and then a 7.5-percent tax increase, and fortunately, the Senate lowered that. It is still a bad tax, but those were tax increases on the rich. Of course, the rhetoric at the time ignored the gas tax increase and ignored the Social Security benefit tax increases. But economic studies have shown that that whole tax package has resulted in $2,600 less personal disposable income for every U.S. household. That is significant.

There has been a lot of discussion about how this tax decrease would affect consumers. I wish that same sensitivity on the other side had been shown when the tax increases were being debated. But as those who argued this was a tax increase on the rich, it does not surprise me they question whether the tax decreases would get to consumers because they underestimated the devastating impact these tax increases would have on every single American, $2,600 in lost disposable income per household.

Of course, the average growth rate in this country is at about 1.7 percent for the last two quarters. That is far too low. Last month, the economy only created 2,000 jobs. We should not be satisfied with that. We should be doing better, and we can be doing better. The reason we are not experiencing greater economic growth is because of this whole tax package, of which the gas tax is a part.

Higher incomes and more jobs would occur had the higher tax rates not been imposed, and this particular gas tax falls disproportionately on those at lower incomes.

I yield back the balance of my time.

Chairman ARCHER. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank Congressman Royce for coming here this morning. He gave us an opportunity for opening statements.

But Mr. Royce, I would just like to mention you have had a good deal of time before the Committee and two questions are still unanswered. One is how we pay for this repeal, and the other one is, I do not think—I may be wrong, but I do not think you gave us a way to assure that the tax goes back to the consumer so that they would notice.

Mr. ROYCE. I shared with you that the legislation would pay for the reduction of this tax by reducing the budget of the Department of Energy, and second, I shared with you a willingness to work with you in terms of that language.

Mrs. KENNELLY. I thank you for that. I have been working on it for some time, trying to give it back to the consumer, which is all our objective. It is almost impossible. But if you find a way, let me know.

Mr. ROYCE. Thank you, Congresswoman.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Royce, I was interested in your last paragraph, when you say, "For these reasons, I am proposing the termination of unneces-

sary programs." I am assuming that you are talking about in the Department of Energy?

Mr. ROYCE. Right.

Mr. HANCOCK. Could you give me a necessary program that they have implemented?

Mr. ROYCE. Let me just share with you that over the last few decades, approximately $90 billion has been poured into energy research and development, $50 billion for nuclear energy, $19 billion for coal, $10 billion for solar, $5 billion for oil, $3 billion for natural gas, $2 billion for geothermal energy, $1 billion for hydropower, and given the dramatic sums invested in energy R&D over the last few decades, the government has little to show for its effort.

Although a small success here and there can obviously be demonstrated, the commercial returns on those investments do not even come close to matching the sums allocated. If Federal energy R&D programs were operated by a single business, that business would have gone bankrupt long ago.

My point is that as we look at the Department of Energy, we can make reductions there and this bill targets 30 percent reductions.

Mr. HANCOCK. I notice that the estimate of what we are spending on the Department of Energy is $16 billion a year. Is that correct?

Mr. ROYCE. Approximately.

Mr. HANCOCK. We are talking about a reduction in the tax of roughly $5 billion?

Mr. ROYCE. That is correct.

Mr. HANCOCK. Under those circumstances, would you advocate privatizing and turning these programs over on a competitive grant basis just completely for the necessary energy research, the R&D, and completely closing the Department of Energy?

Mr. ROYCE. What I have targeted are specific proposals that have been made by former Secretaries of the Department, proposals made by the General Accounting Office, and they total a sum of about 30 percent of the agency budget.

So that has been my recommendation at this time, because there is a connection between reducing the gas price, reducing the tax assessment for the American public, and the growth of this Department ostensibly created during the Carter administration to do something about energy prices in this country. Now, as we look at the cost to this country of close to $16 billion a year for this Department, it is clear that we should look at downsizing and cutting back some of those costs.

Mr. HANCOCK. Thank you. I think if we could move more in that direction in a lot of departments in government, we would be a lot better off.

Thank you, Mr. Chairman.

Chairman ARCHER. Are there any other Members who have not inquired who would like to inquire?

Mr. ROYCE. Mr. Chairman, I would like to thank you and I would like to thank the Members of the Committee.

Chairman ARCHER. Congressman Royce, thank you for taking the time to appear before the Committee and to respond to questions. We appreciate your input. You are excused.

Chairman ARCHER. The Chair would invite our first panel, Mr. Fleenor, Mr. Keating, Mr. Verleger, and Mr. Sherbert, to come to the witness table.

Gentlemen, welcome to the Ways and Means Committee. Our standard rules of procedure are that, without objection, your entire statement can be entered into the record in writing. We would ask that you limit your oral testimony to 5 minutes. There are three lights in front of you: green, yellow, and red. When the yellow light is turned on, it means you have 1 minute left. We hope that we can get your cooperation to summarize within that 5-minute limit.

Under those suggestions, Mr. Fleenor, would you please identify yourself for the record and then you may proceed.

STATEMENT OF PATRICK W. FLEENOR, ECONOMIST, TAX FOUNDATION

Mr. FLEENOR. Mr. Chairman, Members of the Committee, my name is Patrick Fleenor and I am an economist at the Tax Foundation. It is an honor for me to appear before your Committee today on behalf of the Tax Foundation to discuss proposed repeal of the 4.3-cent-per-gallon gasoline tax.

The Tax Foundation is a nonpartisan public policy research institute which has conducted analysis of tax policy since 1937. We do not take positions on specific pieces of legislation. Our goal is to explain as precisely as is possible the current state of fiscal policy and the consequence of particular legislation in light of established tax principles so that you, the policymakers, have the information you need to make informed decisions.

I have a prepared statement which I will submit for the record. I will summarize my statement.

The problem we find with the 4.3-cent-per-gallon gas tax has been discussed earlier. The initial concept of using the proceeds of excise taxes on motor fuels to fund transportation projects was a sound one. People using the Nation's transportation infrastructure are assessed a user fee via the excise taxes on motor fuels to fund highway construction, maintenance, and operation. The concept has long been recognized as a central tenet of public finance, known as the benefit principle.

The problem with the 4.3-cent-per-gallon gas tax is that it goes into the general fund and not into the Highway Trust Fund. This has undermined the integrity of the user fee concept that was initially envisioned for the Highway Trust Fund.

Repeal of the 4.3-cent-per-gallon gasoline tax would help to reestablish this principle. I would be happy to answer any questions.

[The prepared statement follows:]

Statement of

Patrick W. Fleenor
Economist
Tax Foundation

before the

COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

on

The Impact of the 1993 Tax Increase on Transportation Fuels

May 8, 1996

Mr. Chairman and Members of the Committee, my name is Patrick Fleenor and I am an economist at the Tax Foundation. It is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss the proposed repeal of the 4.3 cents per gallon gasoline tax.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has monitored fiscal policy at all levels of government since 1937. The Tax Foundation is neither a trade association nor a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and as clearly as possible the current state of fiscal policy and the consequences of particular legislation in light of established tax principles, so that you, the policy makers, have the information to make informed decisions.

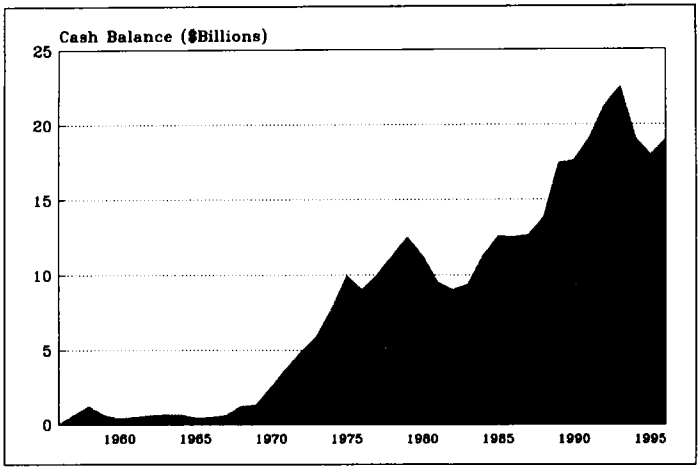
By abolishing the 4.3 cents per gallon gasoline tax, Congress would be acting in accordance with well established principles of public finance. If these principles had been applied over the past two decades, American households would face a federal gas tax that is substantially lower than the 18.3 cents per gallon tax imposed today. Application of sound principles would also have helped to maintain the Federal Highway Trust Fund as a user fee type system.

The Benefit Principle and the Federal Highway Trust Fund

An established tenet of public finance is the benefit principle. This idea dates back to Adam Smith and earlier scholars of public finance. It states that an equitable tax system is one in which the beneficiaries of a public service are taxed in accordance with their use of that service. Such a system creates a market-type mechanism which both forces users to conserve on their use of the service and provides it with a source of funding.

During the first 13 years of its life, the Federal Highway Trust Fund was an example of this type of arrangement. Users of the nation's transportation infrastructure were assessed a fee, via excise taxes on transportation fuels. These fees were then deposited into a trust fund and were withdrawn to pay for the construction, maintenance, and operation of transportation projects. Figure 1 illustrates that from the time of its creation in 1956 until 1969, virtually all of the revenue collected from excise taxes on transportation fuels and

Figure 1
Highway Trust Fund Cash Balance, 1956 - 1996
(Highway and Transit Accounts)



deposited into the Federal Highway Trust Fund was reinvested in the nation's transportation infrastructure.

The integrity of this user fee type system first began to break down in the early 1970s when the Federal Highway Trust Fund began to accumulate large balances. This was an indication that users of the nation's transportation infrastructure were being assessed a fee in excess of the benefit they were receiving. In accordance with the benefit principle, excise taxes on transportation should have been reduced at this time so as to maintain the equality between what users of the system were being required to pay and the actual costs of operating the system. Instead, excise taxes on transportation fuels have been consistently increased since this time and the Federal Highway Trust Fund has continued to maintain

huge surpluses. At the end of FY 1995, the latest data available, this surplus was $19.0 billion. Because the federal budget process allows these surpluses to be used as an offset against shortfalls in other parts of the budget, the revenues in this trust fund have, in effect, been used to finance other federal programs.

The integrity of this user fee type system was further undermined by passage of the Omnibus Budget Reconciliation Act of 1990. Like prior legislation, this act imposed a temporary 2.5 cents per gallon levy on all fuels used in highway and rail transportation. This temporary levy was set to expire on September 30, 1995. Unlike prior legislation, however, this legislation directed the proceeds of this tax hike into the General Fund rather than the Federal Highway Trust Fund. For the first time the tradition of using motor fuel taxes to fund transportation projects had been formally broken.

The Omnibus Budget Reconciliation Act of 1993 further dissolved this link by assessing a permanent 4.3 cents per gallon excise tax on motor fuels used in transportation. As was the case with the 1990 Act, all of the revenue collected from this tax was explicitly dedicated to the General Fund, not the Highway Trust Fund.

Repeal of the 4.3 Cents Per Gallon Gasoline Tax

The original concept of using the proceeds of motor fuel excise taxes to fund transportation projects was firmly rooted in the benefit principle. As stated above, however, the integrity of this system has been undermined by both the build-up of huge surpluses in the Federal Highway Trust Fund and the diversion of transportation fuel excise tax revenues into the General Fund. Repeal of the 4.3 cent per gallon gasoline tax would help to restore integrity to the system.

Mr. HERGER [presiding]. Thank you, Mr. Fleenor.

We will now hear from David Keating, executive vice president of the National Taxpayers Union.

Mr. Keating, your testimony, please.

STATEMENT OF DAVID L. KEATING, EXECUTIVE VICE PRESIDENT, NATIONAL TAXPAYERS UNION

Mr. KEATING. Mr. Chairman, my name is David Keating. I am executive vice president of the 300,000-member National Taxpayers Union, and we appreciate the opportunity to appear before the Committee today in support of repealing the 4.3-cent-per-gallon gas tax increase adopted in 1993.

Repealing this tax will provide real and immediate tax relief to millions of working Americans. It will do so without the need to file any new forms to the U.S. Government, which I think is a great thing.

I recognize it is very difficult for those who favor big government to give up any revenue. For the past few days, we have heard news media accounts that repeal of the tax would mean little because it would mean savings of only some $40 or $50 per year for the average family. But we can and should do more to provide tax relief. This should be the beginning of a tax relief program.

I also remind you not to focus solely on averages. Recognize that averages do not give an honest picture of the help that repealing this tax would give to many Americans, including those who live outside metropolitan areas because they cannot afford high housing costs in the inner suburbs, those who do not have access to federally subsidized mass transit systems, and those who must use their cars to drive long distances to work or school.

A few months ago, I am sure many of you read the article in the Washington Post about how many workers must commute from the outer suburbs in many cities. There are people who commute from Winchester, Virginia, to Washington, DC. Obviously, repeal of this gas tax increase will greatly affect their pocketbooks. Remember, too, the commuters who must spend hours sitting on so-called freeways, burning up gasoline.

It is not simply the tax paid at the pump but the tax paid through higher prices at retail stores. Virtually everything bought in today's stores is delivered by trucks, and truckers must also pay higher motor fuel taxes from this 1993 tax hike.

Cutting this gas tax will not affect spending on infrastructure because the 1993 tax hike was simply a revenue raising device and none of the revenue was earmarked for highway repair or construction.

Please consider that the gasoline tax is not a true user fee, since its burdens bear little relationship to the actual use of or damage to the Nation's infrastructure. In fact, we could cut the gas tax even more if Congress were to reform expenditures from the Federal Highway Trust Fund or to move to a real user fee concept and reduce general gasoline taxes accordingly.

I think it is clear that cutting gas taxes would also increase our Nation's anemic economic growth rate. My written statement discusses some of the research that has been published on this subject.

Yesterday, according to the Tax Foundation, was Tax Freedom Day, the theoretical point at which we stop paying our taxes and begin earning money for ourselves. Tax Freedom Day came a day later this year, and it has been coming later in recent years. Our citizens expect and deserve significant relief from this crushing tax load. Working until May of each year is far too much for the average person. Much more needs to be done to provide tax relief, but decreasing the gas tax would provide the average American with an immediate, visible, and measurable reduction in the severity of the tax bite.

Mr. Chairman and Members of the Committee, you have an opportunity to provide real tax relief to Americans squeezed by high taxes by repealing this burdensome tax.

Thank you.

[The prepared statement follows:]

Statement of
David L. Keating
Executive Vice President,
National Taxpayers Union
before the
Committee on Ways and Means
U.S. House of Representatives
on the
Proposed Reduction of the Gasoline Tax
May 8, 1996

Mr. Chairman and members of the Committee, thank you for this opportunity to appear today in support of the proposal to repeal the 4.3 cents-per-gallon motor fuels tax increase that was imposed by the 1993 tax act.

The repeal of this tax is the best available means that the Federal government has to provide real and immediate tax relief to millions of working Americans who are faced with higher gas prices when driving to work and meet family needs.

I recognize that it is very difficult for those who favor big government to give up any revenue that could be used to support their objectives. For the past few days, we have seen their misleading claims in the media that repeal of the tax would mean little to most people because it would mean a savings of *only* some forty or fifty dollars per year for the *average family*.

Please do not focus solely on *averages*. Recognize, instead, that *averages* do not give an honest picture of the help that repealing the tax would give to those Americans who:

- live outside metropolitan areas because they cannot afford high housing costs;
- do not have access to modern mass transit systems, or must commute to or from areas not served by mass transit;
- must use their cars to drive long distances to work or school; or
- are in lower income levels where transportation costs use up a large share of their income and who often drive older, less efficient cars.

One recent news account reported the *average* savings per family from repeal of the 4.3 cents tax on motor fuels in D.C. ($30), Maryland ($46), Virginia ($52), and nationally ($48). The article did not illustrate the tax relief that repeal of the tax would give to the worker who lives in Frederick, Maryland or Winchester, Virginia who must commute 80 or 100 miles each day to Washington, or the worker in more rural parts of the country who commutes even further to work, or the workers who spend hours sitting in traffic jams on "freeways" in California.

Remember also that the tax that drivers pay at the gas pump is only a small part of the burden that is imposed on them by a motor fuels tax. A tax on motor fuels is also paid by those who produce, transport, and supply the goods and services upon which all of us depend. Thus, taxes on gasoline are reflected in the price we pay for our groceries, our clothing, our housing and other necessities. Again, those in low and middle income levels bear a heavy burden because a larger share of their income is used to pay for these necessities.

It is easy to see why many who live inside Washington's beltway or in other metropolitan areas favor a high gasoline tax. Those who live in the Washington area enjoy

a modern mass transit system that has received massive construction and operating subsidies -- at the expense of taxpayers across the country -- while those taxpayers outside the area struggle to support their families and pay their taxes.

Opponents of reducing gasoline taxes have abjectly failed to make a rational political or economic case for their position.

Those who warn that cutting the gasoline tax will increase the deficit overlook current efforts by many in the House and Senate who support offsetting any projected revenue loss with reductions in wasteful or low-priority spending. Decreasing the federal rate by 4.3 cents would amount at most to a tiny fraction of one percent of all annual federal outlays. Congress could also examine any of a myriad of additional program reforms -- from power marketing subsidies to television spectrum giveaways -- that could easily provide billions more for tax relief.

Historical evidence shows that unrestrained spending, not restrained taxes, fuel deficits. Recent studies from the Joint Economic Committee have found that each dollar in new taxes has triggered over one and one-half dollars in new spending.

This lesson is not lost on the American people. They instinctively distrust politicians who tell them that enacting -- or preserving -- tax hikes are good for families because they reduce the deficit. A recent series of scientific polls of 1,000 registered or likely voters by Grassroots Research, an independent polling firm found that 78% of those surveyed believe that if taxes were raised for the stated purpose of reducing the deficit, the money would actually be used to fund other government programs. These results suggest that defending the current gas tax burden because of its impact on the deficit will not resonate with most Americans.

Cutting the gas tax will not affect spending for federal highways under the Highway Trust Fund. The 1993 gasoline tax increase was simply a revenue raising device, and the revenues are not earmarked for highway construction or repair.

The gasoline tax is not a true "user fee," since its burdens bear little relationship to the actual use of or damage to the nation's infrastructure. The gas tax could be cut even more if Congress were to reform expenditures from the federal Highway Trust Fund. Another way to provide more substantial tax relief would be to move to a real user fee and reduce general gasoline taxes accordingly. Most of the damage to the nation's highways comes from heavy trucks, and the motor fuels tax does not compensate for this damage.

Those who are concerned about the environmental impact of reducing gas taxes should re-examine how the present flawed structure already serves as a roadblock to more efficient environmental policy. The gas tax distorts the marketplace and hampers incentives for automobile and truck users to minimize highway congestion and associated environmental damage. Virtually every industry charges higher prices to avoid long waits or overuse in peak periods by customers. For example, it normally costs more to make a phone call during the day than it does at night. But the toll to cross the Lincoln tunnel in New York City is the same 24 hours a day.

Cutting gas taxes could also increase our nation's anemic economic growth rate. One analysis estimated that an average of 8,000 auto and related industry jobs alone would be lost for every penny of higher gas taxes. Another study from the Institute for Research on the Economics of Taxation found that a gas tax hike of 7.3 cents per gallon, originally proposed as a substitute for the ill-fated BTU tax, could have cost between 200,000 and 225,000 jobs.

IRET concluded that a tax hike of that magnitude could have reduced GNP by approximately $25 billion. As a result, a significant share -- as much as one-fourth -- of the proposed additional gas tax revenues would have been offset by lost revenues in income and other taxes.

Although the final gas tax increase to which Congress agreed in 1993 was 4.3 cents, the basic economic lessons from studies of the 7.3-cent increase still apply. Clearly, economic growth could have been more robust, and would be more robust in the coming years, if the increase was repealed.

At the beginning of this Congress, the Contract With America initially promised taxpayers $354 billion in tax relief. That promise eventually shrank to $245 billion, only to be vetoed in its entirety by President Clinton. It is sadly ironic that yesterday, taxpayers were able to "celebrate" Tax Freedom Day, the theoretical point at which they stop working to pay taxes and begin earning money for themselves. Tax Freedom Day came one day later this year.

Our citizens expect and deserve significant relief from this crushing tax load. We hope that the rest of the 1990 and 1993 tax increases will be repealed. While much more needs to be done, decreasing the gas tax would provide the average American with an immediate, visible, and measurable reduction in the severity of the tax bite. Congress and the President should not delay in providing this down payment on a less burdensome tax system.

Mr. Chairman and members of the Committee, you have an opportunity to provide real tax relief to Americans squeezed by high taxes. Repeal this burdensome tax.

Mr. HERGER. Thank you very much, Mr. Keating.

We will now hear from Philip Verleger, vice president of Charles River Associates.

Mr. Verleger.

STATEMENT OF PHILIP K. VERLEGER, JR., VICE PRESIDENT, CHARLES RIVER ASSOCIATES

Mr. VERLEGER. Thank you, Mr. Chairman. It is an honor to appear here today. I note that I received the invitation at about 5 o'clock yesterday afternoon, and so my testimony is very brief. I have attached a speech that I gave earlier this month to SIGMA, the Society of Independent Gasoline Marketers, explaining my interpretation of recent events in gasoline markets.

I should say I appear as an individual and the views I express are my own, not those of Charles River Associates, an economic consulting firm. I have also served in the past at the U.S. Treasury, and my primary business is as a petroleum economist and consultant to the petroleum industry.

I am here to comment solely on whether the consumer will receive any benefit from a reduction in the 4.3-cent-per-gallon gasoline tax. As I explained in the speech to the Society of Independent Gasoline Marketers, the increase in the price of gasoline is due to a series of facts, almost all entirely unrelated right now to the current gasoline tax.

The increases are caused by regulations imposed by the U.S. Environmental Protection Agency, which have almost criminalized the distribution of gasoline. The higher price of gasoline today is substantially due to EPA regulation.

The increases in price also stems from the fact that we have had a series of serious problems at U.S. refineries after a number of years of good luck.

The increase in gasoline prices recently is due to the fact that consumption has risen, in part, because consumers have shifted to much larger vehicles.

It is my conclusion that over the next 3 months, there is nothing Congress can do to affect the retail price of gasoline in most regions, because it can neither increase the supply of gasoline nor reduce its consumption. Had EPA not issued regulations that made it very difficult to import gasoline, we could import gasoline in larger volumes and that might bring down the price. But essentially, the supply now is inelastic.

I note that the chairman of Atlantic Richfield Co. said this week at the stockholder meeting that he was not sure a cut in the gasoline tax would be reflected in lower retail prices.

I am concerned the temporary cut in the gasoline tax would lead to uncertainty in financial markets due to the concern in their markets over the budget deficit. I can envision some increase in interest rates in the event of this particular tax cut.

Therefore, I conclude that the cut in the gasoline tax would probably not be reflected in retail prices or get to the consumer until after Labor Day. In the meantime, the cut could quite possibly increase voter cynicism about the actions that take place in this town. In my opinion, it is a bad idea, particularly on the proposed 7-month basis.

Thank you for inviting me to speak.

[The prepared statement and attachment follow:]

Testimony of Philip K. Verleger, Jr.
Vice President
Charles River Associates[1]

Before
Committee on Ways and Means
U.S. House of Representatives

May 8, 1996

The recent increase in gasoline prices has led to proposals to temporarily suspend the 4.3 cents per gallon tax on gasoline imposed as part of the 1993 Budget Reconciliation Process. I believe that such an action would be a drastic mistake for the following reasons.

First, as I explained in a speech given to SIGMA, the Society of Independent Gasoline Marketers of America, the increase in gasoline prices is the result of a number of factors. Among the most important of these are (1) regulations promulgated by EPA that limit the flexibility of the gasoline distribution system, (2) accidents at certain critical refineries, and (3) the increase in gasoline consumption that has resulted from higher speed limits and the purchase of less fuel-efficient cars. Suspension of the gasoline tax will do nothing to correct these factors.

Second, the increase in gasoline prices is the consequence of a limited supply of gasoline. Under these circumstances, the only two ways of bringing about a reduction in the price of gasoline are to (1) increase supply or (2) reduce consumption. Since the tax cut will affect neither supply nor demand, I conclude it will do nothing to affect retail prices.

Third, the decrease in the gasoline tax will have an adverse affect on government revenues and will cause an increase in the budget deficit. Further, I fear that a temporary cut in the gasoline tax will increase concerns in financial markets that the United States is losing its willingness to address the budget deficit. If this happens long-term interest rates could increase and economic activity could be adversely affected.

Fourth, I believe there is a real possibility that tightness in gasoline markets will prevent the benefit of the cut in the tax from reaching the consumer until the fall. If this happens the tax cut will serve only to increase voter cynicism.

Fifth, I strongly applaud efforts by both the majority and the minority parties to remove the federal government from micromanagement of the U.S. economy. We learned from a long and very difficult period in the seventies that government intervention in the economy often had perverse effects. Most economists credit much of the steady improvement in the economy since 1980 to the removal of government controls over energy regulation and other sectors of the economy. The proposed cut in the gasoline tax represents a return to the interventionist past.

For these reasons - and a host of others - I strongly oppose the proposal to cut the gasoline tax under the current circumstances.

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[1] Affiliation shown for information purposes only. The opinions expressed in this paper are solely those of the author and do not necessarily reflect the views of Charles River Associates.

Market Chaos

A Speech to The
Society of Independent Gasoline Marketers of America

by

Philip K. Verleger, Jr.
Vice President

Charles River Associates
1001 Pennsylvania Avenue
Washington, DC 20008

April 28, 1996

Thank you for inviting me to appear at this annual meeting of the Society of Independent Gasoline Marketers. I am particularly grateful to Leo Liebowitz and Ken Doyle for the invitation. It is a special pleasure to be here in this lovely location.

These are not, however, lovely times for gasoline marketing business. Recent increases in prices of crude oil, heating oil futures, natural gas, natural gas futures, and gasoline futures, and in wholesale prices of heating oil and gasoline, have led a number of parties to question to the market's rationality. The phrase I hear every day is " what's going on?" Recent articles in *The Wall Street Journal* and hearings before the California Air Resources Board have created more smoke than light.

Why all the noise? Consider the following facts. Since December the price of natural gas has increased from $2 per mcf to $14 per mcf on spot markets. This winter some consumers of natural gas in Chicago paid $60/mcf for small supplies of natural gas — the equivalent of $360 per barrel for oil or $8.60 per gallon for gasoline. (Imagine how drivers of natural-gas-powered vehicles would have felt if they had been forced to pay such prices.) Spot heating oil prices rose from $0.50 to $0.79 per gallon in New York Harbor. Crude oil prices increased by 50 percent from $17 per barrel in mid-December to $25.43 a few weeks ago. And now some observers — myself included — say gasoline will be next.

While I will refrain from offering a forecast of prices for the summer today, I would like to talk to you about the factors driving the markets. It is important for you to understand these factors because they are likely to become a permanent fixture on the landscape — a fixture you must understand if you want to survive. I will briefly list these factors and then go into more detail on many of them.

The *first* critical factor driving prices up is environmental regulation or rather, regulations. In particular, regulations mandating the introduction of various types of gasoline and regulations that make it economically dangerous to own storage have limited available supplies and increased prices.

The *second* factor driving up prices is bad luck. For the last several years, directors of refining economics at every company I know have hoped that one of their competitors would suffer an upset. No one wanted their friends to have a major disaster and clearly no one wanted to see refinery workers harmed. But everyone secretly hoped the supply chain would be moderately disrupted. This year, the disruptions are happening.

The *third* factor is consumption. American consumers are in love with the large utility vehicles that are subject to minimal CAFE standards. They also love speed, and the increase in speed limits has boosted use. The EIA estimates that the combined effect of these factors may raise consumption by 2 percent. I think growth may be larger if supply is available.

The *fourth* critical factor is weather. Cold weather provided an extra stimulus to consumption this winter, perhaps delaying the shift to maximum gasoline production. At the same time, droughts and low grain stocks are boosting agricultural demand for fuels while limiting ethanol availability.

The *fifth* factor is the industry's aggressive effort to boost return on investment. Through all sectors of the economy, including the energy industry, CFOs have been sending out the order to increase returns on assets or dispose of them. One response has been to reduce working capital invested in inventories.

The *sixth* factor has been the desire to avoid losses if and when oil prices collapse. Companies do not want to be caught with high priced inventories if this happens.

The *seventh* factor is the loss of liquidity in energy commodity markets — particularly gasoline. This has made it harder to hedge and has reduced the market's usefulness.

The *eighth* and probably least important factor has been speculation. Over the last few years, speculators have influenced oil price movements, and as of last Tuesday, speculators had clearly contributed to the increase in gasoline prices. However, their role in the recent episodes has been minimal. In fact, increased speculation might work in the interest of gasoline marketers.

Together, these eight factors have created a witch's brew of price volatility, high spot prices, high retail prices at times, and an absolutely impossible business environment. While I fervently wish this situation would go away, I am here today to tell you it won't. I am also here to tell vou there is very little the government can do in the short run to fix the problem unless it repeals important environmental laws, which it won't. Thus my task here is to provide some advice on how you might survive and profit in this more turbulent environment.

GOVERNMENT REGULATIONS

One of the primary causes of the price increase — in my view, perhaps *the primary cause* — is, unfortunately, government regulation. Various laws enacted by ill-informed or uncaring legislatures and enforced by equally ill-informed regulators have combined to reduce the oil industry's ability to supply the market with products required by consumers. These regulations and laws have also removed the flexibility of the petroleum distribution system, making large price increases more likely.

The actions that I believe have had the most pernicious effect are those related to groundwater contamination and reformulated gasoline. Enforcement of the Clean Water Act has almost made it a crime to operate a petroleum storage facility. As a consequence, every company has sought to limit its storage capacity and rely hopefully on the other guy. Shell capacity of storage has been reduced, and ironically, companies have been complemented by environmentalists for their actions.

And why not complement them? After all, storage facilities are unsightly, occasionally pollute, and perform no obvious service that consumers or environmentalists can see. Thus the closure of these facilities has been viewed as good.

However, the opponents of storage miss one important point — capacity is necessary to smooth out unexpected blips in production or consumption. Inventories allow firms to meet unexpected surges in consumption or cuts in production in an apparently seamless fashion. If inventories are not available, we all know what happens. As we learned in first-year economics, prices change (increase) until markets clear. If buyers panic, the increase can be quite dramatic.

Thus the government's admirable push for clean water combined with its arbitrary implementation of the Clean Water Act have contributed to the price increase by making it more difficult, more costly, and more financially dangerous to own storage facilities.

The second regulatory contributor to the price increase has been the introduction of reformulated gasoline. The RFG program represents another example of a well-intentioned program that has harmed both consumers and refiners. I would like to say the program's impact has been a surprise. However, I cannot. Indeed, I wrote about the implications of the program almost two years ago and my forecast has proven to be all too true.

There are, as you know, a host of problems with the RFG program. However, the basic difficulty with the regulations is they require more product segregations. This requirement ties up existing storage facilities and limits distribution flexibility. The consequence is that companies have to hold larger total inventories to meet a given level of total demand, while limiting the possible impact of sudden changes in consumption or production. If 300 million barrels of stocks was the correct amount before the transition to RFG, 400 million barrels may be the right number today.

However, as noted above we are operating with fewer total stocks, not more. Thus the clean water regulations and the RFG regulations are in conflict. The result is price volatility.

Of course, the problem could be resolved by importing more products. However, the ability to do this has been reduced by regulations included in the RFG program, which have effectively boosted the costs incurred by foreign refiners who participate in the market. The net effect has been to limit imports.

REFINERY ACCIDENTS

Bad luck at the nation's refineries has also contributed to price volatility. For the last several years, refiners have operated at historically high utilization rates. Experts have marveled at the industry's success and, at the same time, crossed their fingers because they recognized that refineries can experience disruptions. This year it appears the industry's luck has run out. During the period of peak distillate consumption, several East Coast refineries experienced disruptions that caused them to cut output. And this spring, several West Coast refiners have experienced outages that led to reductions in gasoline and heating oil production.

Such disruptions would have caused price changes in the past, but the effect would have been smaller because there was greater fungibility among products and larger inventories. Today, the mandated shift to a wide variety of products combined with the higher risk of holding inventories exacerbates the impact of refinery problems.

Unfortunately, the problems that have occurred this year have come about early in what is known as the driving season. This fact should concern you, the public, and those policymakers who are awake. The loss in productive capacity threatens to leave us unprepared for the summer — especially if there are more refinery problems.

CONSUMPTION

The third factor contributing to recent market events is increased consumption. Here there is a big surprise that I would like to bring to every bureaucrat's attention: consumers drive more when their income increases. Consumers also like comfortable cars. For years, environmental advocates have pointed to Japanese and European automobile owners as being environmentally correct because they did not buy big cars. At least they did not buy big cars until their incomes increased. Recently, sales of full-sized passenger vehicles in these countries have increased dramatically. If you want proof, just visit Tokyo. The freeways there are packed with large cars crawling along at 5, 10, or 15 kilometers per hour, depending on road conditions.

In the United States, consumers have shown a strong preference for vans and sports utility vehicles. Air conditioning is also a popular option. As a consequence, consumption per car is increasing again after remaining stable for years. I expect it will continue to increase.

A further stimulus has come from the removal of the "double-nickel" speed limit. As most of you know, average speeds have picked up noticeably since the 55 mph speed limit was repealed. Fuel economy per vehicle has declined as speed has increased.

Unfortunately, the members of Congress who restored the higher speed limits did not bother to grant relief to the refining industry in terms of making or storing more gasoline. The people who produce the fuel are expected to make do under the more rigorous program.

The consequences are not surprising. Consumption has increased while limits on storage and production have remained fixed. Bottlenecks have occurred. More bottlenecks will occur.

WEATHER

Weather has also played a very important role in the market gyrations over the last few months. Cold weather during the winter boosted heating oil consumption and pushed up prices. High distillate prices caused refiners to operate in maximum distillate mode longer than they had intended, thus delaying the shift to gasoline.

The drought in the grain belt will add pressure on prices this spring by cutting the availability of ethanol to the gasoline pool and by boosting consumption from the agricultural sector. The impact is identical to the effect noted earlier when I discussed the role of government regulations. Supply was reduced by the cold weather and drought, and high prices are now stimulating consumption.

CASH MINIMIZATION AND JUST-IN-TIME INVENTORIES

One of the important and, until recently, ignored stories in the industry has been the aggressive effort by senior managers to extract cash from the business. For the last ten to fifteen years, companies have worked very hard to reduce the amount of working capital tied up in stocks. Recently, however, the effort to limit inventories took a new turn — firms began to tolerate runouts.

The impact of the change in strategy should not be underestimated. This was brought home to me recently when I made one of my periodic presentations to the senior managers of a major oil company. One individual in the audience asked me what was different today from the situation a year ago or two years ago. This individual went on to note, "We have been trying to minimize working capital invested in stocks for years."

I responded by asking for a show of hands from the audience by individuals who had managed terminals. I then asked these people whether the situation had changed. The answer was that it had. Up until late 1994 or early 1995, the cardinal rule for terminal managers was never run out. One former manager noted, "There are quite a few used car salespeople who once had promising careers in the oil industry until the terminal they were managing ran out of product. Then they quickly became expendable."

The situation today is different. One major keeps a sign in its trading room that says "KILL." The goal is not to kill the competition but to "*Keep Inventories Low and Lean.*"

The effects of this new policy were seen in the natural gas market this winter. Last year (that is, in the fall of 1994) many local distribution companies (LDCs) went into winter with high stocks which, it turns out, were not needed because the weather was warm. As a result gas that had been purchased for $1.80/mcf had to be sold for $1.40/mcf or less. Some of the losses were passed on to LDC stockholders because regulators treated the losses as imprudent.

This year the LDCs apparently went into winter determined not to be stuck with unwanted stocks at the end of the year. Inventories were much lower and, as it turns out, inadequate for demand. The consequence was much higher prices.

The same situation occurred in the distillate market. In the spring of 1995 dealers found that they had unwanted inventories of heating oil. In the past these stocks would have been sold into the distillate market. However, the imposition of more stringent requirements on diesel fuel made it impossible to sell the fuel for over-the-road use. The product had to be held or sold at a large loss.

This year heating oil dealers entered the winter with lower stocks. When cold weather arrived, they were forced onto the spot market, where they bid up prices. Their demand spurred refiners to continue in maximum distillate mode for a much longer period.

Here again one can see the pernicious impact of government regulations on the market. The shift to low-sulfur diesel fuel, while undoubtedly a good idea, has fractured the distillate pool and removed market flexibility. When consumption is unexpectedly higher than anticipated, the incremental requirements must be met from production, not stocks.

AVERSION TO FALLING PRICES

The recent market events can also be traced to the fear of an impending price collapse. For the last nine to twelve months, oil buyers have operated in fear of an impending glut of oil and the possibility of another price collapse. This worry has been exacerbated by the promise or threat of Iraq's return to the world oil market, a concern that seemingly dominates the action of every trader.

There are two obvious ways to deal with this problem. The first is to hedge inventories. The second is to either own no inventories or operate with the minimum level of stocks. Most companies have decided to cut or eliminate inventories.

The first option — hedging — has become a less and less satisfactory means of obtaining financial production from price collapses as inventories have been drawn down. To be precise, the lower inventories are, the more expensive it is to hedge. The cost of hedging is revealed in the spread between the first and second month futures contracts (a so-called calendar spread). As these spreads worsen, a firm considering holding inventories and hedging faces increased "backwardation" (a condition that exists when cash oil sells at a premium to forward oil). In turn, the cost of hedging increases.

For example, in periods of high inventories, oil futures may sell for two or three cents per gallon more than cash. In such circumstances, a firm that hedges actually locks in a profit, selling not at today's price but at a price that is two cents higher. Under these circumstances, it is not expensive to hold stocks.

However, in periods of low inventories it becomes expensive to hedge. Gasoline supplies today may sell for 65 cpg, while supplies for next month may sell at a discount of 2,3,4, or 5 cpg. In such a situation it is very, very expensive to hold stocks.

This phenomenon can also be described using terms from the insurance industry. During periods of high inventories, it is very inexpensive to purchase price insurance (that is, to hedge). It becomes progressively more expensive to buy insurance as inventories decline.

Unfortunately, the desire to minimize stocks to avoid potential losses from a price collapse has a way of becoming a self-fulfilling cycle. As stocks decline, the cost of buying price insurance (hedging) increases and as the cost of buying price insurance increases, firms reduce inventories. Today we are in one of those cycles. Some companies have begun to run down stocks to free up working capital and to avoid inventory losses of the type associated with the 1986 price collapse. As inventory levels decline, their actions push the market into backwardation, causing other companies to cut stocks.

LOSS OF MARKET LIQUIDITY

The gasoline market has also been plagued by a loss of liquidity in the futures market. This has made it more difficult to hedge substantial volumes and, as a result, limited the ability of foreign offshore refiners to participate in the market.

The loss of liquidity can be traced to the shift to reformulated gasoline — again evidence of government meddling — and to the confusion at the state level as to the specifications required. Here the finger needs to be pointed squarely at the governors of New Jersey and Pennsylvania. Their actions last year on "opt outs" and the months in which oxygenates are required had a devastating impact on the gasoline futures market. Consumers in their states are now paying heavily for these actions.[1]

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[1] I prepared an affidavit for the New York Mercantile Exchange in its suit with the state of New Jersey. In that affidavit I stated that the confusion created by the state would result in a loss of liquidity in the market and higher prices this spring. Unfortunately, I was right.

Here I need to point out that futures markets are delicate instruments. Participants use them with care when they are new until they can be sure that the delivery mechanism works and that futures prices converge to cash prices. Use drops every time there is a change in specifications. For example, use of the gasoline contract dropped in the mid 80s during the switch from leaded to unleaded gasoline. Use also dropped with the switch to RFG until the basis between the products could be established.

However, the uncertainty created by the governors of Pennsylvania and New Jersey has caused a far greater decrease than might have been predicted. Further, use has not picked up substantially.

When you think about it, you reach the conclusion that there is no reason for use to pick up. There is still uncertainty regarding the continued participation in the RFG program by many counties in the Northeast. Indeed, one or two entire states may drop out. Further, the EPA has made it clear that regulations requiring prolonged reviews of withdrawal petitions will be waived. Since the Republicans took over Congress, the EPA has been all too willing to take the politically expedient action and let a state or county opt out on almost no notice. The agency's view seems to be "so what if a few oil companies lose money. It is not our problem."

This uncertainty makes it much riskier to hedge and much more advantageous to hold low stocks. This is precisely the action the industry has taken. Unfortunately, marketers and consumers pay a heavy price for this.

The uncertainty also makes it much riskier to be an independent refiner. And not surprisingly, firms like Tosco have aggressively expanded into the retail business, in part to protect themselves from the whims of government regulation.

SPECULATION

Speculators are also blamed by some observers for recent market events. The purchases by these participants, it is claimed, have tended to raise the level of prices and boost price volatility.

In my view this conclusion is incorrect. Indeed, I would argue that the problem is there is too little, not too much speculation.

Let me begin by defining speculation. Speculation in commodity futures consists of the purchase or sale of commodity futures or other instruments linked to commodities by buyers or sellers. These buyers and sellers are not involved in the underlying physical business and for them, the fluctuations in the commodity price do not correlate with fluctuations in the revenues received from the firms' actual business. In short, speculators buy or sell the commodity to earn a return on the fluctuation of the commodity's price.

Those who participate in speculation range from single individuals (the infamous doctors and dentists) to hedge funds to pension funds. Today a large share of the money comes from pension funds, who have concluded that the overall returns on the funds under management can be increased or risk exposure reduced by investing in commodities. This group of speculators is more appropriately labeled "commodity investors."

Taken together, speculators tend to be buyers, not sellers of commodity futures. Examining data from the Commodity Futures Trading Commission reveals that the speculative segment of the market tends to be long, not short futures. This seems to imply that speculators push up prices.

Such a conclusion is incorrect because speculators must offset their positions, ultimately selling out a long position or buying back a short position. Thus speculators (including commodity investors) will bid up forward prices when they buy and then depress cash prices when they liquidate their positions. Alternatively, speculators will push down forward prices when they short the market and then push them up when they offset their positions. Since speculators on average tend to be long, it appears that speculation pushes up forward prices.

By boosting forward prices, speculation boosts the economic incentive to manufacture gasoline and to hold inventories. Thus speculation tends to help, not hurt, this segment of the business.

The positive impact of speculation could be seen at its best during the period in which Metalgesellschaft dominated the market — say, from the spring of 1993 to the spring of 1994. Although that firm's actions were referred to in the press and some academic articles as hedging, MG was in fact engaged in a very large bet on higher oil prices — a bet that could have put many firms out of business. MG's bet took the form of being long gasoline and heating oil futures. Its trading pushed up forward prices and provided an enormous incentive to make gasoline and hold inventories. One firm, Tosco, even acknowledged that the incentive provided by the market caused it to increase production of gasoline and heating oil at its Bayway refinery by 50 percent.

The beneficiaries of MG's bet were consumers and marketers. The increased demand for futures led to greater production and lower prices.

Unfortunately, there are too few speculators today. As a result, the market provides less of an incentive to manufacture and store gasoline. Consumers and marketers are the losers.

The decline in speculation is directly related to the problems cited above with RFG — in other words, government regulation. Surprising as it sounds, speculators want the same thing the industry wants — a fair market. One of the elements of a fair market is liquidity. Speculative funds want to be able to open and close positions without affecting prices. Thus they will participate in large markets but stay away from small markets.

The shift to RFG and the government's poor management of the transition has limited liquidity in the market. Open interest in gasoline futures had dropped by 70 percent from peak 1993 levels. Speculation is down and prices are up. You know who has lost.

CONCLUSION

Let me conclude then by suggesting that many of the causes of the current market turmoil can be found in Washington and in the capitals of the 50 states. Regulation adopted relating to the introduction of reformulated gasoline, higher costs associated with the storage of petroleum products, last minute changes in the RFG program, and increases in speed limits have contributed to the market volatility both directly and by cutting into the liquidity of the futures market. Bad luck and cold weather have also had a significant role in 1996. Finally, the aggressive push for increased financial returns and the focus on shareholder value have caused companies to withdraw cash from inventories, causing further chaos.

What can one see for the future? My instinct is to say more of the same. I see no hope that the governments will come to understand the effects of their actions any time soon. Even if government officials did understand, I would not expect them to act because in my view they just do not care. I also do not expect to see suppliers willingly increase inventories again. The day when the President can call on the industry to achieve an inventory level of 240 million barrels of heating oil by September 1, as Jimmy Carter did in 1979, is past. Instead, managers will be driven by the need to maximize shareholder value. The result will be more efforts to cut stocks.

This brings me then to the role of the independent marketer. What should you do? While it is impossible to offer specific answers, let me sketch out a few thoughts.

First, you should not count on your suppliers to hold inventories for you at their expense. Inventories are a form of insurance, which in many cases have been offered free to marketers. The day of such free insurance is over. This change may mean that you want to hold larger inventories — especially if you have the facilities. The purchase of inventories as strategic short-term assets may yield very large returns.

Second, do not expect the market to yield uniform prices or costs. The shift to just-in-time inventory strategies and the chaos in government regulation will create enormous differences in costs. Expect these differences to be reflected in the market place and develop strategies to deal with them. Your business is becoming more and more like the airline business, where a group of traditional suppliers are being forced to compete with low-cost carriers. The firms that survive will be the ones that learn to cope with the change — not fight it.

Third, innovate. This January I was asked to investigate the implications of the deregulation of gasoline marketing for MITI, the Ministry of Trade and Industry, in Japan. In preparing my paper, I looked into the developments that had occurred in France over the last ten years. There a new form of marketer — the hypermarket — had totally changed the market in that period. In 1985 there were roughly 60,000 gasoline stations in France and 55 percent were owned by

majors. Today there are only 20,000 stations and roughly 50 percent are hypermarkets. (Hypermarkets are supermarkets with attached gasoline stations. You might call them "super convenience stores.") The same phenomenon is now occurring in the United Kingdom and is about to start in Japan.

I do not know whether the hypermarket phenomenon will reach the United States. However, I do know that firms need to innovate to stay in the business. Thus I conclude by advising you to continue pushing the innovation curve if you want to survive.

Let me thank you again for inviting me to speak.

Mr. HERGER. Thank you, Mr. Verleger.

Now we will hear from Melvin Sherbert, chairman, legislative committee, Service Station Dealers of American and Allied Trades.

Mr. Sherbert.

STATEMENT OF MELVIN SHERBERT, CHAIRMAN, LEGISLATIVE COMMITTEE, SERVICE STATION DEALERS OF AMERICAN AND ALLIED TRADES; AND OWNER/OPERATOR, TWO AMOCO STATIONS, SUITLAND, MARYLAND

Mr. SHERBERT. Thank you, Mr. Chairman. Mr. Chairman and Members, I am an Amoco lessee dealer in Prince George's County. My family operates two service stations. It is just 20 minutes from here. I am also the past president of Service Station Dealers of America and I serve now as their chairman of Government Affairs.

We support the repeal. We thought it was a wrong move when it was imposed on us. Since the beginning of the interstate system, we have lived with the fact that user fees made sense, and whether we are waiting in traffic and cussing, and not because of the construction, we are still aware that those are our dollars that we spent at our service stations to fix our roads and bridges. So this 4.3 cents should have never been there to start with, and we do support the repeal of it.

It will be seen. I assure you, it will be seen. Over the last week, I have been talked to by economists and we have heard today about these average prices. I assure you, there are no average prices at Suitland Amoco or Marlow Heights Amoco that I operate. The price there reflects a few pennies more than what I pay for it that day.

So when this tax was imposed, within a few days of that, my price went up those few pennies, and when that tax comes off, when the inventories are cleared, that will go on the street that day, yes. If you want to measure all the rises and falls over the course of 1 year in the gasoline price, then yes, you might say the average price this year was no different than the average price last year, but I assure you, the price on my corner is different.

I have spent the last 2 weeks walking around at each station, talking to my customers, and I have taken a lot of abuse, which I do believe I have countered, because it is not our fault as dealers. Dealers are making less per gallon today than they were 1 month ago. We are selling fewer gallons today than we were 1 month ago. For what it is worth, our customers are shifting from our premium to our regular, and though there are only a couple pennies difference in our profit between the two, that is not insignificant when you sell thousands of gallons.

So it will make a difference in my neighborhood, and yes, we do have to receive that price reduction. You are right. If oil companies, and I cannot believe in this marketplace, with all the public relations that they are going to receive, they would refuse to pass that decrease on to me as a dealer—I know I am going to pass it on. If I chose not to pass it on, there is always one service station dealer on every street who would like to be the lowest, and the rest of us want to match that price and we will do it, no matter what. That is the art of our business and that is how you make a living, making a few pennies and selling a lot of product.

In 1972, when I went into business, I made a little over 7 cents a gallon. Now it is 1996 and I am making a little bit more than 8 cents a gallon, after 24 years. There are a lot of reasons why we have been able to accomplish that, the efficiency of the business and the way we operate the different volumes that we have. But the point is that we continue to make the same per gallon as we always did.

I have to tell you that when you were talking earlier, there were comments from the Members about what is going on on the west coast. Some of those dealers right now are going for a month or two without making any money, maybe losing money because of this situation that has been imposed on them.

We think that this tax should be repealed. If you choose not to repeal it, put it in the trust fund where it belongs and at least we will get some use out of it. I do not want to be too bold to address this to you, but to put this on the American motorist to reduce the budget deficit was just wrong and I think it would be wrong to continue it. It is a tough choice to make, to have to go out and find other ways to do it, but it can be done.

Thank you.

[The prepared statement follows:]

Statement of Mr. Melvin Sherbert
Chairman, Legislative Committee
Service Station Dealers of America and Allied Trades

Mr. Chairman and members of the Committee: My name is Melvin Sherbert and I operate two Amoco service stations in Prince George's County, Maryland. I am past president of the Service Station Dealers of America and Allied Trades and currently serve as the chairman of the Association's Legislative Committee. SSDA-AT is a national federation of state associations representing tens of thousands of small business owners and operations nationwide.

SSDA-AT supports the proposed repeal of the 4.3 cents per gallon enacted in 1993.

From the inception of the interstate highway system, SSDA-AT supported the concept of a user fee with revenues directed to the Highway Trust Fund.

In 1993, SSDA-AT opposed the 4.3 cent levy because this money was directed to deficit reduction. In our opinion, this violated the agreement between the government and the motoring public. It set a bad precedent and should now be corrected.

We believe that if the tax were to be repealed that the savings would be passed on immediately and directly to the motorist. Service station dealers operate on a cents per gallon rather than a percentage of the cost of product. Thus, the savings to motorists would be passed on as soon as the repeal would be realized.

SSDA-AT concurs with the American Highway User Alliance that the nation's roads and bridges need improvement. If not repealed, the 4.3 cents per gallon should be directed to its proper place . . . The Highway Trust Fund.

Motor fuel tax increases for deficit reduction is bad policy. We opposed the increase in 1993 and we support the repeal today.

Thank you.

Mr. HERGER. Thank you, Mr. Sherbert.

Mr. Verleger, in your written testimony, you state that since the tax cut will affect neither supply nor demand, you conclude it would do nothing to affect retail prices. My question is, Are you saying that taxes, unlike other costs of production or sale, have no effect on the price of gasoline?

Mr. VERLEGER. Sir, it depends, as you have heard undoubtedly many times here, on the elasticity of supply. Next fall, after Labor Day, there will be some flexibility in the supply side. Right now, there is essentially no elasticity in the supply of gasoline. The problem has been created primarily by EPA.

Currently, there is no flexibility to increase supply. We are living on the hairy edge. If we have one more fire at a major refinery, we will have substantially higher prices because there is no flexibility on the supply side to so regulate the system. If the price were to fall with a tax cut, there would be more demand. However, price would have to increase again because now a new supply could be available.

It depends, sir, on the supply elasticity. There is just no flexibility right now. That is why I said the price paid by consumers would not change. That is why Bill Niskanen, chairman of CATO, said the same thing in this morning's Washington Post. If there is no flexibility in supply, then a tax cut is not reflected in lower consumer prices. If there is flexibility in supply, then the consumer would see a lower price.

Mr. HERGER. What time period are we talking about? I guess a further question is, Do you believe that an increase in the gas tax would also have no effect on the retail prices?

Mr. VERLEGER. It is interesting that in 1993, we had an increase in the retail price because, essentially, there was some cut in supply in October. But by December 1993, the retail gasoline price averaged—and I agree with the previous speaker's statement about averages being a sin—about 5 or 7 cents lower than they had been in September, before the tax was imposed. So the tax went in effect in October, and by December, it had vanished, as had 3 or 4 more cents per gallon.

Mr. HERGER. Mr. Sherbert, you are in the business yourself. Do you agree with this comment?

Mr. SHERBERT. No, I do not. I agree that that is probably a fact, that the prices were 5 to 7 cents cheaper, but they would have been 9 to 11 cents cheaper if that tax had not been imposed at that time.

Mr. HERGER. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Sherbert, last night, I had the advantage of watching you on television with two other industry experts and one of them pointed out that the price of crude oil had dropped from $25 per gallon in April to $21 per gallon, and that it is anticipated that prices at the pump could come down relatively soon. What do you think about that?

Mr. SHERBERT. It is my feeling that that will happen, and we have these seasonal rises and falls every year. What happened this year, of course, is that we had a double increase, and I blame that on the speculation of the oil companies about where they were going to get the product and the fact that they are keeping their

inventories so low now, they do not have any depth to respond to it. But the prices should go down. Now, whether they will go down the 20-some cents that they went up, I do not know.

Mr. COYNE. But is it realistic to expect that as a result of that price going from $25 to $21, that at least that would overshadow any decrease of 4.3 cents per gallon, all other things being equal?

Mr. SHERBERT. Unless someone chose to put it in their pocket, I think we would have that increase plus the 4 cents, and the dealers are not going to do that, I assure you. Whatever price we get, we add those 4, 5, 6, 7, 8 cents that we make to it, and that is the way we are going to continue to do it.

Mr. COYNE. So before too long, we are going to see a price decrease at the pump no matter what happens with the 4.3 cents per gallon?

Mr. SHERBERT. Did you say increase or decrease? I am sorry.

Mr. COYNE. Decrease.

Mr. SHERBERT. We should see a decrease over the course of the next 2 months, I guess. And I am only an expert, keep in mind, of what happens at Marlow Heights and in Suitland, Maryland.

Mr. COYNE. Mr. Fleenor, I wanted to address this to the Tax Foundation. Do you think the budget deficit has come down over the past 3 years?

Mr. FLEENOR. Yes, it has.

Mr. COYNE. Do you think that the 4.3-cent-per-gallon tax had any influence on that?

Mr. FLEENOR. I am sure it has, but our point, again, was that initially, the trust fund was set up as a dedicated user fee and we have strayed from that principle with the 1993 bill.

Mr. COYNE. Yes, I understand that. You are philosophically opposed to using that money. You would rather see it used for infrastructure. But there is no denying, is there, that the 4.3 cents per gallon had some influence on reducing the deficit, in your judgment?

Mr. FLEENOR. Sure.

Mr. COYNE. Thank you.

Chairman ARCHER [presiding]. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Verleger, I am happy you are here today for two reasons. Number one, I think you have made the point that there are some of us in Congress who are concerned about extremism in the environmental regulations that have been imposed upon this country and the damage it does to our economy. Some of us are trying to put some balance back in those regulations and the enforcement of those regulations and we are not trying to rape the environment. We are simply trying to bring balance back into environmental regulation in this country.

So I appreciate your comments about how it is the EPA and environmental regulations that are one of the major causes of the price hikes in gasoline. I think we can point to other sectors of our economy where the same is true.

Number two, I appreciate your being here because you have given me a wonderful idea to balance the budget. If taxes do not affect the retail cost at the pump of gasoline, then I think we ought

to just have a $50 a gallon tax and that way we can solve the deficit and the consumer will not know the difference.

What we have here today is Mr. Verleger, on the one hand, an economist, who makes a living making assumptions, and Mr. Sherbert, on the other hand, who makes his living selling gasoline. Mr. Sherbert disagrees with Mr. Verleger. He says, if I get to take the 4.3 cents off the front of my gasoline tank, I do it. Mr. Verleger says, oh, no, that is not true. If we reduce the tax by 4.3 cents, Mr. Sherbert is not going to take it off the front of his gasoline tank. Who is right? I would vote with the guy who actually has the gas tank.

Mr. Verleger, I would like for you to respond to that.

Mr. VERLEGER. Sir, as you know, I have a great deal of sympathy with the retailer. I know he would take the 4.3 cents a gallon off and pass it on. I would go visit him. The trouble is, he does not impose the 4.3-cent-per-gallon tax, as you know, because of the law that you passed. The 4.3-cent-per-gallon tax is imposed where gasoline breaks bulk, which in this case, is at the Fairfax terminal, where I believe Amoco delivers. What is required is for the price to come off there.

What I said about supply and demand was that the price in the market is set by equilibration of supply and demand, and normally, consumers buy more if the price goes down. The price cannot go down if the industry cannot produce any more.

My point now is EPA has so jiggered the system—I think you were the one who noted we could have had the BTU tax, and I testified here opposed to the BTU tax—but if we do not fix the EPA distribution regulations which make it almost impossible to move product, and if one does not fix the production process and the import rules, there is no more product, so there will be no more supply, so the price cannot come down. That is the point I am making.

I know Mr. Sherbert would reduce the price by 4.3 cents per gallon. Indeed, given the way the system works, I suspect somebody would reduce it by 5.3 cents per gallon. But first, it has to come off at Fairfax.

Mr. MCCRERY. I do not disagree with that, but surely, surely, you must admit that if we were to impose $50 of tax, the price would go up, and then if the next week we were to repeal that $50, the price would go down. Certainly, we do not expect immediately to see at every gas station a 4.3-cent reduction in the price of gasoline to the consumer because there are many other factors which affect the price of gasoline. I do not argue with that, sir. But for you to go further than that and state that if all other factors remain the same and we remove the 4.3-cent gas tax, nothing would happen to the retail price of gasoline, I think is a stretch.

Mr. VERLEGER. As I said, sir, I understand that you are correct about the assumptions and some portion of it will probably get seen, and a good portion of it will get seen after Labor Day. But in the meantime, you will hear from your constituents this summer.

Mr. MCCRERY. Oh, I understand. We are going to have some explaining to do when the price does not come down. In fact, it may go up because these pressures that you have talked about may be exacerbated in the next couple of weeks. We do not know.

Mr. VERLEGER. That is right.

Mr. MCCRERY. But the only thing that we can control today in this Committee—we have no jurisdiction over the EPA, unfortunately—the only thing we can control in this Committee is the tax, the direct tax on that gallon of gasoline, and that is what we are proposing to do something about. As you have just stated, it probably will be seen to some extent in the price by the consumer. We do not know to what extent because we cannot control those other factors. But all in all, I appreciate your testimony. I think it has been very good. I appreciate Mr. Sherbert's, as well.

Chairman ARCHER. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Chairman Archer, and I thank the witnesses for coming.

I am right back where I started from when this discussion began 1 week ago, when we were really kind of taken unawares that Senator Dole decided we were going to repeal this tax. Everything said here today is true. Mr. Sherbert would reduce it if he could. Do you pump gas, or is it automatic? Is it self-serve?

Mr. SHERBERT. No, I have a full facility that has bays and pumps and then we have—a rare one—a classic pumper.

Mrs. KENNELLY. Thank you. I am always for equality, but I still think men pump better than women pump and I look for a gas station like yours. I like full-serve pumps.

Here is what is happening, I think, and would Mr. Verleger and Mr. Sherbert continue this conversation. Am I right that when the fuel comes to the rack, the wholesaler goes to the rack and takes it in the truck and then delivers it to the retailer?

Mr. SHERBERT. That is true, but there are different classes of trade. I am an Amoco lessee dealer with direct supply by Amoco. So it does come into Amoco's terminal. Then Amoco delivers it directly to me. There are others where there is another class of trade that would pick up product at the rack and deliver it to either their own stations or to other dealers.

Mrs. KENNELLY. Am I right, Mr. Verleger, it is not only that Mr. Sherbert does not control the change in price or the wholesaler who delivers it to Mr. Sherbert that does not control the change in price. We have to go back, because we are in a free market society, back to the rack where, in fact, the tax is paid, am I right?

Mr. VERLEGER. I believe that is correct, yes.

Mrs. KENNELLY. So in a free market society, it is only natural that the person who paid the tax wants to get that back. Even though everybody would love to give the consumer a break, there is no guarantee whatsoever if we repeal this tax that, in fact, the consumer would get that break. You not only go back to Mr. Sherbert, who does not make the decision, the wholesaler does not make the decision, but the person that bought the gas from the crude originally makes the decision, am I right?

Mr. VERLEGER. I believe that is correct.

Mrs. KENNELLY. This is the exercise that we are going through—and it is a serious one. Let me tell you, Mr. Chairman, this is very serious for me. I have the unfortunate position of representing a State that has the highest gas tax in the United States of America, so I take this very, very seriously.

Having said that, I also come from a State that is still in recession, is beginning to get involved in the new world of trade—25 percent of our State product is in trade—and we are really interested in reducing the deficit so that the small businesses that are popping up in Connecticut and the small tool companies that are making it have money that small businesses can use. So we are very interested in this.

What I see here, and Mr. Verleger, tell me, since you have studied this question, what I see, by the 4.3 cents going directly into reducing the deficit, we have a guarantee that will happen.

Mr. VERLEGER. I believe that is the way the law is written.

Mrs. KENNELLY. So it happens. But if we repeal the gas tax, there is a lot of questioning here today whether the consumer, in fact, would ever see it because of the seasonal uses of gas. After Memorial Day and on, you see prices often going up because of the high use. We have had a winter that was very long and we have had the changeover to gasoline, so we do not have any guarantee there.

Mr. VERLEGER. That is correct.

Mr. SHERBERT. From a marketing point of view, that may be true, that you do not have it, but whatever price I will be posting, I have to assume it will be 4.3 cents less than I would have been posting otherwise. I am beginning to get the feeling that since I am here today, everybody is going to believe that at least the dealers would pass it on, but the oil companies are not here, so they will just say they are not going to do it. I think they will do it. They have——

Mrs. KENNELLY. But Mr. Sherbert, is that in your hands to do if it does not, in fact, happen before? If, as I said, the people who originally sold the gas do not reduce the price, will you be able to?

Mr. SHERBERT. You are right. Anyone along the chain that would choose to reap some unmerited profits off of this could do it, but with the way public relations is today, I cannot imagine an oil company taking that risk right now. They are already taking all the heat they can possibly take, and from us, too.

Mrs. KENNELLY. Mr. Sherbert, I have been through this raising of gas prices a number of times and I wish I had the faith of those up the stream, more faith in them than I do today. I certainly hope you are right. But I think history shows there is no guarantee they will pass on the reduction.

Mr. SHERBERT. If they do not do it, then they are wrong.

Mrs. KENNELLY. You are right.

Mr. VERLEGER. Congresswoman, I am struck by the fact that, in part, price is set by the capacity to make gasoline. EPA has made it very difficult to import gasoline. Indeed, we lost in the World Trade Organization for good reason, for unfairly disadvantaging foreign refiners.

If we lose any more refining capacity this year, if a cat-cracker at some refinery goes down, supply is simply going to be limited. As every Member of this Committee knows, when the supply is limited, price increases. So I do not think it is fair to say that the industry is trying to pocket the tax. This is the force of supply and demand——

Mrs. KENNELLY. I know that, sir. I know it is the marketplace.

Mr. VERLEGER. I want to make sure everybody understands where the problem is.

Thank you.

Mrs. KENNELLY. I think that is the problem. Where the problem is is the marketplace.

Chairman ARCHER. The gentlelady's time has expired.

The Chair would like to follow up on some of the points that have been made before recognizing another Member.

Mr. Sherbert, how many competitive brands of gasoline are sold in your overall market area, that is, the Baltimore area?

Mr. SHERBERT. There are about nine companies.

Chairman ARCHER. Nine? We heard the statement earlier that the seven big major companies would get together and fix the price of gasoline. There are more than the seven big major companies that are involved in the manufacture and the sale of brands of gasoline in this country, is that not correct?

Mr. SHERBERT. Oh, yes. There are a lot more brands than that. I am just talking about in the State of Maryland and the District of Columbia.

Chairman ARCHER. Mr. Verleger, you neglected to mention in your testimony or comments to questions that we are not limited to the supply of domestically produced gasoline at the pump in this country. We do import a good bit of the finished product, do we not?

Mr. VERLEGER. Chairman Archer, I think I said that EPA, in promulgating its RFG regulations, made it significantly more difficult to import gasoline into the United States. I know I said that.

Indeed, I also said, just 1 minute ago in response to Congresswoman Kennelly's question, that we lost before the World Trade Organization. This is something that one of the candidates for President in your party was complaining about. We lost because EPA's regulations were ruled to treat foreign refiners more harshly than domestic refiners. Had we not disadvantaged importers, more imports would be available. The Venezuelans are attempting to bring products here as are the Finns. But some of that capacity is not yet available.

I would also say that the current experience repeats the experience in 1989, when the Exxon Valdez went aground and the refineries in California lost crude. We had a very high price, and there were hearings then, too. Gas flowed from St. Croix and from the gulf to California and raised prices in Maryland and all across the country. At that time, there was no EPA regulation that limited imports, and so the problem was resolved much more easily.

Chairman ARCHER. I think you bring some very constructive testimony to this Committee relative to how environmental regulations can drive up the price of a product. Then you have to get into the question of whether they are constructive, reasonably done, objective, and so forth, which then leads to another question. Regardless, they certainly will drive up the price of a product.

But we are not limited, even today, to our domestic refinery capacity as far as the available gasoline in the marketplace.

Mr. VERLEGER. That is absolutely correct.

Chairman ARCHER. But the price—I hope you will agree to this—that the wholesale price of gasoline is quoted every day on the commodities market and is traded as a market item.

Mr. VERLEGER. The wholesale price of one of 220 varieties of gasoline is traded on the New York Mercantile Exchange.

Chairman ARCHER. That is correct.

Mr. VERLEGER. Open interest in that contract is now 70,000 contracts. It used to be about 160,000 or 180,000 contracts. I provided testimony to the Federal court in New Jersey for the New York Mercantile Exchange against the State of New Jersey's attempt to change the regulations because all the changes in regulations that have been enacted, both by EPA and the States, have eliminated liquidity in that market.

I will tell you, sir, that many companies, including most of the importers I work with now, will not import to the United States because they do not trust the liquidity in that market as the price quoted for the volume and the liquidity has dropped substantially.

Chairman ARCHER. I am aware of that, but the point I am trying to make is that gasoline is a commodity. It has a market price, as other commodities have market prices.

Mr. VERLEGER. It used to have more of a market price. Now there are 220 varieties.

Chairman ARCHER. I understand that, and they all play off of whatever the market is doing at any one particular time. They are not all traded on the commodities market, but they all play off of that. There are varieties of crude oil that are not bought and sold on the commodities market. You might have heard of the commodity of Texas light crude, though not true of all crude oils, they play off of that price. It is a marketable commodity that has a market price.

All of your testimony today is accurate in the sense that many factors affect the market price of a product. But that market price, which is determined on a give and take basis every day in the marketplace, is overlaid by the tax burden. The tax that is levied on gasoline is a retail sales tax. It must be collected from the consumer and added on top of whatever the commodity market price of the product is. Do you disagree with that?

Mr. VERLEGER. Sir, in the first——

Chairman ARCHER. No. Do you disagree with that?

Mr. VERLEGER. It is collected from the consumer. As you know from teaching economics, when supply is absolutely inelastic, the market clearing price is not affected.

Chairman ARCHER. But you are getting off of the question. When the supply is inelastic, it affects the basic market price of the product. I agree completely with that. But levied on top of that is a tax that must be collected from the consumer, and——

Mr. VERLEGER. Mr. Chairman, Bill Niskanen, who is a good friend, and I know is an acquaintance of yours, and I both agree on this one. If the supply is tight, during the period the supply is tight, the consumer may not see the tax cut. That is the thrust of my point in my testimony.

Chairman ARCHER. And you and I agree. That is the market price of the product.

Mr. VERLEGER. Right.

Chairman ARCHER. That determines the market price of the product. If the supply is tight and the demand does not adjust to it, the price of the product will go up. We know that. That is basic economics.

Mr. VERLEGER. Yes.

Chairman ARCHER. But layered on top of that must be collected the tax that government levies, whether at the State or the local level. The tax is not considered in the commodities market which determines the price of the basic product. The price of the basic product is determined by market forces, as you have enunciated.

Mr. VERLEGER. Right.

Chairman ARCHER. The tax must then be collected from the consumer. It is a consumer-levied tax on top of whatever the market price is.

When products are imported into this country and they have to deal with the environmental restrictions and whether there can be more or less of a flow, the price is not determined by the tax that is levied by government. It is determined by the market forces that apply, and we are in agreement on that.

As a result, it is impossible to determine whether the tax has been passed on or not. This is the point that my colleague, Mr. McCrery, was saying. The market price can go up or down in a very short period of time, and we have seen that at the pump, both from a decline and an increase, dramatic changes at the pump, going down and going up, within 1 week's time, within a couple of days' time, and I am sure Mr. Sherbert can testify to that.

But no matter what happens to that basic price, the tax must be collected. Therefore, it will clearly have an impact on the price of the product at the pump.

If, for example, we embrace the concept that we must have some sort of a legislated price which shows the price at the pump has gone down 4.3 cents; and if, in fact, the market price of the product goes down 4.3 cents, which the futures markets tell us it will, regardless of what we do, the producers could easily say they have done all the law required and therefore, will not reduce it anymore. That seems rather silly to me.

We saw this during the time of price controls back in the seventies, where the price control became a floor as well as a ceiling. Most economists will agree that that can easily happen in the marketplace because price controls distort the very market that you are talking about. When you attempt to dictate a price, you find you have had a counterproductive effect compared to what you would otherwise have.

It is very interesting to note that historically, prices of gasoline went down when Reagan removed the price controls. That is a historic fact.

I just think we need——

Mr. VERLEGER. We have no argument there.

Chairman ARCHER. I know it. I think we are in agreement. I am not trying to argue. I am trying to establish common ground——

Mr. VERLEGER. Fine. I understand.

Chairman ARCHER [continuing]. And have this publicly in the record because this is going to be the issue that we are going to

have to treat when we get into the amendment process. So I am glad that we agree, and I have overabused my time.

Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

I understand before I arrived that my colleague, Mr. Hayes from Louisiana, stated he was one of six Democrats to vote against this tax bill in 1993 containing the gasoline tax. Frankly, I think he was mistaken. I think it was nine, because I was one of the six or one of the nine that voted against it very much for the reason I understand Mr. Hayes said. I want the record to be clear that I was one of those that voted against it.

I am sorry my friend, Mr. Coyne, left, because I wanted to make this point while he was present. Mr. Fleenor, you were asked by Mr. Coyne if you would agree that at least the gasoline tax helped contribute to a reduction in the deficit, and I believe your answer was in the affirmative.

Mr. FLEENOR. Yes, it was.

Mr. LAUGHLIN. Would you agree with me that that misses the point that this has been an unfair tax on those American citizens that, because of where they live, pay an inordinately higher tax if they live in a rural area, dependent upon their vehicle, than those who for whatever reason, good or bad, may choose to live in big cities that have subways, buses, other forms of mass transportation?

Mr. FLEENOR. Sure.

Mr. LAUGHLIN. Would you say that again, because it was pretty weak and I did not hear it very well.

Mr. FLEENOR. I would concur, yes.

Mr. LAUGHLIN. So the supporters of this gasoline tax, then, would you agree with me, are supporting an unfair tax on those citizens that choose to live in rural America rather than in the cities?

Mr. FLEENOR. In a sense, yes.

Mr. LAUGHLIN. Either it is fair or unfair.

Mr. FLEENOR. Again, the idea behind the original gas tax was to set up a user fee, and if people living in rural areas are using more of the highways, in that sense, it would not be unfair.

Mr. LAUGHLIN. That is the point I wanted to go to next. If it is going for deficit reduction to reduce the national deficit of all of America, then would you not agree with me, it is unfair to put it heavier on those who live in rural America than it is to put it on those who live in the cities?

Mr. FLEENOR. Again, our criticism of the 4.3-cent tax was that it broke the idea down of dedicating these revenues to highway construction.

Mr. LAUGHLIN. The point I want to make is that historically, a gasoline tax has been paid by those who derive a benefit from paying the tax, is that not correct?

Mr. FLEENOR. Right, and we think that is a very sensible idea, that people who use the roads are paying for them.

Mr. LAUGHLIN. I come from a very large rural area. Would you be shocked to know that I have a lot of constituents who would not mind paying a 15- or even a 25-cent gasoline tax if it all went to safer roads and safer bridges that they utilize?

Mr. FLEENOR. No, it would not.

Mr. LAUGHLIN. You would not be, would you?

Mr. FLEENOR. I would not be surprised.

Mr. LAUGHLIN. I can very honestly represent that to you.

Mr. FLEENOR. But again, that is the idea behind a user fee. People are desiring safe roads, as you say, and the commonsense idea behind the user fee is that they, in essence, pay for it through the gasoline tax.

Mr. LAUGHLIN. I represent some people that just last week had a schoolbus on Highway No. 59, that had almost the entire busload of children go to the hospital because it is a two-lane road in a rural part of our State, and I can tell you that they would not mind having their tax doubled or tripled if they knew it was going to make a four-lane safer road that we have in the metropolitan areas.

Mr. FLEENOR. Right, but that is just our point. The problem we find with the 4.3-cent tax is that it is not going to the Highway Trust Fund. It is going to the general fund.

Mr. LAUGHLIN. Then you agree with me it is unfair that it is going to deficit reduction and not to the benefit of those who are paying it?

Mr. FLEENOR. Exactly. The original idea behind the trust fund was to fund highway and transportation projects.

Mr. LAUGHLIN. Mr. Verleger, I want to shift to the EPA for 1 minute. As you talked about reduced capacity from our refineries, is it not true that many of the refineries are, in fact, closing, abolishing jobs in America and moving that refinery capacity offshore, either to the Caribbean islands or even places out of the North American continent because of EPA requirements?

Mr. VERLEGER. I know of three or four refineries that have closed, sir. I know a lot more refineries that would close if it were not for EPA laws as regards the Clean Water Act and remediation required when you close those refineries. So it is a mixed story.

The big problem is, we are not getting enough investment in the United States to make more gasoline. The National Petroleum Council concluded the industry had to invest $10 billion just to meet the standards mandated by the Clean Air Act amendments of 1990, and most of that investment was nonproductive investment. It did not add to capacity and it did not add to long-term jobs.

Mr. LAUGHLIN. Mr. Verleger, would you agree that those who are upset with the higher gasoline prices ought to do a little beating up and leaning on the EPA to get a better balance between gasoline capacity, gasoline production, get more balance in EPA in those areas, rather than beating up on the seven big oil companies?

Mr. VERLEGER. Congressman, I think they should do a lot of beating up on EPA to get them to write rules that achieve in a much more efficient fashion the goals for clean air rather than beating up on the seven oil companies. I absolutely agree with you.

Mr. LAUGHLIN. And would that not create more jobs in America that employ more people?

Mr. VERLEGER. I think it probably would, sir.

Mr. LAUGHLIN. Thank you, Mr. Chairman, and I thank all of you for being here.

Chairman ARCHER. Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

First, I would like to ask Mr. Verleger, were you invited here by the minority side of this Committee?

Mr. VERLEGER. I think I was invited by the minority side, sir. I am an independent, so it——

Mr. ZIMMER. I am not casting aspersions on your independence.

Mr. VERLEGER. I understand.

Mr. ZIMMER. It is just that for those people who think that this institution, this House, has not changed since November 1994, when the Democrats invite a witness who is affiliated with the CATO Institute and who bashes the EPA, I think it shows that the ground has shifted a bit.

I think we pretty well established your view that in the short term, the prices at the pump will not necessarily change. But in the longer term, over a period of 1 year, assuming we can keep this reduction in the tax for 1 year, do you see that finally the reduction in the tax will show up at the pump?

Mr. VERLEGER. Yes. After Labor Day, I am fairly certain it will show up at the pump.

Mr. ZIMMER. So it will be approximately 4.3 cents?

Mr. VERLEGER. I am not sure whether it will be 4.3 cents. As you know, and as Congressman Archer said, enough assumptions can be pushed around to get it anywhere from 3 cents to 2 cents to 4.3 cents, maybe even more.

And I will say, as a former Treasury official, the main reason I am worried here about this is that this is being advertised as a 4.3-cent reduction in the price of gasoline. As you know from visiting around the country and visiting your district, the public has a justifiable cynicism with Washington.

So if Congress were to pass a law and say the price is going down by 4.3 cents a gallon and the prices then do not go down, in fact, they go up this summer because everybody is driving their larger cars at 75 miles an hour and creating greater demand, I think that there would be a lot of unhappiness in the public. That is my worry, and that is a huge worry on my part.

Mr. ZIMMER. Thank you.

Mr. Fleenor, the Tax Foundation made some predictions back when this gasoline tax was originally considered about the impact on jobs in the United States. Do you have any prediction as to what the reduction in the gasoline tax will do as far as creating jobs?

Mr. FLEENOR. I did not work on that report. What I could say is that in the long run, a reduction in the gas tax will reduce the wedge between the cost of producing a product and its price. That will reduce the deadweight loss in our society and you should expect an increase in jobs as a result.

Mr. ZIMMER. For the record, Mr. Chairman, in 1993, the Tax Foundation predicted that the 4.3-cent increase would cost 69,508 jobs nationwide. I commend you on your precision in that prediction. I would like to know exactly what history has given us.

The second question I would like to ask is whether you and the Tax Foundation believe that the gasoline tax is a regressive tax in the sense of the word that economists use it, that is, that poor peo-

ple pay a higher percentage of their income for this tax than wealthier people do.

Mr. FLEENOR. That may or may not be true, but again, the idea of a user fee is that people pay for services they use, and we think that is a very sound idea. People who drive on the highways and use our transportation facilities should pay for them. It may be the case that people who drive—the demographics may be such that lower income people use the highways more. I do not know if that is true or not. But in that case, we would not find necessarily a problem with that if it is indeed the case they are using the facilities more.

Mr. ZIMMER. The information I have seen indicates wealthier people pay one-fourth the relative amount in taxes as a percentage of their income on gasoline than poorer people who perhaps may drive less but often use older cars and obviously are earning less money. So the same amount of fuel tax will be a larger percentage of their income. Does anyone on this panel have any data that they can share with me on this?

For those on the minority side of the Committee who are always showing us distribution tables about the impact of tax cuts or tax increases on the wealthy versus the less wealthy, I would hope that maybe when we consider this legislation, we will have some discussion of the impact of this tax, which I am convinced falls far more heavily on the poor and the middle class than it does on wealthier Americans.

I yield back the balance of my time.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. LEVIN. Mr. Chairman, are you calling on three Republicans in a row?

Chairman ARCHER. Mr. Levin, I do not show any request from any other Democrat. If you wish to be——

Mr. LEVIN. I thought you were going down——

Chairman ARCHER. If you wish to be on the list, I am happy to have you on this list. Mr. Christensen, if you will wait 1 minute, I will recognize Mr. Levin and then we will get to you.

Mr. Levin.

Mr. LEVIN. I will be glad to wait. I just wondered what——

Chairman ARCHER. That is fine. I just did not have your name on the list.

Mr. LEVIN. Whatever your preference is.

Chairman ARCHER. I would prefer to rotate. Mr. Levin is recognized.

Mr. LEVIN. I thank you, and welcome to all of you.

Mr. Verleger, in the Post this morning, you are quoted as saying,

> The Republican-sponsored solution to the current fuels problem is nothing more and nothing less than a refiners' benefit bill. It will transfer upward of $3 billion from the U.S. Treasury to the pockets of refiners and gasoline marketers.

Does the Post quote you accurately?

Mr. VERLEGER. That was a piece, Mr. Levin, that I submitted to the Post as an op-ed piece last week when I believed that this was a 12-month tax reduction, not a 7-month tax reduction. I learned last night that this tax reduction was, in effect, from, I guess, June 1 through December 31, which would change the numbers.

But as I said, and as Mr. Niskanen said in the same article, it is unlikely that the consumer would see much of the effect of the reduction certainly during the summer, and so a substantial share would go to refiners, yes.

Mr. LEVIN. Let me just talk a bit, then, about the issue of the dedication of the moneys, and Mr. Fleenor and Mr. Sherbert, you have referred to that. Was 1993 the first time an increase in the gas tax was used for general revenue purposes? Do you know?

Mr. SHERBERT. No, I do not believe so. I think that there was an earlier amount in maybe 1990 and that was temporary and then came off, or was made into the transportation fund. I do not know which.

Mr. LEVIN. Mr. Fleenor.

Mr. FLEENOR. I think it was the 1990 bill.

Mr. LEVIN. Right. One-half of the increase went to the General Treasury. So 1993 was not the first time, correct?

Mr. FLEENOR. The first permanent increase was in 1993.

Mr. LEVIN. But it was not the first time. Five years is not very temporary. It was not the first time in a deficit reduction bill that moneys from a gas tax increase were used for deficit reduction purposes, is that not accurate?

Mr. FLEENOR. That is accurate, yes.

Mr. LEVIN. Would you tell me—and by the way, four Members of this Committee on the Republican side voted for the 1990 bill that had a gas tax increase, one-half of which went to the General Treasury, as well as most Democrats. Do you know of any legislation between 1990 and 1993 that was introduced to repeal that increase or to earmark it?

Mr. SHERBERT. I certainly do not know. I know that was the figure that we had.

Mr. LEVIN. Mr. Sherbert, let me ask you. Did your association in those years support legislation to undo the gas tax increase, the one-half that was earmarked for the General Treasury?

Mr. SHERBERT. No. We certainly would have, but you are right, we did not, since there was none to support.

Mr. LEVIN. Did you lobby for it?

Mr. SHERBERT. No. We were opposed to the concept from the beginning, and what scared us, of course, was what we actually saw, that first it was 2.5 cents, then it became 4.3 cents. We thought the next step was going to be 8 cents or whatever, and that is why we are very excited today about this coming off.

Mr. LEVIN. The answer is no, your organization did not?

Mr. SHERBERT. No.

Mr. LEVIN. Mr. Fleenor, do you know of any materials from the Tax Foundation on this point?

Mr. FLEENOR. The Tax Foundation does not support or oppose specific pieces of legislation.

Mr. LEVIN. Was there any material that you wrote during this period on this subject?

Mr. FLEENOR. No. Again, our whole point is that originally, these revenues were dedicated, and we thought that was a sound principle of taxation. Our opposition to it in this instance is, again, that the money is not going toward highway construction.

Mr. LEVIN. But during these years of the 5-cent increase, one-half of which was going to the General Treasury, is there any literature that came out from your organization on this subject?

Mr. FLEENOR. I do not believe so.

Mr. LEVIN. So this bill, the 1993 bill, did not set the precedent, the 1990 bill did. That was passed on a bipartisan basis, and one of the leaders in the effort was the Majority Leader of the U.S. Senate, Mr. Dole.

I think the question is—and I think, Mr. Verleger, you have put your finger on it—if we are going to do this, will it benefit the consumer? Is there any assurance it is going to help the consumer rather than, as you say, going to refiners and gasoline marketeers? There has been no testimony today that gives any assurance that that will happen, that it will go to the consumers, so we had better work on that.

Chairman ARCHER. The gentleman's time has expired.

Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Verleger, I want to thank you for your testimony here today. Even though we may not agree on the effects of a 4.3-cent repeal, I do agree with you on a number of things you have said today. I agree with you on the EPA. I agree with your quote, and if I am quoting you correctly, "the EPA has criminalized the distribution of gasoline."

Mr. VERLEGER. You heard me precisely, sir.

Mr. CHRISTENSEN. If I am quoting you correctly, "The EPA should be hit hard on the head." This past year, many of us in the Majority have taken a beating from environmental extremists saying that we are "for dirty water and dirty air." You mentioned two things that I would like you to expand on and that is the Clean Water Act and remediation, and then I would like to hear some ideas you would have for this body as far as environmental regulations that would make it better for the American people as far as bringing some common sense back into the environmental regulations.

Then last, I would like to know what would be your best guess as a percent decrease if we could bring these regulations into line with some common sense. What kind of percent decrease do you think we might see in the market prices, if they were enacted?

Mr. VERLEGER. Sir, the point I have been making for 2 years on EPA's regulations with respect to gasoline are that in implementing the Clean Air Act amendments of 1990, the EPA mandated that companies must essentially adopt entirely new procedures for the management of inventories. What these do is reduce the flexibility of turning tanks over. It is effectively like telling a grocery store they have to keep one-half of their dairy shelves empty every day, so it means you ought to double the number of shelves, the shelf space you have, if you are going to carry the same amount of milk.

At the same time, the Clean Water Act makes it very hard to build tanks. Nobody wants to see tanks. The consumers do not like tanks; they leak. Look at what happened in Fairfax. So, essentially, companies have been closing tanks, cutting tanks down. That is the

smart thing to do for shareholder value. That is effectively saying the grocer should reduce the amount of space it has for milk.

Now, the third step the EPA has done is required many different types of gasoline be distributed. As I think I said to Chairman Archer, it is 220. That is the number of specifications that Colonial Pipeline has. That is the artery that brings us our gasoline here. And EPA refuses to allow commingling of different types of gasoline.

It is as if EPA told that grocer not only do you have to keep one-half your shelf space empty and our regulations are going to make you want to have fewer shelves, but you cannot put chocolate milk in the space where you used to have nonfat milk. The chocolate milk has always got to be in the same space and the nonfat milk has always got to be in the same space. What this does is if you work through the complicated inventory models is almost guarantee that you are going to have shortages and very high prices. That is what happened out in California. That is what has happened here on the east coast. That is what has taken the liquidity out of the New York Mercantile Exchange.

So the first step that really is needed, and I understand it is not in the purview of this Committee because I have sat here for many hours over the years, is that EPA should be instructed by Congress to adopt regulations that allow the industry to use the inventory management practices that they followed in the past. The result would still be cleaner air. In addition, distributor flexibility would be increased.

Then second, EPA must adopt a rational strategy for dealing with clean water and tankage and storage. Some of the laws are State laws and some of them are Federal laws. But if they were changed, and this is just making the regulations work within a market context, we would get much lower prices.

Mr. CHRISTENSEN. I want to thank you for your testimony. I fully agree about the overzealous efforts of the EPA and trying to bring some common sense back into that area that has been severely lacking over the last 20 years.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman, and I want to thank our witnesses for their testimony.

I have been listening and trying to understand the rationale for the repeal of the gasoline tax at this point. I guess I have heard three explanations. One, it would be good for the economy, that it could produce additional jobs. Second, it would give taxpayers some taxes back. And third, this tax is not dedicated to highways.

Now, the third point, we could correct. We could offer a change in the 4.3 cents to put it into the Highway Trust Fund without repealing the tax, so let us put that aside for a moment and deal with the first two points that have been made.

I understand there was a study done by Mr. Fleenor's group that the 4.3-cent gasoline tax increase would cost this country 69,000 jobs. I am rounding it off. Yet, I am not aware of any verification that in 1993, our economy lost 69,000 jobs when the gasoline tax increase went into effect. The information I have seen indicates that at that time, we had a growing number of jobs even in the en-

ergy-related areas, so that there is no evidence whatsoever that I am aware of to reflect the fact that we lost jobs.

If that rationale were true, we have just seen in the last few months an increase in gasoline prices that are four, five, six, seven times the 4-cent increase, and if the same rationale were true, we would be seeing right now a loss of a half a million jobs in our economy as a result of the price increase per gallon of gasoline.

I do not quite understand that. I am going to give you a chance to respond because I do not quite understand that argument and I want to make sure how we would, in fact, see an economic growth with the repeal of this tax.

Then the third point was that the consumer would get the tax back, and we have no assurance that that will happen. In fact, we have testimony that that will not happen during the summer months because of the inelastic supplies and because the tax is imposed at the rack and by the time it gets to the retail dealer, the retail dealer cannot control what price they put on the gallon of gasoline, so the price is not passed through to the stationowner. I am not picking on the stationowner, because you are controlled by the price of the gasoline when it reaches you. You do not pay the tax. The tax is already included in the product by the time it reaches you.

And none of you have been able to tell this Committee of an effective way to make sure the consumer gets the 4.3-cent tax reduction. No one has come forward with an effective way to guarantee that the tax rebate will actually go to the consumer.

I guess I am somewhat concerned about the premise for the tax reduction, whether, in fact, we will be able to carry out our commitment to the American people by either giving them back some of their taxes or creating greater economic opportunity.

The last point I would make is that if the tradeoff is to reduce the tax and increase the deficit, if that is what ends up happening despite our best intentions to the contrary, if the end result is that the deficit of the Nation goes up, the economic information I have seen is that that would have more negative impact on our economy than the positive impact of reducing the tax revenues. In that case, we would be better off to have lower deficits than to deal with a very modest reduction in the tax, particularly when the consumer is not getting the benefits of it.

Mr. Fleenor, do you want to try to rehabilitate that and tell me why we are going to lose these jobs or gain them back? Do you have any documentation? First of all, do you have any documentation of 69,000 jobs lost?

Mr. HANCOCK. Would the gentleman yield?

Mr. CARDIN. I would be glad to yield.

Mr. HANCOCK. I happen to be a small business man and I can assure you that the gasoline tax and the income tax cost jobs.

Mr. CARDIN. That is not what I really asked. I asked if the increase of the 4.3 cents in 1993—I want to try to focus in on that specific tax increase—the projection was by the Tax Foundation that we were going to lose 69,000 jobs as a result of that tax increase, 69,100 and some. He had the exact number. My question is, do we have any documentation of where those 69,000 jobs were lost in our economy?

Mr. FLEENOR. As I stated earlier, I did not conduct that report. But in general terms, an introduction of a tax will create a tax wedge and introduce an inefficiency in the economy and that will result in the loss of jobs.

Mr. CARDIN. But the truth is that the economic reports during the 1993 period show tremendous job growth.

Mr. FLEENOR. But you are looking at the—sure, I mean, jobs were lost, but these were offset by other jobs which were created. You cannot look at, sir, the macro statistics and say——

Mr. CARDIN. That is our exact point. Look at the deficit. If this has an impact on increasing the deficit, that is going to have an impact on our economy, also.

Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman's time has expired.

The Chair would announce that I would like to complete this panel's testimony before we vote and we will return immediately after the last 5-minute vote.

Does the gentleman from Missouri wish to be recognized?

Mr. HANCOCK. I will be brief. Mr. Chairman, I would like to address Mr. Keating for just 1 minute. He is the chairman of the National Taxpayers Union.

Have you noticed in the conversation here today, Mr. Keating, that we talk about consumers? We have not mentioned very much about taxpayers. I get a feeling up here that the other side of the aisle thinks that those are two different people. They say, well, it is OK to raise the tax on the taxpayers and that is not going to affect the consumers. Is there a difference between consumers and taxpayers?

Mr. KEATING. There is certainly a large overlap. There may be some difference somewhere, but I would say generally, the class is quite similar.

I do not think there is any doubt that, over the long run, a permanent repeal of this gas tax increase will result in lower prices to the American public and lower taxes paid by the American taxpayer. I do not think there is any doubt about that.

I would also like to say something about the loss of jobs. In any economy, you have many different things going on at the same time. I am sure the Tax Foundation's estimate was based on isolating that one change—a hike in the gas tax. The projected loss of jobs was compared to the number of jobs that would have otherwise been created. So if you show an overall increase in jobs, that means you would have had even more jobs had the tax not been adopted. I do not see how anyone can believe otherwise.

Mr. HANCOCK. Let me just say this. Based on the testimony today that we have heard, not from you but from the questions on the other side, we might as well raise the price of the tax 8.2 or reduce it 8.2 or maybe three times as much and it will not have any effect. I think it is a little bit asinine to say that. Actually, any time you raise a tax, whether it is 1 cent, 4 cents, 8 cents, or 12 cents, it is going to have an effect. There is no question about it. Any time you affect energy, you are going to affect capital and labor and we are following around with the energy now.

Thank you, Mr. Chairman.

Chairman ARCHER. Will the gentleman yield to me for a little bit of his remaining time?

Mr. HANCOCK. Certainly.

Chairman ARCHER. What I am picking up from this is that whether it is jobs, which may be lost but there are more jobs created, or whether it is the price of gasoline and if it goes up or down, it seems to me it is compared to what? If you say the price of gasoline is not going to go down compared to what it is today if we remove the 4.3-cent gasoline tax, that could very well be true. The price of gasoline might even go up if we remove the gasoline tax if market forces happen to be coincidentally driving the price up.

Therefore, I think it should be very clear when we say the consumer will not realize it; that we consider whether the overall price of gasoline determined by market forces, which Mr. Verleger adequately and appropriately explained to the Committee is moving up or down.

It is a fact that the tax is not collected at the refinery. The price of gasoline is set at the refinery by market prices, again, which depend on environmental regulations, what the market supply is doing relative to demand, and so forth. The price then goes to the terminal, where the tax is added.

If it goes to the terminal and the tax does not have to be added, Mr. Sherbert will not see that tax in the price of the product that he receives. It seems very clear to me that you will automatically see a reduction compared to what it otherwise would be, not necessarily compared to what the price is today.

I thank all four of you for your testimony today and we do have to go vote. This completes this panel and you are excused. I will say to the Committee and to the next panel, we will try to come back as quickly as possible after the last 5-minute vote.

Thank you very much.

[Recess.]

Chairman ARCHER. The Committee will come to order.

My apologies to our next panel of witnesses. If you will take seats at the witness table, we will commence and try to get you out of here as soon as possible. If we move rapidly, before any other Members get here, we can do that pretty quickly.

I welcome all of you to the Committee. I am sure most of you listened to the previous exchanges, so you will be a little bit prepared about what we will be discussing.

I would like to start off with Hon. Carol Hallett. Carol, if you will identify yourself for the record, you may proceed.

Let me first say that, without objection, your complete statements will be entered into the record in writing. If you will attempt to summarize within a 5-minute period for your oral testimony, we would appreciate that.

Ms. Hallett.

STATEMENT OF CAROL HALLETT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AIR TRANSPORT ASSOCIATION OF AMERICA; AND FORMER COMMISSIONER, U.S. CUSTOMS SERVICE

Ms. HALLETT. Thank you, Mr. Chairman. I am Carol Hallett, the president and chief executive officer of the Air Transport Association of America. I appreciate the opportunity to appear before you and the Committee today.

On behalf of our member airlines, I would like to applaud the Committee's proposal to repeal the 4.3-cent-per-gallon transportation fuel tax. We certainly believe it is the right thing to do. As you know, repeal of the jet fuel tax on commercial aviation has been the airline industry's number one legislative priority since it was enacted in 1993 as part of President Clinton's deficit reduction plan.

At the time of enactment, our industry was granted a 2-year exemption from the tax in recognition of the industry's precarious financial condition, with losses totaling up to $13 billion since 1990. Thanks to you, Mr. Chairman, to Congressman Mac Collins and Congresswoman Jennifer Dunn and the rest of the Committee, an extension of our industry's exemption from the tax was included in last year's budget reconciliation legislation. Unfortunately, that bill was vetoed by President Clinton and the airlines joined all other transportation modes in paying this deficit reduction tax as of the first of October last year.

Jet fuel prices averaged in 1995 55.8 cents per gallon. They reached a low of 54.1 cents last July. But since then, they have steadily risen, with sharp increases in the last several months. Jet fuel prices in March and going into April, which is the latest available information that we have, were about 65 cents per gallon, although some have been reported at 70 cents.

Mr. Chairman, U.S. airlines consume 17 billion gallons of jet fuel per year. Each 1-cent-per-gallon increase in the cost of jet fuel equals an approximate $170 million per year in additional cost to the industry. These rising jet fuel costs are certainly a potential for hikes in our prices, particularly when you add to that the 4.3-cent-per-gallon tax that we are now paying.

Consequently, the 11-cent-per-gallon increase in jet fuel from the 1995 average level is of very serious concern to the airline industry. This 20 percent increase in the price of fuel will add $1.8 billion to our costs over the course of the year. On top of the recent runup in jet fuel prices, the airlines are now, as I have mentioned, also paying the 4.3-cent-per-gallon tax on domestic fuel and that adds another $550 million to our costs.

When we attempt to pass on to our customers this higher cost in the form of fare increases, we would normally see a reduction in demand for air travel services. In fact, industry analysts agree that each 1 percent increase in ticket prices correlates to a 1-percent decline in travel demand.

The industry estimates that passing on this cost results in 5 million fewer passengers a year. This occurs because some passengers opt to take shorter trips via automobiles or other modes of transportation to other destinations, or when some passengers, particu-

larly business travelers who are constrained by budget limitations, decide not to travel at all.

This statistic alone, Mr. Chairman, is enough to drop many flights into the loss column and will surely result in airlines cutting back, particularly in markets that have few passengers to begin with. Economics will tell you that during the 5-year period when the airlinep industry was losing billions of dollars, government-imposed taxes and fees increased significantly more and significantly faster than any single airline cost.

Mr. Chairman, I join with my transportation industry colleagues today to urge you to move as quickly as possible to repeal a tax which affects not only the airlines, our passengers, and our shippers, but quite literally, directly impacts all Americans.

I look forward to responding to your questions.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Carol Hallett
President and Chief Executive Officer
Air Transport Association of America

Hearing before the Committee on Ways and Means
On the Repeal of the 4.3 Cents-Per-Gallon
Transportation Fuel Tax
May 8, 1996

Mr. Chairman, and members of the Committee, I am Carol Hallett, President and CEO of the Air Transport Association of America. On behalf of our member airlines,* I'd like to applaud the Committee's proposal to repeal the 4.3 cents-per-gallon transportation fuel tax.

It's the right thing to do!

As you know, repeal of the jet fuel tax on commercial aviation has been the airline industry's number one legislative priority since it was enacted in 1993 as part of President Clinton's deficit-reduction plan. At the time of enactment, our industry was granted a two-year exemption from the tax in recognition of the industry's precarious financial condition -- losses totaling over $13 billion since 1990.

Thanks to you Mr. Chairman, Congressman Mac Collins, Congresswoman Jennifer Dunn, and the rest of the committee, an extension of our industry's exemption from the tax was included in last year's budget-reconciliation legislation.

Unfortunately, that bill was vetoed by President Clinton and the airlines joined all other transportation modes in paying this deficit reduction tax.

The transportation fuel tax is having an adverse impact on the financial well-being of the airlines.

Jet fuel prices averaged 55.8 cents-per-gallon in 1995. They reached a low of 54.1 cents last July. Since then, they have steadily risen with sharp increases in the last several months. Jet fuel prices in March -- which is the latest available information -- were about 65 cents-per-gallon.

Mr. Chairman, U.S. airlines consume **17 billion gallons** of jet fuel per year.

Each one cent-per-gallon increase in the cost of jet fuel equals approximately $170 million per year in additional cost to the industry.

Consequently, the 11 cents-per-gallon increase in jet fuel from the 1995 average level is of very serious concern for the airline industry. This twenty percent increase in the price of fuel will add $1.8 billion to our costs over the course of a year.

On top of the recent run-up in jet fuel prices, the airlines are now also paying the 4.3 cents-per-gallon tax on domestic fuel consumption which adds another $550 million to our costs.

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*ATA member carriers include: Alaska Airlines, Aloha Airlines, American Airlines, American Trans Air, America West Airlines, Continental Airlines, Delta Air Lines, DHL Airways, Evergreen International Airlines, Federal Express, Hawaiian Airlines, KIWI Airlines, Midwest Express, Northwest Airlines, Polar Air Cargo, Reeve Aleutian Airways, Southwest Airlines, Trans World Airlines, United Airlines, United Parcel Service, and USAir. ATA associate members include: Air Canada, Canadian Airlines International, and KLM-Royal Dutch Airlines.

When we attempt to pass on to our customers this higher cost in the form of fare increases, we would normally see a reduction in demand for air travel services.

In fact, industry analysts agree that each one percent increase in ticket prices correlates to a one percent decline in air travel demand.

The industry estimates that passing on this cost results in five million fewer passengers a year. This occurs because some passengers opt to take shorter trips, via automobiles, or other modes of transportation, to other destinations, or when some passengers (particularly business travelers constrained by budget limitations) decide not to travel at all.

A loss of five million passengers approximates a loss of one person on each and every flight.

This statistic alone is enough to drop many flights into the loss column, and will surely result in airlines cutting back -- particularly in markets that have few passengers to begin with.

Economics will tell you that during the five year period when the airline industry was losing billions of dollars, government-imposed taxes and fees increased significantly more, and significantly faster, than any single airline cost.

Mr. Chairman, I join with my transportation industry colleagues today to urge you to move as quickly as possible to repeal a tax which affects, not only the airlines, our passengers and our shippers, but quite literally, directly impacts all Americans.

I would be happy to answer any questions you or any member of the committee may have.

Chairman ARCHER. Thank you, Ms. Hallett.

Our next witnesses are in tandem, Susan Perry and Harry Blunt, both representing the American Bus Association.

Ms. Perry, would you lead off.

STATEMENT OF SUSAN PERRY, SENIOR VICE PRESIDENT, GOVERNMENT RELATIONS, AMERICAN BUS ASSOCIATION

Ms. PERRY. Yes, I will. Thank you, Mr. Chairman, Members of the Committee. Thanks so much for holding this hearing. We appreciate your doing it and we appreciate being invited to participate.

Before I make three points very quickly, I just wanted to note, as Mr. Royce pointed out, the situation with diesel fuel is much worse in California because of their particular rules and regulations than it is in any other place else in the country. I was in California 2 weeks ago with the California Bus Association and they are suffering very, very badly. I think Mr. Donohue will talk a little bit more about this situation vis-a-vis the truckers in California, and I just wanted to note that it is the same problem for the bus industry with the diesel there.

The diesel fuel, when I was there 2 weeks ago, was up to $1.60 a gallon, and that is up from apparently about $1.10 just 1 year ago. The real threat with that problem is that as summer comes, and this is true all over the country, the bus companies use a lot more fuel than they do the rest of the year, so this is why it is so dire.

There are just three points that I would like to make quickly as to why we are in favor of the proposal to repeal the 4.3 cents. Last year, we testified and we submitted some testimony to this Committee asking for equity among the various transportation modes. What we said was that if the 4.3-cent exemption for aviation were to be continued, that we would like to be included in that exemption and we felt that that was a mater of equity.

As Carol said, their proposal to continue their exemption died when the budget reconciliation bill was vetoed, so that did not happen, either. Now that Congress is proposing to repeal the tax for everybody, I guess you could call that the ultimate equity and we applaud that effort.

In addition to the lack of equity with the way the tax was imposed on the various modes, the American Bus Association opposes the tax for two reasons. One of them certainly has been well discussed at length and that is diversion from the Highway Trust Fund. We do believe that moneys collected from the use of highway fuel should be deposited into the Highway Trust Fund and dedicated for those purposes.

We believe that the tax is a regressive tax and it disproportionately hurts bus passengers. It is difficult for bus companies to absorb any additional costs. Many of them are already enduring operating ratios in excess of 100 percent, which, obviously, they cannot do for terribly long, but a lot of them are doing it.

In addition to the bus companies being in a rather precarious condition, the bus passengers are the least affluent of the travelers, so any increase in ticket price, were the companies to pass it on to them, would affect them very adversely. According to Greyhound's demographics, 44 percent of its passengers have annual incomes of $15,000 or under. So I think it is a particular burden on the inner-city bus companies as well as on their passengers. I have gone into details of this in my written statement.

I would just thank you very much at this point for the opportunity.

[The prepared statement and attachment follow:]

STATEMENT OF SUSAN PERRY
SENIOR VICE PRESIDENT-GOVERNMENT RELATIONS
AMERICAN BUS ASSOCIATION

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

MAY 8, 1996

Mr. Chairman and Members of the Committee:

My name is Susan Perry and I am the Senior Vice President of Government Relations for the American Bus Association (ABA). Thank you for the opportunity to testify in favor of repealing the 4.3 cents per gallon federal fuel tax.

ABA is the national trade association of the intercity bus industry, representing more than 700 bus and tour company members in the United States and Canada. Most of these companies are small businesses, many of which are family owned. They operate regular route, charter and tour, airport express, special operations, and contract services. The ABA membership also includes another 2,300 travel and tourism organizations and suppliers of services and products to the bus industry.

The intercity bus industry pays approximately $7.4 million per year in additional taxes because of the 4.3 cents per gallon surtax. The industry operates about 945 million bus miles and consumes about 172 million gallons of diesel fuel each year. The number of gallons multiplied by 4.3 cents per gallon yields a tax revenue of approximately $7.4 million.

ABA strongly supports repeal of the 4.3 cents per gallon federal fuel tax for three reasons. First, and most important, the fuel tax is a regressive tax with a disproportionately adverse effect on the typical bus passengers, including the elderly, the young, the poor, and those in rural America. The regressive nature of the tax is exacerbated by the recent dramatic rise in fuel prices.

Second, for the first two years it was in effect, until October 1995, the 4.3 cents tax was paid by the bus industry but not by the airline industry, which competes with our members directly in intercity passenger markets.

Third, the $7.4 million in tax revenue paid by the bus industry (or any of the other revenue raised by the 4.3 cents surtax) has never been used for highway construction and maintenance, unlike other federal fuel taxes that have been placed into the Highway Trust Fund since 1956.

For these reasons, the tax should be repealed immediately.

The Regressive Fuel Tax Hurts Bus Passengers Disproportionately

ABA supports repeal of the 4.3 cents a gallon federal fuel tax because it is regressive, and therefore imposes a disproportionate burden on bus passengers. The intercity bus industry transports the elderly, the young, members of the military, those in rural America, and those in the lower income brackets. In fact, Greyhound's demographic research indicates that 44 percent of its passengers have annual incomes of less than $15,000. For these Americans, the fuel tax, included as part of the cost of transportation, takes a higher portion of their incomes than it does for the more affluent Americans who travel on Amtrak or airlines or in private automobiles.

The regressive nature of the tax is exacerbated by the dramatic increase in diesel fuel prices over the past year. In April 1995, the nationwide average price of diesel fuel was $1.10 per gallon. By April 15, 1996 the nationwide average price had increased to $1.30 per gallon. Many bus carriers have long term contracts for services, and they are unable to renegotiate increases based on variable fuel costs. Repealing the 4.3 cents tax would help to alleviate the pressures imposed by the fuel price surge.

Intercity bus passengers can ill afford to pay this additional tax, and the financially strapped intercity bus industry cannot afford to continue paying this tax, particularly when it provides no benefit for bus operators.

Equitable Treatment for the Intercity Bus Industry

Last summer, when I testified before Congress on the federal deficit reduction fuel tax, I asked for equity among modes. If the Congress were going to extend the exemption for airlines, or expand the exemption to Amtrak, I asked that the bus industry receive the same treatment. Now, the leadership is proposing to solve these equity problems by repealing the tax for all modes. ABA believes that this is the most equitable solution available.

For the two year period beginning October 1, 1993, the intercity bus industry paid the 4.3 cents fuel tax while the airline industry was exempt from the tax. Airlines have only recently begun paying the tax, and they have sought to extend their exemption in perpetuity, ostensibly due to their industry's precarious financial health. Amtrak has also sought an exemption from the tax.

The bus industry competes directly with the airline industry, yet the bus industry has paid this tax all along while the airlines have not. Moreover, since deregulation in transportation markets, and the advent of regional airlines and discount air fares, that intermodal competition has increased markedly. Discount air fares have not only hindered the profitability of airlines, they serve as a check on bus fares as well. Thus, the bus industry suffers from the same precarious financial condition as the airline industry.

For example, according to the former Interstate Commerce Commission, for the first six months of 1995 (the latest period for which data are available), the top ten regular route intercity bus carriers had a combined operating ratio of 104.92, i.e., they incurred $104.92 in costs for every $100.00 in operating revenue. For Greyhound Lines, Inc., by far the largest carrier in the bus industry, and the only nationwide carrier in the industry, the operating ratio was 107.66 for that period. The bus industry is no stranger to tight margins and bottom lines in the red.

The bus industry also suffers from a striking disparity in net federal subsidies by passenger transportation mode. As compared by Robert R. Nathan Associates in a July 1995 report,[1] the airline industry receives a net federal subsidy[2] of $6.38 per passenger trip, Amtrak receives a net federal subsidy of $54.88 per passenger trip, and the bus industry receives a net federal subsidy of **five cents** per passenger trip. See Attachment 1.

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[1] The Impact of Higher Motor Fuel Taxes on the Intercity Bus Industry, Robert R. Nathan Associates, Inc., Arlington, Va., July 1995.

[2] A "net federal subsidy" is the aggregate amount of federal spending on infrastructure and operating subsidies received by a mode minus the amount of federal user taxes paid by the mode.

By repealing the 4.3 cents fuel tax for all modes, bus, air and rail, Congress would begin to restore the competitive balance in intercity passenger transportation markets across the modes.

Highway Trust Fund Diversion

Since the inception of the Interstate Highway System in 1956, all federal fuel taxes were paid into the Highway Trust Fund and then disbursed to the states for highways and bridges. Highway users, including the intercity bus industry, were willing to pay the federal fuel taxes as an investment in the nation's infrastructure. This trust fund system has provided a nationwide highway system that has played a critical role in the economic development of this country and contributed dramatically to the mobility of Americans.

The trust fund concept, however, was breached in 1993 by the Omnibus Budget Reconciliation Act (OBRA), which imposed the 4.3 cents per gallon federal fuel tax but diverted the revenue to the general fund to reduce the size of the federal budget deficit. Not a nickel of this tax revenue goes to construction, repair or maintenance of the nation's highway system.

If the highway system were in adequate repair, this diversion might not present such a critical issue to the intercity bus industry and other highway users. But by any measure, the infrastructure of highways and bridges in this country is deteriorating, and the trust fund spending is falling farther behind investment needs every day.

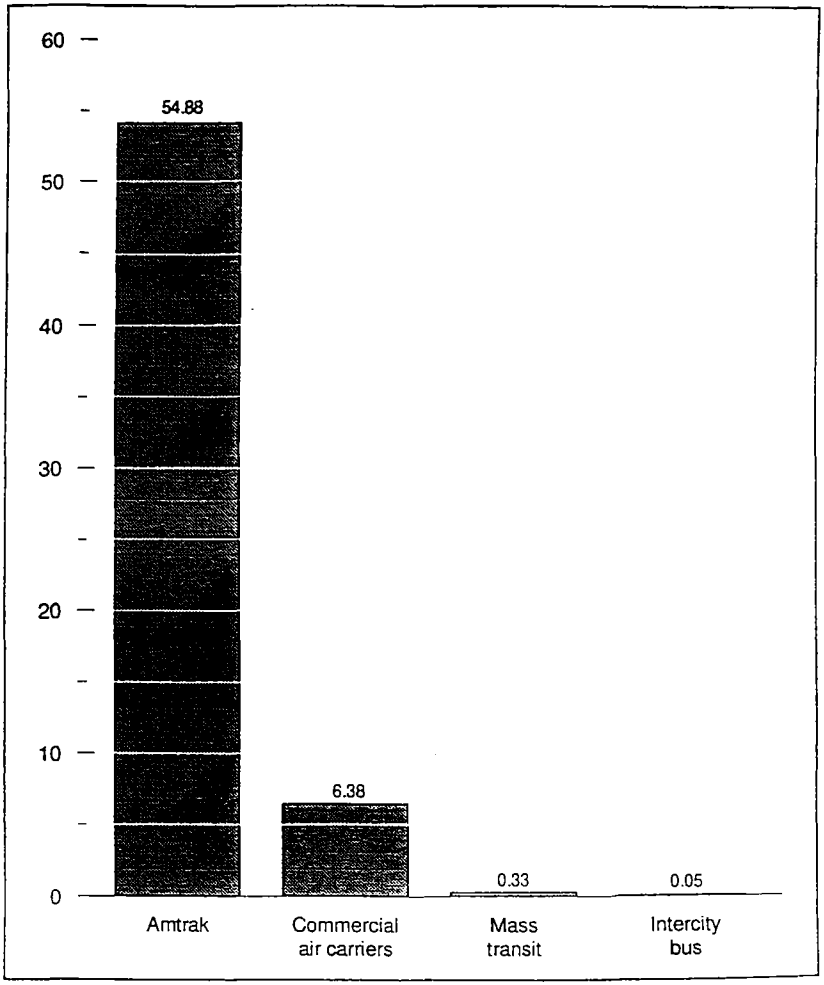
ABA believes that all revenues from federal fuel taxes on highway vehicles must go into the Highway Trust Fund. This will ensure that the investment in our nation's highway system does not fall prey to short term attempts to reduce the federal deficit.

For all of these reasons, it is time for Congress to repeal this mistake made in 1993.

ATTACHMENT 1

Figure 3. Total Federal Subsidies Per Passenger Trip, Net of User Fees, to Passenger Transportation Systems and Modes, 1960-1993

(1993 Dollars)



Source: Nathan Associates Inc.

Chairman ARCHER. Thank you, Ms. Perry.

Mr. Blunt, if you would identify yourself for the record, you may proceed.

STATEMENT OF HARRY W. BLUNT, JR., PRESIDENT, CONCORD COACH LINES, INC., CONCORD, NEW HAMPSHIRE; AND VICE CHAIRMAN, AMERICAN BUS ASSOCIATION

Mr. BLUNT. Thank you. My name is Harry Blunt and I am president of Concord Coach Lines, Inc., of Concord, New Hampshire. I also serve as vice chairman of the American Bus Association.

My company provides scheduled bus service throughout northern New England, serving 37 points in Maine, New Hampshire, and Massachusetts. We carry about a half a million passengers a year.

For the inner-city bus industry as a whole, the 4.3-cent-a-gallon gas tax contributes, as Susan has already said, to a slender profit margin for an industry that is suffering as it is already. As set out in the testimony that Susan made, many of our operators, including Greyhound, are still operating with operating ratios in excess of 100 percent.

This tax simply is an increment in operating costs for us. The bus industry and private business mine have already been hit in recent years with a number of increased operating costs as a result of additional government regulations. I know this Committee does not have jurisdiction over these areas, but it is important for you to keep in mind what we in the transportation industry must contend with because of changing Federal regulatory policies.

In the past few years, just to name a few, we have had to develop compliance programs for clean air, clean water, stormwater runoff, underground storage tank regulations, the Americans with Disabilities Act, drug and alcohol testing, family medical leave bills, and major changes in oil and chemical waste management. Regardless of whether or not we believe that these requirements are justified, and that is not the issue, these policies have added major costs to our industry and major costs to our suppliers, who have passed their costs on to us in increased costs.

Candidly, sir, no one from Congress has ever come to us and said, What will the cost of this be to your bus passenger? All of these expenses we have had to absorb, and nobody has ever been interested in what this does to the price of a bus ticket.

In the case of my company, we have not had a fare increase in nearly 2 years, except in one minor instance where we had a 2-percent fare increase. Bus carriers simply cannot pass the cost of fuel increases to passengers. Bus travel is extremely price elastic because of the competition with airlines, Amtrak, and primarily the private automobile. The price of a bus ticket cannot increase proportionately to accommodate the actual rise in fuel costs and taxes. The carrier must absorb the cost increases to keep the passengers on the bus.

Having said this, I do know that as a result of cost increases and current spikes in fuel prices, I have talked with some carriers who are anticipating a fuel surcharge in their pricing. I have also been told by these carriers that if this tax is repealed, they would be able to hold off on adding fuel surcharges. Repealing the 4.3-cent tax at this time will assist the strapped inner-city bus industry and that will help our passengers.

I thank you for the opportunity of presenting my views and look forward to answering any questions I may.

[The prepared statement follows:]

STATEMENT OF HARRY W. BLUNT, JR.
PRESIDENT OF CONCORD COACH LINES, INC.
CONCORD, NEW HAMPSHIRE

ON THE
REPEAL OF THE 4.3 CENTS PER GALLON MOTOR FUELS TAX

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

MAY 8, 1996

Mr. Chairman and Members of the Committee:

My name is Harry Blunt. I am the president of Concord Coach Lines in Concord, New Hampshire. I also serve as the Vice Chairman of the American Bus Association.

My company provides scheduled bus service from 37 points in New Hampshire, Maine and Massachusetts. We operate service to Logan Airport and to the new South Station intermodal terminal in Boston.

As a small company that purchases over half a million gallons of diesel fuel each year, we fully support repeal of the 4.3 cents a gallon fuel tax that goes into the general fund. Our annual savings from this tax repeal may be small when compared with the overall cost of the highway system, but it would have a significant impact on our company and its ability to serve our customers.

Concord Coach purchased 546,503 gallons of diesel fuel last year, and we paid $23,500 to the federal government because of the 4.3 cents fuel tax increase that went into effect in 1993. These tax payments are direct operating costs to the company.

For the intercity bus industry as a whole, the 4.3 cents a gallon fuel tax adds to the slender profit margins faced by many carriers. As set out in the testimony of the American Bus Association at today's hearing, many carriers providing scheduled service have operating ratios above 100, meaning that their operating costs exceed their operating revenue. This tax is simply an increment to those operating costs.

Bus carriers have already been hit in recent years with a number of increased operating costs as a result of additional government regulations. I know that this committee does not have jurisdiction over these areas, but it is important for you to keep in mind what we in the transportation industry must contend with because of changing federal regulatory policies. In the past few years, we have had to develop compliance programs under the Clean Air Act, the Clean Water Act (including stormwater runoff and underground storage tank regulations), the Americans with Disabilities Act, drug and alcohol testing for bus drivers, and expanded OSHA regulations. Regardless of whether or not we believe that these requirements are justifiable on policy grounds, these compliance programs all add costs to our expense statements. The 4.3 cents a gallon tax was added on top of these requirements two and one half years ago.

In addition, the price of fuel has gone up dramatically in the past few months. In April 1995, the national average price for diesel fuel was $1.10 a gallon. By April 1996 the price had risen 20 cents to $1.30 a gallon. That 20 cents a gallon increase cost my company $109,300 in one year. Our total annual ticket revenue is only about $6 million, so the 20 cents a gallon price increase, along with the 4.3 cents a gallon fuel tax, amounts to 2.2 percent of our total ticket revenues. In an industry with notoriously thin margins, this has an exorbitant impact on profitability.

Bus carriers cannot simply pass on the cost of fuel increases to passengers. Bus travel is extremely price elastic because of the competition with airlines, Amtrak and private automobiles. The price of bus tickets cannot increase proportionately to accommodate the actual rise in fuel costs and taxes. The carriers must absorb the cost increases to keep the passengers on the bus.

(Having said this, I do know that as a result of the cost increases and current spike in fuel prices, some carriers are considering a surcharge on service if there is no relief. They tell me that repealing the 4.3 cents tax would alleviate their need to add a new charge.)

Furthermore, the 4.3 cents a gallon tax does not even benefit the intercity bus industry. Unlike the other federal fuel taxes paid by bus carriers, the 4.3 cents tax goes into the general fund, and not the Highway Trust Fund. This money is deposited into the general fund and is not spent on construction, repair or maintenance of the nation's highways. The tax simply counterbalances a small portion of the federal budget deficit.

Repealing the 4.3 cents tax at this time will assist the strapped intercity bus carriers. And whatever you can do to assist us will help our customers.

I thank you for the opportunity to present my views to the committee today, and I ask that you vote to repeal this tax as soon as possible.

Chairman ARCHER. Thank you, Mr. Blunt.

Mr. Donohue and Mr. Bowman are both here representing the American Trucking Associations.

Mr. Donohue, if you will specifically identify yourself for the record, you may proceed.

STATEMENT OF THOMAS J. DONOHUE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN TRUCKING ASSOCIATIONS, INC.

Mr. DONOHUE. Thank you, Mr. Chairman and Members of the Committee. I am Tom Donohue, president and chief executive officer of the American Trucking Associations. As you indicated, Don Bowman, our chairman of the board, is with us today.

Mr. Chairman, 9 million Americans make their living in the trucking business. We represent 78 percent of the Nation's freight bill and account for 5 percent of the gross domestic product. Mr. Chairman, we buy 40 billion gallons of diesel and gasoline and we drive 350 billion miles every year, so you can imagine that skyrocketing fuel prices have had a devastating impact on our industry.

Most of our companies are small. Fuel prices can represent up to 20 percent of their overall operating costs, and a 16- to 20-cent-per-gallon increase in diesel fuel prices, like we are experiencing today, can easily tip the balance between staying in business or going out of business. That is why the 4.3-cent fuel tax increase enacted in 1993 should be repealed for all fuels. The repeal should be made immediately and, preferably, permanently.

There are particular problems with both diesel and gasoline that the Committee should consider in terms of California. The extreme gasoline price increases in California appear to result from the difficulty of requiring statewide use by June 1 of a special reformulated gasoline which cannot be produced as fast as needed because of the refining process, as you have heard discussed today. The problem might be addressed by a phase-in or a short delay.

Congress should take a close look at whether special California diesel makes sense in the light of the high cost and the very little increase in clean air. We have made major improvements in clean air with electronic engines.

In addition, the Congress should look at providing a relief mechanism when the price of fuel in the air quality areas gets considerably over what it is everywhere else. Maybe there is a trigger; I am not sure. Think about it, Mr. Chairman. California is the largest State in the union, has the fifth largest economy in the world, and we are strapping their primary mover of goods, trucks, with an additional 30 or 31 cents a gallon more than every place else in the country.

It would help to keep inflation in check if we moved on this, and certainly help to keep their economy in shape. Consumers would save about $6.5 billion a year in fuel taxes if we went ahead on your suggestions here, Mr. Chairman, and every truck in this country would save $600 a year.

In conclusion, I would like to say that repealing this tax is not about politics that happen to be going on in this building. It is all about jobs and preserving thousands and thousands of jobs and opportunities in this country for people in our business. It would really help if we just stepped up and, for once, said, We are not going to collect a tax that is not going into the trust fund, that is not building roads, and that is not helping the people that move the Nation's goods.

I thank you very much, sir.

[The prepared statement and attachments follow:]

Before the

UNITED HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

STATEMENT OF THOMAS J. DONOHUE
PRESIDENT AND CHIEF EXECUTIVE OFFICER
AMERICAN TRUCKING ASSOCIATION, INC.
ACCOMPANIED BY DONALD M. BOWMAN
CHAIRMAN, D.M. BOWMAN, INC.

May 8, 1996

The American Trucking Associations, Inc. (ATA) appreciates the opportunity to testify on repealing the 4.3-cent general fund fuel tax and on fuel prices. We wish to make three points:

- The 4.3-cent general fund fuel tax should be repealed immediately for all fuels. Taxes on highway fuel should go into the Highway Trust Fund and be used only for highway purposes, as has historically been the case.

- Repeal should be immediate and, preferably, permanent. If making repeal permanent would slow down its enactment, we would favor a short-term repeal followed by more comprehensive legislation that includes permanent repeal.

- There are particular problems with both diesel and gasoline supply in California. The extreme gasoline prices, which have drawn all of the media attention to date, appear to result from the difficulty of forcing statewide use by June 1 of a fuel that cannot be produced fast enough to meet the immediate demand; this might be addressed by a phase-in or short delay of the "clean burning gasoline" mandate. However, diesel fuel also costs consistently more in California than elsewhere even though the clean air benefits are less certain. Congress should take a close look at whether special California diesel makes sense in light of the high, permanent cost to the entire economy. In addition, Congress should look at providing a relief mechanism when California diesel prices exceed the national average by more than a certain margin. The current 31 cent differential is harming truckers and their customers nationwide.

I. ATA REPRESENTS THE TRUCKING INDUSTRY

ATA is the national trade association representing trucking companies of all sizes, industry segments and regions. More than 35,000 companies belong directly to ATA or to our 51 state and 14 specialized national affiliates. These companies range in size from individual owner-operators to carriers with thousands of trucks. Diverse as those businesses are, they all use fuel. Thus, ATA has a strong interest in fuel taxation.

II. TRUCKING PLAYS A VITAL ROLE IN THE ECONOMY

Nine million Americans make their living in the trucking business. Trucking is a $360 billion industry, representing some 5% of gross domestic product. Shippers

overwhelmingly choose to send goods by truck; trucking now accounts for 78% of the nation's freight bill.

As businesses at all stages of production trim inventories, they increasingly rely on frequent and precisely timed truck deliveries to make sure they have enough raw materials, parts and final goods to keep operating. This growing dependence on trucking instead of storing materials has held down costs and made suppliers more nimble in meeting changing demands from both domestic and foreign consumers.

At the same time, this dependence makes the financial and competitive condition of the trucking industry all the more important to the entire economy. With a profit margin of less than 1.5% in 1995, the trucking industry cannot afford taxes that are unique to transportation industries.

III. FUEL IS A MAJOR EXPENSE FOR TRUCKING

Fuel costs account for anywhere from 4% to 20% of a trucking company's operating revenue, depending on the nature of the company's vehicles, customers and length of haul. The burden of fuel costs--and fuel taxes--falls on all carriers and their customers but it does so very unevenly. Operations with especially heavy fuel needs include: long-haul trucking; van lines; and activities that use fuel for nonhighway purposes, such as the motors used for refrigerated trailers, dumping, trash pickup and compacting, and concrete and other mixing and pumping operations.

Unfortunately, fuel costs have been soaring lately--even more in much of the nation for diesel fuel than for the gasoline that has received most of the media attention. The Energy Department's Energy Information Administration (EIA) surveys 250 truck stops every week. Because shippers, carriers, government agencies and other rely on these surveys to determine fuel price trends, EIA recently began, at ATA's request, conducting this survey three times a week, instead of weekly. The survey shows that the nationwide average retail price for diesel fuel rose 15% in just 10 weeks, from $1.13 per gallon on February 5 to $1.305 on April 15. The latest survey, done May 6, showed the national average was still $1.292. (See Table 1 and Figure 1.)

EIA also compiles five regional averages. Those averages reveal that prices rose throughout February in the regions that use heating oil, namely the East and Gulf Coasts and the Midwest. Although heating oil typically is a bit cheaper than diesel fuel, utilities, factories and fuel oil distributors who may have had trouble getting enough heating oil (or natural gas, in the case of dual-fuel facilities) probably started buying diesel fuel during the coldest weather last winter, pushing up diesel prices in those regions. Now that winter has finally ended, diesel prices in those regions have eased a bit. But in the Rocky Mountain and West Coast regions, prices began to move up in late February or early March and are still climbing. Total increases in those regions have been steeper and more sudden: a 26-cent jump in just 7 weeks in the West Coast.

Commercial trucks will consume over 40 billion gallons of fuel this year - 24.3 billion of diesel fuel and 16.1 billion of gasoline. Commercial truck owners will contribute $8.8 billion in fiscal 1996 in fuel taxes to the federal treasury, of which $1.7 billion will go to the general fund and $7.1 billion to the Highway Trust Fund. These figures are calculated at current federal tax rates of 24.3 cents per gallon for diesel fuel and 18.3 cents for gasoline. In addition, commercial truck owners will pay another $3.1 billion in other highway user taxes on new trucks, tires and highway use. All told, commercial trucks will pay 44% of Highway Trust Fund taxes in fiscal 1996, in addition to $1.7 billion in general fund fuel taxes. Additionally, commercial trucks will pay an additional $13.2 billion in state taxes, not including property and/or weight distance taxes.

IV. THE 4.3-CENT GENERAL FUND FUEL TAX SHOULD BE REPEALED IMMEDIATELY

The trucking industry has willingly paid highway user fees that are in fact used to build highways. A good highway system is good for all citizens and for the nation's economic well-being, and trucking is willing to do its part to improve and maintain that system.

But there is no justification for singling out businesses and individuals for a special burden of deficit reduction based on how much fuel they consume for transportation. The general fund fuel tax, which falls only on transportation fuel, should be repealed immediately. The impact on the budget is minimal, only 0.3% of this year's $1.6 trillion budget, yet the burden on highway using small businesses is substantial, particularly when fuel costs are squeezing many of these businesses to the edge of extinction. This tax also falls unfairly on the poorest automobile drivers who are least able to absorb this cost.

Even the treasury gets some benefit from repeal of this unfair tax. The Joint Committee on Taxation staff estimates that 25% of the revenue loss from dropping the 4.3 cent tax will flow back to the treasury in higher income and payroll taxes. That's because consumers will spend the savings at the fuel pump on other goods and services, which will add to employment and profits in the industries supplying those products.

The savings will show up in a variety of forms. The most immediate impact of course will be right at the gasoline pump and will be greatest for families who use practical but fuel-thirsty minivans and station wagons. These same families will also save when the tax is no longer passed on by shippers in the price of milk, clothes and other goods they buy. They will save again on travel costs, whether by family car or in the costs embedded in the price of a bus, rail or airline ticket. Families that relocate will see the savings in their moving-van costs. The total savings will be about $100 per year for a family of four. That's a genuine, family-friendly tax cut--with no complicated phase-ins, phase-outs or eligibility questions.

V. REPEAL SHOULD BE IMMEDIATE AND PERMANENT IF POSSIBLE

The repeal of the 4.3 cent tax should take place immediately to provide relief when it is most urgently needed to counter today's soaring fuel prices. Because the tax on highway fuels is imposed at the terminal rack where tank trucks pick it up for delivery to retailers and bulk fueling facilities, the repeal will be reflected in the price that users pay within days.

If possible, the repeal should also be permanent. Too many taxpayers now must contend with the uncertainty of temporary income and excise tax provisions. This much-needed repeal should not be added to the list of provisions that lie in legislative limbo. However, we recognize that permanent repeal may take longer to work through the legislative process. Therefore, we would support an immediate but temporary repeal if Congress needs more time to work out permanent repeal.

VI. CALIFORNIA SITUATION DESERVES ADDED ATTENTION

Prices have been rising especially fast in California in the past few weeks. In fact, since April 15, when ATA began daily, state-by-state tracking of diesel prices at both the terminal rack and the retail fuel pump, national prices have drifted down slightly but prices in California have continued upward almost without interruption. Diesel now costs 31 cents per gallon more in California than in the nation as a whole, according to the latest daily survey of 4000 truck stops by Computer Petroleum Corporation. (See Table 2 and Figure 2.) Because California is such a huge market itself and is the point of origin or destination for so much of the nation's domestic and international freight, these price differentials are

matters of nationwide concern.

Like the rest of the nation, California prices have been affected by high crude oil costs, brought on in part by uncertainty about whether Iraq will soon begin selling oil again, and by unexpectedly strong demand for gasoline. However, the California situation is made worse by California Air Resources Board (CARB) requirements that refiners produce specially formulated "low aromatics" diesel fuel and "clean burning" gasoline. "CARB diesel" has been mandated since October 1993; "CARB gasoline" has been required in the Los Angeles basin since March and will be mandatory statewide beginning June 1. The statewide mandate has produced a short-run surge in demand as every vendor tries to secure supplies by that date from a very limited number of refiners. The inability of either diesel or gasoline customers to purchase fuel produced out-of-state makes them extremely vulnerable to price spikes when demand rises or supply is cut by production problems, such as a refinery shutdown. Unfortunately, both a demand surge and a refinery explosion have hit the California market this past month, leading to a predictable upsurge in prices.

The extreme gasoline prices, which have drawn all of the media attention to date, are likely to subside once refinery capacity catches up to demand. This problem might be addressed by a phase-in or short delay of the clean burning gasoline mandate. However, diesel fuel also costs consistently more in California than elsewhere even though the clean air benefits are less certain. Congress should take a close look at whether special California diesel makes sense in light of the high, permanent cost to the entire economy. In addition, Congress should look at providing a relief mechanism when California diesel prices exceed the national average by more than a certain margin. The current 31 cent differential is harming truckers and their customers nationwide.

VII. CONCLUSION

The trucking industry has always been willing to pay its fair share of legitimate highway user fees. However, it is inequitable and discriminatory to charge trucks disproportionate amounts for nonhighway purposes that do not directly benefit highway users. Therefore, ATA supports immediate, permanent repeal of the 4.3-cent general-fund fuel tax.

If the tax cannot be permanently repealed right away, ATA would favor a short-term, immediate repeal, quickly followed by permanent repeal.

Congress also should begin an immediate review of whether California-only fuel mandates are unnecessarily restricting markets and driving up prices there, particularly for diesel fuel, where the clean air benefits are much less likely to warrant the price penalty that truckers and their customers nationwide suffer as a result of requiring a fuel sold only in one state. In addition, Congress should consider whether it would be appropriate to provide relief from the differential in diesel prices between California and the rest of the country when that gap exceeds a certain level for more than a short period of time.

Table 1: EIA National and Regional Retail Diesel Fuel Prices

($ per Gallon)

	National	East Coast	Midwest	Gulf Coast	Rocky Mts	West Coast
01-Jan-96	1.148	1.147	1.125	1.106	1.203	1.262
08-Jan-96	1.146	1.149	1.120	1.107	1.193	1.261
15-Jan-96	1.152	1.159	1.126	1.117	1.191	1.260
22-Jan-96	1.144	1.152	1.116	1.106	1.188	1.255
26-Jan-96	1.136	1.143	1.110	1.094	1.186	1.247
05-Feb-96	1.130	1.141	1.104	1.088	1.179	1.236
12-Feb-96	1.134	1.142	1.111	1.093	1.180	1.233
19-Feb-96	1.151	1.168	1.130	1.115	1.176	1.233
26-Feb-96	1.164	1.182	1.148	1.125	1.174	1.232
04-Mar-96	1.175	1.190	1.165	1.135	1.187	1.230
11-Mar-96	1.173	1.183	1.163	1.142	1.187	1.228
18-Mar-96	1.172	1.180	1.160	1.139	1.197	1.235
25-Mar-96	1.210	1.231	1.198	1.186	1.213	1.244
01-Apr-96	1.222	1.235	1.208	1.196	1.220	1.283
08-Apr-96	1.249	1.251	1.236	1.218	1.250	1.336
15-Apr-96	1.305	1.299	1.301	1.265	1.309	1.387
22-Apr-96	1.304	1.297	1.287	1.258	1.342	1.431
29-Apr-96	1.285	1.269	1.260	1.214	1.357	1.479
06-May-96	1.292	1.272	1.267	1.216	1.380	1.494

	National	East Coast	Midwest	Gulf Coast	Rocky Mts	West Coast
Last Year	1.126	1.120	1.103	1.087	1.156	1.260
One Year Low	1.093	1.095	1.069	1.055	1.140	1.211
One Year High	1.305	1.299	1.301	1.265	1.380	1.494
1996 Low	1.130	1.141	1.104	1.088	1.174	1.228
% ch. to May 6th	14.34%	11.48%	14.76%	11.76%	17.55%	21.66%

FIGURE 1: RETAIL DIESEL PRICES

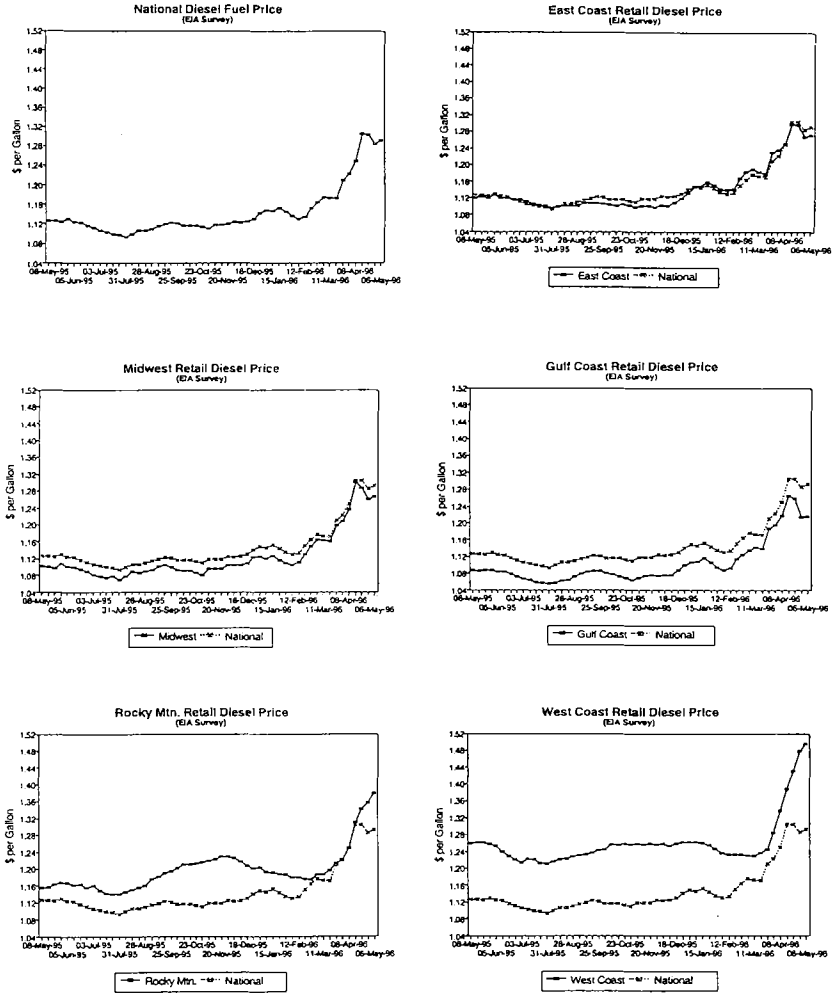
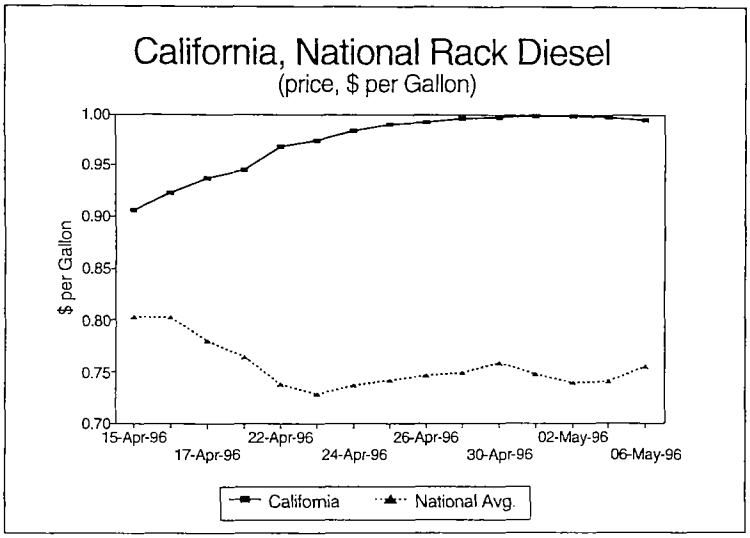


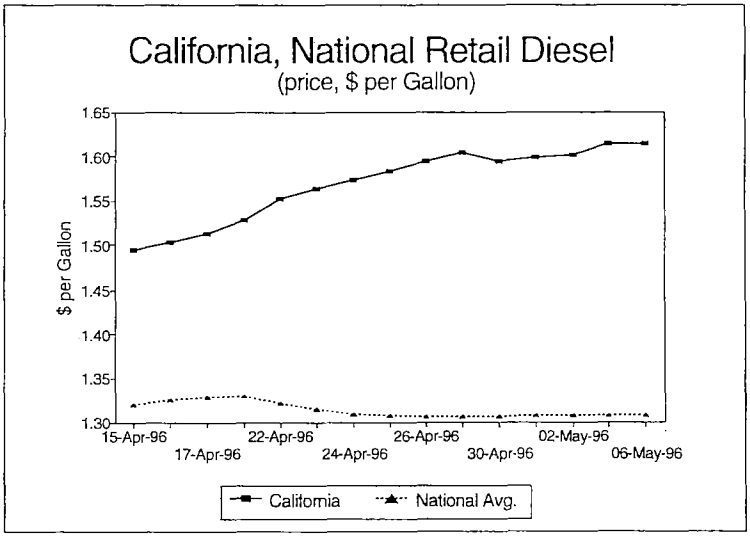
Table 2: California & National Daily Average Rack & Retail Diesel Prices
($ per Gallon)

Date	California Rack	National Rack	California Retail	National Retail
15-Apr-96	0.906	0.803	1.496	1.321
16-Apr-96	0.923	0.802	1.504	1.327
17-Apr-96	0.938	0.780	1.513	1.329
18-Apr-96	0.946	0.764	1.530	1.331
22-Apr-96	0.968	0.738	1.553	1.322
23-Apr-96	0.974	0.728	1.563	1.316
24-Apr-96	0.984	0.736	1.574	1.309
25-Apr-96	0.989	0.742	1.584	1.308
26-Apr-96	0.992	0.746	1.594	1.307
29-Apr-96	0.996	0.749	1.604	1.307
30-Apr-96	0.997	0.758	1.595	1.306
01-May-96	0.998	0.748	1.599	1.308
02-May-96	0.998	0.740	1.602	1.308
03-May-96	0.997	0.740	1.614	1.307
06-May-96	0.995	0.755	1.614	1.308
% Change from 4/15 to 5/6	9.83%	-5.99%	7.89%	-0.97%

Source: Computer Petroleum Corporation PetroNet and ATA

FIGURE 2: CALIFORNIA VS. NATIONAL RACK & RETAIL DIESEL FUEL PRICES





Source: ATA Statistics; data provided by Computer Petroleum Corporation PetroNet© software

Chairman ARCHER. Thank you, Mr. Donohue.

Mr. Bowman.

STATEMENT OF DONALD M. BOWMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, D.M. BOWMAN, INC., WILLIAMSPORT, MARYLAND; AND CHAIRMAN OF THE BOARD, AMERICAN TRUCKING ASSOCIATIONS, INC.

Mr. BOWMAN. Good afternoon, Mr. Chairman and Members of the Committee. I am Don Bowman, chairman and chief executive officer of D.M. Bowman, Inc., of Williamsport, Maryland, and this year's chairman of the board of ATA, the American Trucking Associations, Inc.

My company is a medium-sized truckload carrier. We run around 450 trucks and employ around 600 people. I am here today on behalf of my company and the thousands of other truckers who are experiencing serious problems with rising fuel costs.

The rise in fuel prices is causing major problems for my company and many other ATA companies. For example, the supply of diesel fuel has been interrupted for many of our member companies and operating costs are going through the roof. If we do not get some kind of relief soon, we will be unable to afford to buy the equipment that we need to run our businesses and may even have to lay off some employees.

Let me tell you what kind of effect repealing the 4.3-cent tax would have at D.M. Bowman, Inc. We buy about 8 million gallons of fuel annually. If Congress got rid of the 4.3-cent tax, my company would save $344,000 a year. With that money, I can create eight more full-time jobs, paying a little over $40,000 a year, or I could buy six brandnew tractors.

In summary, Mr. Chairman, there is very little any of us can do about the market forces that are driving up the price of fuel, but there is something we can do about the taxes on that fuel, particularly taxes that do not build roads and bridges. Congress should seize this opportunity to repeal this 4.3-cent tax and help protect jobs and promote economic growth.

I feel that repeal of this tax will mean a reduction of 4.3-cent-per-gallon tax to my company and other end users of the product. I think competition will ensure this.

I would like to thank you for the opportunity to testify today, and I will be happy to answer any questions.

Chairman ARCHER. Thank you, Mr. Bowman.

Mr. Harper, you are our last witness. If you would identify yourself for the record, you may proceed.

STATEMENT OF EDWIN L. HARPER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ASSOCIATION OF AMERICAN RAILROADS

Mr. HARPER. Thank you, Mr. Chairman, Members of the Committee. I am Edwin L. Harper, president and chief executive officer of AAR, the Association of American Railroads. I appreciate the opportunity to present the railroad industry's perspective on current proposals to eliminate portions of the fuel excise taxes.

It is appropriate for the Congress to reconsider fuel excise taxes. The railroad fuel bill has gone up $480 million on an annualized

basis so far this year. That cost will be passed along eventually to everyone who uses electricity, who drives cars, or who eats.

The AAR urges the Congress to repeal the 1993 deficit reduction fuel tax to which transportation modes are subject. All modes are subjected to a 4.3-cent-per-gallon tax, while the railroads are uniquely and inequitably subjected to a 5.5-cent-per-gallon deficit reduction fuel tax.

In discussing fuel tax levels, it is important to distinguish two distinct types of fuel taxes now in place. First, there are fuel taxes which are essentially user charges imposed on nonrailroad modes of transportation to pay for the improvement and maintenance of public infrastructure and right-of-ways on which they depend.

Motor carriers pay fuel taxes to the Highway Trust Fund as a user charge for federally financed construction, operation, and maintenance of the publicly owned streets and highways throughout America. Likewise, inland waterway carriers pay a similar fuel tax to the Inland Waterways Trust Fund.

In contrast, however, to other modes, the railroads build, own, and operate their own rights-of-way, and thus do not pay Federal excise taxes or user fees, fuel or otherwise, for these purposes. The freight railroad industry does not want or need a trust fund. Instead, each freight rail carrier makes its own investment decisions and the industry pays significant property taxes on its privately owned rights-of-way.

Second, other fuel taxes are paid by freight transporters solely for deficit reduction. Prior to 1990, the only purpose of transportation fuel taxes was to finance nonrailroad transportation infrastructure. The 1990 Budget Reconciliation Act extended the fuel tax beyond its historical role as a user fee by introducing a 2.5-cent-per-gallon deficit reduction tax on transportation fuels. This tax was payable by highway users and railroads into the general fund of the Treasury.

The 1993 Reconciliation Act imposed an additional 4.3-cent-per-gallon deficit reduction tax on all transport modes, albeit with a deferred effective date for commercial airlines. This tax remains in place and is the subject of today's hearings.

The deficit reduction diesel fuel taxes imposed in 1990 and 1993 should be repealed. There is no justification for expanding fuel taxes beyond their traditional and appropriate application as a user fee. In addition, it is fundamentally unfair to single out the transportation industry from other segments of the economy to pay for deficit reduction. Moreover, it is grossly unfair to then single out one mode of transportation, the railroads, for an even larger share of the burden.

The 1993 Reconciliation Act provided that on October 1, 1995, one-half of the 2.5-cent-per-gallon deficit reduction diesel fuel tax paid by the railroad industry would be retained and extended, while the tax paid by the trucking industry would be redirected into the Highway Trust Fund rather than dedicated to deficit reduction. Thus, the railroads are now the only payers of the original 1990 deficit reduction tax, originally set to expire last year, at a rate of 1.25 cents per gallon.

The chart, which you will see over here, illustrates the point and makes clear the arithmetic. The AAR urges Congress to remove the

unique and inequitable differential by eliminating the full deficit reduction tax on all modes.

Mr. Chairman, in conclusion, while waiting this morning, I was reading the Joint Committee on Taxation's report prepared on May 2 for the use of this Committee and the Finance Committee. In that text, you will see a chart showing the trust fund, general funds, and so forth. If this Committee and Congress go ahead and eliminate the 4.3-cent-per-gallon tax, what you will see in this column is all zeroes except for the railroad industry. They will be the only one the next time that this chart is created that will be paying a deficit reduction fuel tax of 1.25 cents per gallon. Thus, we hope that you will give careful consideration to making that a part of the total package of eliminating the vestiges of the 1993 act.

Thank you.

[The prepared statement follows:]

STATEMENT OF EDWIN L. HARPER
PRESIDENT AND CHIEF EXECUTIVE OFFICER
ASSOCIATION OF AMERICAN RAILROADS
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
HEARING ON THE IMPACT OF THE 1993 TAX INCREASE ON TRANSPORTATION FUELS
MAY 8, 1996

Mr. Chairman and Members of the Committee, I am Edwin L. Harper, president and chief executive officer of the Association of American Railroads (AAR). I appreciate this opportunity to present the railroad industry's perspective on current proposals to eliminate portions of the fuel excise taxes imposed in the Omnibus Budget Deficit Reduction Act of 1993 (OBRA '93). These proposals involve repeal of the 4.3 cents-per-gallon deficit reduction fuel tax imposed generally on competing modes of transportation. As Congress seeks to repeal the 4.3 cents-per-gallon deficit reduction fuel tax to which transportation modes generally are subject, AAR urges you to also repeal the 1.25 cents-per-gallon deficit reduction tax resulting from OBRA '93 which is uniquely and inequitably paid by the railroad industry.

FUEL TAXES ON TRANSPORTATION MODES ARE NOT AN APPROPRIATE DEFICIT REDUCTION MECHANISM

In discussing fuel tax levels, it is important to distinguish the two distinct types of fuel taxes now in place. First, there are fuel taxes which are essentially user charges imposed on certain individual modes of transportation to pay for the improvement and maintenance of public infrastructure and rights-of-way on which they depend. Motor carriers and other motorists pay fuel taxes to the Highway Trust Fund as a user charge for federally-financed construction, operation and maintenance of the publicly-owned streets and highways throughout America. Likewise, inland waterway carriers pay similar fuel taxes to the Inland Waterways Trust Fund to support federal spending on the publicly-owned inland waterway system. Air passengers, until recently, have paid ticket taxes which support airport and air traffic control system improvements. In contrast to the other modes, however, railroads build, own and operate their own rights-of-way and thus do not pay federal excise taxes or user fees (fuel or otherwise) for these purposes. The freight railroad industry does not want or need a trust fund. As a privately owned and operated industry, each freight rail carrier makes its own investment decisions and pays significant property taxes on these privately-owned rights-of-way.

Second, other fuel taxes are paid by freight transporters solely for deficit reduction. Prior to 1990, the only purpose of the transportation fuels tax was to finance non-railroad transportation infrastructure or operations.[1] The 1990 Budget Reconciliation Act, for the first time, extended the fuel tax beyond its historical role as a user fee, by introducing a 2.5 cents-per-gallon deficit reduction tax on highway users and railroads, payable into the General Fund of the Treasury.[2] OBRA '93 imposed an additional 4.3 cents-per-gallon deficit reduction rate on all transportation modes, albeit with a deferred effective date for commercial airlines; this tax remains in place and is the subject of this hearing.

It is AAR's view that the deficit reduction diesel fuel taxes imposed in 1990 and 1993 should be repealed. It is fundamentally unfair to single out one industry -- transportation -- from other segments of the economy to pay for deficit reduction. Moreover, it is grossly unfair to then single out one mode of transportation -- the railroads

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[1] With the exception of the 0.1 cents-per-gallon Leaking Underground Storage Tank (LUST) tax, which has expired.

[2] The railroad industry alone continues to pay 1.25 cents of this 1990 tax into the General Fund. (This is discussed in detail below in section *III*.)

– for an even larger share of the burden. There is no justification for expanding fuel taxes beyond their traditional, appropriate application as a user fee.

RAILROADS ARE SUBJECT TO A COMPETITIVE INEQUITY UNDER THE CURRENT DEFICIT REDUCTION FUEL TAX SYSTEM

In addition to imposing the 4.3 cents-per-gallon deficit reduction fuel tax, OBRA '93 modified the original 1990 deficit reduction tax in a way that unfairly burdens the railroads. This inequity must be remedied. OBRA '93 provided that as of October 1, 1995, the full 2.5 cents-per-gallon tax paid by the trucking industry and other highway users would be redirected into the Highway Trust Fund instead of being dedicated to deficit reduction, while half of the 2.5 cents-per-gallon deficit reduction diesel fuel tax paid by the railroad industry would be retained. Thus, as a result of OBRA '93, railroads now are the only payers of the original 1990 deficit reduction tax, at a rate of 1.25 cents-per-gallon. Highway and waterway users and commercial airlines pay 4.3 cents-per-gallon into the General Fund of the Treasury, while railroads pay 5.55 (4.3 plus 1.25) cents-per-gallon. This inequity is shown on the following table.

Deficit Reduction Fuel Taxes

(CENTS PER GALLON)

Freight Transportation Modes	1990 Tax	1993 New Taxes	1993 Changes To 1990 Tax (Effective 10/1/95)	Current Total
Railroads	2.5	4.3	-1.25	5.55
Motor Carriers	2.5	4.3	-2.50*	4.3
Inland Water Carriers	0	4.3	0	4.3
Commercial Airlines	0	4.3	0	4.3

*Payment to deficit reduction ended; payment to Highway Trust Fund begun

This discrepancy in the deficit reduction fuel tax rate places the railroads at a competitive disadvantage. It is clearly unjust to require railroads to pay 1.25 cents-per-gallon more to reduce the deficit than their competitors. To remove this inequity, AAR urges Congress to repeal the 1.25 cents-per-gallon differential in conjunction with the repeal of the 4.3 cents-per-gallon deficit reduction tax.

CONCLUSION

AAR applauds Congressional efforts to reduce the level of taxation imposed on transportation by OBRA '93 through the fuel tax mechanism. In AAR's view, however, it is imperative that any initiative to reduce fuel taxes also include elimination of the

deficit reduction diesel fuel tax paid by freight transporters. If the 4.3 cents-per-gallon tax were eliminated, but not the railroads' additional 1.25 cents-per-gallon tax, the railroads would be the only payers of a deficit reduction fuels tax; clearly Congress could not allow such an inequity. The 4.3 cents-per-gallon paid by the railroad industry for deficit reduction totaled approximately $157 million in 1995, for which the railroads would have had much more productive use, including its own infrastructure investments. The industry also was required to pay another $46 million last year for the additional 1.25 cents-per-gallon tax unique to the railroad industry.

AAR urges Congress to repeal the deficit reduction diesel fuel tax currently imposed on the nation's railroads. Deficit reduction should be accomplished by means other than burdening the transportation system with additional costs that do not enhance the efficiency or productivity of the system. It also is critically important that an evenhanded system of taxes be put in place. The nation's tax and budget policies should not be used as a mechanism to disfavor one transportation mode against another. The inequity in current law should be remedied so that the railroad industry will no longer be required to pay more for deficit reduction than its competitors.

Thank you for the opportunity to present AAR's views on this important matter. I would be happy to respond to any questions you might have.

Chairman ARCHER. Thank you, Mr. Harper. You concluded your testimony precisely as the red light came on, so I compliment you for that.

All of you are here today to say that you support the repeal of the fuel tax. You have a little more added to the common request, Mr. Harper, but all of you basically agree that we should repeal the 4.3-cent per gallon tax that went on in 1993. But we are told by other Members of the Committee that none of this will be passed on to the consumer. Why does it make any difference to you?

Mr. HARPER. I would be glad to volunteer on that subject. We operate in an incredibly competitive environment. The railroads since 1980 have become much more productive in many, many ways, and we have operated in such a competitive environment that, in real terms, the cost of our services are about one-half of what they were in 1980.

But about 90 percent of the productivity improvements we have made and the cost reductions we have made have been passed along to the shippers, our customers. Eventually they will go on to the consumers in America because this is such a competitive industry. Our prices have gone down and that has been passed along to the consumer; that is where our cost reductions, for the most part, have gone over the past 15 years.

Chairman ARCHER. But the comments by Members of this Committee to my left have been that you will not get a cost reduction because none of this will be passed on to you. Therefore, you will not be able to give anything to your customers. So why should you be concerned about this?

Mr. HARPER. In the railroad industry, we buy both the dyed and the undyed fuel, and a significant portion of the fuel we buy does not come through the service station distribution chain. Therefore, we believe we will realize cost reductions through the major purchases of about 3.7 billion gallons of diesel fuel a year.

Chairman ARCHER. Let me pursue this a little further, because the Members who assert this argument say that it is not the retailers, nor the distribution system, but the refineries who will simply increase the price of their refined product by an amount equal to 4.3 cents a gallon, and therefore, there will be no benefit to any purchaser of the product.

Mr. HARPER. It is a complex issue, admittedly, but we believe that in the competitive environment that we face today, we will see this happen amongst the many other factors that dictate market prices in the end.

Chairman ARCHER. Mr. Donohue, did you have your hand up?

Mr. DONOHUE. Yes, sir. I think that those who argue against this repeal, suggesting we should not do it because it will disappear some way along the daisy chain and we will never get it, really ought to understand that, as you indicated before about commodity pricing, that the price of oil and diesel and eventually gasoline are going to go up and down with market demands. There is only one set of constants in this whole business, and that is the taxes that are imposed by Federal and State governments.

It is clear to me that if you do not repeal the tax, that whatever happens in the up and down of the price, then the price will be 4.3 cents on top of whatever it otherwise could be. You might well have

a price that is no lower than we have today after withdrawing the fuel tax, but it would have been 4.3 cents higher if the tax had not been repealed.

Second, a lot of the people in our business did not just fall off a turnip truck. We are going to keep the heat on the oil companies. We understand what drives fuel prices up and down and we are going to keep the heat on them to keep their pricing to market forces and not to try and assimilate the benefits of a reduction in taxes. I have observed that oil companies respond to that type of thing on the public level and we now have in Congress for what seems to be the 112th time, an investigation of the oil companies. But that does keep the spotlight on these guys.

I am convinced that we are 4.3 cents better off one way or the other. We know this. If we do not take it off, it is going to be there, for sure.

Chairman ARCHER. Should Congress include a requirement that the price of fuel be 4.3 cents lower after the effective date of this act?

Mr. DONOHUE. Mr. Chairman, I am fundamentally opposed to price controls. They do not work, you cannot follow the little birdie because at the end, when you take them off, prices always go up. I do not think you can legislate that.

I think the role of Congress is to impose or withdraw taxes. When you withdraw them, and with a stern eye toward the people that are providing the product, I think we will get the end result. If they do not, the people at this table will be back in here singing a different song, encouraging you to do something that would be necessary at that time.

But I think we believe, and our industry is convinced, as a purchaser of 40 billion gallons of this stuff, we will get a fair shake out of the oil industry on this matter. They have no place else to go. We buy the product.

Chairman ARCHER. Ms. Hallett.

Ms. HALLETT. Mr. Chairman, airlines buy their fuel at a price set before taxes are added. Therefore, in the highly competitive jet fuel market that we are involved with, we are confident that carriers' costs will go down with the passage of this very important legislation.

At the same time, as an association, we cannot discuss, arrange, or really otherwise deal with any of the consumer pricing issues. We are also convinced that if fuel costs, as our second biggest component of all of our operating expenses go up, our costs of doing business are going to go up. If that cost is held in check, then obviously it is going to be very important in terms of decisions that are made by the carriers.

But I would hearken back to the original concern we have and that is that the airline industry has been working on this issue for over 2 years now. One of the reasons this was so important to us was not only because of our losses, but because President Clinton's own National Commission To Ensure a Strong Airline Industry, led by former Democratic Governor Baililes of Virginia, said that it made absolutely no economic sense to impose this 4.3-cent-per-gallon tax on our industry, and yet that tax has been imposed on us.

Chairman ARCHER. So you are satisfied if we remove it you will see a reduction in your fuel prices?

Ms. HALLETT. Yes. And, in fact, just yesterday, I met with two of our carriers, Aloha and Hawaiian, and they have now been forced to place a surcharge on passengers because of the increase in fuel coupled with the 4.3-cent-per-gallon tax.

Chairman ARCHER. Mr. Donohue, I heard somewhere recently that there were a number of trucks that have been idled by the higher fuel bills in this country. Can you tell us approximately how many trucks are not operating today because they cannot afford to pay the higher fuel bill?

Mr. DONOHUE. Mr. Chairman, let me say that if you take large and small trucks, there are about 5 million trucks running around the country today and almost 2 million tractor trailers. Some are idled from time to time because of overcapacity and high competition in this business.

But I will tell you that in California in particular, where fuel prices are 30 to 31 cents above everything else that has gone up, and in the agricultural industry and others, there are people that are not able to compete and participate. I am sure that you will find that in other industries around this country.

If you are a marginal carrier—understand, we have more than 300,000 carriers. A huge number of them, the great proportion, have less than six trucks. Those are people that buy fuel with the local credit card or sometimes cash, and when that number gets up high enough, that may be the week or the month that they are no longer able to go forward. This is an industry of small companies. This is our second largest cost, personnel being first, and if you cannot get the fuel, you cannot run the truck.

Chairman ARCHER. So you cannot at this time quantify what number or percentage of the trucks have been made inoperative simply because of higher fuel prices? But clearly, what you said is understandable.

Mr. DONOHUE. Mr. Chairman, if I could just add one sentence, one thing that we all know about excise taxes is that they fall hardest on those people least able to pay; whether it is the carpenter that has to drive 60 miles each way to and from work, or whether it is someone that is using his of her car for another reason, and it is the exact same thing in the trucking business. It falls most directly on those least able to pay. So for the small family guy with three trucks, or even one truck, there comes the week that he cannot make that payment. He is not going to run that week.

Chairman ARCHER. Thank you.

Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

I would suggest, Mr. Chairman, that if we had a chance to reschedule the panels, that this perhaps should have been the first panel this morning, because at least this panel has been instructive. The debate, and I would call it debate, that went on this morning was simply the suggestion that this was an easy issue to resolve. It was simply black and white, that we just ought to proceed. As much as the Chairman made reference to those on the left, there are many people, I think, on this Committee that really desire trying to get to the heart of the issue.

Mr. Harper, in fairness, said this is a complex issue. Mr. Donohue, in fairness, said they would put heat on the oil companies.

I think it is a legitimate question for the Minority to ask, will there be relief at the end for the consumer? This is an entirely legitimate question to raise, and what better place to have those issues crystallized than right here at the Committee level.

Mr. Donohue, you said with some assertiveness that you could put heat on the oil companies to ensure that this was, in fact, passed on to the consumer. Would you care to elaborate?

Mr. DONOHUE. I would, Mr. Neal. If I might just digress for one sentence, because I was hoping you were going to be here. I wanted to say, on behalf of the trucking industry, and I think on behalf of some others that are sitting at this table, that your work on behalf of the meals deduction issue, with our employees, the folks making $25,000 to $35,000 or $37,000, the long-haul truckers who drive around this country and are required to be away by DOT law and by their jobs and therefore have to eat away all the time and have very simple meals—they are not eating at Rive Gauche or Chez Francois or something——

Mr. NEAL. Neither are we anymore. [Laughter.]

Mr. DONOHUE. Yes, I understand. That is your fault, not mine. [Laughter.]

But, Mr. Neal, I just want to say that that makes a huge difference in their take-home income when it cannot be deducted, and I just want to thank you on behalf of our industry. It was a first-rate effort.

Mr. NEAL. Thank you for reminding me. I might direct a question to the Chair. Mr. Chairman, will we be getting to those issues, do you believe, before the expiration of this Congress?

Chairman ARCHER. I certainly do hope so. In fact, I contemplate that in budget reconciliation we will once again have a tax package and be able to consider those very issues. I cannot guarantee the gentleman that the President will sign it into law.

Mr. DONOHUE. Now to your question. We had one of the major oil companies on our television show yesterday, Mr. Tell, who is president of the Communications Group of Texaco and who is the head of the Highway Users Federation this year. He really understands transportation.

We heard all of his problems that you heard today about supply and refineries and all that sort of stuff. Those of us that buy fuel and our members that buy fuel on a regular basis keep very careful track of those matters. If all of a sudden we take away 4.3 cents of our tax and that is filled up with an immediate price increase that is not accompanied by some problem in a refinery or a supply issue which we are able to track, I am sure that our individual companies—and Carol Hallett made the point—cannot buy fuel collectively. Although we have thought about maybe getting a business together to do that—our individual companies will put tremendous heat on the oil companies to explain their pricing, and if it became a practice that was widespread, I am sure they would ask their association to intervene with the appropriate government officials.

Maybe by me saying that—and I am sure Mr. Harper and Carol Hallett and others would have the same interest—by me saying that, we are sending a message that it damn well better get passed on.

Mr. NEAL. I think that is the point the Minority in this Committee tried to raise this morning, and if we were not very glamorous in the manner in which we presented it, I think, legitimately, that is the question we wanted raised. We thank you for the answer that you have given.

Thank you, Mr. Chairman.

Chairman ARCHER. Let me just piggyback very quickly on that, if I may. There are 200 companies that produce different brands of gasoline in this country, 200. To say that competition, when costs are reduced by 4.3 cents a gallon, will not force that price down is to say we do not believe in the free enterprise system in any way, shape, or form.

This same argument could be made over and over again, relative to every aspect of the free enterprise system, including the businesses that you people represent; that there must be government to come in and dictate to you what your pricing must be, because if your costs go down, all of you are going to get together and keep your price up. Now, you know that will not happen, and you know with 200 different manufacturers in this country that it will not happen there, either.

Mr. Collins.

Mr. NEAL. Mr. Chairman, could I quickly respond?

Chairman ARCHER. Sure.

Mr. NEAL. Thank you. We subscribe fully to the free enterprise system on this side. We just believe that from time to time it needs a bit of a nudge.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

As the Chairman knows, as well as Mr. Donohue and others, I have been in the trucking business now for a number of years. Back early in my business efforts, I used to go to Atlanta on rainy days and go by the Mack truck used truck lot and kick tires, wishing I could buy another truck. I never will forget the used truck manager asking me one day, "Do you know what the biggest cutthroat in the world is?" And I said, "No, sir, I do not believe I do." He said,

> It is a guy with a used truck, because he will cut prices and he will do everything he can to get a load and in 90 days, he will give up his truck because he cannot make the payment. He did not get enough for hauling the load.

I never have forgotten that.

Mr. Bowman, I find with interest the fact that you said that you buy 8 million gallons of fuel annually and that the 4.3 cents is equivalent to $344,000 a year. Before leaving home Monday, I stopped by my trucking company office to see my son. He was sitting behind the desk with the checkbook open. I was afraid to ask, and did not ask, what is the price of fuel, because I knew when he was looking at that checkbook, he was looking at making some payments on that particular day.

The $344,000 you mentioned could be used to buy additional tractors or to make additional payroll. It also could be used to cover

red ink in a checkbook because of the increase in fuel prices, is that not true?

Mr. BOWMAN. Right.

Mr. COLLINS. Mr. Donohue was asked about the number of trucks that sit still. It is very difficult to judge and determine how many trucks sit still, because oftentimes, as Mr. Donohue says, when the bill comes due to pay that fuel bill, they may not have the money. The truck may sit still for a few days, but I guarantee you, that guy is going to try to find some way to get rid of that truck or some other person to operate it. So there is no definite way to determine or measure how many trucks are sitting still because of the fuel crisis.

I look at it this way. There are two pools of money in this country. There is a public pool and there is a private sector pool. We take from the private sector pool to make the public pool. If we take 4.3 cents less from the private sector pool to put in the public pool, that means it remains in the private sector.

In viewing just the business cycle itself, consumers and purchasers, no matter what level of business it is, that money is going to stay in that private sector and it is going to soon make the full cycle and everybody is going to participate in some way, especially as long as we have competition in this country. As long as we have the dealer network, as long as we have the jobbers network, as long as we have the refiners network, competition is going to exist.

I guarantee you, if my son calls a jobber and asks him the price of a load of fuel and he thinks it is a little bit excessive, he will call the next jobber. The same thing is true with dealers at service stations. A guy across the street sees more people going into the station across the street than they are coming to his, he will drop his price, and eventually, that makes a full cycle. Somewhere along, the consumer is actually going to benefit from the fact that this 4.3 cents comes off of the price of gasoline or fuel or whatever it is.

I hate it that a lot of people in the Congress and a lot of consumer groups, and I saw where the Concord Coalition was here earlier today. I am sorry I missed the earlier portion. But I hate it that they are taking the opinion that we should oppose this, that it is not going to help the consumer.

The truth of the matter is, the working people in this country pay the entire bill. I do not care where you place taxes, what entity you are trying to tax, or where you assess the tax. Working people pay the bill—4.3 cents less coming from the private sector going into the public sector means that the private sector is going to have 4.3 cents remaining there to where working people will have access to it.

I wholeheartedly support the full repeal of this. I do want to ask Mr. Harper, that asterisk that is by the 2.5 cents on motor carriers, what does that asterisk mean?

Mr. HARPER. That means that that 2.5 cents went into the Highway Trust Fund rather than being eliminated altogether. So it was put where I think the consensus today seems to think it belongs.

Mr. COLLINS. But going back to your testimony, the tax itself did not fade away. It just went from one pot to another pot?

Mr. HARPER. The tax itself did not fade away.

Mr. COLLINS. But it is still coming from the private sector into the public pool?

Mr. HARPER. It went into the trust fund, yes, sir.

Mr. COLLINS. Thank you very much.

Thank you, Mr. Chairman.

Mr. HARPER. If I may, the other penny and quarter, though, stayed in the public pocket and did not go back into the railroad infrastructure.

Chairman ARCHER. My compliments to all of you. I appreciate your testimony. You have been very helpful to us as we pursue our desired goals. You are excused.

I would like to enter into the record at this point written statements from both the Concord Coalition Citizens' Council and the American Road and Transportation Builders Association.

[The prepared statements follow:]

THE CONCORD COALITION CITIZENS' COUNCIL

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STATEMENT BEFORE THE COMMITTEE ON WAYS AND MEANS ON LEGISLATION TO REPEAL THE FUEL TAX

May 8, 1996

The Concord Coalition Citizens Council opposes repeal of the 4.3-cents-per-gallon transportation fuels tax levied as part of the 1993 deficit reduction effort. Repeal would make it harder to balance the federal budget.

Outright repeal would reduce revenues by nearly $34 billion over seven years. Suspension of the tax through the end of December, 1996 would reduce revenues by nearly $3 billion.

If offsetting savings were not enacted, the deficit would be increased by those amounts plus interest on the increased debt. Even enacting dollar-for-dollar savings offsets would not "neutralize" the impact that repeal of the fuel tax would have on efforts to balance the budget. This is because the budget savings being considered to offset the revenue loss from repealing the fuel tax are already identified and earmarked as part of the package of policies intended to balance the budget. If these budget savings are used instead to pay for the fuel tax repeal, they would no longer be available for balancing the budget.

We are also deeply concerned that repeal of the 4.3-cents fuel tax would undermine the climate of serious work on deficit reduction that has developed since the last election. Cutting any broad-based tax while the nation is running chronic deficits defies common sense. Concord believes that Congress and the President should enact a legitimate plan to balance the budget first and only then consider tax cuts -- including fuel tax cuts.

It is a sad commentary on the depth of commitment to balancing the budget that after a year of hard work, a balanced budget plan still has not been adopted, while after scarcely a week, a bipartisan stampede to pander to motorists is being allowed to undermine deficit reduction efforts.

What's even worse, the debate over the price and supply of gasoline is occurring at a time when fuel costs in the U.S. are well below their historical average and when market factors already seem to be driving down the cost of gasoline without a fuel tax cut. In any event, gasoline price fluctuations week to week and even neighborhood to neighborhood vary enough that repealing the 4.3-cents-per-gallon fuel tax would not be clearly identifiable at the pump, even if it were in fact fully passed through to consumers.

There are no sound economic reasons to repeal the 4.3 cents of gasoline tax increases. The government should let market forces work.

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Statement of the
American Road & Transportation Builders Association
To
Committee on Ways & Means
U.S. House of Representatives

May 8, 1996

Chairman Archer, Mr. Gibbons, members of the committee. Thank you for allowing us to submit comments for your hearing today on the 4.3 cents per gallon fuel tax currently going to the General Fund.

The American Road & Transportation Builders Association (ARTBA) was founded in 1902 and is the only national association devoted solely to the planning, construction and safe operation of transportation facilities of all types. Our membership of 4,000, located throughout the nation, is composed of contractors, engineers and planners, equipment manufacturers, materials suppliers, financial institutions, educators and transportation officials from federal, state and local governments.

Our membership is greatly concerned that congressional actions in the near future on the 4.3 cent gasoline tax will undermine the nation's ability to develop, maintain and operate an efficient, productive transportation system. Under the extreme pressures of a presidential election year, Congress may take -- or not take -- actions that could preclude for years its ability to adequately fund badly needed transportation improvements.

ARTBA is unalterably opposed to using federal fuel taxes for anything other than to finance improvements in transportation facilities. We strongly opposed enactment in 1993 of the 4.3 cents-per-gallon tax increase for deficit reduction and remain convinced it is bad public policy. That action was totally contrary to the user fee concept adopted in 1956 when the Highway Trust Fund was created. Rather than permanently repealing the 4.3 cents of the tax, we believe the income it produces should be deposited in the Highway Trust Fund.

There are several reasons why this is a necessary move. It is widely accepted that for years the United States has not adequately invested in its transportation infrastructure. The result of this neglect is a transportation system unable to support a dynamic, growing economy. Last October, the Department of Transportation documented that just to maintain current conditions, an additional $15 billion a year was needed for roads and bridges. Transit needs were nearly $2 billion short of needs.

Last year, the Congress approved designation of the new National Highway System, a 161,000-mile network of the nation's most important roads, including the Interstate System. The DOT reports that maintaining current conditions on the NHS requires expenditure of $21.5 billion, more than the total of federal spending for all highways this year.

Under-investment in transportation clearly produces undesirable costs: billions of dollars in urban congestion, reduced business efficiency and competitiveness, unsafe conditions and unacceptable levels of air pollution. The only way to address transportation needs is through increased expenditures.

Congress next year is scheduled to reauthorize federal surface transportation programs. Without additional revenue, the trust fund cannot support an appreciable increase in highway and transit programs. In addition, it is certain that Congress will face the highly contentious issue of how federal highway funds are distributed to the states. These formula disputes have been a major feature of the authorization debate in other years, and in 1997 they are likely to continue to dominate. The inability to devise a simple, reasonable and equitable formula produced the complex arrangement that is now the basis for distributing funds. Failure to find a widely acceptable solution to the formula problem could lead to the disintegration of a transportation program with a national focus, a situation that would not well serve the United States or its citizens.

In addition to reducing the investment deficit, the additional resources provided by the 4.3 cents would greatly simplify the effort to provide equity in distributing transportation funds to the states.

If the 4.3 cents of the gas tax are permanently repealed, political reality suggests that it would be extremely difficult, if not impossible, to increase transportation funding in the foreseeable future.

For these reasons, we strongly recommend that the 4.3 cents not be repealed. If Congress believes some step should be taken to reduce current gasoline prices, collection of the 4.3 cents could be suspended until, say, January 1997, at which time the proceeds should be deposited in the Highway Trust Fund. This action would address the existing price situation and, for the long run, provide funding for a strong national transportation system.

While there may be seemingly attractive short-term reasons for repealing the 4.3 cents of the gas tax, the long-term outcome could be ruinous to the country and difficult to reverse. We firmly believe that the correct -- and more politically beneficial -- approach is to assure stable and adequate funding for the nation's vital transportation system.

Chairman ARCHER. The Committee will stand adjourned.
[Whereupon, at 2:02 p.m., the hearing was adjourned.]
[Submissions for the record follow:]

Statement for the Record
by the
American Waterways Operators
to the
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C.
May 8, 1996

Chairman Archer, members of the Committee, thank you for requesting our comments for your hearing on repealing the 1993 4.3 cents per gallon transportation fuels tax which by law is deposited in the General Fund for deficit reduction purposes.

The American Waterways Operators (AWO) is the national trade association representing the inland and coastal barge and towing industry and the shipyards which build and service our industry's vessels. AWO is comprised of more than 300 individual companies, with a geographic scope ranging from New England to Alaska, and throughout the interior river system of the United States.

As you recall, Mr. Chairman, during the 1993 budget debate, the initial administration budget proposal called for the imposition of a BTU energy tax, and a $1.00 per gallon, 525% increase in the barge fuel tax. This tax is paid only by our industry into the Inland Waterways Trust Fund, which by law, provides funding for 50% of the construction and rehabilitation costs of the multi-use inland waterways infrastructure.

As you likewise recall, due to widespread opposition to these proposals, what was viewed as a compromise proposal was developed to access a 4.3 cents per gallon tax on all transportation fuels, with funds collected going to the General Fund for deficit reduction. Thus, as a result of enactment of this proposal, our industry currently pays 24.3 cents per gallon in federal fuel taxes, 20 cents going into the trust fund, and 4.3 cents going for deficit reduction.

While in the context of the 1993 debate, the 4.3 cent compromise was obviously far preferable to the alternative of a BTU tax of at least eight to ten cents per gallon and the $1.00 per gallon barge tax, the proposal nevertheless breached the government's longstanding commitment to the public that transportation fuel taxes would be used to finance infrastructure improvements, i.e. that user taxes would be returned to the public by way of future infrastructure investments. As a result, AWO's Board of Directors, at the start of the 104th Congress, directed the association to support legislative efforts to repeal the 4.3 cent tax, or if outright repeal is not possible, to support efforts to redirect the levy into the individual transportation trust funds for infrastructure improvements.

We therefore very much applaud the Committee's approval of the repeal proposal and support your efforts to enact this measure as soon as possible.

Thank you.

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May 8, 1996

The Honorable Bill Archer, Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

RE: Ways and Means Hearing to Examine the Impact of the 1993 Tax Increase on Transportation Fuels, May 8, 1996

Dear Mr. Chairman:

On behalf of the Independent Petroleum Association of America (IPAA), I am pleased to submit the following statement for the record on your hearing today. IPAA represents America's 5,300 independent oil and natural gas producers/explorers.

Background. Gasoline prices are racing skyward all across America. In fact, they've reached their highest point since America fought in the Persian Gulf War. And matters could get worse if we don't develop a U.S. energy policy now that encourages domestic oil and natural gas production to drive our cars, heat our homes and fuel our economy. Today's hearing concerns the repeal of the 4.5-cent excise tax on gasoline, but America's independent oil and natural gas producers would also like to offer some other solutions for stabilizing America's energy resource base that can be considered in the future.

When consumers go to the gas station and pay upwards of $1.40 per gallon, they are understandably upset. The fact is the nation experienced one of its coldest winters ever, which, in turn, caused Americans to use up oil supplies to keep warm. Now America is faced with depleted fuel inventories. And as the law of supply and demand states, if supplies are low and demand is high, prices will inevitably go up. That's simply beyond anyone's control in the short term.

Now is the time to take action so that we can protect ourselves from these types of crises in the future. We should increase domestic oil and gas production. We should stockpile our Strategic Petroleum Reserve. But current policies are doing just the opposite. Domestic production is at a 40-year low. And President Clinton and Congress have agreed to continue to sell off the oil from our nation's Strategic Petroleum Reserve in order to balance the budget. We should be adding to that reserve, not taking away from it.

Solutions. We must rely more on American-produced oil. That way, we could protect ourselves from the current scenario. We wouldn't be as vulnerable to another oil embargo. We wouldn't send our children to fight "oil wars." And the benefits go on: more jobs, more royalty dollars in federal and state treasuries, fewer foreign tankers in our waters, more stability.

IPAA urges the Ways and Means Committee to consider options in the tax code that could enhance the domestic petroleum industry -- and ultimately the consumer. Last year, for instance, a bi-partisan coalition of senators and congressmen introduced the Domestic Oil and Gas Production and Preservation Act (S 451, HR 987) which provides tax incentives for domestic oil and gas production, including a tax credit on marginal and new production, percentage depletion reform, expensing of geological and geophysical expenditures, and other updates to the tax code and regulatory system.

Another example of legislation that should be examined is the Energy Independence Act which was introduced by Congressman Mac Thornberry yesterday in response to the gas price situation. This act would change the tax code in a way that would encourage domestic oil and natural gas producers not only to bring existing wells back on line, but also would encourage new wells to be drilled -- adding millions of dollars to our economy, thousands of jobs to our workforce and stability to our energy resource base.

Consumers want relief from high gasoline prices now. And they deserve solutions. America needs a sound energy policy that promotes the nation's crude oil and natural gas producers as our primary suppliers of oil and natural gas. We need to get over our addiction to foreign oil. If we don't develop a strong energy policy now that enhances the domestic oil and natural gas industry, cheap foreign oil will continue to flood our country and play havoc with prices. And then we all suffer the consequences.

IPAA looks forward to working with you and your committee in the coming month to address how, by working together, we might best address this important national policy goal. Please contact Milton Wells, IPAA's director of tax and budget policy, at (202) 857-4722 for more information.

Sincerely,

Lew O. Ward

Lew O. Ward

STATEMENT OF PROPANE VEHICLE COUNCIL

The Propane Vehicle Council hereby submits comments to the Committee on Ways and Means for the record of the May 8, 1996 hearing to examine the impact of the 1993 gasoline tax increase.

The Propane Vehicle Council was established in early 1994 to advance propane's future as a clean, safe and superior-performing alternative transportation fuel. The Council works to remove legislative and regulatory barriers and to increase awareness of propane's advantages as a transportation fuel among government officials, the auto industry and consumers. It also undertakes projects to encourage the development, demonstration and marketing of propane-related technologies and propane-powered vehicles.

Working together with the National Propane Gas Association, the PVC is composed of a wide variety of stakeholders with a significant interest in the transportation fuel market for propane. Council members include propane marketers, propane producers and pipeline operators, equipment manufacturers and distributors, vehicle and engine manufacturers, and associates.

The Propane Vehicle Council applauds your leadership in holding this hearing on the impact of the 1993 gasoline excise tax increase. We support your efforts to repeal the 4.3 cent per gallon gasoline tax increase as an important step in providing the American people with needed tax relief. At a time when gasoline prices have risen to their highest levels in a decade, this decrease in the federal gas tax will have a positive effect on the American family budget. It should be enacted expeditiously.

As you move to repeal the 4.3 cent tax, the Propane Vehicle Council strongly supports your consideration of a proposal to repeal the current tax penalty imposed on clean-burning, domestically-produced fuels. Both Congress and the President recognize the important role that alternative transportation fuels can play in reducing oil imports, improving air quality and providing domestic jobs. Accordingly, U.S. government policies, including tax policy should encourage the use of such fuels.

State and federal taxes are a primary impediment to the use of alternative fuels. Since motor fuels are taxed on a gallonage basis, without regard to the energy content of the fuel, these taxes are markedly different. In fact, federal taxes for alternative fuels, when corrected to a common energy content, are in excess of the rate imposed on gasoline. Propane is particularly disadvantaged; it is taxed at an effective rate of 24.9 cents per gallon (when corrected to a common fuel energy content), compared with the current 18.3 cents per gallon tax on gasoline.

Propane has for many years been the nation's most widely used alternative fuel. It is derived primarily from domestic natural gas. Unlike gasoline, propane is an environmentally-friendly and clean-burning fuel, with the lowest greenhouse emissions of any currently viable fuel. Propane is a safe, reliable energy source throughout the world and is used in homes, farms and businesses, as well as for transportation. Of all the alternative transportation fuels available, propane can most readily be used by fleets and motorists.

Congress failed to recognize that the energy content of a gallon of propane is about 75 percent that of gasoline. Therefore, imposing the same tax on propane as on gasoline is actually very unfair. The tax rate on alternative fuels, assuming the new tax rate on gasoline of 14 cents per gallon (except CNG) should be as follows: propane (10.2 cents); methanol (6.9 cents); ethanol (9.2 cents); LNG (12.0 cents); all with an effective rate of 14.0 cents per gallon.

Congress neither intended to discourage the use of propane nor place it at a competitive disadvantage. Both the Congress and the President have expressed the intent to achieve "fuel neutrality" in their alternative fuel policies. Accordingly, good tax policy dictates imposing a tax on all alternative transportation fuels (except CNG) on a per gallon energy equivalent basis. Such steps would ensure that the congressional policy to encourage the use of alternative fuels is consistently and effectively implemented.

As you draft the gasoline tax reduction proposal, the Propane Vehicle Council urges you and your Ways and Means colleagues to incorporate a proposal that ensures that no alternative fuel pays more federal excise tax than gasoline, and that the government in its tax policy stays out of the business of picking winners and losers in the alternative fuels area. A level playing field is all that we in the propane industry feel is necessary and all that we expect. It is important that (except for compressed natural gas) your proposal equalize the federal tax rate on all alternative fuels.

The Propane Vehicle Council also urges you to craft a proposal that ensures that all alternative fuels continue to contribute to the highway trust fund. We feel that it would be inequitable if any one fuel were exempt from paying any federal excise tax. We acknowledge, for example that compressed natural gas (CNG) is taxed at a level below that of propane. We do feel strongly that any reduction in the federal excise tax on gasoline should at least retain this level of tax and that any vehicle using CNG be required to continue contributing to the highway trust fund.

Mr. Chairman, in developing legislation to reduce the federal excise tax on gasoline, you have an opportunity to correct an inequity in the tax code that has hampered the increased use of safe, clean, domestically-produced alternative fuels. We also hope that as you proceed with the legislation you will ensure that all fuels share in contributing to the highway trust fund. That way you will have produced equitable tax legislation that makes a significant contribution to our nation's energy security and environmental well- being.

STATEMENT OF U.S. REP. NICK J. RAHALL
Before the Committee on Ways and Means
May 8, 1996
Hearing On Motor Fuel Taxes

Mr. Chairman and Committee Members. Seizing upon the recent increase in gasoline prices, some in the House and Senate are proposing to repeal that portion of the federal motor fuel tax--4.3 cents per gallon--which is currently going to deficit reduction. I, on the other hand, believe this is the perfect opportunity to direct those funds to where they should have gone in the first place: the Highway Trust Fund.

To accomplish this goal, last week I introduced H.R. 3372, the "Gasoline Tax Restitution Act of 1996" which would simply redirect to the Highway Trust Fund the 4.3 cents per gallon in federal motor fuel taxes currently going into the General Fund. Joining me in introducing this bill was the ranking Democrat on this Committee, Sam Gibbons, and the ranking Democrat on the Committee on Transportation and Infrastructure, Jim Oberstar.

The fundamental reason why I believe this Committee should consider taking this approach, rather than outright repealing the 4.3 cents per gallon tax, is because of the pressing need to address the Nation's crumbling highway infrastructure.

According to the latest statistics available, in 1993 all levels of government provided $39 billion in highway capital expenditures, with the federal government accounting for $17.1 billion of that amount. Yet, the cost to maintain the Nation's highways and bridges is estimated at $54.8 billion, and to improve it at $74 billion, on an annualized basis.[1] This means that we need $15.8 billion in additional revenues *just to keep the overall system in its present condition* and are $35 billion short of the amount of revenue required to make necessary improvements.

Poll after poll shows that the American motorist, while not enthused about paying taxes, nonetheless supports paying gasoline taxes if the money is dedicated to the Highway Trust Fund for the purpose of maintaining and building new roads, highways and bridges.

I would also submit that most motorists believe that it is a fundamental responsibility of their government to maintain the highway system and that the majority of them believe improvements should be made.

H.R. 3372 offers this Congress an opportunity to at least begin making a dent in the current shortfall in highway spending. Each penny in federal motor fuel taxes raises between $1.1 and $1.3 billion in receipts for the Highway Trust Fund. This means that H.R. 3372 could provide between $4.73 and $5.59 billion in additional revenues to maintain and improve our Nation's highway system.

Mr. Chairman, next year the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA) expires and Congress will be faced with the task of reauthorizing the federal-aid highway program. It certainly makes sense for us to begin working today to ensure there are enough revenues available to bolster our efforts to address America's crumbling highway infrastructure. The legislation I am advancing is one way to do it, and I would note, do it without raising new taxes on the public.

Thank you for your consideration of this matter.

[1] 1995 Status of the Nation's Surface Transportation System: Condition & Performance, Report to Congress, U.S. Department of Transportation

STATEMENT
on
PROPOSALS TO
REPEAL THE 4.3-CENTS-PER-GALLON
FUELS EXCISE TAX
for submission to the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. Chamber of Commerce
by
William T. Sinclaire
Senior Tax Counsel and Director of Tax Policy
May 8, 1996

The U.S. Chamber of Commerce -- the world's largest business federation, representing 215,000 business members, 3,000 state and local chambers of commerce, 1,200 trade and professional associations and 76 American Chambers of Commerce abroad -- appreciates this opportunity to express its views on proposals that would repeal the 4.3-cents-per-gallon General Fund transportation motor fuels excise tax (the "1993 fuels tax"), enacted as part of the *Omnibus Budget Reconciliation Act of 1993* ("OBRA '93").

Majority Leader Robert Dole (R-KS) is proposing to repeal the 1993 fuels tax and recently issued a joint statement with House Speaker Newt Gingrich (R-GA) calling for the immediate repeal of the tax through the end of 1996, with permanent repeal to be considered in the context of the 1997 fiscal-year federal budget. Senator Phil Gramm (R-TX) and Representative Edward Royce (R-CA) have also introduced bills -- S. 1727 and H.R. 3375, respectively -- that would permanently repeal the 1993 fuels tax. The U.S. Chamber welcomes these efforts and our members overwhelmingly support repeal of the 1993 fuels tax.

The Chamber opposed OBRA '93 because it increased the tax burden of both individuals and businesses. Included in OBRA '93 was a provision that imposed a permanent 4.3-cents-per-gallon excise tax on various motor fuels used in highway, rail, water and air transportation. We assert now, as we did then, that additional fuels excise taxes slow economic growth, heighten inflation and worsen unemployment.

Excise taxes, by nature, are regressive and assessed without regard to one's ability to pay. The burden of the 1993 fuels tax has been falling disproportionately on smaller businesses, individuals with fixed incomes and low-income workers. Increased fuels taxes, therefore, have the most negative impact on those who can least afford them.

The 1993 fuels tax goes into the U.S. Treasury's general revenue account to finance the federal government's overall spending. There is no reasonable justification for specifically targeting motor fuel purchasers for spending or deficit reduction purposes. General fund fuel taxes unfairly penalize those individuals, businesses and industries that rely heavily on automobile, bus, truck, rail, air or other modes of transportation.

Generally, transportation and other businesses that are obligated to pay higher motor fuels taxes either pass the extra cost on to their customers in the form of higher prices, cut back expenses -- such as labor and capital investment -- or incur lower net income. Conversely, a decrease in motor fuel taxes would offset these negative developments.

Opponents of repealing the 4.3-cents-per-gallon fuels tax assert that there is no guarantee that such a repeal would lead to lower gasoline and other motor fuel prices. They claim that the oil industry would profit from the repeal of the tax since it would not reduce prices by a corresponding amount. However, this argument fails to take into account a basic free-market dynamic -- competition.

A business that incurs a lower input cost could seek to capture more market share by lowering its prices. Competitors would have to lower prices as well or risk loss of market share.

In the case of a lower excise tax, all suppliers would face a similar decrease in costs, creating pressure on the entire industry to lower prices.

The amount of the tax reduction that would be passed on to consumers depends on the elasticities of supply and demand in the market involved. For a good such as motor fuel where demand is relatively inelastic, it is likely that most of the reduction would be passed on to consumers.

Of course, other constantly changing factors in the market will affect an industry's supply and demand and therefore the market price. Consequently, the change in price brought on solely by the repeal of a tax may be masked by changes in other factors. This means that the repeal of the 1993 fuels tax does not guarantee that the final market price will be lower than before repeal. It does mean, however, that it would be lower than it would have been without repeal.

Opponents of repeal also state that the 1993 fuels tax does not need to be repealed since fuel prices in the United States are significantly lower than those in other countries around the world. While we may have lower fuel prices than other nations, it is unsound reasoning to rationalize the existence of an excise tax that retards economic growth and costs jobs simply because other countries impose higher taxes on their citizens. The United States needs to keep its income and excise taxes as low as possible in order for its businesses to be competitive internationally.

For the above reasons, the U.S. Chamber urges this Committee to support repeal of the 4.3-cents-per-gallon fuels excise tax enacted as part of OBRA '93.

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FINANCIAL CONDITION OF THE MEDICARE PROGRAM

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

JUNE 6, 1996

Serial 104–75

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FINANCIAL CONDITION OF THE MEDICARE PROGRAM

THURSDAY, JUNE 6, 1996

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

The Committee met, pursuant to notice, at 9:38 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
May 30, 1996
No. FC-17

CONTACT: (202) 225-1721

Archer Announces Hearing on Financial Condition of the Medicare Program

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing to review the most recent findings of the Trustee's Report on the current financial condition of the Medicare program, with particular focus on the Federal Hospital Insurance Trust Fund (HI Trust Fund). **The hearing will take place on Thursday, June 6, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m.**

The Committee will receive testimony from the Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds.

BACKGROUND:

The payroll taxes paid by working Americans and employers into the HI Trust Fund pay for about 60 percent of the medical care for Medicare beneficiaries. The Hospital Insurance program (Medicare Part A) is obligated to cover the costs of inpatient hospital care and other related services for those Americans who are entitled to insurance coverage under Medicare Part A.

In the first two calendar quarters of the current fiscal year, the HI Trust Fund spent more for Part A benefits than it received in income. Further, the Congressional Budget Office (CBO) has testified that their most recent HI Trust Fund projections suggest that the fund may become insolvent as early as 2001, even sooner than had been projected in the 1995 Report of the Trustees of the HI Trust Fund.

The timing and magnitude of these deficits in the entitlement portion of the Medicare program are of the gravest concern to the Members of the Committee because there is no legal or fiscal basis under which benefit payments could be made if the fund became insolvent and there were insufficient revenues to cover hospital and other health care bills. For instance, the CBO testified that under their baseline economic and demographic assumptions, the amount of spending reductions, or increased revenues, that would be required just to close the looming deficit and achieve a positive HI Trust Fund balance in 2006 would be over $370 billion. The HI Trust Fund would still then go into rapid bankruptcy unless substantial and sustained longer-term corrective steps are taken.

"The Ways and Means Committee considers preservation of the Medicare program for current and future beneficiaries to be a sacred public trust. I am very concerned about the findings of the Trustees with respect to their judgements about the future solvency of the Medicare program," Archer said.

FOCUS:

This hearing will review the 1996 Report of the Trustees on the financial status of the Medicare program, with particular focus on the financial status of the HI Trust Fund.

(MORE)

WAYS AND MEANS COMMITTEE
PAGE TWO

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, June 20, 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 300 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. If we can get our guests to take their seats, the Committee will begin, and we might suggest that the Members do as well.

Madam Secretary and Mr. Secretary, welcome, and thank you for coming this morning. This is an important time, I think, for this country because yesterday, as trustees, you released the 1996 report on Medicare, and I, for one, hope we can begin a new partnership to save Medicare from bankruptcy, the moment of which is accelerating as time goes by and even as we sit here.

I think all of us should agree on this. Saving Medicare should not be a partisan issue. This is an election year, and there is going to be a temptation to move toward partisanship on the part of many people in this city, but this is really an American issue, and it spans generations. It is not just the question of do we save Medicare for the current senior citizens, but can we feel confident that it is going to be intergenerationally fair.

So I hope that the time has come for us to join together to do what is best for the Nation and not what is best for our respective reelection campaigns.

Yesterday's report, unfortunately, confirms that Medicare is going broke faster than projected, and its decline is accelerating at a rate worse than the trustees' estimates only last year.

When you were before us last year and we talked about this, the trustees had predicted that Medicare would have a surplus of $5 billion in fiscal year 2002. Now your report says that Medicare will have a deficit of $101 billion in that year, and I would say a 1-year deterioration of an incredible $106 billion.

Your projections that you base your outlook on are the intermediate projections, and I think it is important for us to note that the actuaries always give an optimistic projection, an intermediate projection, a pessimistic projection, and then sometimes a worst-case projection.

Your report is based on the intermediate projection. On that projection, the trustees now think Medicare will go broke in the year 2001, but they were wrong last year, and we have no guarantee that they are not wrong this year, too. In fact, the trustees' more likely pessimistic projection states that 1999 will be Medicare's last year if we don't do something, and that is just 3 years away, 1999.

It is also interesting to note that as it was true last year in your report that when you read what the actuaries said, it is that it was more likely that it would deteriorate faster than less likely that it would deteriorate faster than the intermediate report. They say that again this year.

So, if we have to err, we ought to err on the side of caution and safety of the fund and not assume that the intermediate projections are going to be the ones that are accurate, as they were not accurate last year.

Alarm bells should be going off across America, and this report really, I believe, validates what we have been saying all along.

I don't think we should be silent. I think we must not do what politicians and previous Congresses have done for decades. We must not tell people that everything is fine and then wait until a crisis to act.

We did not come here today to engage in politics as usual, and we didn't come here to sell out our constituents just for the sake of the next election. I believe both parties, there are surrogates, and all politicians need to put politics aside and do what is in the Nation's best interest to save Medicare.

I would hope that there will be no more ads, no more demagoguery, no more Medicare scare tactics, and that partisan politics will take a holiday for the rest of this year.

So I call on all of us, including President Clinton, to do two things. I hope President Clinton, through both of you, and both of you will be major players in this, will update his existing Medicare proposal to reflect the deepening Medicare crisis. What was proposed last year is not good today. The conditions are different today, the baseline is different, the projections are different, and the crisis is deepening.

The President should show his leadership on Medicare by offering a new bill that avoids shell games and tax increases and gimmicks.

Number two, I call on the President to see that senior citizens are told the truth. Senior citizens deserve to know the truth.

I call on President Clinton to mail a copy of the trustees' report to every single senior citizen so that they can read it for themselves and not have it translated through any of us or translated through the media, and I will tell you, senior citizens do read.

Ms. Secretary, I trust you agree that senior citizens deserve to know the truth, and if so, I trust that you will send them a copy of this report.

Once again, I call for a new era of partnership, not partisanship, to save Medicare. Enough of the attacks, enough of the allegations about cuts that are really spending increases, enough of the meanness and pettiness that is too often associated with Washington. I believe that is what the American people expect from us, and I hope that we won't let them down.

Let me say to all of the Members of the Committee, as usual, any written statements, opening statements on the part of Members, without objection, will be inserted in the record.

[The opening statements follow:]

Opening Statement by Chairman Archer
Hearing on the 1996 Medicare Trust Fund
June 6, 1996

Good morning Madame Secretary and Mr. Secretary. Thank you for coming.

Yesterday, you released the 1996 report of the Medicare Board of Trustees. Today, I hope we can begin a new partnership to save Medicare from bankruptcy. Saving Medicare should not be a partisan issue. It should be an American issue. The time has come for us to join together to do what's best for our nation - not what's best for our respective re-election campaigns.

Yesterday's report sadly confirms that Medicare is going broke faster than projected and its decline is accelerating at a rate far worse than the Trustee's estimated only last year. In 1995, the Trustees predicted Medicare would have a ***surplus*** of $5 billion in fiscal year 2002; they now report that Medicare will have a ***deficit*** of $101 billion that year. That's a one-year deterioration of an incredible $106 billion.

Under their intermediate projection, the Trustees now think Medicare will go broke in 2001, but they were wrong last year and we have no guarantee that they're not wrong this year too. In fact, the trustees' more likely pessimistic projection states that 1999 will be Medicare's last year. That's just three years away! 1999!

Alarm bells should be going off across America. This report validates what we have been saying all along.

We cannot remain silent and we must not do what politicians have done for decades. We must not tell people that everything is fine and then wait until a crisis to act. We did not come here to engage in politics as usual, and we didn't come here to sell out our constituents just for the sake of the next election.

I believe both political parties, their surrogates, and all politicians need to put politics aside and do what's in the nation's best interest to save Medicare. No more ads. No more demagoguery. No more Medascare tactics. Partisan politics must take a holiday.

Today, I call on President Clinton to do two things. One - He should update his existing Medicare proposal to reflect the deepening Medicare crisis. The President should show leadership on Medicare by offering a new bill that avoids shellgames and tax increases. Two - Senior citizens deserve to know the truth. I call on President Clinton to mail a copy of the Trustee report to every single senior citizen so they can read it for themselves. Mr. Secretary, I trust you agree that seniors deserve to know the truth. If you do, you'll mail them this report.

Once again, I call for a new era of partnership, not partisanship, to save Medicare. Enough of the attacks. Enough of the allegations about cuts that are in reality spending increases. Enough of the meanness and the pettiness that is too often associated with Washington.

That's what the American people expect from us and I hope we won't let them down.

STATEMENT OF THE HONORABLE JIM RAMSTAD
WAYS AND MEANS COMMITTEE
June 6, 1996

HEARING ON THE 1996 MEDICARE ANNUAL REPORTS

Mr. Chairman, I commend your leadership in calling this important hearing promptly after the release of the 1996 Annual Report on the financial status of the Medicare program.

I appreciate the opportunity to review this critical issue this morning with Secretaries Shalala and Rubin. We have the responsibility and a rare second opportunity -- after President Clinton's veto of our legislation to preserve and strengthen Medicare -- to respond in a bipartisan way to the ever growing fiscal crisis facing Medicare.

All of us in this room are extremely concerned about both the short- and long-term health and fiscal well-being of the Medicare program. For months, reports from the Treasury Department, the Congressional Budget Office [CBO] and others have predicted the worsening financial health of the Medicare Hospital Insurance Trust Fund.

Yesterday, the bipartisan Social Security and Medicare Board of Trustee Reports confirmed these earlier predictions and our worse expectations -- Medicare, which 37 million older Americans count on for their health care services, is on a collision course with bankruptcy by 2001.

While yesterday's news is not surprising, it serves as a call to action. Unless we get control of Medicare spending and reform current operations now, the fiscal condition will only continue to deteriorate, and the prescription to cure this diagnosis will only become more difficult if action is delayed.

The Trustee Reports indicate that current Medicare beneficiaries on average have only approximately five years left to receive Hospital Insurance benefits and services before the trust fund evaporates. The report is equally alarming for the "Baby Boom" generation and younger people who are paying substantial payroll taxes into a program for benefits they may never receive.

Mr. Chairman, I welcome the conversation we will begin today with Secretaries Shalala and Rubin. I look forward to hearing policy options they recommend to put Medicare on the path to good health as well as preventative measures to assure the long-term solvency, integrity and stability of the program for future beneficiaries.

Again, Mr. Chairman, thank you for your leadership in calling today's hearing. I look forward to working with you, Representative Thomas and the Administration in a direct and forthright manner to restore fiscal health to our Medicare program for today and tomorrow's beneficiaries.

JON CHRISTENSEN
2D DISTRICT, NEBRASKA

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ON LEGAL REFORM

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Congress of the United States
House of Representatives
Washington, DC 20515–2702

OPENING STATEMENT
BY
REP. JON CHRISTENSEN

Before the
Committee on Way and Means
June 6, 1996

Medicare is going broke.

Yesterday the Board of Trustees for Medicare -- which includes Clinton-appointees Secretary of Treasury Robert Rubin, Secretary of Labor Robert Reich, and Secretary of HHS Donna Shalala -- issued its 1996 report. The latest Trustees Report confirms what many of us have been saying for quite some time -- that Medicare is going broke even faster than predicted. The Medicare trust fund lost money last year for the first time since 1972, causing the Trustees to declare that Medicare will be ***completely bankrupt by the year 2001.***

That's just five years away!

Last year this Committee crafted legislation that would have protected and preserved Medicare for this generation and the next. It would have saved Medicare by giving our senior citizens more choices for better quality health care. It would have saved Medicare by *increasing* the amount spent per beneficiary each and every year. It even included the creation of a bipartisan commission to solve Medicare's long-term problems. Yet President Clinton chose politics over principle and vetoed this legislation.

I refuse to allow Medicare go bankrupt because some see political advantage in understating its problems. I invite my Democrat colleagues to join us in our efforts to protect and preserve Medicare. Let's work together in a bipartisan fashion to save Medicare without gimmicks and without tax increases.

As President John F. Kennedy once wrote, "We, the people, are the boss, and we will get the kind of political leadership . . . that we demand and deserve." It's time for President Clinton, congressional Democrats, and big labor bosses to put politics aside, to quit demagoging, to stop scaring seniors, and to give us the leadership the American people demand and deserve.

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Chairman ARCHER. I recognize Mr. Stark for an opening statement.

Mr. STARK. Thank you, Mr. Chairman.

Before we start, I would just like to say that one of the reasons we are here today debating in this democracy is because 52 years ago this morning, young men like our absent Ranking Member, Mr. Gibbons, helped to save the world for all of us and make Milwaukee famous by jumping behind the lines at D-day carrying two bottles of Schlitz. Sam is not here, but it was a very important day in his life and for the country.

Then, I would like to go on to say that this is the fourth hearing we have had on the part A trust fund running out of money in 5 or 6 years, and I am not sure there is any news here. I feel like I am in the movie, "Groundhog Day."

For the fourth time, we Democrats are saying stop the hearings and let us vote to approve the $124 billion in Medicare cuts proposed by the President, which will extend the life of the trust fund into the middle of the next decade, and I presume about the same length of time, give or take a month or two, that the Republican bill would extend it.

If it is merely a question of you wanting that $124 billion adjusted to the current baseline, I am sure that the President and the Cabinet would find a way to do that. But unlike your proposals, the President does not make radical changes in traditional Medicare, and I think if those were left out, the President might find a way to have no tax increases if you would drop the tax cuts, which are about eight times as big as his tax increases.

The Republican proposal shifts tens of billions of dollars in costs onto the seniors by allowing doctors and hospitals to charge extra for a basic Medicare package.

Republican proposals weaken the antifraud laws. They spend extra billions on medical savings accounts for the wealthiest and healthiest seniors. They make life-threatening cuts in the safety net and academic research hospitals. Your proposals cap total spending on Medicare regardless of inflation or oil crisis or epidemics. It is a mindless cap that could destroy the program, which might, of course, be what people say that Speaker Gingrich has wanted to do.

The dollar difference between us is not great. It is your additional policies which radically threaten Medicare that we oppose.

So, if you really want a simple extension of the life of the trust fund, sit down with the President, let us pass his cuts in the neighborhood of $124 billion, but for the peace of mind of the Nation's disabled and seniors, stop proposing radical restructuring and cost shifting onto the seniors.

I guess, finally, Mr. Chairman, please stop trying to scare the seniors. Twenty-five times, the trustees have told us that at some date in the near future, Medicare would run out of money, and we have before, always on a bipartisan basis, done what was necessary to keep the program functioning. We will again.

No one ever made a big deal of these trustees' reports before last year, and that was the year you proposed $270 billion in cuts in Medicare, none of it going back into the trust fund, all going to help pay for $245 billion in tax cuts. You then used the trustees'

report to cry the sky is falling. It became the big excuse, the mantra for a radical restructuring of Medicare. You are still playing that game, and you are still scaring seniors.

It is time to push aside those radical changes and deal with the numbers that will extend Medicare into the middle of the next decade, at which time we all have to sit down with another scenario and talk about the long term.

Thank you.

[The opening statement follows:]

STATEMENT OF CONGRESSMAN PETE STARK
COMMITTEE ON WAYS AND MEANS
JUNE 6, 1996

MEDICARE PART A TRUSTEES' REPORT

Mr. Chairman:

This is the third hearing we've had this year on the Part A Trust Fund running out of money in 5 or 6 years. There is no news here. I feel like I'm in the movie "Groundhog Day."

For the third time, we Democrats say "stop the hearings and let's vote to approve the $124 billion in Medicare cuts proposed by President Clinton, which will extend the life of the Trust Fund into the middle of the next decade."

Unlike your proposals, the President's cuts do not destroy traditional Medicare.

The Republican proposals, on the other hand, shift tens of billions in costs to seniors by allowing doctors and hospitals to charge extra for the basic Medicare benefit package. Your proposals herd seniors into managed care plans--the kind of plans the Chairman recently likened to Soviet-style medicine. Your proposals weaken many anti-fraud laws. Your proposals spend extra billions on Medical Savings Accounts for the wealthiest, healthiest seniors. Your proposals--driven by the desire to give tax breaks to the wealthiest in our society-- make life-threatening cuts in the safety net and academic research hospitals. Your proposals cap total spending on Medicare, regardless of underlying inflation, oil crises, or epidemics--a mindless cap that could destroy the program.

The dollar difference between us is not great. It is your additional policies which radically threaten Medicare that we oppose. If you really want a simple extension of the life of the Trust Fund, let's pass the President's cuts ASAP. But please, for the peace of mind of the nation's disabled and seniors, stop proposing radical restructuring and cost shifting to seniors.

Finally please, stop scaring seniors. Twenty-five times, Trustees have told us that at some date in the near future Medicare would run out of money, unless we did something--and we have always done what was necessary to keep the program functioning. We will again. No one ever made a big deal of these Trustee reports before last year. That was the year you proposed $270 billion in Medicare cuts in order to help pay for $245 billion in tax cuts. You then used the Trustees' report to cry "the sky is falling." It became your big excuse for this radical restructuring of Medicare. You are still playing that game, and you are still scaring seniors. It's time to stop.

Chairman ARCHER. So much for politics taking a holiday.

Madam Secretary, you may recognize my question because it is the same one I needed to ask last year. Given the rapid decline of the trust fund balances during the past year, how confident can we be that the trust fund will not collapse before 2001? Is it possible that the fund could become insolvent within the next 3 to 4 years, that is, 1999 or 2000?

Secretary SHALALA. I am sorry, Chairman Archer. Do you want our opening statements?

Chairman ARCHER. Oh, I am sorry. Of course, I do.

Secretary SHALALA. I would be happy to answer the question.

Mr. BUNNING. We listened to C–SPAN last night.

Chairman ARCHER. Just file that question away for the moment, and we are happy to receive your opening statements.

Ms. Secretary, Secretary Rubin, we are pleased to have you.

Secretary RUBIN. Delighted to be with you, Mr. Chairman.

Let me say that we will abandon the order of precedence in which we would ordinarily testify, and I will accede to Secretary Shalala since she is the lead person in the administration on health and health care.

Let me just make one comment, though, if I may, Mr. Chairman. We would agree with you that people do need to work together, and the worse this problem is, the more important it is that we act and we act now.

I would add that the President from the day he stepped into the Oval Office has focused on health care with enormous intensity, and each of the years that we have been here, he has proposed serious measures to extend the exhaustion date of the HI Trust Fund, the part A trust fund. The plan that we proposed in the 1996 and 1997 budgets would extend the trust fund to, roughly speaking, the middle of the next decade, and the 1997 plan was certified by the actuaries, I believe it was yesterday, as extending the exhaustion date to 2006. So that is an evaluation of the current program that the President has put forth.

With that, let me, if I may, turn the microphone over to Secretary Shalala.

Chairman ARCHER. Madam, Secretary, we will be pleased to have your statement.

STATEMENT OF HON. DONNA E. SHALALA, SECRETARY, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary SHALALA. Thank you. Mr. Chairman and Members of the Committee, thank you for the opportunity to report to the Committee on the 1996 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Supplementary Medical Insurance Trust Funds. My longer testimony has been submitted for the record.

I think it is important to start by agreeing that it is very essential that we make every effort to reassure the 37 million Americans who rely on Medicare; their benefits are and will be there for them. I think the bipartisan tone that you introduced would also lead us, both parties, to want to reassure the Medicare recipients that we intend to deal with the trust fund issue.

The HI Trust Fund had a current balance of almost $130 billion at the end of 1995, nearly an all-time high. Claims will be paid. The key is that we must act soon and in a bipartisan manner to ensure the solvency of the trust fund.

Since he took office in 1993, the President has viewed the financial health of Medicare as a top national priority. In his first year in office, the President proposed an economic recovery package that included Medicare changes that added 3 years of solvency to the trust fund. That bill, as you know, was passed in Congress without Republican support.

In 1994, the President again proposed changes in Medicare as part of his health care reform plan; that would have added 5 years of solvency to the trust fund.

In 1995 and again in 1996, the President is proposing $116 billion in additional Medicare savings, as scored by CBO, that would ensure trust fund solvency well into the next decade.

There is now a sufficient level of common ground agreement on Medicare savings that the two political parties can come to the table and agree on legislation. Our collective job is to do just that.

At the same time, we must begin to address the long-term challenges facing the Medicare Program. The trustees have proposed creation of an independent advisory group to help shape just such a package.

Let me spend a few minutes explaining this year's trustees' report. Trustee fund expenditure growth is driven by increases in enrollment, the complexity of medical services, and health care inflation. In the future, trust fund expenditures are projected to rise more rapidly than trust fund revenues. Anticipated increases in the volume and the complexity of medical services are expected to result in expenditure growth rates in excess of payroll growth.

Beginning in the year 2010, demographic shifts that will occur with retirement of the baby boom generation are projected to drive the expected imbalance between expenditures and revenues. At that point, a larger proportion of our population will be eligible for Medicare, and a smaller percentage will be paying the taxes that support the trust fund.

The 1996 trustees' report, which we present to you, estimates the trust fund will be exhausted by 2001. That reflects a change from our 1995 projection that the trust fund would remain solvent until 2002. This is based, in part, on 1995 actual experience. As we reported previously, actual expenditures from the trust fund were 3.1 percent greater than we had projected last year. In addition, revenue from payroll taxes was 1.2 percent lower than projected. Further, the actuaries have updated their projections in key areas.

[The 1996 trustees' report is being held in the Committee's files.]

First, spending for home health care, for skilled nursing facility care, for hospice care is growing more quickly than we had projected.

Second, hospitals are billing Medicare more quickly and performing a greater volume of more complex medical procedures on elderly patients.

Third, we have updated our long-range economic and demographic assumptions. These kinds of fluctuations are not uncommon.

In fact, 2 years ago, we also estimated that the HI Trust Fund would be depleted in 2001. Last year, when the fluctuations went the other way, we moved the date back to 2002, and now we are back to 2001. What hasn't changed and never will is our determination that these problems be addressed.

The trustees also continue to project rapid growth in Supplementary Medical Insurance Program cost well into the future. Over the next 5 years, outlays are expected to increase 63 percent in the aggregate and 55 percent per enrollee. During the same period, the program is expected to grow about 28 percent faster than the overall economy.

Based on these projections, the trustees make two recommendations. First, we recommend prompt, decisive, effective action to ensure short-term HI Trust Fund solvency. Such action is required, so that Medicare continues to meet its obligations to America's senior citizens and those living with disabilities.

Second, we recommend the establishment of a national advisory group on Medicare reform to provide critical information needed in the discussion and orderly development of solutions to the program's long-run financial problems.

If timely and effective action is taken, we believe that solutions will be found that can restore and maintain the financial integrity of the Medicare Program in the short term and in the long run.

The good news is that the President already has on the table a set of Medicare reforms that would achieve this first goal. Following the completion of the trustees' report, I ask the Health Care Financing Administration's actuaries to assess the impact of the President's plan on the solvency of the trust fund. Their analysis indicates that the enactment of the President's plan would guarantee nearly a decade of solvency. That would be more than enough time for the independent advisory group to conduct its important work and for the Congress to act on its recommendations.

Mr. Chairman, the President's plan represents a balanced approach, one that protects Medicare beneficiaries while expanding choice and preventive benefits. It does not impose additional costs on beneficiaries, and it does not open the trust fund to ill-conceived experimentation.

It is important to note that there are a sufficient number of policy areas in common in both the President's Medicare plan and the proposals made by the Republican leaders in Congress. What we need to do now is to focus on those common areas of savings and come together in support of a package of reforms to achieve our common goal.

Let me assure you, Mr. Chairman, that this administration and these trustees take seriously our responsibility to current and future Medicare beneficiaries to ensure the solvency of the Medicare Trust Fund. We can and I believe we will act together in a responsible bipartisan manner to restore financial solvency and public faith in this vital program.

Mr. Chairman, I now yield to my colleague, Secretary Rubin.

[The prepared statement follows:]

Testimony

Donna E. Shalala

U.S. Secretary of Health and Human Services

Mr. Chairman, Members of the Committee, thank you for the opportunity to address the Committee on the 1996 Annual Report of the Board of Trustees of the Federal Hospital Insurance (HI) Trust Fund and Supplementary Medical Insurance (SMI) Trust Fund. Each spring, the Medicare Trustees submit their annual report on the status of the Trust Funds to Congress. The report, which was released yesterday, projected that under intermediate assumptions the HI Trust Fund would be depleted in 2001.

We should not alarm our Medicare beneficiaries. The Trust Fund contained nearly $130 billion in assets at the end of 1995. The balance is currently near an all-time high, and there is no imminent danger that claims will not be paid. There is time for us to act but let me emphasize that we should act now to ensure the solvency of the HI Trust Fund. We are hopeful that we can find common ground with this Committee and with the Congress on Medicare reforms that will strengthen the HI Trust Fund in the short-term, and provide us with sufficient time to carefully consider approaches to preserving the fund's long-term solvency.

Let me remind you that this report is consistent with our three previous reports. In fact, over the past 15 years, the Trustees have projected the date of insolvency to be anywhere from 1987 to 2005, and each year they recommended that Congress take action to protect the HI Trust Fund. Each time, the Congress and the Executive branch have always been able to respond to short-term challenges, improve the short-term longevity of the HI Trust Fund, and ensure continued Medicare protection for beneficiaries.

Only a few years ago, when the Clinton Administration took office, the HI trust fund was projected to become insolvent in 1999. We immediately took action, proposing a package of $56 billion in Medicare savings that extended the solvency of that trust fund for another three years. I believe that our record reflects our unwavering commitment to ensuring that the trust fund remains solvent.

Summary of the 1996 Report and Recommendations.

Let me begin by describing the HI Trust Fund and the services it supports for Medicare beneficiaries. The HI Trust Fund pays for inpatient hospital care, as well as expenditures for home health services, skilled nursing care, and hospice care. In 1995, the HI Trust Fund paid for $116.4 billion in services for 33 million aged and 4 million disabled beneficiaries.

The HI Trust Fund is financed primarily by payroll taxes. Employees contribute 1.45 percent of wages, and there is a matching contribution by employers. Self-employed individuals contribute 2.9 percent of self-employment income. OBRA 93 removed the ceiling on the amount of earnings that are taxable; consequently, this tax applies to all earnings. The Trust Fund also receives income from interest earnings on its assets, revenue from taxation of Social Security benefits, and income from miscellaneous sources.

Supplemental Medical Insurance (SMI) or Part B covers physician services, along with outpatient hospital services, laboratory services and durable medical equipment. The SMI trust fund is financed by general revenues and premiums paid by enrollees and it covers Part B services. Part B premiums are deducted directly out of the monthly checks of Social Security beneficiaries. In 1996, premiums are $42.50 per month.

While SMI or Part B growth affects the federal budget deficit, unlike the HI Trust Fund, the SMI Trust Fund could never become insolvent. In the 1996 report, the Medicare Trustees note that the financing established for the SMI program for calendar year 1996 is estimated to be sufficient to cover program expenditures and preserve an adequate contingency reserve. Trust fund income is projected to equal expenditures for all future years -- but only because beneficiary premiums and government general revenue contributions are automatically increased to meet expected costs each year.

Medicare Trust Fund expenditures are driven by increases in enrollment, the complexity of medical services, and health care inflation generally. In the future, Trust Fund expenditures

are projected to rise more rapidly than Trust Fund revenues. Anticipated increases in the number and complexity of medical services are expected to continue to result in expenditure growth rates in excess of payroll growth. Beginning in 2010, the demographic shift that will occur with the retirement of the baby boom generation is projected to drive the expected imbalance between expenditures and revenues. After that point, a larger proportion of our population will be eligible for Medicare, and a correspondingly smaller percentage will be paying the taxes that support the Trust Fund. Over the 75 year long-range projection period, trust fund income as a percent of taxable payroll remains relatively level, while the expenditure rate rises steadily.

The 1996 Trustees Report projects about 5 years of HI Trust Fund solvency. Unless the Congress acts, the HI Trust Fund will be exhausted in 2001 using the Trustees' intermediate assumptions. These intermediate assumptions represent the Trustees' best estimate of the expected future economic and demographic trends that will affect the financial status of the HI Trust Fund.

There are several reasons why the 1996 projection differs from the 1995 projection. First, actual 1995 Trust Fund experience was somewhat worse than expected, and three main factors, involving Trust Fund expenditures, Trust Fund income, and economic assumptions, contributed to this estimating variation.

(1) Actual expenditures were 3.1 percent greater than the Trustees had projected last year, primarily because hospital patients were somewhat sicker and more costly, and because hospitals billed Medicare more rapidly in 1995 than we had projected at the outset of last year.

(2) Income to the Trust Fund was 1.2 percent lower than projected, primarily because of slower than expected wage growth and because of our lack of experience in estimating the income resulting from the payroll tax changes made in OBRA 1993.

(3) Each year the Trustees use more current data and update their assumptions as they evaluate the performance and solvency of the HI Trust Fund.

In addition to actual 1995 Trust Fund experience, other factors contributed to our new projection that the long-term financial balance of the Trust Fund will be less favorable than we had projected last year.

(1) Use of skilled nursing facility and home health services is now projected to grow at a faster rate in the future than we had projected last year.

(2) We now project future hospital patients will be somewhat sicker and more costly than previously projected.

(3) We have updated our long range economic and demographic assumptions.

(4) The new 75 year window on which we base our long range projections includes 2070, an additional year of poor performance, but no longer includes 1995, a year of relatively good performance.

Based on our projections, the Trustees make two recommendations. First, we recommend prompt, decisive, effective action to ensure short term HI Trust Fund solvency. Such action is required so that Medicare services continue smoothly, as beneficiaries expect. It also is required to ensure sufficient time for consideration of options to ensure long run Trust Fund solvency.

Our second recommendation is related to Medicare's long term financial concerns. The Trustees recommend the establishment of an advisory group to address long term solvency. The advisory group for Medicare recommended by the Trustees will contribute to the

development and thoughtful consideration of policy options in response to this unprecedented demographic shift.

The President Has a Plan to Ensure the Short-Term Solvency of the Trust Fund.

Since taking office, the President has worked to improve HI Trust Fund solvency and has taken concrete action to strengthen Medicare.

As I mentioned earlier, the President's 1993 five-year deficit reduction package (OBRA 93) extended the life of the Trust Fund by an additional three years by achieving realistic Medicare savings and by stimulating general growth in the economy. In addition, the President's health care reform plan, the Health Security Act, would have extended the life of the HI Trust Fund for an additional five years.

This Administration continues its commitment to controlling Medicare costs in the future. As part of his comprehensive plan to balance the Federal budget, the President has proposed $116 billion as scored by CBO in specific policy changes designed to strengthen Medicare. The President's proposal will ensure the life of the HI Trust Fund for about ten years from now, as both our actuaries and CBO have estimated.

To achieve these savings, the Administration's plan modifies Medicare provider payments in a number of ways that promote greater efficiency and make Medicare a more prudent purchaser. Our plan also achieves savings through increased efforts to combat waste, fraud and abuse. We also propose to move part of the financing of the home health benefit to Part B so that under Prat A it retruns to the acute-care benefit that it was intended to be. Importantly, we would achieve these savings and extend the life of the HI Trust Fund while maintaining and strengthening key protections for the beneficiaries Medicare serves.

The primary HI savings achieved in the President's proposal are derived from specific provider payment provisions and by shifting the financing of the post-hospital aspect of the home health benefit back to Part B. The plan provides incentives to hospitals for efficiency by constraining updates for hospital operating costs, reimbursing reasonable levels of capital costs, reforming medical education payments, and reforming the rules governing transfers from a hospital to a post-acute care facility. It also reforms payments to home health agencies and skilled nursing facilities by establishing prospective payment systems for these providers.

The Administration plan represents a balanced approach -- one that protects traditional Medicare while expanding choice and preventive benefits. First, our proposal does not impose additional costs on beneficiaries; the plan maintains Part B premiums at 25 percent of program costs. Second, our plan does not contain dangerous changes -- like MSAs that cost money and undermine the HI Trust Fund by encouraging new plans to engage in "cherry picking" of healthier beneficiaries. Third, the Administration also would maintain critical limits on "balance billing," which protect the program's 37 million beneficiaries from excessive charges from providers. Fourth, our plan maintains important protections for low-income Medicare beneficiaries. Fifth, our package expands the range of private plans available under Medicare without harming the traditional fee-for-service program or shifting new, burdensome cost responsibilities onto beneficiaries. Finally, coverage of key preventive benefits like mammograms are improved under our proposal.

Conclusion

As the Trustees have recommended, action is needed in the short-run to gain sufficient time for an advisory group to make recommendations on approaches to long-term solvency. It would be irresponsible not to take action.

While we have major concerns with elements in the Republican budget proposal that are threatening to the Medicare program and to its beneficiaries, we do acknowledge areas of

commonality. We note that CBO has estimated that both the Republican and the Administration's balanced budget proposals would have the effect of extending the HI Trust Fund solvency for about the next decade. It is time to set aside the controversial elements in the competing Medicare proposals to fashion a Medicare package of changes that can be enacted and that can extend the HI Trust Fund sufficiently in the short-term to enable us to face the challenges of the future.

This Administration believes in Medicare. We take seriously our responsibility to current and future Medicare beneficiaries to ensure the solvency of the HI Trust Fund. The Trustees Report is a call to action, but it should not be cause for unnecessary alarm to beneficiaries, present or future. We can and must move forward in a responsible, bipartisan manner to quickly enact reasonable Medicare reforms that will address short-term solvency, providing us with sufficient time to carefully consider approaches to preserving Medicare for the long-term.

Chairman ARCHER. Mr. Secretary.

STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary RUBIN. Mr. Chairman, thank you.

I will submit, if I may, a written statement for the record.

Chairman ARCHER. Without objection, both of your written statements, if they are lengthier than your oral presentation——

Secretary RUBIN. They are.

Chairman ARCHER [continuing]. Will be inserted in the record.

Secretary RUBIN. Good. Thank you, Mr. Chairman.

I, too, am pleased to appear once again before this Committee in my role as managing trustee and chairman of the Medicare Board of Trustees.

Each year, as Secretary Shalala said, we report to the Congress on the financial status and prospects of the two Medicare Trust Funds. Secretary Shalala has just reported the essence of the report on those two funds.

Surely, one of the most important accomplishments of this country over the past 30 years has been to substantially reduce poverty among our senior citizens and disabled persons, and thereby also reduce the burden on and the anxiety of their children.

Medicare has been an integral part of this very successful effort. There are few issues of greater concern to working families than the cost of retirement and providing health care to the elderly.

The trustees consist not only of three members of the President's Cabinet, but also two outside trustees. Again, this year the trustees have reported what the trustees have been saying each year for the past several years: That the Medicare Trust Fund must be strengthened. We said that in 1993, we said that in 1994, we said that in 1995, and it is no news that we say that again in 1996.

As trustees who are members of the administration, we have worked with the President to accomplish exactly this. As Secretary Shalala said, in 1993 the President enacted reductions with respect to Medicare that extended the HI Trust Fund exhaustion date by 3 years, to 2002.

The President's 1996 and 1997 budget proposals both include Medicare plans that would extend the HI Trust Fund by roughly 10 years, to the middle of the next decade, in the context of a balanced budget and without spending reductions that we consider excessive or structural changes that we consider imprudent.

Thus, 1 year ago the President offered a budget plan to extend the exhaustion date of the Medicare Trust Fund. We could have done it then. We could do it now. Mr. Chairman, we agree with you, it is absolutely time to get this job done, and it is our desire to work with Congress to get this job done.

The President and the congressional majority have made proposals that address this issue, but there are significant differences, as I just suggested, both in the excess of the reductions that the congressional majority recommends over the reductions recommended by the President and in structural changes which we do not consider to be sound.

Having said that, as Secretary Shalala said, there is enough common ground so that, we believe, a Medicare plan could be put into

effect that would extend the exhaustion date by enough years so that there would be more than ample time to put in place a program to deal with the long-run problems of the Medicare Trust Fund.

The administration has on the table a proposal to address the HI Trust Fund problem and the rising cost in the rest of the Medicare Program in a thoughtful manner and to produce effective, acceptable solutions that will stand the test of time.

Mr. Chairman, we are fully ready to work with you and the Members of the Committee and the Members of Congress to do what is necessary to meet the needs that the trustees have spoken to each of the past several years: To put in place an effective Medicare reform plan that will extend the exhaustion date and then get to work on the long-term problems of Medicare using, as Secretary Shalala said, a commission that we recommend be established.

Thank you.

[The prepared statement follows:]

ADV 9:30 a.m. EDT
Remarks as prepared for delivery.
June 6, 1996

RECORD TESTIMONY OF TREASURY SECRETARY ROBERT E. RUBIN
COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Committee:

I am pleased to once again appear before the Ways and Means Committee in my role as Managing Trustee and Chairman of the Medicare Boards of Trustees. The Boards report annually to the Congress on the financial status of two separate Medicare trust funds -- the Hospital Insurance (or HI) Trust Fund and the Supplementary Medical Insurance (or SMI) Trust Fund.

One of the most important things our country has done over the past 30 years has been to work to reduce poverty and deprivation among senior citizens and disabled persons, and thereby also reduce the burden on and the anxiety of their children. Medicare has effectively provided a reliable source of medical care coverage for aged and disabled Americans. There are few issues of greater concern to working families than the cost of retirement and the problem of providing health care to the elderly.

As we have said for many years, the exhaustion date for Medicare is close. We should act. We must act. The best solution before the Congress to fix Medicare has been offered by President Clinton in his balanced budget proposal. We should pass that plan now, and then work together on a bipartisan basis to develop a long-term solution that the program needs and the country deserves.

The trustees include the members of the cabinet directly concerned with Social Security and Medicare, plus two members representing the broader public interest. As the trustees have reported for a number of years, this year's reports confirm that the costs of the SMI program continue to rise rapidly and that the HI Trust Fund will be exhausted about a year after the turn of the century. We note that as of December 1995 the HI trust fund had a balance of $130 billion, but that it is projected to be depleted in the year 2001. All of the trustees met yesterday and agree with the report.

This is, obviously, not news to this committee. We provided a similar report a year ago, when the exhaustion date was projected to be 2002, and the year before, when we projected it to be 2001. Secretary Shalala and I also testified before your committee on this subject three months ago. Finally, the Congressional Budget Office produced its own independent projection last month, with an exhaustion date of 2001.

As we have in the past, we strongly urge prompt enactment of legislation to address the HI Trust Fund shortfall. Although the President and the Congress have made proposals that address this issue, there are structural and policy differences between them. However, there should be sufficient common ground to agree on legislation to extend the life of the trust fund.

We also note that this is only a first step in the longer-term process of review and reform. There are important changes underway in our health care system. These changes will affect both the quality and cost of medical care, and they will affect our decisions concerning Medicare. There are also significant demographic shifts ahead as the baby boom generation begins to retire in 2010 and the rates of retirees to working Americans begins to rise more steeply. We as trustees have recommended the creation of an advisory group to review these complex issues and help fashion solutions.

From the very beginning, this Administration has clearly recognized the importance of maintaining the solvency of the HI trust fund. The President's 1993 deficit reduction plan extended the trust fund exhaustion date by three years.

Last year, the Administration proposed additional measures to extend the HI trust fund. The President has advocated since June of 1995 reducing Medicare spending growth per beneficiary with savings scored by the Congressional Budget Office at $116 billion through 2002 and guaranteeing the solvency of the trust fund for more than a decade. The reforms give seniors more choices among private health plans, attack fraud and abuse, cuts the growth of provider payments but holds the Part B premium to 25 percent of program costs.

Medicare financing is a complex interaction of demographics and the rapidly rising costs that affect all parts of our health care system. We need to carefully reform Medicare. The Administration believes that the growth of federal health care expenditures, including Medicare, needs to be reduced in order to control the budget. But reducing this growth must be done by carefully weighing trade-offs and reforming these programs in the context of its impact on the health care delivery system. You can reach a balanced budget by preserving what is right about Medicare and still produce savings, or you can cut Medicare the wrong way at the cost of irreversibly damaging this important program.

Arbitrary attempts to resolve the financing crisis may restore solvency to the HI Trust Fund, but will create and intensify other problems. Specifically, we are concerned that excessive reductions in Medicare, largely through reduced payments to hospitals, and particularly in combination with deep Medicaid cuts may shift costs to the private sector and reduce quality of care for Medicare beneficiaries.

The Trustees have again provided the Congress, as they have for the last several years, with early and continued warning. It is time to act. Although the exhaustion date is now believed to be five, instead of six, years away, there still is more than enough time to extend it. It is better to do part of the job now, and do it right to avoid a hasty, unworkable solution that may have to be undone in the future.

Financial Status of the Medicare Trust Funds

As noted, the 1996 Trustees report projects the HI Trust Fund will be exhausted in 2001, one year sooner than projected last year. This worsening largely reflects
program cost increases.

Over the long term, the 75-year actuarial deficit (interpreted as the amount of payroll tax increase or benefit reduction needed now to balance the trust fund over the next 75 years) was increased from last year's estimate of 3.52 percent to 4.52 percent of payroll.

The increase is largely the result of larger projected increases in the complexity of cases, a more rapid projected growth rate in home health care and skilled nursing facility costs, and the permanent effects of the higher than expected level of spending since the last report. The HI program remains substantially out of long-run actuarial balance, and that problem is not addressed by either of the current Congressional budget resolutions or the Administration's proposal.

The Trustees also continue to project rapid growth in Supplemental Medical Insurance program costs well into the future. Over the next five years, outlays are expected to increase 63 percent in the aggregate and 55 percent per enrollee. During the same period, the program is expected to grow about 28 percent faster than the overall economy.

Combined HI and SMI costs are expected to increase from 2.7 percent of GDP in 1996 to 8.8 percent in 2070 -- more than tripling -- due to anticipated demographic changes and projected increases in costs per beneficiary. Because of this rise in long-term program costs and the expected exhaustion of the HI fund in 2001, the Board of Trustees recommends effective Medicare reform, but again, we believe that this must be done with a careful weighing and balancing of all impacts and all considerations and in the context of the rapidly changing health care sector.

Medicare Financing and Health Care Reform

When the Hospital Insurance program faced financing problems in the past, Congress and the Executive Branch have been able to cooperate on making modest changes in the program that slowed the rate of cost increases.

The program has experienced financial difficulty since its inception in 1966 because of rapidly rising hospital costs, higher-than-expected utilization, and program expansion. During the 1990s, program expenditure increases were below those of the previous decade, reflecting a comparatively moderate rise in overall health care inflation and utilization.

Much can be done to strengthen the Medicare program. Taking steps to extend health insurance coverage to the uninsured population, and developing, through insurance reform, a competitive health care market will create a more efficient system. This increased efficiency will slow the growth in overall health care spending and provide long-term savings to the Medicare program.

In closing, the Administration has proposed steps to strengthen the HI Trust Fund problem and address the rising costs in the rest of the Medicare program in a thoughtful manner, and produce effective, acceptable solutions that will stand the test of time. Although we don't have bipartisan agreement on some of the structural changes that many members of the Majority are advocating, last year there was agreement on a significant number of Medicare proposals that would strengthen the Part A trust fund.

The President's balanced budget plan contains savings proposals that our actuaries estimate would extend the solvency of the Hospital Insurance Trust Fund through 2006, long enough to give us time to work together on longer term solutions. As we have done in the past, the Clinton Administration remains ready to work with the Congress to achieve the security that is so important to elderly Americans.

I will be happy to answer any questions you may have.

Chairman ARCHER. Thank you, Mr. Secretary.

Mr. Secretary, as Chairman of the Board of Trustees, of the Medicare Board of Trustees, could you just briefly tell the Committee why this board was created initially and what its role and responsibility is?

Secretary RUBIN. The board being the Board of Trustees?

Chairman ARCHER. Yes.

Secretary RUBIN. My view, Mr. Chairman, is that the Board of Trustees has the responsibility for overseeing the work of the actuaries and to review the soundness of the part A trust fund and to do exactly what we are doing today, to come to you, the Congress, and to make our recommendations going forward.

I might add that I think that whether it was originally intended or not, I think the board does have an additional benefit, and that is that it is an energizing force. These annual meetings become an action-forcing event, and I think the board has served a very useful purpose.

If you go back, as I said in my statement, to 1993, the 3½ years at least that I have been part of all this and being part of the administration, the trustees each year have gone to the Congress and said the exhaustion date is coming much too soon, we must act and we must act now, and as I said in my statement, each year the President has been very actively involved in putting forth proposals enacted in 1993 and then proposed, but not enacted subsequently to that, to extend the trust fund.

Chairman ARCHER. I thank you for that because that certainly is what I believed the purpose of the board is, also.

You mentioned the makeup of the board. Can you tell us how many of the board are Democrats and how many are Republicans?

Secretary RUBIN. The three members of the administration, it will probably not surprise you to hear, are Democrats.

Chairman ARCHER. Or certainly would not admit, otherwise. OK.

Secretary RUBIN. I think I can safely say they are Democrats, but you are correct. If they weren't, I suspect they wouldn't acknowledge that.

We have two outside members. I honestly don't know what they are. We don't function in that way.

Chairman ARCHER. No, I understand that.

Secretary RUBIN. Mr. Chairman, we had a really good meeting yesterday. We had the reports from the actuaries, and then we had questions. We had discussion. We had a little bit of debate. It was really a very good meeting. I couldn't tell you from the discussion whether these people were Democrats, Republicans, Monarchists, or whatever they might be. All I could tell you is it was a very good substantive discussion.

Chairman ARCHER. The point I am trying to get at is that this, if anything, is really a bipartisan board that is objectively looking at Medicare, and giving us not any sort of a partisan report, but one that is objectively done in a way to let the country know, year by year, what the status of Medicare is, and as you said, help to activate solutions if there are problems on the horizon.

Secretary RUBIN. Mr. Chairman, absolutely, and the work that we report to you is actually done by the career actuaries.

Chairman ARCHER. Yes, yes.

The reason I am asking that is because I believe in looking at your report that it is professionally done and that it is an objective look to the best of our ability to project what will happen in Medicare, or I would say as close to the truth in moving away from any election rhetoric or partisanship or politics or anything else as we could have in evaluating Medicare.

I know that many senior citizens have come to me and said, "Gee, we really would like to read that report. We get 10-second sound bytes on television. We get a little blurb in the newspapers, and maybe if we watch C–SPAN, we can see the hearings." I am wondering if it wouldn't make sense for this to go out regularly to every senior citizen so that they can be aware of precisely in an objective way of what is going on with Medicare.

I mentioned that in my opening statement, and I would hope that you would agree to let the senior citizens have the truth.

I assume also, from what I have just said, that you would agree that what you have put in there is not something to scare senior citizens, and that by getting the facts out and getting the truth out that that is not an effort on your part to scare senior citizens or on the part of any of the members of the Board of Trustees, but really to just put the reality before the American public.

Secretary RUBIN. Mr. Chairman, absolutely. The trustees' report is done by professional actuaries, and the desire is simply to, as you correctly say, promulgate the facts with respect to Medicare to the American people. We have a short form of this which is, I think, relatively readable and relatively understandable.

Chairman ARCHER. I would hope that the entire report, so that it would not be subject to any possible editorializing through synopsis or whatever else would be submitted and given and mailed to all of the senior citizens which is easy to do through the computerization of the program.

Let me go back to my first question which jumped in before you were able to make your statements. Last year I asked you, Madam Secretary, whether the decline in the trust fund balances could be more rapid than what was in the intermediate report, and as a fact, it did occur more rapidly than what was in the intermediate report.

Given this decline in the last year, is it possible now that the fund could become insolvent in an earlier period of time of 1999 or the year 2000?

Secretary SHALALA. Mr. Chairman, this is an intermediate estimate of an exhaustion date of 2001. It is the trustees' best estimate of the exhaustion date.

It is true that a more pessimistic outcome, the actuary has suggested, is more likely than a more optimistic outcome. However, the intermediate estimate of exhaustion is still our best estimate. The actuary explains this issue in his own letter, which is on page 95 of the trust fund report.

Readers are cautioned not to focus solely on just one set of assumptions but rather to recognize that any result within the range shown can reasonably be expected to occur.

As noted in this report, the assets of the Hospital Insurance Trust Fund are projected to be depleted within 5½ years under all three sets of assumptions. Thus, regardless of the specific assumptions used, the need for prompt attention to the fund's financial imbalance is apparent.

What the actuaries have given us is a range. The low cost estimate is 5½ years. The intermediate is 5 years. The high cost is 4 years. The range is between 2000 and 2001. That is the narrowest range that we have had recently.

The reason for that is that as you get closer to the exhaustion date, your range gets closer and closer, and some people suggest you get slightly more accurate.

The best way to explain it is through an analogy, Chairman Archer. Do you play tennis?

Chairman ARCHER. I used to.

Secretary SHALALA. If I had a tennis ball and I was aiming at your nameplate, if I aimed it from here, my chances of hitting your nameplate within range would be possible because I am a pretty good tennis player, but if I was a foot from you, my chances of hitting the nameplate would be much better. As we get closer to that exhaustion date, the range is going to narrow, and that is the point, I think, that we are all making. So, whether it is 2000 or 2001, we have picked what we think is the best estimate, which is the intermediate estimate.

I don't know whether Bob wants to add anything to that.

Chairman ARCHER. Based on what the actuaries have said, and I will read another part of what they said, "In particular, the likelihood of a future result that is more adverse than the intermediate projection may exceed the likelihood of a more favorable result."

Secretary SHALALA. Yes.

Chairman ARCHER. So it seems to me that the specific answer to my question must be that it is possible that it could be exhausted, possible that it could be exhausted at an earlier year.

Secretary SHALALA. That is precisely why we do estimates. What we have done is chosen the intermediate estimate, but provided and not hidden in any way the range that has been provided by the actuary. The high-cost range which is the most pessimistic is the year 2000, but the whole range is from 2000 to 2001.

Secretary RUBIN. Mr. Chairman, could I add one thing on that?

Chairman ARCHER. Sure.

Secretary RUBIN. In reference to this very paragraph you just read, and it said exactly what you said it says, one of the actuaries made the comment yesterday that there has been a tendency in the past at least when they miss an estimate in 1 year to somewhat overreact in the next year. It was just an informal comment, not a formal comment. That would suggest the opposite of this since they miscalculated last year, and there is a larger deficit; that maybe this year they will go in the other direction.

The conclusion I reach from all of this is really the one that you had in your opening statement, which is, the worse this thing looks, the more important it is that we get together, we act, we act now, and as Secretary Shalala and I both said, we believe that there is more than an adequate basis for coming together and putting in place a plan and putting in place a plan now.

Chairman ARCHER. I think the importance of this is that the earlier that it might occur, the more important it is that we act earlier.

Secretary RUBIN. Correct.

Chairman ARCHER. That is the important point that I would like to make.

Unfortunately, if we wait too late, what we know from past experience is that once we are right up at the edge of the cliff, the only option is to increase taxes, and increasing more payroll taxes is a deterrent to job creation and will be highly negative on the economy and unfair to future generations. We cannot let that happen.

Let me also ask you one last question, and then I will yield. Medicare has, up until now, always had the funds to meet its payments out of the part A trust fund. I think it is important also for people to understand that what we are talking about here is both part A trust fund and part B, but part B, which is for simplicity's sake the doctor's bills, part A, the hospital bills, part B is not in the trust fund, per se. It has its own trust fund, but that trust fund automatically is replenished out of the General Treasury, and, therefore, cannot go bankrupt until the Nation itself goes bankrupt.

Mr. Secretary, I assume that will not happen on your watch or my watch, but as long as the general fund, the General Treasury has money, it will automatically replenish part B.

Of course, that means the potential of borrowing more money from the outside or raising taxes or reducing spending in some other category, but part A can go bankrupt, the hospital funds, because there is no authorization under the law to pay those bills if the money is not in the trust fund, and it is the recipient of the payroll withholding taxes, the so-called FICA taxes.

I see you both nodding your heads. So I assume you agree with everything that I have said up to this point.

Medicare part A has also always had in a trust fund enough to pay the hospital bills that are submitted. That would not be the case under bankruptcy.

Do you have a fiscal contingency plan for paying benefits if the trust fund went broke, or do you have any other legal authority to pay Medicare's bills from any other fund or source if the trust fund is bankrupt?

Secretary RUBIN. Mr. Chairman, I will yield to Secretary Shalala. She has a different response, but my response would be that it simply can't happen.

We have at least 5 years under the report that we have just submitted. As you have said now a number of times, and we obviously agree with you, it is imperative that we act and act now, and I assume, Mr. Chairman, that even if we don't act very quickly, we will act relatively soon because, as you said, the exhaustion date is coming closer.

I do not believe, at least in my judgment, that is not a realistic problem for the American people because I believe that the approach of the exhaustion date is simply going to force the political processors to do what they need to do, though I agree with you they should do it as soon as possible.

Secretary SHALALA. Let me share Secretary Rubin's view that we are simply not going to let this happen. But your direct question is, is there any imminent danger that bills won't be paid. The answer is no. The HI Trust Fund has about $120 billion in assets which the HI trustees project is enough to ensure the part A bene-

fits will be paid for about 5 years. So there is plenty of time here to enact legislation.

If the trust fund assets were depleted, Medicare would still be able to pay a portion of the claims using current income from the HI payroll tax and other sources, but the point I think everybody is making on exhaustion is that we would not have enough income to pay all the claims on time. So, initially, there would be a delay in provider payments, for example. Let me reiterate—none of us intends that that happen.

Chairman ARCHER. No. I understand that none of us intend that it happen, and hopefully, as we both have been saying, we will work out an answer to this, but using your analogy or comparison to tennis, the closer you get in this case, the harder it is to hit the nameplate.

Secretary SHALALA. Which leads us to the conclusion that we should do it now.

Chairman ARCHER. Precisely.

Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Chairman. I will be brief, and I think you have been very thorough.

Mr. Chairman, we believe the trustees. We are ready, willing, and able to act. I have read all of these trustees' reports in the past. This one is not that much more shocking than all of them have been over 25 years.

In the past, we have been down to 2 years of solvency, and we have fixed it without a lot of folderol, and we can do it this time again.

I think the principal difference between the Democrat side and the Republican side is that we want to take the savings that we create in Medicare and plow it back into the Medicare Trust Fund and not use those savings to offset tax cuts for very fortunate Americans. That is the principal difference.

When we can work out that little political difference, we can work out the future solvency of the trust fund for a long, long time.

I thank you, Mr. Chairman. That is all I have to say.

Chairman ARCHER. Sam, I had hoped that we would not get into that sort of partisanship today. I have tried to lay the groundwork to stay away from it because your colleague, Mr. Stark, said the same thing. I would like for us to stick to the facts.

Both of you know that any savings from any plan, whether it is the administration's plan or whether it comes out of the Congress will stay in the trust fund and will be used to pay the bills out of the trust fund.

What is done in other parts of the budget are totally independent of that. So it is just not factual, and I wish we could stay away from the partisanship. We are saying here is what divides us politically and so on. Let us talk about the facts, and let us see if we can't get the truth to the American people and find an answer that we can agree on.

Mr. Thomas.

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

It might surprise some folks in the room that I agree with a portion of what the gentleman from California, Mr. Stark, said that this does, indeed, remind me also of the movie, "Groundhog Day."

If you actually saw the movie, the reason Bill Murray was condemned to repeating the same day over and over again was because he wasn't getting it right, and what we have done in coming here over and over again is, I think, we have to admit we haven't gotten it right. Just as in the movie, until we get it right, we are going to be doing it over and over again.

What does getting it right where Medicare is concerned mean? It means no gimmicks, no new taxes, and certainly no deliberate misrepresentation of actions.

Madam Secretary, on page 3 of your testimony, you indicated,

> . . . the President's 1993 5-year deficit reduction package . . . extended the life of the trust fund by an additional 3 years by achieving realistic Medicare savings and by stimulating general growth in the economy.

Didn't you also get more than $50 billion in new taxes by removing the cap on the payroll tax for the HI Fund and by taxing Social Security recipients and moving that money which otherwise would have gone into the general fund into the HI Trust Fund? Isn't that also the way in which the President helped solve the HI Trust Fund in 1993, or am I inaccurate?

Secretary RUBIN. Do you want me to respond?

Secretary SHALALA. Yes.

Secretary RUBIN. Mr. Thomas, as I remember the 1993 program, the President took measures that involved, I think, about $52 billion.

Mr. THOMAS. Did the President's plan remove the cap on the payroll taxes?

Secretary RUBIN. The President's plan removed the cap on the payroll taxes——

Mr. THOMAS. Did the President——

Secretary RUBIN. Wait 1 minute. No. Let me finish.

Mr. THOMAS. The answer is yes, Mr. Rubin.

Secretary RUBIN. No.

Mr. THOMAS. I have 5 minutes, please.

Oh, it didn't raise the cap?

Secretary RUBIN. Wait, let me finish. He raised the tax on the payroll tax——

Mr. THOMAS. Yes.

Secretary RUBIN [continuing]. So that most affluent Americans would have to pay their full share of the taxes. That was part of a total tax program. That was part of a total deficit reduction program. That has generated the recovery we are enjoying today.

Mr. THOMAS. And you raised taxes on Social Security recipients and shifted it from what would have been the general fund into the HI Trust Fund. Isn't that also true?

Secretary RUBIN. What he did was to reduce about $50 billion, I think, in Medicare expenses. He also took two tax measures that hit the most affluent Americans. He put that into the HI Trust Fund. These were politically difficult, but subsequently responsible measures in which the most affluent Americans contributed along with the cuts in the health care program in order to extend the HI Trust Fund by 3 years.

Mr. THOMAS. So you agree there were $50 billion in new taxes that were used to shore up the fund for the 3 years?

Secretary RUBIN. I am not sure about——

Mr. THOMAS. Madam Secretary——

Secretary RUBIN. I am not sure about——

Mr. THOMAS [continuing]. On page 3 of your testimony——

Secretary RUBIN. Wait 1 minute. I am not sure about the $50 billion.

Mr. THOMAS. Madam Secretary, on page 3 of your testimony, you say that the current President's plan helps save Medicare by shifting the financing of the posthospital aspect of the home health care benefit back to part B. What percentage of that would be paid out of the general fund?

Secretary RUBIN. I can answer.

Secretary SHALALA. Yes.

Secretary RUBIN. Are you talking about the structure of the current plan?

Secretary SHALALA. Yes. He is talking about shifting the home health care——

Secretary RUBIN. Yes.

Secretary SHALALA [continuing]. Payments from part A to part B.

Mr. THOMAS. $55 billion of the President's solution was shifting from HI to the part B program. What percentage was paid out of the general fund in that program?

Secretary RUBIN. $55 billion is shifted to the part B program.

Mr. THOMAS. Yes. What percentage would be paid out of general fund money?

Secretary RUBIN. As a matter of law, as you know, the premium is supposed to constitute 25 percent of the part B program, but that is an arbitrary number determined at the beginning of each year.

Mr. THOMAS. No, I think you are wrong.

What percentage is going to be paid out of the general fund on the shifting of home health care from the HI fund?

Secretary RUBIN. Oh, the $55 billion? It will all be paid out of the general fund.

Mr. THOMAS. It will all be paid out of the general fund.

Secretary RUBIN. That is correct, and you know something—wait 1 minute, Mr. Thomas.

Mr. THOMAS. Madam Secretary——

Secretary RUBIN. Mr. Thomas.

Mr. THOMAS [continuing]. On national TV yesterday——

Secretary RUBIN. Mr. Thomas, let me finish.

Mr. THOMAS. Yesterday, you said you were going back to the program prior to 1980. Did you purposely mislead the American people, or did you not understand the way the program ran in the seventies? Because it was subject to the deductibles and the premiums in the eighties, and this, as you might have to admit, is an unprecedented shift, 100 percent from the HI Trust Fund to the general fund. Isn't that also true?

Secretary SHALALA. Congressman Thomas, it also——

Mr. THOMAS. The taxpayers are going to pick up 100 percent of this fund. It never occurred previously. You misrepresented the fact that it was going back to the program prior to 1980, or did you not understand how the program worked? Your choice.

Secretary SHALALA. Congressman Thomas, this is, in fact, one of the areas of common agreement, I would point out, since it was also incorporated in the Republican plan, the transfer of——

Mr. THOMAS. I think you will find that is not so.

Secretary SHALALA [continuing]. Part of the home——

Mr. THOMAS. That is not so. The Republican plan does not include that.

Secretary SHALALA. In fact——

Mr. THOMAS. Is this unprecedented, moving 100 percent from the HI to the general fund? Is this unprecedented?

Secretary SHALALA. In fact, Congressman Thomas, it was included in the——

Mr. THOMAS. Is this unprecedented, moving——

Secretary SHALALA [continuing]. Republican plan.

Mr. THOMAS [continuing]. $55 billion?

Mr. STARK. Mr. Chairman, can the witness be allowed to testify?

Secretary SHALALA. It has been a recommendation of Republican plans from the beginning, and 227 Republicans, including yourself, voted——

Mr. THOMAS. Does our most current——

Secretary SHALALA [continuing]. For the transfer——

Mr. THOMAS [continuing]. Plan include that?

Secretary SHALALA [continuing]. From home health.

Mr. THOMAS. Does our most current plan include that?

Secretary SHALALA. Congressman Thomas, to be fair to me, we have not seen the details of your most current plan.

Mr. THOMAS. And I am telling you the plan doesn't do that.

Your plan moves $55 billion from the general fund, the trust fund to the general fund.

Secretary SHALALA. No.

Mr. THOMAS. Has that ever been done historically, to your knowledge?

Secretary SHALALA. Yes, by the Republicans who——

Mr. THOMAS. No. Historically——

Mr. STARK. Mr. Chairman? Mr. Chairman? Mr. Chairman?

Mr. THOMAS. It is obvious that——

Mr. STARK. Mr. Chairman?

Mr. THOMAS [continuing]. "Groundhog Day" is going to be repeated until they quit purposely misrepresenting statements.

Chairman ARCHER. The gentleman's time has expired.

Mr. LEVIN. Mr. Chairman, a point of procedure?

Chairman ARCHER. The gentleman's time has expired.

Mr. LEVIN. Mr. Chairman, I have a point of procedure.

Mr. Chairman?

Chairman ARCHER. Mrs. Johnson.

Mr. LEVIN. Mr. Chairman, I have a point of procedure.

Mrs. JOHNSON. Thank you, Mr. Chairman.

Chairman ARCHER. Mrs. Johnson is recognized for inquiry.

Mrs. JOHNSON. Thank you, Mr. Chairman.

Mr. Chairman and Secretary Shalala and Mr. Rubin, I have long been a strong advocate of home health services. I also believe very, very firmly that we have a public trust to manage Medicare in a way that assures that it will be there.

We have an opportunity and we have a responsibility to act on this program this year. When we have seen a program shoot from a $5 billion surplus to a $100 billion deficit in a single year, you have got a swing of $106 billion in 1 year. That is billions. That is not millions. That is not hundreds of thousands. That is not thousands. I mean, $106 billion in the eyes of most of the people I represent is, frankly, an awful lot of money. We really have to act this year if we are going to preserve Medicare.

You say there is a lot of agreement, and bottom line, on the outside there is. The President is willing to cut $128 billion. That coupled with some real reforms that would reduce the rate of growth in the way that the First Lady testified before this Committee was necessary would certainly assure the American public that we were capable of fulfilling the public trust that we share. As we examine those numbers, we really have to try to focus on the facts.

When you save money with your left hand by simply moving some of that money to another fund, it is not the same as saving money, period. So the $55 billion that you are going to shift from part A to part B, which under the Republican proposal we would simply control, we would do things so that we would control the rate of growth in spending in Medicare, I think responsibly so that we can make those savings, you want to make that savings by simply taking some money from one pot and dumping it into another, but I want to think about where that money is going when it moves to the part B trust fund.

Currently, seniors pay $42 per month. Under current law, those premiums would rise to $54.70 by the year 2002. Under the President's proposal, if you move that $55 billion to part B, then under the President's proposal for a 25-percent premium and these transferred costs, premiums will be $69.50 in 2002, and this is according to CBO. I am not making this stuff up. I am not pulling this out of thin air. These are real dollar amounts that we are going to have to work with.

In other words, by moving the $55 billion from part A to part B, and in part B treating it as we traditionally have, then, you see, you increase premiums $15 per senior per month. That is a lot of money, and I think we have to think about that.

In addition, of course, you do also increase taxpayer subsidy so that the total would be $127 per month. Seniors pay $42. The government would pay $127. The government would pay $167 for disabled. That money shifts to the taxpayers and to the seniors. That is the way the program is structured.

Secretary SHALALA. Let me sort this out because I think there is some misreading of our plan.

First, we do accomplish the $55 million shift from part A to part B without increasing premiums, which does, in fact, help the trust fund, and as I indicated, is consistent with previous Republican proposals, such as H.R. 2425.

Second, our $55 million shift is not——

Mrs. JOHNSON. Madam Secretary, just a second. You need to clarify what you just said.

Secretary SHALALA. It is 100 percent picked up by the fund. We have it 100 percent.

Mrs. JOHNSON. Madam Secretary, if you will suspend. You need to clarify what you just said.

You testified that the program was going back to the old program. I have read it that way. The old program had 25 percent premiums. If you shift $55 billion to part B, that 25 percent is going to represent more dollars because that fund is taking more money. It is paying for more things. So it is costing more money. So the 25 percent is going to be of a larger pie. So, according to CBO, the costs are going to go up per beneficiary $15 per month in premium.

Secretary SHALALA. Congresswoman Johnson, I didn't testify regarding the pre-1980 program. I said it in answer to a question, as Congressman Thomas pointed out.

Chairman ARCHER. Without objection, the Chair will permit the Secretary to answer even though the time has expired.

Secretary SHALALA. Thank you very much, Congressman.

What I said about pre-1980 is that home health care was located in part B. That is the first point I made.

The second point I have just made is that when we shift $55 billion to part B to help the trust fund, we leave some of home health care in part A, the part that is attached to hospitalization, for instance, and to direct acute care, and we take the long-term chronic care and put that in part B which is from a policy point of view a more appropriate place to put it. Also, we do not raise premiums. We don't throw it into the pot and then redo the premium.

Mrs. JOHNSON. But who pays, then? If you move $55 billion——

Secretary SHALALA. The taxpayers. Clearly, the taxpayers. We said that it is 100 percent general fund-financed.

Mrs. JOHNSON. So this is a tax increase. I mean, let us get at it. If this is going to be new tax revenues, it has got to come from somewhere.

Secretary RUBIN. No. Congresswoman Johnson?

Mrs. JOHNSON. We have got to be straight about this.

Secretary RUBIN. Could I try it one time?

Secretary SHALALA. OK.

Secretary RUBIN. Let me try to be helpful for 1 second. What we did was to take the $55 billion, just as Secretary Shalala said.

Mr. THOMAS [presiding]. Mr. Secretary, the time was allowed for the Secretary of HHS to answer the question. The time has expired.

Secretary SHALALA. In addition to that, the $55 billion is not included in our $116 billion as certified by CBO. We do, in fact, take substantial savings out of part A, and I could go through those for you, too.

Mrs. JOHNSON. All I am saying, Madam Secretary, is that part A is going bankrupt by 2001. part B is also galloping toward bankruptcy. If we are going to move expenditures from one fund to another——

Chairman ARCHER. The gentlewoman's time has expired.

Mrs. JOHNSON [continuing]. We have to pay for them.

Mr. THOMAS. The gentleman from California.

Mr. STARK. Thank you, Mr. Chairman.

I just think it is kind of neat to have the Secretary of Treasury here and I can order him to answer me yes or no, and I want to tell you, when I pay my mortgage sometimes and that flexible rate

goes up, I want to call you, but I will just ask you this this morning, Mr. Secretary.

I recall that in 1993, as you indicated before, we did change the amount of the Social Security income that was taxable, and that money was dedicated to the part A trust fund. Is that correct? Yes or no.

Secretary RUBIN. The answer to that is correct, yes.

Mr. STARK. Nobody called it a gimmick, I don't recall, at that time.

Then, not so long ago, this Committee determined that it would be a good idea to decrease the amount that is taxed, and it would take the money out of the part A trust fund. Is that not correct?

Secretary RUBIN. That is my understanding.

Mr. STARK. About how much would that amount to, to the closest couple of billion for a 7-year window? It sticks in my mind, $30-some-odd-billion is what that cost the trust fund. Did anybody call that a gimmick that you recall?

Secretary RUBIN. If they did, Mr. Stark, I did not hear it.

Mr. STARK. I guess, further, that the trust funds, as I do recall, were part of a political compromise back in the sixties. They are not part of the Constitution, and we have moved items between A and B, at least in my experience in legislating on the Medicare area, and with bipartisan support. It was never called a gimmick.

Would you agree, and I would ask both of you this, that fixating on the trust funds obscures the real issue, which is what is total Medicare spending and what ought we do to control the package? Nobody has raised the issue of cutting billions out of Medicaid, which the Republicans are doing, which will impact most of the 40 percent of the Medicare beneficiaries who are poor and called that a gimmick.

Ought we not to deal with the trust fund and Medicare in its entirety? Would that not be the sensible, reasonable way to proceed?

Secretary RUBIN. Mr. Stark, the answer to that question is yes, and if I could just expand on my yes for 1 second.

Mr. STARK. Please, sir.

Secretary RUBIN. That is really precisely the point of the President's program to put in place reductions. Your point is absolutely right, to put reductions in part A that will extend the exhaustion date because while this was a creation of Congress, nevertheless, the creature does exist and it needs to be dealt with. Extend that to the middle of the next decade. Shift the $55 billion into the general fund. We would discipline with respect to the overall budget, and Mr. Thomas will take comfort from this—without any increase in taxes, and in fact, with a substantial middle class tax cut program, we were able to accomplish that and at the same time reach a CBO balanced budget in the year 2002 which seems to me fills out that answer.

Mr. RANGEL. Would the gentleman yield?

Mr. STARK. I would be glad to yield.

Mr. RANGEL. Thank you.

I won't be able to stay for this hearing, but I want to join in with the Chairman of the Committee with his bipartisan request to see whether or not we can make public to the senior citizens this Medicare trustees' report. I have to admit that every time I go home the

seniors are waiting for me at the airport asking me, "Is the report out, is the report out."

So I think it would be a great public service if you could really allay the fears of the seniors by issuing a report.

In addition to that, I really think that after they see the report and recognize the problem and in order to continue the spirit of bipartisanship, you might want to put some Republican solutions and some Democratic solutions to it. So that after you indicate how good the program has been, I think a quote from Senator Bob Dole saying that I was there fighting the fight, 1 out of 12 voting against Medicare in 1965, that might give some balance to where we are going in the future.

As a matter of fact, I think the distinguished Speaker's remarks might bring a bipartisan reflection on the serious nature of this when he said in 1995 that we didn't get rid of Medicare in round one because we don't think that is politically smart, and we don't think that is the right way to go through a transition, but we believe it is going to wither on the vine because we think people are going to voluntarily leave it and then go into how under the Republican plan doctors will be able to charge more than the regular reimbursement rates, so they can understand how we are going to make the transition.

Last, I hope, and this is going to be difficult, but it is very important, that you make certain that regarding the $345 billion tax cut, explain to them that it has nothing to do with the suggested $288 billion in cuts in Medicare, or for lack of a better word, savings because the only way to resolve this problem is to follow in the spirit of my friend, Mr. Thomas, in the Chair, in a bipartisan way, and I would appreciate it if we can get that report out.

Thank you.

Mr. THOMAS. The gentleman's time has expired.

Does the gentleman from Kentucky wish to inquire?

Mr. BUNNING. Yes. Thank you, Mr. Chairman.

Mr. Rubin, you are the head trustee of the Social Security Board of Trustees. You obviously know that the Secretary of the Treasury, the Secretary of Health and Human Services, the Secretary of Labor, Acting Commissioner Chater, one Democrat and one Republican are on that Board of Trustees. That is by law.

So the question that Chairman Archer asked you is that there are five Democrats and one Republican. You know that as well as I do.

Secretary RUBIN. Mr. Bunning, if I had known it, I would have responded to Chairman Archer. I truly did not, but I appreciate the information.

Mr. BUNNING. One of the main reasons that they have the trustees is to make sure that the Social Security Trust Fund gets a report every year, also.

Secretary RUBIN. Yes.

Mr. BUNNING. In fact, that happens to be the trustees' primary responsibility. The Medicare Trust Funds are just in coordination with the Social Security Trust Funds. I say that in all due respect to your answer to Chairman Archer.

Only in Washington, DC, could Mr. Stark's remarks be considered a cut since our proposal and the Balanced Budget Act of 1995

was to increase Medicare spending per beneficiary from $4,800 to about $7,200 per beneficiary. That is not a cut. That is an increase of almost $3,000 per beneficiary, $2,500.

Secretary Shalala, regarding the transfer of health care funds and the House-passed Medicare Preservation Act, we used a similar device. It was taken from a Democratic substitute offered during markup. It was dropped in the conference on the Balanced Budget Act as inappropriate, and setting a precedent, which Republicans agree that they could not and would not support.

So, in regard to your answer to Mrs. Johnson, those things were dropped in conference and never were voted on the floor of the House of Representatives. It was never sent to the President of the United States. The fact that he vetoed it even though it wasn't in the bill, it was not in the bill that the President had before him.

Secretary SHALALA. But it was passed in the House.

Mr. BUNNING. And taken out in conference as inappropriate.

Secretary SHALALA. So you voted for it, Mr. Bunning?

Mr. BUNNING. One time, yes, and I voted for the Balanced Budget Act as it came back out of conference when it was out of the bill, also.

Secretary RUBIN. That was with the $270 billion of Medicare cuts?

Mr. BUNNING. It didn't have any cuts.

I just repeated to you what was in the bill, an increase in spending on Medicare per beneficiary from $4,800 to about $7,100-plus. That is an increase. Even in Washington, DC, that is an increase, Mr. Rubin.

Secretary RUBIN. When you get into semantics, it doesn't matter much. What matters is what is happening in substance, but the fact is that after the cuts, beneficiaries would receive less.

Mr. BUNNING. What cuts are you talking about?

Secretary RUBIN. The cuts we were just referring to.

Mr. BUNNING. No, no, no. We are not talking about any cuts.

Secretary RUBIN. Let me put it differently, if I could, Mr. Bunning. After the $270 billion of something, that was in the bill, the recipients of health care services, 3 or 4 years out, would receive less in health care services than they would have without.

Mr. BUNNING. Not if they would have incorporated all the other changes that we had made, all the different program changes that we had in the Medicare Reform Act. No, it would not have.

Secretary RUBIN. With all due respect, Mr. Bunning, I don't——

Mr. BUNNING. Well, I mean, that is a difference of opinion, and that is why we are having such a terrible time determining how we are going to solve this dilemma in less than 4 years or maybe 5 years, depending on whose scenario you look at.

Secretary SHALALA. Congressman Bunning, let me go back to where we are trying to find some common ground.

Mr. BUNNING. We have enough common ground to settle this if the President of the United States would sit down and really determine what he wanted to do.

I can go chapter and verse with you. He didn't even submit any savings in the Medicare Program in his submission to the 1996 budget, not one penny.

Secretary RUBIN. That is not correct, Mr. Bunning.

Mr. BUNNING. That is absolutely correct if you go back and look at the budget.

Secretary RUBIN. I remember the budget. I was very much a part of putting it together.

He had $124 billion.

Mr. BUNNING. Absolutely not one penny. Go look at the budget. You must have worked on it.

Secretary RUBIN. I apologize. It was the June budget, the 1996 budget which was our June budget, at $124 billion; the 1997 budget, $124 billion which CBO marked at $116 billion, if I remember correctly.

Mr. BUNNING. It was never balanced, Mr. Rubin.

Mr. THOMAS. The gentleman's time has expired.

Secretary RUBIN. CBO scored the budget as balanced in the year 2002.

Mr. BUNNING. No, not even according to CBO.

Mr. THOMAS. The gentleman's time has expired.

Does the gentleman from Tennessee wish to inquire?

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

Thank you, Madam Secretary and Mr. Secretary. I can assure you, we will give you time to respond to some of these questions that are coming to you.

The Medicare trustees' report can only confirm what we already know, and that is the Republicans should accept the President's call to balance the budget and strengthen the Medicare Trust Fund. I think that is what we all are trying to accomplish, and that is what we would like to accomplish as Democrats on this Committee and in this Congress.

As CBO testified in its April 30 Hill testimony, Madam Secretary, the projected date of the insolvency should be viewed as not telling us anything that we don't already know, but confirming what we have known for some time about the insolvency of the trust fund.

The President has already acted to save the trust fund in the President's 1993 economic plan. It extended the trust fund by 3 years without a single Republican vote in the Congress.

The President's health care reform plan would have extended the life of the trust fund by 5 years had we acted up on that legislation.

The President's balanced budget guarantees the life of the trust fund for a decade, if I am not mistaken. Is that correct, Madam Secretary?

Secretary SHALALA. That is correct.

Mr. FORD. Also, I think the Medicare system had problems in the past. The Congress has acted responsibly to address these problems.

Madam Secretary, I think that the Chairman of this Committee, along with Mr. Thomas, submitted a letter to you dated February 6 in which it states the trust fund went broke in 1995. Did it go broke in 1995, Madam Secretary?

Secretary SHALALA. We had reserves in 1995.

Mr. FORD. You tried to explain this to someone else a minute ago and I think you were cut off, but I am picking it back up.

Secretary SHALALA. We obviously had reserves in 1995, and we used those reserves, but expenditures were exceeding income in that year.

Mr. FORD. Was money there to pay the bills?

Secretary SHALALA. There was money there to pay the bills.

Mr. FORD. So the trust fund did not go broke in 1995?

Secretary SHALALA. It did not go broke in 1995.

Mr. FORD. Madam Secretary, this Committee is charged with the responsibility to bring about trust fund solvency over the next 5 years according to what the trustees have issued in the report as late as yesterday afternoon, and it confirmed something that we have already known.

You all have been cut off several times by my good colleagues on the other side of the aisle. Secretary Rubin and Madam Secretary Shalala, your testimonies were good. How do we approach this and take the grid lock out of the gimmicks that the Republicans are talking about?

Senior citizens, as well as all taxpayers in America, want to see us bring about solvency to the Medicare Trust Fund. We as Democrats and I am sure there are some Republicans of good will on this Committee and in this Congress would like for that to happen as well. Do you have any suggestions?

You are being cut off by the Republicans. It is clear that they do not want to hear what the administration is saying and the trustees are saying. Do you need some time to tell us as Democrats and Republicans as to how we ought to approach this solvency problem?

Secretary SHALALA. Yes. Thank you, Congressman.

There are areas of commonality, although not necessarily specific proposals. In fact, I thought the home health care was a good one because both Republicans and Democrats have favored it over the years, and it seems to me that where there have been votes we could have clearly talked. Let me give some other examples.

Although the levels of savings that are estimated and the specific policies differ, both sides agree on some concepts. We agree that we need to strengthen certain elements of fraud and abuse controls. We agree that we need to restructure how Medicare pays managed care organizations. We agree that we need to modify the physician payment system and the structure for the revisions. We have agreed that we need to move the prospective payment systems for skilled nursing facilities and home health services, although we disagree on how we make the transition.

We agree in concept at least that we need to provide incentives to hospitals for efficiency by constraining cost updates for operating cost, reimbursing reasonable levels of capital cost, and that we need to reform the medical education payments.

There are areas of commonality, and it is hard for us to believe that if we strip out all of the controversial policy proposals where we disagree that we can't find enough savings to extend the trust fund for 10 years and then put in place that bipartisan advisory commission to deal with the longer range problems of the Medicare system.

We have listened carefully and reviewed carefully our proposals and the Republican proposals. We believe that we can find a set

of things that we agree on to deal with the short-term issues, and we are prepared to do that.

Mr. THOMAS. The gentleman's time has expired.

Mr. FORD. Thank you very much, Madam Secretary.

Thank you, Mr. Chairman.

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

Mr. HOUGHTON. Yes. Thank you, Mr. Chairman.

Mr. Secretary and Madam Secretary, it is good to have you here.

Let me just try to sort of recast the numbers as I understand them. We all understand there is a problem. We have got to do something about it.

The total numbers which the Republican side and the White House come up with are about the same. The only difference, big difference, is in terms of this $55 billion, which you take from part A into part B.

I am not clairvoyant. I can't make judgments for other people, but I would imagine in this discussion that that is going to be off the table. So the question, really, is twofold.

One, how far does the $73 billion in real cuts or real reductions and expenses get us, and what do the actuaries say about this?

Two, is there any way to squeeze out more money rather than transferring from one account into another in our attempt to save this thing? That is the whole focus that we are dealing with.

Secretary SHALALA. I think that is the whole point, Congressman Houghton, of sitting down and trying to see areas of agreement.

If you look at our specific policy proposals, they are different. If you look at the areas where we are trying to make changes, they are similar, which is the point I am making. We think that it is possible to sit down, to take off the table where we clearly can't agree or don't want to talk in the short term and to see if then we can find enough common ground savings to deal short term by adding another 5 years to the trust fund that would give us a decade. That will leave us plenty of time to put an advisory commission in place and to take a longer term look at the way the Medicare system is organized in this country. That is the only point we are making.

I brought up home health care, and I am sorry I stepped into it, because I saw votes on it, and I saw the Republicans using it during earlier years while I was here. Frankly, from a policy point of view, I could make an argument for doing the transfer because there is an underlying set of principles about how part A and part B have worked that justify taking part of home health care and putting it in part B.

I am not going to lay out all the issues on the table here. The point is, as we have looked carefully at these issues, we think we can sit down and find enough savings and extend the trust fund in the short run, and we believe we ought to do that now and deal with the long-run problems as part of an advisory Committee.

Mr. HOUGHTON. Sure.

Secretary Rubin, would you have any comment?

Secretary RUBIN. Mr. Houghton, I guess my view is the one that I expressed before to Mr. Thomas. The objective that we had was to extend the part A trust fund into the middle of the next decade.

We accomplished that. We want to do it without harming beneficiaries. We accomplished that. We want to do it in a manner that was prudent so that we didn't affect health care for the elderly. We did that. We want to have a balanced budget scored by CBO in 2002 when we accomplish that, and we have a letter from CBO to that effect. Mr. Bunning seemed to have some skepticism about that. So we accomplished all of our objectives.

I do think that that does lead to the point that Secretary Shalala said. I think the serious point, and I guess it was Mr. Stark perhaps who said it—I don't remember exactly. I think the serious point is what do we do about the long term. Having done all that, what do we do about the long term? There, nobody has solved that problem, and our recommendation, as Secretary Shalala said, is we should have a commission and we should have a real bipartisan process and get at that.

Mr. HOUGHTON. I understand that, and obviously, the long term is the critical issue, but the point is that as I look at the numbers, you have got $73 billion in real savings without shifting the $55 billion from one account into another.

I would think in advance of having this commission sit together that maybe the actuaries could come up and tell us is that enough, is that going to do the job.

Secretary RUBIN. Mr. Houghton, with all due respect, I know you used to be in business and so was I. I don't think that from a business sense that is the right question because I think it was $72 billion and not $73 billion, but it doesn't make any difference. It is not the $72 or $73 billion. It is the total program for part A, and the total program for part A was both the reduction and the shift.

Mr. HOUGHTON. Yes. I guess my feeling is that when you take a big chunk of your savings in order to resurrect this fund and just move it from one account into another without increasing at any case the premiums of those people who are going to be paying for part B, I just think it is unrealistic.

So what I am concentrating on is in the hard money and whether that is going to be enough.

Secretary RUBIN. With all due respect, this program would work. CBO scored this program as extending the exhaustion date to 2005. It is certainly their view. The actuaries actually scored it as extending the exhaustion date to 2006. So this will work within the timeframe that we are talking about. It does leave us, unfortunately, this very complicated, long-term problem, which I think many of the people who have commented today have commented upon.

Mr. HOUGHTON. Thanks. My time is up.

Mr. Chairman, thank you.

Mr. THOMAS. I thank the gentleman.

Does the gentleman from Louisiana wish to inquire?

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

I thank both of you for coming before us today and sharing with us your testimony and your responses to our questions.

First of all, I would just like to establish the three scenarios that are in the trustees' report. We have talked most about the intermediate scenario which provides that at the end of fiscal year 2001, there would be a $53 billion deficit in the trust fund. Under the

low-cost scenario or the best-case scenario that the trustees set out, at the end of fiscal year 2001, there would be a $5 billion shortfall. Then, under the high-cost scenario or the worst-case scenario, at the end of fiscal year 2000, there would be a $33 billion deficit or shortfall in the trust fund.

So, under any scenario, best case to worst case, we will be out of money in the trust fund if no changes are made by the end of fiscal year 2001, and under the worst case, we could, in fact, call into the red in the trust fund some time in calendar year 1999 which is only 3 years from now.

I know that both of you have said, and I agree, that we are going to do something. We must do something to avert the trust fund being without funds. Why? Because, unless you can tell me something that I am not aware of, if the part A trust fund does not have funds to pay hospital bills for Medicare patients, those bills don't get paid, do they? There is no authority that we have or you have to pay those bills outside moneys in the trust fund.

Secretary RUBIN. Yes. That is precisely why, as Secretary Shalala and I both said, I think one could say with a high level of confidence the action we take.

Mr. MCCRERY. Oh, I agree. I agree. I just want to establish in everybody's mind that that is the reason for the urgency. If this trust fund goes bankrupt, if there is no money in the trust fund, hospital bills cannot be paid under any existing authority. Is that correct?

Secretary SHALALA. Or they will be paid only with the income coming in, as I explained——

Mr. MCCRERY. Right.

Secretary SHALALA [continuing]. Which means all of the bills wouldn't be paid, but that is unacceptable, as you have said and as we have said.

Mr. MCCRERY. So we all acknowledge that this is an urgent problem, and I appreciate the administration coming forward with a plan that does solve the immediate problem.

So we are really talking about a matter of degree here as to how we approach the short-term solution and how that short-term solution puts us in shape to address the long-term problem. We haven't talked much about the long-term problem here today because, obviously, our focus right now is getting out of this trap that we are in on the trust fund, but the long-term problem will be, by all accounts that I have read, even more difficult to solve than the problem we are talking about here today because the age demographics of this country are such that around the year 2010, 2012, the baby boom generation, which is the biggest part of our population, will start to retire.

So we are really, I think, discussing or we should be discussing what is the best short-term solution not only to get us through 2006 or 2001, but what can we do now to put us in the best shape to solve that long-term problem.

Obviously, we have a disagreement between the Republicans in Congress and some Democrats, I would submit, and the administration because we have, in fact, called for a much higher level of savings or cuts, however you want to phrase it, in the Medicare part A program than the administration.

I, for one, would not like to put all of our eggs in the commission basket and hope that there is something going to drop down from the sky and give us some easy solution. I don't think that is going to happen. I have zero faith in that.

I have faith in the commission coming up with some solutions, but they are not going to be easy.

So I would rather do some things now that will put us in better shape then to solve the bigger problems of the baby boomer's retirement.

I just wish that we could sit down outside of the election atmosphere and decide what is best. I think if we were to do that—and there are some Democrats in this Congress who have sat down with us and have arrived at a plan that is more than the administration suggests. I wish we could come up with a plan that we could all agree on and get it done.

I would just like for your comments on my analysis of where we are and where we should go.

Secretary SHALALA. Mr. McCrery, I think that the urgency of dealing with the short-term issue has brought us to the conclusion that we ought to see where there is common ground and get the additional 5 years that will give us 10 years of solvency and then set up an advisory committee.

We specifically called it "advisory" because it is also our conclusion that it will take political leaders of both parties to devise the long-term solution, not simply a bunch of experts that you are going to adopt their plans. To have that thoughtful discussion will take some time. So we have recommended a short-term solution.

Anything beyond that, looking at what happened over the last year, would make me very nervous because of how the private health care system impacted Medicare growth rates, which is a whole different discussion. But the discussion does lead me to believe that we need to take a very thoughtful look at the extent to which Medicare and Medicaid underpins the entire health infrastructure in this country, and when the private sector is squeezing down, how much that impacts back on Medicare. So I would want to be extremely careful as we edged our way into much stronger reforms.

Mr. THOMAS. The gentleman's time has expired.

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

Mr. MATSUI. Thank you, Mr. Chairman.

I want to thank both Mr. Rubin and Secretary Shalala for being here, and I really appreciate the objectivity of the report. It has always been objective, ever since 1970 when we began having these actuarial reports from the trustees.

I would like to just clarify perhaps what is maybe a misunderstanding. In terms of the increase, people talk about while a cut is really not a cut, it is an increase, and so, therefore, we are using misnomers in Washington, DC. That is not true. We should look upon this issue as a per capita issue.

We are spending today, 1996, $4,700 per year for health care benefits for the average senior citizen. In the private sector, we are spending $4,000 per year for the average person in America. So we are spending $700 more per year for the average senior today, 1996.

Mr. Bunning raised in his questions, in the year 2002, 6 years from now, we will be spending $7,400 for each senior citizen, approximately $2,700 more than we do today. So he says that is an increase, and that is an increase.

The only irony about this is that the private sector actuaries and insurance companies say that we are going to be spending $8,500 for the average American. So we are going to be spending approximately $900 less for somebody 85 than we would for somebody 35, and that is the number that we really have to look at.

What we are doing under the Republican proposal is actually spending less money projected 6 years from now for the average senior citizen than we will for somebody who is healthy and in the work force, and that is because in the Republican proposal, inflation was only 5.7 percent per year for Medicare. Whereas, in the private sector, it is going to be 7.4 percent per year for the average worker in America, and that is why the seniors should be concerned about the proposal that the Republicans presented because what is going to happen is they are going to have third-rate health care coverage in America should that happen.

Let me just make one further observation, if I may, as well. This problem will be fixed. I think both Secretaries said we are going to fix this problem. It is a short-term problem. I think Mr. McCrery talked about the long-term problem. We are going to have to set up a commission in all three. The administration, the Democratic proposal and Republican proposal suggested a commission for the year 2010 and beyond because that is when the baby boom population occurs, and that is when we are really going to have to solve this problem.

What we are talking about now is a short-term solution. I have been on this Committee now for 16 years. In 1982, for example, we projected that the insolvency for Medicare would occur in 1987, 5 years. In 1983, we had a bipartisan group of Members. It was both Mr. Jacobs, and I know that Mr. Stark was working on it, and Mr. Gradison, and if you recall then, we passed the DRGs and made massive changes in the reimbursement system. We got to the point, then, when we had a 13-year solvency as a result of that.

We have had about seven or eight different reconciliation bills in which we have had bipartisan support in making sure that we have had short-term solvency of this particular problem. So there is no reason why we can't solve this problem. We shouldn't mislead the public and start saying, "Chicken Little, the sky is falling," because it is not going to fall. We are going to solve this problem.

We have had predictions of a 5-year solvency period, a 6-year solvency period, and a 7-year solvency period. In fact, President Clinton when he took office, we projected in 1993 the solvency would end in the year 1999. Actually, in 1993 when we passed the reconciliation bill, we picked up 2 years. So we have been aware of this problem. It is not anything new. Nobody has been hiding this particular issue.

So let us get on to solving the problem. Let us try to work in a bipartisan fashion if we possibly can. I know it is an election year. It is very difficult, but we owe it to the seniors and the American public to lower the decibel level on this report. It is really unnecessary to make more out of it than it really is.

I yield now to Mr. Stark.

Mr. STARK. I thank the gentleman for yielding.

I just wanted to ask the Secretary very quickly, the Republican Chairman of the Defense Authorization Committee said that we are going to increase the dollars that we give them in the budget, but adjusted for inflation, it will be a decline or a cut.

Isn't that the same thing that we are talking about in Medicare? We are increasing the dollars, but with inflation, it is a decline or a cut.

If in defense it is a cut, how can it be an increase in Medicare? We are doing exactly the same thing. Do I miss something in the way that budgets are built, Mr. Secretary?

Secretary RUBIN. Mr. Stark, leaving aside semantics, I think what we wanted to look at is what Mr. Matsui was suggesting which is what are the services that are going to be delivered in some outyear, and if you reduce expenditures on an inflation-adjusted basis, then you are going to be reducing the services that are delivered, and you can call it a reduction, a cut, or anything else. That is what your Defense Committee Chairman was, I suppose, referring to, and it is really the frame of reference that at least I have used in referring to the Medicare reductions as cuts.

Mr. STARK. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman's time has expired.

Madam Secretary and Mr. Secretary, is it possible that we might come together in whatever solution that we can come up with, hopefully on a bipartisan basis? Could we have an initial agreement that we will not shift the responsibility for paying for what are some of the part A trust fund obligations in today's law over into the General Treasury? Even though budgetarily it offsets, it offsets budgetarily in the strict sense of the word. However, it does not recognize the fact that whatever we do to the general fund, which, Mr. Secretary, you have the responsibility for, has not exacerbated the problems of that fund.

Part of the problem today, I think, with the way our budgeting works is that the moneys that are in the trust funds mask the true operating deficit.

Secretary SHALALA. Mr. Chairman?

Chairman ARCHER. The true operating deficit is really what we as a Nation need to be concerned about in the long run. If we simply move obligations and responsibilities out of the trust fund which are currently being paid for out of the trust fund, we say now we are going to pay for those out of the General Treasury. We have not done anything about the operating deficit. We have increased the operating deficit in the future for this country.

So it seems to me that in good faith that both of us should enter into an agreement that we are not going to enter into that sort of financial gimmickry and try to save the trust fund without simply offloading responsibilities from it onto the General Treasury. Could we have that kind of agreement between us going in?

Secretary SHALALA. I think the answer is no. The agreement that we would like to have going in is that we wouldn't take anything off the table until we get to the table.

The point I would like to make, Chairman Archer, since we don't have time to do this here is we would like to lay out for you the underlying policy arguments because home health started very small and then evolved into something that is quite different and that may not be appropriate for part A. We would like to lay out the underlying policy argument that we made to back up the President's recommendation.

So, to be fair, we want to go to the table, but we are not prepared to take anything off of the table until we get there.

Chairman ARCHER. The problem is not with the question of how we handle home health care in a better way. The problem is that irrespective of how it is handled, it has got to be paid for, and simply taking that payment responsibility out of the trust fund and putting it on the General Treasury does not solve the problem.

Secretary SHALALA. But if we can produce savings that get the trust fund out another 5 years so that we have a decade while we are looking at what kind of thoughtful reforms we want to put into the Medicare system, I simply don't want to argue about what we should come to the table with once we get there, Chairman Archer.

Chairman ARCHER. This is not to say what reforms should not be adopted in order to be able to have more value out of the moneys that are spent for health care for senior citizens.

Secretary SHALALA. Yes.

Chairman ARCHER. This is not to prejudge any of that. It is just to imply that we ought to agree that we are not going to embrace a solution which appears to save the trust fund, but increases the operating deficit of this country, and that is what troubles me.

We would both agree to that, in whatever the ultimate plan was, that that would not be the way that we would do it.

Secretary SHALALA. One of the things that we have done, also, in part A is made some recommendations on savings. That is another reason why we need to get to the table and to lay out what we are trying to do. Doing some reordering of how the Medicare system is financed, if we could get some short-term agreement, is perfectly appropriate, but I think what we would like to do is bring our proposals to the table and you bring your proposals to the table and let us see what the underlying policy arguments are. I think that is only fair, but let us get to the table.

Chairman ARCHER. I appreciate the indulgence of the Committee in letting the Chair enter into this line of inquiry.

Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman.

I just have a couple of points, and then I would like to ask you a question, Secretary Shalala.

It is clear that Medicare is going broke faster than was expected and that that trend seems to be getting worse every day. In 1995, the trustees projected a surplus of $5 billion in the year 2002, and today we are learning that Medicare will have a deficit of $101 billion in that same year. I think that $106 billion loss in 1 year is a startling reversal of fortune for anybody looking at this problem.

Second, Medicare's last year may be just 3 years away, in 1999, and the concern is that the trustees' report was in error last year. This year's report, even optimistically, assumes bankruptcy in the

year 2001. The concern is there is no guarantee that the trustees may not have to go back and redo their assessment and projections.

I believe the President's proposal should reflect this deterioration in the trust fund, and I agree with Mr. Matsui, there is no reason we shouldn't solve the problem without games and without tax increases, and we should work together because we do need to find common ground, but I think it is very important that we not include games or tax increases in that proposal.

Last, I think the public, and particularly our senior citizens, need to know the truth, and I would like to see this report, and echo others' concerns that this report be mailed to every senior citizen in the country, but my question is this. In the Supplementary Medical Insurance Trust Fund report, the trustees note a couple of concerns.

One is that the program costs have been growing faster than GDP, and they expect that trend to continue under present law, and second, the concern that the general revenue fund will fund an ever-larger share of part B spending as the premium share declines, and it is estimated to fall below 25 percent in 1998. I realize that part of the President's proposal is to raise part B premiums, but how do we reconcile that concern over the higher general revenue financing cost in part B and at the same time propose to shift $55 billion more onto the taxpayers under the home health transfer?

Secretary SHALALA. Let me answer that question this way. First of all, we have proposed a long-term process for looking at both part A and part B of the Medicare Program because there are, in fact, changes going on within the system as the entire health care system in the United States changes.

Second, the shift, as I have indicated, has an underlying policy justification. The President does not want to raise the premiums.

Medicare recipients on average have incomes of $11,000 a year. Their drugs are not covered by the Medicare Program. They are increasingly pushed in terms of their own fixed incomes, and we are very reluctant to just shift costs onto relatively low-income recipients. This is the reason why we should put a short-term solution in place and then consider longer term at what the mix is between the payroll tax and trust funds and what the general fund ought to account for and what we can do to slow down the growth of part of the system.

I have laid out areas of commonality in which I think conceptually we have some agreements regarding proposals to slow down growth, and I just think we can get there in a short-term proposal. It will certainly be somewhat controversial, I am sure, to providers and hospitals, but if we put it together, we can together all make the justifications together.

Mr. CAMP. I appreciate that answer.

Secretary SHALALA. Sorry. I am allergic to Washington.

Mr. CAMP. I appreciate that answer.

The concern is the cost will have to come from somewhere because you do acknowledge that moving $55 billion over will put an added burden on part B. Premiums are a smaller amount of funding for part B. So it will have to come from general revenue or somewhere else.

Secretary SHALALA. Simultaneously, we are also doing some things to slow down some of the growth in part B, plus a set of other reforms, including waste, fraud, and abuse reforms, getting a hold of some of the growth in home health care and skilled nursing facilities. I mean, you have to do a number of things.

I am convinced that we can do this short-term package to extend the life of the trust fund into the next decade. The President has laid out his proposals. We are prepared to go to the table to do it.

Mr. CAMP. Thank you.

Thank you, Mr. Chairman.

Mr. THOMAS [presiding]. Does the gentleman from Georgia wish to inquire?

Mr. COLLINS. Thank you, Mr. Chairman. I am going to be brief because I don't believe in beating a dead horse.

I do know both of the Secretaries. The greatest challenge that we face as a Nation, as well as the representatives of the people of this country, is the deficit spending that occurs here in this town daily, and I think the biggest threat that this Nation faces as far as its democracy is the national debt that keeps accruing also on a daily basis.

We are speaking of 37 million people, approximately, who are insured under Medicare, and we are all very concerned about those 37 million people and their health insurance, but we also have to be concerned about the 98 million people who pay the bill, and that is the working people of this country who actually have a net tax bill.

It doesn't matter where you shift the cost or the funding, those same people pay the bill. It doesn't matter where you shift the tax or what entity you put it on or, what you call it, a user fee or an excise tax. Those same 98 million people pay the bill. They pay the bill whether it is for Medicare or welfare or for Medicaid or defense, you name it.

They also are paying the bills at home for their families to provide the same necessities and benefits that each one of those entitlement programs provide for those 37 million under the Medicare, plus millions who are under the welfare and Medicaid, and I think we need to think about those people.

We have a plan that is offered by you and the administration that will rescue—rescue Medicare, but it won't save it. I am not saying that the plan that the Republicans are offering will save it. I think we must look at how we save the program as well as we save the whole existence of our democracy.

I am pleased to hear you say that you are not going to take anything off of the table until we get to the table because, under that same interpretation, I read that you are not really objecting to anything that we are bringing to the table until we get it to the table for a full discussion. I think that is good.

I was frustrated and disappointed that the President vetoed the previous balanced budget which included the Medicare Preservation Act, but in further analyzing it and thinking about it, and I have told people back home, I don't think it was all bad because, what it did, it was continuing the debate upon what we are talking about and the needs and the challenges and the threat that this country faces.

I hope you do keep an open mind when those that represent the Congress and the people come to the table to work with you and the other members of the administration in objectively looking at all areas of change that will further rescue or save Medicare, all policy changes.

You may say that you won't and don't like certain changes today and policy that may, as you say, threaten certain areas. We wouldn't offer that policy change if we thought it threatened anyone. We offer it out of good intent, the same as the President offers his proposal, out of good intent. So let us do keep an open mind.

Let us do work toward the solvency of Medicare and prevent it from going bankrupt and not just attempt to bring it out in the water to rescue it. It is drowning in red ink. Once we get it on the boat, we have got to get a resurrection.

Thank you for your time.

Thank you, Mr. Chairman.

Secretary SHALALA. Thank you, Congressman Collins. Thank you for your thoughtful remarks.

I repeat, we won't take anything off of the table until we get to the table, and I don't expect your party to do any different. We do have open minds, and I do see a compromise there somewhere.

Secretary RUBIN. Could I just add one thing to that? As Secretary Shalala said, we do have open minds, and we are committed to solving the problem. I think there are certain structural proposals that are contained in the congressional majority's plan, MSAs, for example, and balanced billing, which we do feel are not in the best interest of the health care program.

Mr. COLLINS. Let us keep in mind, too——

Mr. THOMAS. The gentleman's time——

Mr. COLLINS. Let us keep in mind, too, those 98 million people who are paying the bill.

Secretary RUBIN. Mr. Collins, I think it would be fair to say that there is nobody who has done more, probably in decades, to achieve fiscal responsibility in this country than the President with the 1993 deficit program.

Mr. THOMAS. The gentleman's time has expired.

Does the gentlewoman from Connecticut wish to inquire?

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. Chairman, earlier Mr. Stark said he felt like he was in "Groundhog Day," a Bill Murray movie, déjà vu, and I feel exactly like he did. There is only one difference, Mr. Chairman, and that is your party is now in the majority.

We had to take that tough vote in 1993, which I think all of the Members of this body, the Ways and Means Committee, understand. We can all talk or be very tightlipped or be very serious about this. To fix this problem, it is going to take some very hard decisions by all of us.

I voted in 1993 to save Medicare. It was a very tough vote. I have many constituents that still don't like my vote, but we had to do it to save Medicare, and once again, we are all going to have to do it because we are all on the same side.

The other thing I was thinking of is the song, "Say It Isn't So," because all I have heard this morning was how you cannot take

funding for home health care from part A and transfer it into part B.

Mr. Chairman, for the record, on October 19, there was a vote to move home health care services beyond 165 days from part A to part B. Every member of the majority voted for that. In other words, every Republican on this Committee voted for it.

On October 26, there was a vote to move home health services beyond 150 days from part A to part B. Every Member of this body who is a Republican also voted for that legislation.

So let us not say it can't be so. We are trying to find a solution to the problem, but don't ask Donna Shalala, our Secretary of HHS, to take that off the table after you have voted for it twice.

It is on the table. There is a lot of money there, and we have to look at it.

I want to use the remainder of my time, Madam Secretary, to have you once again explain your thinking behind moving home health care, part of it, not all of it, part of it, from part A to part B.

Secretary SHALALA. The home health care benefit was originally designed like the skilled nursing home benefit, to provide short-term recuperative post-acute care services to people after they were discharged from the hospital. It has now evolved.

In fact, the benefit was originally only available to beneficiaries who were discharged from a hospital following a minimum 3-day stay, and the first 100 visits were financed under part A of Medicare.

If the beneficiaries exhausted all of the part A visits and carried part B insurance, they are eligible to receive additional visits financed under part B, under our proposal, but the point is that we started out with a program that was simply going to take care of people for a relatively small number of days after they got out of the hospital. It evolved into a comprehensive, long-term program that many of the Members of this Committee have spoken to me about over the years, to allow people to stay in their homes who have chronic illnesses.

A lot of the growth is in the long-term care part of the home health benefit. That part, conceptually and the way in which the Medicare Program was designed, ought to be in part B. The more emergency home health care ought to stay in part A. For this reason, our bill transfers home health care costs after 100 days, the short-term part, transfers the long-term part, plus other non-hospital-related home health visits to part B.

This means that the remaining part A benefit is consistent with the skilled nursing home benefit in part A in which we pay for 100 days of skilled nursing home benefits after a hospital stay.

So, conceptually, it makes all sorts of sense. It is the way the program was originally designed. It evolved into something else, and there is a clear policy justification for moving it. That is why I believe that this proposal came up on the Republican side and was voted for twice favorably by House Republicans. It makes all sorts of sense. We ought not to take it off the table, and we ought to discuss it as part of this short-term discussion.

Mr. THOMAS. Does the gentleman from Ohio wish to inquire?

Mr. PORTMAN. I thank the Chairman. I missed Bill Murray and "Groundhog Day," but it does seem like déjà vu all over again. It is the third time since I have been on the Committee that you have been before us.

Mr. THOMAS. That is Yogi Berra.

Mr. PORTMAN. Yogi Berra, not Bill Murray.

I have a couple of quick questions, and I do have a number of questions. I will try to keep my questions short so we can get the answers.

The concern you raised earlier in response to Mr. McCrery's question regarding the private health care market intrigues me. From what I heard you say, Secretary Shalala, you would be concerned about any long-term changes in Medicare and getting into some of the fundamentals of Medicare because you would want to be, as I remember, extremely careful because the health care system is being, in a sense, supported by Medicare based on some of the recent data you have seen.

Can you expand on that briefly?

Secretary SHALALA. Yes. We are trying to figure out what the explanation is for this more rapid growth, beyond what our actuaries assumed, and there is some indication home health care visits have grown more rapidly. The health care system is evolving into one in which there is a lot of activity outside of the hospitals.

Our bills are being paid faster. Some of that is reinvention, and that is, instead of paying our bills in 35 days, which is what it was when we started the administration, we are now paying our bills in 30 days.

We streamlined the process of bill paying which means the hospitals are coming in faster to get their bills paid, and using more electronic systems and other kinds of things to do that.

What does this mean? If you go out and talk to the hospital administrators, we are a very good payer. We are not getting the deep discounts that corporations are negotiating with hospitals and with other kinds of providers. But, getting our money faster helps to keep the hospital infrastructure clearly out there providing care.

Mr. PORTMAN. Yes.

Secretary SHALALA. The hospital system in this country, and the entire health care system is going through rapidly changed economics, with the private sector negotiating very deep discounts. We would like to get some of those discounts and slow down some of our growth.

What I am saying is we have got to be extremely careful that what we are not seeing here is some theoretical cost shifting to Medicare.

Mr. PORTMAN. I couldn't agree with you more.

Secretary SHALALA. I want to be careful as we do the long-term proposals to make sure we understand what is going on.

Mr. PORTMAN. I may have misread what you said earlier, but what I inferred was that you think, therefore, we should be very careful about making changes in the program for fear that we could, in a sense, have Medicare catch up with the private health care market. I think that is precisely what we need to do.

Secretary SHALALA. And I agree with that.

Mr. PORTMAN. I think cost shifting is a problem. It is all the more reason to move ahead much more rapidly.

I think the numbers from the trustees' report and so on are probably understated for that reason alone, and I think that should be an impetus to all of us to move forward with fundamental change that at least tries to bring Medicare into this century, if not the 21st.

Let me just keep going because I have so many questions, and I would like to get your input.

We talked a lot about short-term and long-term solutions. We talked about the magnitude of the problem. Just very briefly, if you look at the intermediate projections, which have proven to be more optimistic than the actual projections, we are talking about a $375 billion deficit by the year 2005. The year 2010, as you have indicated, is when my generation starts to retire, and we have the demographic shift with fewer workers paying into the system and a lot more people getting benefits.

What are the numbers in 2010 based on the intermediate projections? Do you have those?

If you don't have those right now, we can get those for the record. I would guess they would be well over 1 trillion.

Secretary SHALALA. I will provide it for the record.

[The following was subsequently received:]

The projected deficit in the Medicare Hospital Insurance Trust Fund at the end of 2010 is $1.2 trillion.

Secretary SHALALA. The point is that we have got to act before 2010.

Mr. PORTMAN. Precisely.

Secretary SHALALA. We know that, and that is my point about the way in which we do our payment system and the kind of fundamental changes that we need to make in the Medicare system.

Mr. PORTMAN. Exactly.

I think the point we are making with regard to shifting home health from part A to part B, which I don't think is a good idea unless it is done in the full light of day, is the fact that you are shifting, in essence, the home health responsibility over to the taxpayer which either means more deficit spending or higher taxes.

In deference to my friend, Bob Matsui, who is now gone, who went through this with Bill Gradison, my predecessor, we have a different environment now. We have a $5 trillion debt we are dealing with. We have a situation where we don't have the latitude to do that kind of shifting, at least without doing it in a very deliberate fashion.

Many on the other side are saying we are acting like Chicken Little, it is not a big deal, we can solve it. Mr. Stark talks about us cutting below inflation which is not true based on the latest HCFA study. Health care costs are increasing nationally by about 4 percent or below. Medicare costs are increasing as you know, by about 10 percent. Our proposal increased Medicare spending by about 7 percent per year, which was consistent with what the President and Mrs. Clinton talked about in 1993.

So this kind of conversation where, in essence, the other side of the aisle is saying take it easy, this is not a big problem, we don't need to worry about it. I think that what you are saying with re-

gard to the private health care market and what we all recognize, which is the looming debt and a deficit problem that is bigger than all of this, we are in a different world, a different era, and we cannot take it easy. We have to solve this problem both for the short term and long term.

I thank the Chairman.

Mr. THOMAS. The gentleman's time has expired, and I know the Secretaries wish to get out by around noon. We have a vote on right now. So, if we can all honor the lights, more Members will have an opportunity, and if someone feels they aren't totally compelled to ask a question, the Chair would appreciate that as well. So we will continue through this vote, if you will allow us, to try to meet your timeframe.

Does the gentleman from Pennsylvania wish to inquire?

Mr. ENGLISH. Thank you, Mr. Chairman. I appreciate this opportunity.

Secretary Rubin and Secretary Shalala, thank you for being here.

I have listened to some of my colleagues. One of them that I respect in particular on this panel suggests that we lower the decibel level on the problems in Medicare, and I have to tell you, I could not disagree with him more.

I think this is a crisis. Having been a city finance officer at a time when our city was having severe financial problems, I don't believe that the problems that you have outlined in your report and Medicare can be swept under the rug.

I appreciate the fact that in the specifics of your report, you suggested we do need to take immediate action, and I think this is all the more important to recognize since some in Congress seem to be in denial about the dimensions of this problem.

Secretary Rubin, if you were back on Wall Street and this were a private entity we were talking about, I happen to think that it would be very close to receivership, and for that reason, I think we do need to reduce the level of partisanship in this debate and there may be a vehicle for doing that.

I suspect both of you are aware that last year, about 10 months ago, I introduced a bill, the Commission to Save Medicare Act, which would create a BRAC-like commission on a permanent basis to review the Medicare Program and to suggest necessary revisions over time to preserve the program.

I would like to encourage both of you to look at this bill and to take it back to the President. You have made a general reference to a commission in your report, and I would ask you to go beyond that and suggest a permanent commission that we need and one that can act, moving beyond the traditional jurisdictions of this body, to send recommendations directly to the floor.

May I ask you, have either of you developed a position on this BRAC commission approach which has been endorsed by the Hospital Association?

Secretary SHALALA. We don't have an official position.

Let me say that the advisory group that we have proposed has no details to it, and as I indicated to Chairman Archer and Mr. Thomas, we did that on purpose, so that we could sit down and talk about the appropriate elements.

I also believe that none of us should have any cover on this issue. We know what the problems are. We ought to get the best advice we can possibly get in a bipartisan manner, and bipartisan political leadership ought to come together to put the solution together.

So we would be happy to look at your bill. We have not written in any details on purpose, as part of our pledge for bipartisanship.

Mr. ENGLISH. And I appreciate that.

Let me also say that the purpose of this commission would not be to create cover, but to create a truly nonpartisan process. This is a bipartisan bill to create a nonpartisan reform process and to try to get beyond the rhetoric which, unfortunately, has even been in evidence today.

We need to establish some sort of entity above the fray to give us objective advice.

Secretary SHALALA. As you know, Social Security has that, and when Social Security was separated from the Department, a commission went with Social Security which meets about four times a year, but we didn't have similar commission legislation for the Medicare.

Mr. ENGLISH. My only suggestion beyond that is any commission has to have teeth and has to have a real institutional role and be more than just an advisory commission.

I will be writing to the President and asking him to endorse this commission. Time is very much of the essence, and we appreciate your being here. We look for an opportunity to lower the partisan rhetoric.

Thank you very much.

Secretary SHALALA. Thank you, Congressman English.

Mr. THOMAS. I thank the gentleman.

No Democrat having returned from voting, I will recognize the gentleman from Nevada, Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I want to talk a little bit about the numbers. In the numbers that you were projecting, no recession was predicted during that time, correct? A recession would affect payments into the system.

Secretary SHALALA. No. Remember, we are on a very, very tight period.

Mr. ENSIGN. I am just making a point.

Secretary RUBIN. I think it depends which numbers you are talking about. My recollection is it is in the report someplace. I think in the worst-case basis, there actually was.

Mr. ENSIGN. But not in the intermediary.

Secretary SHALALA. Not in the intermediary.

Secretary RUBIN. I believe, not in the intermediary.

Mr. ENSIGN. The reason I bring that up is just yesterday we marked up our welfare reform bill, and Mr. Levin from Michigan pointed out that in a very, very long period of time, if we go out all the way to 2001 without a recession, he would be surprised by that.

The reason I bring that up is 2001, without a recession built in there, is probably the farthest we are going to get. In other words, the worst-case scenario may be if we get a recession, and that is probably the way it is going to be.

Secretary RUBIN. I don't want to swear to this, but my recollection of the numbers is to get to the worst case, you have to have some pretty severe recessionary conditions. That is my recollection, but you look at the assumptions and see what it really is.

Mr. ENSIGN. I am just saying, if a recession hits that things are even worse.

Secretary RUBIN. It will move you.

Mr. ENSIGN. I agree with you, and I appreciate the fact that you have both come here today to say that we absolutely need to address this problem now.

Secretary Shalala, I just wanted to mention one thing to you.

Secretary SHALALA. Congressman Ensign, in the worst-case scenario, I am told that there are two back-to-back recessions that would have to occur for us to get to the year 2000.

Mr. ENSIGN. OK, good.

Actually, this has to do with acting short term on your part, but I think that it is actually going to be one of the answers, long term, to our senior health care problems. It has to do with the things that you are granting right now, and that is the waivers from the SHMO–2s, the social HMO–2s.

I have been in contact with Dr. Vladeck. In my area, we have one of the demonstration projects that he would have the waiver granted by July 1. I would encourage that that be done.

From what I understand from the company, it is not happening by that July 1 promise date, and I would just encourage you to check on that because I think that the social HMO–2s are really one of the long-term answers to senior health care because most of the problem is spent at the end of a person's life, most of the time when that person wouldn't want that money to be spent, and the social HMOs are the only plan that address this. None of the other plans address this. That is the fundamental problem to our financing of Medicare and Medicaid. Whereas, innovative programs, like the social HMO–2s are the only things that are really taking a look at that.

Having said that, in our working together, trying to work together here and sit down at the table and work out our differences, besides medical savings accounts, which we know that you have a severe problem with, and medical malpractice reforms—I know the administration has severe problems with malpractice reforms, correct?

Besides those two things which are pretty obvious, what other things in our proposal—forget the numbers, but what other policy changes in our proposal does the administration have severe problems with?

Secretary SHALALA. Choice.

Mr. ENSIGN. OK.

Secretary SHALALA. Those that drafted your proposal, probably have assured you that a Medicare recipient coming out of a fee-for-service and a Medigap plan would be able to go into an HMO. But what if they didn't like the HMO and after 1 year wanted to go back into the program they were in before? Under your plan, they can't do that. There is not real choice.

Mr. ENSIGN. I beg to differ. They can. After 1 year, they can go back.

Secretary SHALALA. But they can't go back at the same price if they are ill at all because the Medigap plan problem has not been fixed in your plan.

Let me explain that to you. Medigap is only available in a window for 6 months when you first enter the Medicare Program——

Mr. ENSIGN. I am almost out of time. Let me ask you this as you are finishing. Wouldn't that cause risk, basically the aversion to healthy people when you are in, when it benefits you, and then if you have got to be able to switch back at the end of that year——

Secretary SHALALA. Real choice means that you can go back and forth between plans. We have fixed that in our plan. You have not fixed it in your plan—for the millions of people who have no experience in HMOs.

Second, the issue of balanced billing, that you lay out some plans in which people can pay on top.

Third, the issue of what the premium is going to be, we see Medicare recipients as they get older getting poorer and having more medical needs. We would want to be extremely careful what kind of burdens we shift onto them, whether it is a new doctor or a hospital being able to charge them more on top of their plan or them getting into an HMO and wanting to get back into their fee-for-service or an increase. Those are the kinds of concerns that we have about the plans, all of which we are happy to talk to you about, but the concerns are pretty fundamental.

These are different, though, than the kind of savings discussions we can have because conceptually I think there are areas where we could reach agreement.

We don't have to do those other kinds of things to take care of the trust fund, but only to resolve the short-term trust fund issue.

Mr. ENSIGN. My time has expired, and thank you, Mr. Chairman.

I would just like to end with, I think both sides have to be willing to not be uncompromising when we sit at the table.

Thank you.

Mr. NUSSLE [presiding]. The gentleman from Michigan.

Mr. LEVIN. Thank you, Mr. Chairman.

There has been discussion, which you have helped to clarify, about the nature of this problem. There is a problem. You acknowledge it as trustees.

As has been pointed out, this isn't the first time that there has been a problem with the trust fund or with Medicare expenditures. Indeed, I was looking over a list, and some of these years have already been referred to, of when this Congress acted 1980, 1981, 1982, 1983, 1985, 1987, 1989, 1990, 1991, and 1993.

So, in the last 15 years, in the majority of years this Congress has had to act, until now or at least until 1993, we did show in a bipartisan basis, and hopefully, we may now do that.

I think what may convince the majority to come to the table is this. They have used the report to highlight a problem, but I don't think by whipping up the problem they are going to persuade a public that doesn't like their medicine.

When there is an ailment, the worse you make it, you are in a predicament if the medicine won't work or if it is rejected. So, hopefully, people will now be willing to come to the table in a bipartisan basis.

There has been a discussion here about the taxes that we imposed a few years ago. It is interesting in the Republican plan that none of those taxes relating to Medicare are touched. You accept them.

So I think you ought to stop talking about the taxes that were included as one portion, but not the major portion, of our action of a few years ago.

I would just like to ask the two of you, point blank, you said you want everything on the table. Is the administration ready to come to the table without conditions to discuss with Congress an approach to the present problems facing Medicare as well as the long-term problem?

I think, maybe, I will ask you to give a yes or no on that. Are you willing to come to the table?

Secretary SHALALA. We certainly are willing to come to the table. Our only condition is the condition the President started with, and that is at the end of the day, quality health care has to be available for the elderly and for those disabled citizens that are served by the Medicare Program. Going to the table, that is the single assumption that we go in with.

Mr. LEVIN. Thank you.

Thank you, Mr. Chairman.

Mr. NUSSLE. The gentleman from Texas will inquire.

Mr. LAUGHLIN. Thank you, Mr. Chairman, Madam Secretary and Mr. Secretary.

I want to shift a little bit from that very important group of American citizens we have been talking about from the start of this hearing until this point, and that is the senior citizen because you can well tell I am closer to that group than I am the group I want to talk about, and that is the young worker who is fresh out of college or fresh out of high school that is going to enter the work force.

I want to make an observation to you before I ask my question. I represent the most ethnically diverse district in my State, and perhaps the Nation, and certainly one of the most diverse economic districts in my State. So I would say it would rival the Nation.

Over the past year when I have appeared, and I do it frequently, before high school groups, the question about Medicare has come up, and always the topic of taxes with that.

After giving perhaps a partisan viewpoint—last year, as you know, I was a member of both parties. I feel I can somewhat present both parties' perspective. I have asked this ethnically and economically diverse group I represent how many are in favor of having their taxes increased to preserve Medicare for their grandparents who they love dearly and eventually their parents whom they love on some days. Having been a parent, I can vouch for that part.

You know, to this day, not one hand has gone up, and it concerns me because you look at the demographics of the workers per retiree, and I recall seeing in USA Today some months ago—and I want to say the number of workers. Secretary Rubin, since you come from Wall Street, you may know better than I, but my memory is that there will be about 300 workers per retiree around the turn of this century.

We know from the Congressional Research Service that in 1965 when this Medicare benefit was given to us by Congress and the President, there were 4.4 workers per retiree. Today there is 3.9, and we are told in the trustees' report that by the year 2030, there is going to be 2.2 workers per retiree.

How are we going to address this problem from the viewpoint, not of the seniors whom we have worried about all this hearing, but for those who are going to pay? In a few years, I will be in that crowd of seniors. I hope the good Lord lets me do that.

How are we going to address the concern of this crowd that is going to be in the work force, that at least in my region of the country have said they don't want to pay any more taxes toward this system? We are shifting money from part A to part B, and we can make all the arguments we want. That is camouflaging or shifting the problem from one area to another for a period of time.

How do we tell the young people, you really don't have to worry about this system?

Secretary RUBIN. Mr. Laughlin, if I may say so, I think you are raising a broader and exceedingly important problem which is the whole problem of the country's fiscal position, and frankly, to be personal for one moment, that is a fair measure of why I came into government because I agree with you. I think that it is absolutely critical with respect to the future of this country, and I believe that the President in 1993 was historic in terms of the significance of turning around the fiscal direction of this country. We quadrupled the debt from 1980 to 1992, and now the deficit has fallen by more than half.

As you correctly say, part of the solution going forward has to be a long-term solution to the Medicare problem, and as we have now said many times in this proceeding, that is something we all need to get together and try to accomplish. We believe this commission could be helpful in that respect. Neither our plan nor the congressional majority's plan addresses that issue.

In the interim, because of the authorization and peculiarities with respect to hospital care for the elderly, we have to deal with this part A trust fund, and the proposal that we put forward is a way of dealing with the part A trust fund without adversely affecting effective health care for the elderly, but I think that you couldn't be more right. We then need to turn to the long-term problem, and we are committed to doing so.

Mr. LAUGHLIN. I want to ask a short question, and if you don't want to answer it yes or no, you can give a longer answer.

President Clinton submitted his bill, and since his bill has been submitted and his plan has been submitted, we have gotten your report that indicates there has been a deterioration in the trust fund.

This plan, in fairness, by the President was submitted before these latest findings. Do you agree that the President's plan needs to be revised in view of the latest report and finding that we have in the trustees' report?

Secretary SHALALA. I do not. In fact, the trustees reported the same findings in 1993 and 1994 and 1995. Our conclusion was the same, even with a couple of more years, and the President's plan directly responds to our knowledge about the trust fund.

Secretary RUBIN. Plus, I might observe, if I may, Mr. Laughlin, the actuaries delivered a letter to Secretary Shalala. I think it was yesterday, didn't they? It was saying that the President's plan in the context of the findings in this report would extend the exhaustion date to 2006. So it is a very current evaluation by the career actuaries.

Secretary SHALALA. Yes.

Mr. LAUGHLIN. Is that a part of this trustees' report, that letter?

Secretary SHALALA. It was handed out as part of the trustees' report. We would be happy to provide it to the Committee for the record.

[The following was subsequently received:]

DEPARTMENT OF HEALTH & HUMAN SERVICES

Health Care Financing Administration

Memorandum

Date June 4, 1996

From Chief Actuary, HCFA

Subject Estimated Year of Exhaustion for HI Trust Fund under Administration's Balanced Budget Proposal

To Administrator, HCFA

This memorandum responds to your request for the estimated year of exhaustion for the Hospital Insurance trust fund under the Medicare provisions in the Administration's balanced budget proposal. Based on the intermediate set of assumptions in the 1996 Trustees Report, we estimate that the assets of the HI trust fund would be depleted in mid-calendar year 2006 under the Administration's proposal

In the absence of corrective legislation, trust fund depletion would occur early in calendar year 2001 under the intermediate assumptions Thus, the Administration's proposal would postpone the year of exhaustion by roughly 5½ years

The financial operations of the HI trust fund will depend heavily on future economic and demographic trends For this reason, the estimated year of depletion under the Administration's balanced budget proposal is very sensitive to the underlying assumptions In particular, under adverse conditions such as those assumed by the Trustees in their "high cost" assumptions, asset depletion could occur significantly earlier than the intermediate estimate. Conversely, favorable trends would delay the year of exhaustion. The intermediate assumptions represent a reasonable basis for planning

The estimated year of exhaustion is only one of a number of measures and tests used to evaluate the financial status of the HI trust fund. If you would like additional information on the estimated impact of the Administration's Medicare proposals, we would be happy to provide it.

Richard S. Foster

Richard S Foster, F S A.

Mr. LAUGHLIN. Thank you very much.

Mr. THOMAS [presiding]. I thank the gentleman.

Does the gentleman from Iowa wish to inquire?

Mr. NUSSLE. Thank you, Mr. Chairman.

First of all, I have enjoyed your testimony. We are in a difficult situation. The interesting thing about this, it is not much different than a town meeting that you have back in Iowa. Everyone wants to talk about the problem, but as Mr. Laughlin was just pointing out, the seniors don't want their benefits cut. They don't want premiums going up. They obviously don't want to change much, and the younger people don't want to pay much more. So we are stuck between a rock and a hard place, and it just so happens it is your turn to sit in the hot seat and deal with those answers.

In the spirit of bipartisanship, and hopefully to the table to discuss, I am just wondering what issues you think—and let us take for a moment that we can in some kind of short-term way, whether it is the President's plan or our plan or some variation of the two, get to 2006. Let us just assume that for a moment.

To get much beyond that, what issues do you see us needing to address at the table?

Secretary SHALALA. To get beyond 2006?

Mr. NUSSLE. Yes. In other words, the long-term approach to dealing with this problem. What are the issues that we need to discuss at the table?

Secretary SHALALA. Well, I don't think there is anything that we need to discuss at the short-term table other than what kind of an advisory Committee we need in the long run, and how to make the trust fund solvent in the short term. But certainly, as we look at the short-term savings we might get and agree upon, we need to look at the implications of those so they don't cut off long-term options.

If we want to do something on provider payments or on new ways of developing a payment scheme for skilled nursing homes, for instance, we don't want to cut off our options for the future. So we would have to have a very careful conversation, and that is the fundamental point I was making to an earlier question.

Mr. NUSSLE. What are our options for saving Medicare in the long term? I mean, what kind of options do we have?

Secretary SHALALA. I would not want to second guess a long thoughtful review by an advisory group.

Mr. NUSSLE. I understand that, but there are only a few things, as I see it, and if I am wrong, please tell me. You can increase the amount of money going into the trust fund. You can decrease the amount of money coming out of the trust fund.

Secretary RUBIN. I think it leads to one question, and I am not an expert on Medicare. Secretary Shalala is far better equipped to answer, but it seems to me at least one of the questions is, as the President tried to address and I think did address very effectively in his 1994 health care reform program, are there measures you can take so that the entire health care system would function more effectively that will in turn benefit the Medicare Program? I really think we missed an enormous opportunity in 1994 to address this problem in that context.

Mr. NUSSLE. In the paper today, one of the Democrats on the Committee here said that to fix the longer term problem, Mr. Stark said the Democrats probably would resort either to a government takeover of the hospital and health insurance payment system or raising payroll taxes. If those aren't the options, what are the options?

Secretary SHALALA. Congressman Nussle, I think that is too narrow.

Mr. NUSSLE. I would agree.

Secretary SHALALA. We have got to find ways.

Mr. NUSSLE. He seems to be speaking——

Secretary SHALALA. And we, for instance——

Mr. NUSSLE [continuing]. Through you.

Secretary SHALALA [continuing]. Added a huge new initiative on waste, fraud, and abuse which has bipartisan support and we hope will be moving through the Congress, but we have got to look at health care, at what we are trying to achieve and through what institutions we are trying to achieve it. We have to make a much more substantial investment in prevention that will help to save us money, so that we can spend money on those who are truly sick and prevention has to be an integral part.

We now have moved out immunization rates in this country up to 75 percent and have the lowest rates of childhood diseases in American history.

Mr. NUSSLE. I understand that.

Secretary SHALALA. All of that saves money, and that has to be folded into——

Mr. NUSSLE. Yes, but how much money does it save? I mean, we are talking, under anybody's projections, waste, fraud, and abuse, and I am not suggesting that should be lightly looked at. We all agree that that needs to be tackled, but when you are talking about percentages of the overall problem, when it comes right down to it—and I am not trying to put words in your mouth, but I am just saying when we look out into the crystal ball and we look at this long-term problem, when it comes right down to it, it is the amount of money going into the trust fund, i.e., I think more taxes, or it is the amount of money leaving the trust fund, less money leaving the trust fund, i.e., a reduction in the rate of growth, cuts, reduction in benefits, more copayments. That is what I am wondering.

Secretary SHALALA. Congressman Nussle, I think that the advisory Committee will give us all of the above in terms of the list.

Mr. NUSSLE. That is OK, but see, what I am saying——

Secretary RUBIN. Mr. Nussle, could I make a suggestion?

Mr. NUSSLE. No. Just wait 1 minute.

What I am saying is—and this is what troubles me, and I do it, too. Everybody on the Committee does it. The Congress does it. The President is doing it. Everybody is doing it.

We know who votes. We know what is going on. We know what is at stake. It is amazing that we are even having this discussion about Medicare because it is the third rail. I think there is at least some ability through some leadership to do something about it, but I think it is illusory to suggest that unless you are willing to go into some of these bigger ticket items that you are going to able to solve this with a little tinker here and a little tinker there.

Secretary SHALALA. Congressman Nussle, there is nothing in anything we have said——

Mr. THOMAS. The gentleman's time has expired.

Secretary SHALALA [continuing]. That will ever suggest to you that we think tinkering with the system, with the Medicare system, is what is required for the long term. You shouldn't hear that in our tone.

All we have done is come to report that this trust fund needs a short-term fix and a long-term process for taking a look at how we provide health care in this country to two of the most vulnerable groups.

Mr. THOMAS. The gentleman from Maryland, I know, wants to inquire.

Mr. CARDIN. Thank you, Mr. Chairman, and let me thank both of our Secretaries for their testimony here today and their willingness to respond to all the questions that have been put to them.

I want to return to what Chairman Archer stated in the beginning, and that is a challenge to the Democrats and Republicans to come together to deal, hopefully, in 1996 with Medicare.

I appreciate the willingness of the administration to come to the negotiating table without any preconditions to sit down and try to work out as comprehensive a solution to Medicare as we can in 1996. I think that is the right approach that we need to take. However, there are not that many days left in this session. We are running out of time, out of legislative days.

So let me, if I might, try to make some suggestions and see whether we couldn't advance the Medicare reform discussion and get your responses to it.

First, as far as the long-term solvency issues and the affordability issues of Medicare, it seems to me that you have been very clear that we need a bipartisan review and an objective review. Therefore, we need a commission.

Congressman English of this Committee has made such a recommendation. It was included in the Republican bill. It is not included in the trustees' report.

If we were to separate that issue and bring to the President a separate recommendation on a commission, if the Republican leadership in the House and Senate would present that to the President, is it my understanding that the administration would welcome such a commission and would move forward on the long-term issues of Medicare?

Secretary SHALALA. No. The answer is we would very much like to sit down with congressional leadership and work out a process.

We have suggested an advisory Committee to deal with the long-term issues of Medicare.

Mr. CARDIN. So we could work on that as one issue, try to keep it as one issue and try to get that done in 1996 and get that started.

Secretary SHALALA. I think the President would be deeply unhappy with us if we did not link it, though, to the short-term need and insist that we deal with the short-term issue as soon as possible.

Mr. CARDIN. I want to get to that next. I just want to put that aside. If we can just isolate one issue over which, perhaps, there is agreement between the Democrats and Republicans.

On the short-term solvency issues or affordability issues, today's situation is not unusual. That has been pointed out by many of my colleagues. We had a more severe problem in the early seventies which we dealt with by changing the Medicare system. We had the problem again in the eighties where the solvency date was similar to what we have today, and we made certain modifications. We also had a similar problem earlier in the nineties. So we have confronted this issue historically at different times and have dealt with it in the short term.

Your proposal is $116 billion that has been put forward in savings. There has been a lot of talk about the home health care. My understanding is that regardless of the transfer of the home health care services, your proposal will save $116 billion.

Secretary SHALALA. Correct.

Mr. CARDIN. That is scorable CBO savings. It is real.

Many of your suggestions that deal with slowing down reimbursements to providers, whether they be hospitals or physicians or other, in part A or B, and changing some of the philosophy in which we reimburse our providers is consistent with the recommendations that have been made by the Republicans in their legislation and in their discussions.

Am I correct that there is a lot of similarity in that $116 billion?

Secretary SHALALA. Yes. Well, at least there is similarity in areas if not in the specific proposals.

Mr. CARDIN. I guess my suggestion is why can't we just put together a package that contains those areas that we are in agreement and get that to the President and have the President sign that. At least that would extend the insolvency date of the part A trust fund by a few years and remove this 5-year concern that has been brought by the trustees' report. Would the President sign such a bill of areas where there is agreement between the Democrats and Republicans on this issue?

Secretary RUBIN. According to what the President has said, as recently as yesterday, finding a common ground is clearly a constructive thing to do. He believes we should do it preferably in the context of reaching a balanced budget, but we need to move forward.

Mr. CARDIN. I would just hope that if there is an area that is controversial for either the President or the Congress, we could put that aside. Let us go with what we have agreement on so that we can at least move the solvency of the trust fund, and I think you will find we can probably move that by 5, 6, 7 years in areas we have common agreement.

I know my time is over or shortly over. I just want to mention one other point from a Maryland perspective.

Last week, you announced, at least HCFA announced, that Maryland was selected for a pilot program on managed care reimbursement under Medicare. I would ask that you review that because that plan was developed without consultation with our health care community, including our seniors and our managed care operators, nor in consultation with our congressional delegation.

I am just going to ask that you develop a way in which we can sit down and talk about this pilot program before it moves forward.

Mr. THOMAS. The gentleman's time has expired.

I am mindful of the Secretary's timetable, but the gentleman from Massachusetts indicated he wishes to inquire and he has not had an opportunity.

Mr. NEAL. Thank you, Mr. Chairman. I do want to thank the two of you for being here this morning and point out that I think you did a very good job in terms of describing the parameters of the debate and the dilemma that we face.

The great thing about serving in the House is that eventually public opinion does play out, and the truth is that the new majority discovered that people like Medicare. Many of us have contended for a long time that it could be repaired without being axed.

When we hear comments from the Speaker of the House who suggested that we would allow Medicare to simply wither on the vine or the Senate Majority Leader who said at one point that he was proud of having voted against Medicare at its inception some years ago, the reaction from seniors across the country was predictable, and it was discovered by many Members of this body as they went back home to talk about what was happening.

Let me also point out one quick thing as well. President Clinton deserves a lot of credit for having had the courage at least to bring up the issue of health care reform, 3 years ago, and while the issue faded here, as many issues do on the radar screen in short time, in short order, the truth is that in some measure we are back to those measures again in this very debate.

Secretary Rubin pointed out that we were prepared last year to speak to some alterations in the Medicare Program to get us through this difficulty and this challenge that we face. But we should not lose sight of the fact that not only has Medicare added life to years, and years to life, but the average male, I believe, at the turn of the century lived to be about 48½ years old. Today that individual lives well into his late sixties and early seventies. In some measure, that is a reflection of the success of the Medicare Program.

My specific question to you, and I will only hold you to one question, is it your sense that in the right form, the majority here now, the current majority, and the minority and the White House could get together and resolve these issues.

The questioning of you two was very restrained today compared to what I had anticipated, and the reason it is restrained is because some have discovered that people back home were very upset about 270 billion dollars' worth of cuts in Medicare and simultaneously having 240 billion dollars' worth of cuts in taxes for people who, incidentally, weren't asking for those tax cuts.

Is it your judgment that we ought to be able to get together, and I count myself in the middle of the Democratic Party, and resolve these issues in an amicable forum with some of the recommendations that the administration has previously made which, by the way, have now turned out to be sound?

Secretary SHALALA. Congressman, it is not only our judgment. We believe that we must get together and solve the short-term

issue and then put a process together to deal with the long-term questions about the Medicare system.

Mr. NEAL. Mr. Secretary, do you care to add to that?

Secretary RUBIN. No. I think Secretary Shalala said it very well and succinctly.

Mr. NEAL. Thank you, both.

Secretary SHALALA. Thank you.

Mr. THOMAS. I want to thank both of you.

It is somewhat disturbing as we are talking about trying to work together that both the Secretary—and the gentleman from Massachusetts just repeated the number, 270. The reason he repeated it is because at one time it was a number, but that number became 160, and the number is now in the 150s. That is called movement. That is called change. You might even call it progress.

What we heard today was a repeat that you didn't need to make a change on your side. That makes it very difficult.

You have talked about short term and long term. Madam Secretary, I would indicate to you that I think an excellent gesture on your part would be to talk about the fact that currently inside HCFA you are working on regulations to open up without statutory changes the managed care program to try to find some savings in that area. Those are policy changes rather than programmatic or long-range changes, but if we could perhaps sit down and begin to talk about the way in which we are planning on making changes statutorily and that we are talking about making changes inside the structure at the same time, I think it would send a clear signal that perhaps rhetoric is turned down and the willingness to work together, notwithstanding your willingness to continue to utilize the general fund as a primary funder of this program and the majority's unwillingness to allow you to do that.

To the extent we can work on current changes, as well as the legislative short term and long term, that I think would send a very positive message.

Any reaction at all?

Secretary SHALALA. Yes. Congressman Thomas, as you can imagine, I do have a reaction. I think that you have misrepresented what we have said, very clearly.

We have said that this program must change; that there must be a short-term and a long-term strategy for that, and we have said that repeatedly since 1993. The President has consistently laid out proposals to do exactly that.

Mr. THOMAS. I know you are uncomfortable and want to characterize it as mispresentation when I indicate to you that the 1993 change was more than $50 billion of a transfer to taxpayers' money from the general fund to the HI Trust Fund. I know you are uncomfortable when I indicate that the $55 billion home health care shift from the trust fund over to payment by taxpayers out of the general fund is a misrepresentation. The fact of the matter is it is not. It is the utilization of the general fund to mask, if you will, the problems that we need to change in the HI Trust Fund.

Until and unless we understand what each other are doing and represent the aspect honestly in front of the American people, it is going to be very, very difficult to sit down and work out remedies.

The $270 billion, quoted today, is a misrepresentation of the Republican's position.

The failure of the Secretary of the Treasury to understand that the original 1996 fiscal year budget had no Medicare savings in it was obviously a failure to remember a program that he apparently worked on.

Unless and until we can meet on some kind of a working arrangement in which we set aside the political rhetoric and that we lay out an attempt honestly to change the way in which we have both been relating over this last year, you are going to see a 1997 report in which it is not a $400 billion deficit in 2006, but it will be $1 trillion, and that will be a disaster on both our sides, and I want to thank you.

Secretary SHALALA. If we see that report, Mr. Thomas, it will not be because this administration did not step forward and lay out the issues and be prepared to see changes made and be prepared to go to the table. That is the invitation that we have issued. That is what we are prepared to do.

Mr. THOMAS. And you need to understand that as long as you try to get the fix out of the general fund, we will have difficulty coming together. Understand that and we will be able to move forward.

Thank you very much.

This Committee is adjourned.

Chairman ARCHER. Mr. Secretary and Madam Secretary, the Committee has adjourned, but I want to personally apologize to you for not being here for the entire hearing. I was called over to the floor because we have a bill on the floor that we had to be involved in. So I just wanted to let you know that I was not turning my back on you and walking out on you. I had no choice. Thank you for coming.

Secretary SHALALA. We missed you, Mr. Chairman.

Chairman ARCHER. Thank you. Thank you for coming to be with us today.

[Whereupon, at 12:17 p.m., the hearing was adjourned.]

REPLACING THE FEDERAL INCOME TAX

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

VOLUME IV

Impact on International Competitiveness of Replacing the Federal Income Tax

JULY 18, 1996

Impact of Replacing the Federal Income Tax on Manufacturing and Energy and Natural Resources

JULY 31, 1996

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IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX

THURSDAY, JULY 18, 1996

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

The Committee met, pursuant to notice, at 10:08 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
June 26, 1996
No. FC-18

CONTACT: (202) 225-1721

Archer Announces Hearing on the Impact on International Competitiveness 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 impact of the proposed replacement tax systems on the international competitiveness of American workers and businesses. **The hearing will take place on Thursday, July 18, 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; 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 the international competitiveness of American workers and businesses, particularly the effects on imports and exports.

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 Monday, July 8, 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 Tuesday, July 16, 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, Thursday, August 1, 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 on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS_MEANS/' or over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

*****

Chairman ARCHER. The Committee will come to order.

Today, our hearing is going to focus on the impact of fundamental tax reform on international competitiveness, a subject I believe is critical to the future of this country in the next century.

Over the last decade, the world has developed and is continuing to develop into a truly global economy. At no time during our Nation's history has our economy been more dependent on the economies of other countries.

While our trade policies have been constantly changing to accommodate this globalization of the world's economies, our tax policies, in my judgment, have not.

The two most recent tax initiatives in 1986 and 1993 created obstacles to international trade and development rather than a facilitation of U.S. competitiveness. To this day, I have not been able to find any valid reason for enacting the 1986 and 1993 international tax provisions. This is one of the reasons I felt that adjustments to the 1986 and 1993 tax provision should be undertaken at the earliest possible date.

I view today's hearing as the first steps toward developing a tax system that will not only serve this country's revenue needs, but one that will also stimulate and encourage the all-important international trade and development.

As the world's economies continue to become more interrelated, the need for a tax system that is compatible with our country's international trade objectives becomes crucial.

In addition to being compatible with our international trade objectives, our new and revised tax system will, of course, have to take into account the increasing amount of electronic commerce that is being conducted on the Internet and other forums. Unless these electronic commercial transactions are addressed, our future tax system could face serious problems.

I am, of course, fully aware of the vital role income, estate, and gift tax treaties play in today's world. Unfortunately, the Founding Fathers decided to give another Committee jurisdiction over tax treaties. Despite this unfortunate oversight, I would welcome any comments our witnesses may have on how our international tax treaty network could be improved to better reflect the changing world in which we now live.

I now recognize Mr. Gibbons for any comments he would like to make.

Mr. GIBBONS. Mr. Chairman, I commend you for holding these hearings. They are very important.

I have come to the conclusion that America's future welfare depends upon how well we train our brains and how well we organize our economy. I look at a part of our economy and notice the tremendous drag our revenue system imposes upon our economy, and I hope these hearings will help us find a way to improve that economy and efficiency.

Thank you.

Chairman ARCHER. Thank you, Mr. Gibbons.

[The opening statement of Mr. Ramstad follows:]

STATEMENT OF REP. JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON REPLACING THE FEDERAL INCOME TAX
July 18, 1996

Thank you, Mr. Chairman, for convening this critical hearing on the international implications of reforming our tax system.

The hearings we have held last year and this year under your leadership have reinforced the need for a tax system which is simple and fair for all Americans.

In the context of a global economy, the defects in our current system have put American companies at a competitive disadvantage with their foreign competitors who don't have the same burdens with their tax codes. We have heard the horror stories about the complexity of computing the foreign tax credit and the huge compliance costs of computing the tax on foreign source income.

It is absolutely critical to consider the impact of tax reforms on U.S. trade, keeping in mind that exports make up about 11 percent of America's gross domestic product. We must consider how other countries will react to U.S. tax reform, and how our efforts might affect the 50 bilateral tax treaties currently in effect with our trading partners.

I am looking forward to the testimony of our distinguished panelists, who will help us understand these challenges.

Thank you, Mr. Chairman.

Chairman ARCHER. We have outstanding witnesses to give us their views before the Committee today, and we will start off with Carol Dunahoo, international tax partner of Price Waterhouse.

Let me say for the benefit of all the witnesses that the Committee operates on the basis of requesting your oral testimony be limited to 5 minutes and that any more lengthy written statement will be inserted in full in the record. We would appreciate your effort to cooperate on the 5-minute time presentation.

Ms. Dunahoo.

STATEMENT OF CAROL A. DUNAHOO, INTERNATIONAL TAX PARTNER, PRICE WATERHOUSE LLP; ON BEHALF OF INTERNATIONAL TAX POLICY FORUM

Ms. DUNAHOO. Good morning. I am a partner with Price Waterhouse's Washington National Tax Service. However, I am testifying this morning on behalf of the International Tax Policy Forum, which is a diverse group of 26 U.S.-based multinationals, including manufacturing, service, energy, and financial service companies.

The International Tax Policy Forum sponsors research and education on the U.S. taxation of income from cross-border investments. A list of the member companies is appended to my written statement.

We welcome the opportunity to testify today on the potential tax policy and competitiveness issues under the various tax reform proposals before the Committee.

As Chairman Archer has noted, the markets for our companies have become increasingly global. Yet, our tax rules continue to differ in significant respects from those of other major industrialized countries, such as France, Germany, and Japan. These differences can place U.S. companies at a serious disadvantage when competing with their foreign-based counterparts.

In addition, as the Chairman has noted, the existing U.S. rules for taxing in foreign-source income have been developed in a patchwork fashion dating back, for the most part, to the sixties. The resulting rules are among the most complicated in the world, and the cost of complying with those rules is a hidden tax on U.S.-based multinational companies. This is why the Forum believes it is so important to review the international tax provisions of U.S. law in connection with fundamental tax reform.

This Committee is now considering several fundamental tax reform proposals, including the unlimited savings allowance, or American tax proposal, sponsored by Senators Nunn and Domenici, a flat tax sponsored by House Majority Leader Armey, and the national retail sales tax, sponsored by Representatives Schaefer and Tauzin.

In addition, several other important fundamental tax reform proposals have been articulated during the past few years, including the subtraction method VAT, a value-added tax proposal, of Congressman Gibbons, which shares many of the features of the American business tax.

All of these proposals would eliminate the Federal income tax and replace it with a new consumption-based tax system. Each of the three recently introduced proposals would tax only U.S. oper-

ations. They would repeal most of the U.S. withholding taxes on income paid to foreign investors. U.S. businesses operating abroad would not be taxed on their foreign-source income, nor would dividends paid by the foreign subsidiaries back to the U.S. companies be subject to tax.

Because foreign operations would be excluded from the U.S. tax base, our complex foreign tax credit rules and numerous regimes taxing the unrepatriated income of U.S.-controlled foreign corporations would be eliminated.

In attempting to simplify the current system dramatically and to enhance competitiveness, all of these proposals represent serious efforts to address some of the gravest shortcomings of the present tax system. However, each raises new international tax issues that have not yet been fully explored.

One of the most significant questions is how foreign governments would react to a decision by the United States to repeal its income tax system and replace it with a consumption-based tax system. On the one hand, some countries might respond negatively by terminating treaties with the United States in the belief that internal U.S. law would confer adequate tax relief unilaterally. This, of course, could seriously disadvantage U.S. firms, which would become subject to higher foreign tax rates in the absence of treaties.

Foreign governments might also feel compelled to enact stricter pricing rules and other antiabuse measures, simply to protect their tax base. Indeed, the United States could become a preferred tax jurisdiction from the perspective of other countries if its income tax were eliminated and replaced with a system that exempts portfolio income.

For this reason, it is possible that foreign governments might even consider nontax measures, including capital controls, to stem the potential flow of capital into the United States.

Alternatively, foreign governments might try to capture revenue foregone by the United States, so that both U.S. multinationals and foreign investors in the United States simply would end up paying more income taxes to other countries.

On the other hand, it is quite possible other countries may simply opt to leave their tax treaties with the United States in place and perhaps even lower their own taxes to attract continued U.S. investment.

The reaction to the enactment by the United States of fundamental tax reform could vary from country to country and is difficult to predict with any certainty.

Another issue in evaluating the leading tax restructuring proposals is the treatment of exports and imports. The national retail sales tax proposal and the USA tax both are "destination-based" taxes, meaning that imports are taxed and exports are exempt. Destination-based taxes are imposed on the consumption of goods and services within the United States.

By contrast, the flat tax is an "origin-based" tax, which taxes exports but not imports, and the tax base of an origin-based tax is domestic consumption plus net exports.

Destination-based taxes offer several advantages over origin-based taxes, in particular greater administerability in the area of transfer pricing. In fact, multinationals would have an incentive to

shift profits into the United States under a destination-based consumption tax, which, of course, would be helpful to U.S. tax administrators, but equally disconcerting to their foreign counterparts.

Another potential issue is whether a move to a consumption-based tax system with border tax adjustments would pass muster under international trade rules. The answer to this question is not yet clear. It has been raised with respect to at least one proposal, the USA tax.

International trade rules, of course, generally permit border adjustments for indirect taxes, but bar such adjustments for direct taxes. The issue is that although the USA business tax is similar to a VAT, it is drafted as a direct tax and could, therefore, be challenged. It also provides a credit for payroll taxes, which is atypical of foreign VAT systems and might be viewed as violating GATT requirements. However, the answer to this question is not clear.

Finally, each of the major tax reform proposals could have a major impact on USA research and development, technology, and exports. I will leave this issue to other members of the panel to comment on.

If no immediate consensus can be reached on a more ambitious reform, changes to our current international tax regime should be seriously considered. At a minimum, any reform in this area should address the foreign tax credit rules, the antideferral rules, and the alternative minimum tax as applied to the foreign tax credit, and it should be undertaken in a comprehensive fashion.

The International Tax Policy Forum recommends that any changes to the current system be carefully considered for their potential international consequences before adoption. While each of the leading restructuring proposals offer some advantages over the current system, each also involves an element of risk.

The International Tax Policy Forum looks forward to working with the Committee as it explores these issues and applauds the Committee's leadership on these difficult matters.

Thank you.

[The prepared statement follows:]

STATEMENT OF CAROL A. DUNAHOO
INTERNATIONAL TAX PARTNER
PRICE WATERHOUSE LLP
ON BEHALF OF INTERNATIONAL TAX POLICY FORUM

I. Introduction

I am Carol A. Dunahoo, a partner with Price Waterhouse's Washington National Tax Service, and I am testifying today on behalf of the International Tax Policy Forum. Founded in 1992, the International Tax Policy Forum is a diverse group of U.S.-based multinationals, including manufacturing, service, energy, and financial service companies. The Forum sponsors research and education regarding the U.S. taxation of income from cross-border investments. John M. Samuels, Vice President and Senior Counsel for Tax Policy and Planning of General Electric, is chairman of the Forum. Price Waterhouse's Washington National Tax Service acts as consultant to the Forum. A list of member companies is attached as Appendix A of this testimony.

The Forum welcomes the opportunity to testify today on the potential tax policy and competitiveness issues that arise under the various fundamental tax restructuring proposals being considered by the Committee. The companies that make up the ITPF are committed to developing a system for taxing U.S. companies that promotes the international competitiveness of the United States. Increasingly, the markets for our companies have become global, and our competitors are foreign-based companies operating under tax rules that are much more favorable than our own.

The existing tax law, as the Committee well knows, has been developed in a patchwork fashion over many years. In many instances, current law creates barriers that harm the competitiveness of U.S. companies. These rules also are horribly complex for U.S. companies and the Internal Revenue Service. That is why the Forum believes it is so important to the Committee to review the foreign tax rules in the context of fundamental tax reform.

II. International trade and investment in the U.S. economy

The ability of U.S. businesses and workers to compete in an increasingly integrated world economy has become an issue of vital importance in recent years. The value of international trade (imports plus exports) as a percentage of GDP has more than doubled -- from 7 percent in the 1960s to 17 percent during the first half of the 1990s. The share of U.S. corporate earnings attributable to foreign operations similarly has jumped -- from 6 percent to 16 percent over the same period. Despite the net debtor status of the United States, *direct* investment by U.S. companies abroad continues to exceed foreign direct investment in the United States -- by $180 billion in 1994.

In 1995, U.S. exports of goods and services totaled $805 billion, or 11.1 percent of the nation's gross domestic product.[1] U.S. multinationals play a critical role in encouraging exports. In 1993, 58 percent of the $465 billion of U.S. merchandise exports were associated with U.S. multinational corporations: they shipped $110 billion of exports to their foreign affiliates and another $139 billion directly to unaffiliated foreign buyers.[2]

III. Important differences between U.S. and foreign taxation of income from international operations

U.S. international tax rules differ in a number of respects from those of other major industrialized countries such as France, Germany, and Japan. These differences can place U.S. multinational

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[1] U.S. Department of Commerce, "Survey of Current Business," April 1996.

[2] U.S. Department of Commerce, "U.S. Multinational Companies: Operations in 1993," June 1995, p. 39.

corporations at a serious disadvantage when competing with their foreign-based counterparts. The following are some of the more important differences:[3]

- The United States taxes the worldwide income of U.S. businesses and U.S. citizens. Many other countries exempt foreign source business income either by statute (*e.g.*, France) or by treaty (*e.g.*, Germany).

- The U.S. foreign tax credit system requires complex calculations of separate limitations for different categories of income. The systems of other countries are frequently simpler or offer benefits to their multinational corporations that the U.S. system denies to U.S. companies seeking to compete globally.

- Most countries' anti-deferral regimes do not tax active business income but instead are limited to passive types of income. In contrast, the United States imposes current U.S. tax on several types of active business income as well as on passive income, to the detriment of its companies seeking to compete with their foreign counterparts.

- Unlike other major industrial countries, the United States treats a loan from a foreign subsidiary to its domestic parent as a deemed dividend, potentially triggering current U.S. tax on foreign income. Current U.S. law also deviates from that of other countries by treating as deemed dividends certain transactions entered into in the ordinary course of business by financial intermediaries and other companies.

- The United States has more detailed and complex rules for allocating and apportioning expenses between domestic and foreign source income than does any other major industrialized country. These rules often conflict with provisions adopted by other countries, giving rise to the risk of double taxation.

- Unlike other countries, the United States imposes an alternative minimum tax that can result in U.S. tax being imposed on foreign income that has borne foreign income tax in excess of the U.S. rate.

The U.S. rules for taxing foreign source income are among the most complicated in the world. The cost of complying with these rules represents a hidden tax on U.S.-based multinational companies. Recent research has confirmed that the international provisions of the U.S. tax code impose disproportionately high compliance burdens -- both relative to U.S. tax rules for domestic income and relative to foreign countries' taxation of international income.[4] For example, one survey of firms in the IRS's large-case audit program found that compliance costs amounted to $1.5 million for a typical large-case business. The survey found that nearly 40 percent of total federal tax compliance costs was attributable to foreign source income. This is disproportionately large compared to the average fraction of assets (21.1 percent), sales (24.1 percent), and employment (17.7 percent) abroad.[5]

Our foreign-based competitors enjoyed a much different situation, according to a survey conducted for the European Community's Ruding Committee.[6] That survey of 965 European firms found no evidence that compliance costs were higher for foreign source income than for

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[3] From Financial Executives Research Foundation, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, 1996, Ch. 9.

[4] See Marsha Blumenthal and Joel B. Slemrod, "The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications," in *National Tax Policy in an International Economy: Summary of Conference Papers*, (International Tax Policy Forum: Washington, D.C., 1994).

[5] *Id.*

[6] *Id.*

domestic source income. Thus, while U.S.-based firms are subject to disproportionately high compliance costs when they attempt to compete abroad, European-based competitors are free from similar obstacles.

The cumulative effect of the U.S. tax code's more restrictive provisions and higher compliance costs is to subject U.S. multinationals to higher effective tax burdens on their cross-border investments than their foreign competitors must bear on similar investments and operations. A number of recent studies have quantified the importance of these factors.[7]

IV. Fundamental tax reform: Key international issues

Among the recently introduced proposals before the Committee are several fundamental tax reform proposals -- the Unlimited Savings Allowance (USA) Tax, sponsored by Sens. Sam Nunn (D-GA) and Pete V. Domenici (R-NM); the Flat Tax, sponsored by House Majority Leader Dick Armey (R-TX); and the National Retail Sales Tax, sponsored by Reps. Dan Schaefer (R-CO) and Billy Tauzin (R-LA). In addition, several other important fundamental tax reform proposals have been articulated in recent years, including the subtraction-method value-added tax (VAT) proposal of Ways and Means Committee ranking Democrat Sam Gibbons (D-FL).[8]

All of these proposals would eliminate the federal income tax and replace it with a new consumption-based tax system. Each of the three recently introduced proposals would tax only U.S. operations. These bills would repeal most U.S. withholding taxes on income paid to foreign investors. U.S. businesses operating abroad would not be taxed on their foreign source income, nor would dividends paid by foreign subsidiaries back to their U.S. parents be subject to U.S. tax. Because these systems generally exclude foreign operations from the U.S. tax base, they would eliminate the foreign tax credit rules and the complex series of rules taxing certain unrepatriated income of U.S.-controlled foreign corporations.

By attempting to dramatically simplify the current system and to enhance competitiveness, all of these proposals represent serious efforts to address some of the gravest shortcomings of the present tax system. The degree of interest and time devoted to these proposals shows an awareness of some of the current system's most serious defects, which exact a heavy toll on the ability of U.S. firms to compete abroad.

Each of the major fundamental reform proposals also raises certain new issues in the international context that have not yet been fully explored. Important international issues to be examined include:

A. Reactions of other countries

It is not clear how foreign governments would react to a decision by the United States to repeal its income tax system and replace it with a consumption-based tax system. They might respond negatively -- by adopting new anti-abuse rules or terminating existing tax treaties with the United States -- or simply opt to leave their treaties with the United States in place, and perhaps even lower their own taxes, to attract continued U.S. investment.

One of the features that may concern our trading partners about the pending consumption tax proposals is their proposed elimination of taxes on virtually all savings and investment -- including income from the portfolio investments of foreign residents. As some commentators

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[7] See Financial Executives Research Foundation, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, 1996, Ch. 10.

[8] For purposes of our discussion, Rep. Gibbons' subtraction-method VAT shares many of the same features as the USA Business Tax.

have observed, all of the proposals would exacerbate the difficulty many countries already have in taxing the foreign source portfolio income of their residents.[9] This problem would be made worse if the United States decided unilaterally to forego withholding tax on portfolio interest and dividends, royalties, and other types of portfolio income. Indeed, eliminating the income tax system and replacing it with a system that exempts portfolio income could well turn the United States into a tax haven of sorts from the perspective of other countries.

In addition, while the pending proposals could actually alleviate U.S. concerns regarding transfer pricing practices and earnings stripping, they likely would exacerbate foreign concerns about these same issues. This is because none of the leading replacement tax proposals would tax income, so both U.S. and foreign multinationals would have a strong incentive to shift otherwise taxable profits into the United States.[10]

In response to these concerns, foreign governments might either pursue an approach similar to that of the United States -- that is, lower their taxes on savings and investment as well -- or attempt to capture the revenue foregone by the United States.[11] This latter option could involve taxing their resident multinationals on worldwide profits, including U.S. source profits.[12] In addition, foreign governments could impose new anti-abuse rules; for example, they might enact earnings-stripping rules limiting the deduction of interest paid to U.S. affiliates. Foreign governments also might deny a foreign tax credit for U.S. taxes under a new consumption tax system.

If foreign governments were to adopt such tax measures, foreign investors in the United States could end up paying more income taxes to their home country in lieu of paying income tax in the United States. Foreign governments also might consider non-tax measures, including capital controls, to stem the potential flow of capital into the United States.

B. Risks to the U.S. tax treaty network

If the United States were to replace its current income tax system with one of the leading consumption-based tax reform proposals, it is not clear how the U.S. tax treaty network would be affected. The United States now has bilateral income tax treaties with nearly 50 countries. The treaties provide numerous benefits to investors, including reduced withholding tax rates on income flows between the United States and the treaty partner.

Under the USA Tax, the Flat Tax, and the National Retail Sales Tax, U.S. withholding taxes on income of foreign corporate investors would be repealed. Therefore, the reduced withholding tax rates under the treaties no longer would confer a special benefit to foreign treaty partners. As a result, U.S. tax treaty partners -- all of which have some form of income tax system -- may view themselves as providing benefits to U.S. investors, while their own investors receive few benefits from the United States under these income tax treaties. Accordingly, treaty partners may believe they have little to gain by continuing their existing tax treaty relationships with the United States or by reducing cross-border withholding tax rates in future treaty negotiations.

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[9] See Reuven S. Avi-Yonah, "The International Implications of Tax Reform," *Tax Notes*, November 13, 1995, at 913, 922.

[10] Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal* 48 No. 4, December 1995, at 619; and Reuven Avi-Yonah, "Comment on Grubert and Newlon," *National Tax Journal* 49 No.2, June 1996, at 259, 262.

[11] Avi-Yonah, *supra* note 10, at 262.

[12] *Id.*

On the other hand, it is possible many treaty partners may wish to maintain their treaties with the United States to preserve certain other benefits provided under the agreements. In addition to lowering withholding rates, tax treaties also include guidance on a number of important issues, such as rules for determining each country's jurisdiction to tax multinational business income, as well as on numerous industry-specific questions. In addition, treaty partners might decide to maintain a treaty relationship with the United States because imposing the higher statutory withholding rates on U.S. investors would make foreign jurisdictions less attractive as locations for U.S. investment.

C. *Trade issues: Transfer pricing and the "origin" and "destination" principles*

The leading tax restructuring proposals differ in their treatment of exports and imports. The National Retail Sales Tax proposal and the USA Tax both are "destination-based" taxes. Under the destination principle, imports are taxed and exports are exempt. Destination-based taxes are based on consumption of goods and services within the United States. By contrast, the Flat Tax is an "origin-based" tax. Under the origin principle, exports are taxed and imports are not. The tax base of origin-based taxes is domestic consumption plus net exports.

Some observers believe destination-based taxes, such as the National Retail Sales Tax and the USA Tax, promote exports and discourage imports. Despite the intuitive appeal of this idea, economists generally believe that destination-based taxes offer no long-term export incentives.[13] In any event, destination-based taxes do offer other advantages over origin-based taxes. Foremost among those advantages is greater administrability -- particularly in the area of transfer pricing.

Under a destination-based tax, transfer prices no longer would be relevant to determining U.S. tax liability because a company's tax base would be equal to its domestic sales less its domestic purchases. Because export sales -- and presumably also royalty receipts from abroad -- would be exempt, and imports -- including royalty payments to foreign parties -- would be non-deductible, the prices set for such transactions would not affect the U.S. tax base. Accordingly, there no longer would be any opportunity to use transfer prices to reduce U.S. taxes. Rather, multinationals actually would have an incentive to shift profits out of other countries that impose income taxes and into the United States.[14]

By contrast, under an origin-based tax, such as the Flat Tax, transfer pricing would continue to be a concern from a U.S. perspective, because export sales would continue to be taxable and imports would be deductible. The elimination of transfer pricing concerns under a destination-based consumption tax makes a strong case for using a destination basis should Congress choose to adopt a consumption-based tax system.

Destination-based taxes hold another potential advantage over origin-based taxes: Experience has shown destination-based taxes (such as the VAT) are more easily harmonized among nations than are origin-based taxes (such as the income tax). Despite the efforts of the Ruding Commission, the European Union has, for example, had much greater success in harmonizing the VATs of member countries than the income taxes.

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[13] Grubert and Newlon, *supra* note 10 at 628. See also Gene M. Grossman, "Border Tax Adjustments: Do They Distort Trade?" *Journal of International Economics 10*, February 1980, 117-128; Avinash Dixit, "Tax Policy in Open Economies," from *Handbook of Public Economics*, eds. Alan Auerbach and Martin Feldstein, Amsterdam: North-Holland, 1985; Martin Feldstein and Paul Krugman, "International Effects of Value-Added Taxation," from *Taxation in the Global Economy*, ed. by Assaf Razin and Joel Slemrod, Chicago: University of Chicago Press, 1990, 263-278.

[14] Grubert and Newlon, *supra* note 10 at 637; Avi-Yonah, *supra* note 9 at 917.

It is important to note that all of the major consumption-based tax alternatives would eliminate certain export incentives provided under our current income tax system. Repeal of the foreign sales corporation (FSC) and export source rules could have a major impact on companies that manufacture in the United States for export to foreign markets. To ensure that such a major policy shift is not made inadvertently, any examination of consumption-based tax alternatives should consider collateral effects of this sort very carefully.

D. Legality under international trade rules

Another issue is whether a move to a consumption-based tax system with "border tax adjustments" would pass muster under international trade rules. This question already has been raised with respect to at least one fundamental tax reform proposal -- the USA Tax. International trade rules generally permit border adjustments for indirect taxes, such as value-added taxes, but they bar such adjustments under direct taxes, such as income taxes.

Although the USA Business Tax is similar to a value-added tax, it is drafted as a direct tax and therefore might be challenged under trade rules. Another feature of the USA Tax that might cause concerns is the credit it provides for payroll taxes -- a feature not present in foreign VAT systems. It is possible that a payroll tax credit could be viewed as inconsistent with GATT requirements.[15]

E. R&D and technology issues

The leading proposals to restructure the U.S. tax system could have a significant impact on decisions relating to the development and use of technology. All three leading tax reform proposals -- the USA Tax, the Flat Tax, and the National Retail Sales Tax -- would represent a major break from the current law treatment of R&D. None of the three proposals would retain the R&D tax credit and none would provide any incentive for performing R&D activities.[16]

Moreover, the Flat Tax could increase the tax burden on R&D substantially. Under the Flat Tax, foreign source royalties would be treated as payments for the export of intangible property and, therefore, would be subject to tax. Because the Flat Tax, like other major reform proposals, eliminates the opportunity to credit or deduct foreign taxes on royalties, foreign source royalties could end up bearing a sharply higher tax burden. As a result, a wide range of intangible licensing arrangements -- including royalties for the use of U.S.-developed technology -- would be subject to higher tax burdens under the Flat Tax. In comparison, foreign source royalties generally would be exempt under the USA Tax and National Retail Sales Tax.

These and other effects of the various proposals on R&D expenditures should be weighed carefully to ensure that one of the main goals of tax restructuring advocates -- increasing the national rate of economic growth -- is not undermined by inadvertently causing a decline in R&D spending in the United States.[17]

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[15] See Victoria Summers, "The Border Adjustability of Consumption Taxes, Existing and Proposed," in *Tax Notes International*, June 3, 1996, at 1793, 1800. Summers's article cites a letter from the Assistant Secretary for Tax Policy, U.S. Department of the Treasury, to Senator Sam Nunn (D-GA), February 1995.

[16] Section 174 of the Internal Revenue Code, enacted in 1954, provides a deduction for qualified research and experimentation (R&E) expenditures. Since 1981, section 41 of the Code also has provided a 20-percent tax credit for certain qualified research expenditures; this credit expired June 30, 1995, but pending legislation would restore it.

[17] See "Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century," The National Commission on Economic Growth and Tax Reform, January 1996. According to the report, "attention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."

V. Incremental reform of the income tax system

Many proponents of fundamental tax reform would like to replace the current tax system entirely with a consumption-based tax. However, if no immediate consensus can be reached on a more ambitious reform, incremental changes to the existing income tax system should be adopted to alleviate the ills of that system in the interim. Reforms to the current system could help address numerous areas of complexity in the international provisions of the tax code.

At a minimum, any incremental reform effort should address the following issues:

A. Foreign tax credit

The United States taxes its citizens, residents, and domestic corporations on a worldwide basis and seeks to alleviate international double taxation through the foreign tax credit. The foreign tax credit, however, is subject to significant limitations. While foreign rules will determine the amount of foreign tax imposed (subject to U.S. currency translation rules), foreign source income must be redetermined under U.S. rules for purposes of the foreign tax credit. The differences between the U.S. and foreign definitions of taxable income -- particularly the rules on the sourcing of income and the allocation of deductions -- create complexity and increase the risk of double taxation. Other countries with foreign tax credit systems frequently seek to promote harmony, minimize complexity, and avoid double taxation by using the foreign jurisdiction's definition of taxable income for foreign tax credit purposes.

In addition, the U.S. rules impose numerous limitations on the availability of foreign tax credits, which bring their own complexities and further erode the effectiveness of the foreign tax credit mechanism in reducing double taxation. For example, separate limitations apply to eight special categories (or "baskets") of income. In addition, U.S. taxpayers that own interests of between 10 and 50 percent in foreign companies must compute a separate foreign tax credit limitation for each such company. These separate limitations generally are intended to prevent foreign taxes on one type of income from offsetting U.S. taxes on other types of foreign income. As a result, however, companies often are prevented from utilizing their foreign tax credits fully, increasing the likelihood of international double taxation. Moreover, these separate limitations impose substantial administrative complexity on U.S. firms attempting to calculate the amount of foreign tax credit to which they are entitled. Measures to simplify and streamline the foreign tax credit rules could greatly reduce the compliance burdens faced by U.S. businesses competing abroad.

B. Anti-deferral rules

The United States generally does not tax U.S. shareholders on foreign source income earned through a foreign corporation until such income is repatriated to the United States, just as it does not tax individual U.S. taxpayers on the earnings of corporations in which they own stock until dividends are declared and paid. This deferral is intended to permit U.S. taxpayers to compete internationally by reinvesting their foreign earnings without subjecting such earnings to current U.S. income taxation.

The United States, however, has adopted significant anti-deferral regimes that generally tax U.S. shareholders currently on certain types of undistributed foreign income, as if such income were repatriated. Although other developed countries also limit the extent to which their taxpayers may defer tax on certain income earned by affiliated foreign corporations, the U.S. rules are considerably more far-reaching and complex.

For example, the anti-deferral regimes of other developed countries generally eliminate deferral only for passive income. In contrast, the U.S. anti-deferral regimes also eliminate deferral for many types of active trade or business income, including financial services income, refining income, international shipping and aircraft income, and certain other types of income. One important example is the fact that, since 1987, the United States generally has denied deferral for income from active foreign business operations of U.S. banks, insurance companies, and other

financial intermediaries. This denial of deferral has hamstrung these key sectors of the U.S. economy as they seek to compete effectively with their foreign-based counterparts. Similarly, under section 956A as added to the U.S. tax code in 1993, deferral is now limited for CFCs with "excess" amounts of passive assets. The United States is the only major country that imposes such limitations on its taxpayers operating abroad.

Unlike other developed countries, which generally have only one anti-deferral regime, the United States has six anti-deferral regimes. These regimes, enacted piecemeal over the last half-century, reflect a series of responses to perceived shortcomings in the deferral rules existing at the time of enactment. The aggregate result is a "patchwork" system that requires current taxation of certain types of income by reference to different factors and criteria (or imposes an interest charge on certain actual or deemed dispositions). The multiplicity and complexity of these anti-deferral regimes imposes significant compliance costs for U.S. taxpayers and heavy administrative burdens for U.S. tax administrators.

C. *Alternative minimum tax*

The stated purpose of the alternative minimum tax (AMT) is "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits."[18] This purpose is accomplished by imposing an AMT to the extent that AMT liability exceeds regular tax liability.

Under regular income tax rules, a U.S. taxpayer may have a foreign tax credit equal to 100 percent of its U.S. tax liability on foreign source income. This result acknowledges that the taxpayer already has paid tax to the jurisdiction where the income was derived at a rate equal to or greater than the rate of tax that the United States would impose on that income.

For taxpayers subject to the AMT, however, the foreign tax credit may offset no more than 90 percent of a taxpayer's AMT liability. Not only does this limitation on the foreign tax credit lack any clear tax policy rationale, it also appears inconsistent with certain U.S. treaty obligations.

D. *Time for a more comprehensive approach?*

If an effort at incremental income tax reform is to succeed where others have failed, however, policy makers will have to think more comprehensively about such issues. They will need to consider not only specific amendments that have been proposed to current U.S. income tax rules, but also more far-reaching reforms that have not yet received serious consideration in the United States.

For example, in response to complaints about the anti-deferral rules of current U.S. law, policy makers should give serious thought to consolidating the existing regimes and modifying their scope to achieve greater consistency with the anti-deferral rules imposed by our major trading partners. However, even with such changes, the U.S. anti-deferral rules would still be far more complex and burdensome than those of many other countries, which apply a much simpler effective foreign tax rate test or impose current tax only on active business income from specified low-tax countries. Such alternatives may not ultimately prove preferable to the basic U.S. approach of imposing a current tax only on specified types of income, but they should be given serious consideration in any fundamental reform process.[19]

As another example, it has become increasingly clear since our current foreign tax credit system was adopted in 1986 that it imposes unacceptable compliance and enforcement burdens on taxpayers and tax authorities alike. Large companies must devote substantial resources each year

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[18] S. Rep. No. 99-313, 99th Congress, 2d Sess. 518-519 (1986).

[19] See U.S. Department of Treasury, *International Tax Reform: An Interim Report*, January 1993.

to obtain and process from sources all over the world the information that is needed for the foreign tax credit computation. It has become impossible for U.S. multinationals to perform the actual computations without the aid of sophisticated computer software, and it is impossible for the Internal Revenue Service to audit those computations without relying on such software. These tasks certainly would be simplified by proposals to reduce the number of foreign tax credit "baskets" required by current law. However, perhaps it is time to consider replacing the basket approach entirely with some simpler foreign tax credit system, or perhaps even with a territorial income tax system (described below).

VI. Territorial income taxation

Another option would be to retain an income tax system but move from worldwide taxation to a territorial tax system for taxing foreign income. A "territorial" or "exemption" tax system is used in some form, either by statute or by treaty, by more than a dozen major industrialized countries, including the Netherlands, France, Germany, and Canada. Rather than merely deferring tax until foreign-source income is repatriated, countries with territorial income tax systems exempt the active business income earned abroad by their multinationals. Multinationals based in such countries, therefore, pay only the local tax imposed in countries in which they do business.

A move to a territorial income tax system could promote the competitiveness of U.S. multinationals by exempting foreign source dividends and branch income. This could help ensure that foreign subsidiaries do not pay more tax in the aggregate on corporate income than do their foreign-based competitors in foreign markets.

However, it is not clear that a move to a territorial income tax system would greatly simplify current law for all taxpayers. Because passive investment income presumably would be taxed, look-through, anti-deferral, and foreign tax credit rules generally would remain necessary for passive foreign income. Moreover, source rules and rules regarding allocation and apportionment of expenses would be needed to limit the territorial exemption to active foreign income.

Transfer pricing issues would be at least as important under a territorial income tax system as they are today. Finally, it is important to note that a territorial income tax could actually increase U.S. tax on foreign-source royalties and export income as compared to current U.S. law. Under a territorial system, excess foreign tax credits on dividends no longer would be available to reduce U.S. tax on foreign source royalties and export income.

VII. Conclusion

While the international tax impact of the various fundamental tax reform proposals thus far has not received the same attention as have the domestic aspects of these proposals, they could have profound effects on the ability of U.S. companies and U.S. workers to compete in the global marketplace. Lawmakers must be careful to give full consideration to these international issues as they weigh replacement tax alternatives.

A switch to a consumption-based tax system could provoke undesirable reactions from our trading partners. A unilateral move to a consumption tax system could prompt trading partners to impose anti-abuse rules and other measures aimed at capturing the taxes foregone by the United States. Our trading partners may feel compelled to take these steps to prevent taxpayers from shifting profits into the United States and, thereby, eroding their tax bases. In addition, our tax treaty partners may consider terminating tax treaties because those agreements no longer would confer significant benefits from the United States. This could result in serious hardships for U.S. firms, which in the absence of the treaties would become subject to higher foreign withholding tax rates. Both of these possibilities -- the expansion of foreign taxing jurisdiction and the abrogation of tax treaties -- should cause policy makers to think carefully before undertaking any radical overhaul of the current tax system.

In addition, each of the leading fundamental tax reform proposals could increase tax burdens on U.S. technology and U.S. exports, with potentially harmful effects to the economy.

If a consumption tax is adopted, a destination-basis system, such as the USA Tax or the National Retail Sales Tax, would have some advantages over an origin-basis system (such as the Flat tax) -- namely the elimination of transfer pricing disputes from the U.S. perspective and consistent tax treatment for exports of goods and intangible property.

Incremental reforms also may offer a possible alternative to the various fundamental tax reform proposals. Such incremental reforms could go a long way toward addressing many of the more serious tax barriers to improved competitiveness, particularly if policy makers take this opportunity to rethink some of the basic assumptions of the current U.S. income tax system.

A territorial income tax system is another alternative worthy of serious consideration if a consumption-based tax system is not adopted. However, it is not yet clear whether a move to such a system would be an improvement. While a territorial income tax system would appear helpful in theory to multinational business, it may not be a panacea. In practice, this approach could result in stiffer taxes on foreign source royalties and exports, while retaining existing compliance burdens for foreign source passive income.

The International Tax Policy Forum recommends that any changes to the current system be carefully considered for their potential international consequences before adoption. While each of the leading restructuring proposals offers some advantages over the current system, each also involves an element of risk. The International Tax Policy Forum looks forward to working with this Committee as it examines these issues.

Appendix A. ITPF Member Companies

American Express Company
AT&T
Caterpillar, Inc.
CIGNA Corporation
Citicorp
Dow Chemical Company
Eastman Kodak Company
Emerson Electric Co.
Exxon Corporation
Ford Motor Company
General Electric Co.
General Motors Corporation
Goodyear Tire & Rubber Company
Hewlett-Packard Company
Honeywell, Inc.
IBM Corporation
ITT Industries, Inc.
Johnson & Johnson
Levi Strauss & Co.
Merrill Lynch
Morgan Stanley Group, Inc.
Philip Morris Companies, Inc.
Premark International, Inc.
Tenneco, Inc.
Tupperware Corporation
United Technologies Corporation

Chairman ARCHER. Thank you, Ms. Dunahoo.

I should have mentioned earlier that the Committee would appreciate each witness identifying himself or herself for the record prior to testifying. Ms. Dunahoo, you did that.

Thank you very much.

Our next witness is Kevin Conway.

STATEMENT OF KEVIN G. CONWAY, CHAIRMAN, COMMITTEE ON TAXATION, FINANCIAL EXECUTIVES INSTITUTE; AND VICE PRESIDENT, TAXES, UNITED TECHNOLOGIES CORP., HARTFORD, CONNECTICUT

Mr. CONWAY. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Committee, my name is Kevin Conway. I am the vice president of taxes at UTC, United Technologies Corp., in Hartford, Connecticut.

I am here today as the chairman of the tax committee of FEI, the Financial Executives Institute. FEI is a leading trade association whose membership includes 14,000 senior financial officers of 8,000 U.S. member companies.

The international issues relating to fundamental tax reform are a vital issue to FEI and its membership, and I am pleased to submit for the record a written statement which we have prepared, which we think describes many of the issues that need to be considered.

The key point I wanted to emphasize for the Committee this morning is that under the current system, U.S. multinational corporations are at a serious competitive disadvantage in competing in the global marketplace, and the main reason for this disadvantage is that a U.S. multinational's profits are subject to two levels of taxation.

When UTC operates outside the United States, and we operate in all but six countries of the world, our profits are subject, first, to a local income tax. After we pay the local income tax, there is a second tax, the U.S. tax, and the issue we have to deal with is our competitors are either subject to territorial taxes; that is, they only pay one tax where they operate locally, and their home jurisdiction doesn't subject them to a second level of tax; and the rest of our competitors have a worldwide system like the United States, but they don't tax their international profits to the extent or degree that the U.S. system does.

This was recognized long ago, and under our worldwide system of taxation, the adverse impact of double taxation was mitigated by two key tax policies. One was the foreign tax credit system and the other was the deferral system. Deferral and foreign tax credits are not corporate benefits and they are not corporate welfare. They are international tax policy mechanisms designed to avoid the significant adverse impact if $100 of international profits were taxed, say, to a 35-percent rate offshore and a second time at a 35-percent rate in the United States. We would be totally noncompetitive under that type of a system.

So we enacted the foreign tax credit system and the deferral system to mitigate the adverse tax consequences and level the playingfield for U.S. multinationals.

What has happened, Mr. Chairman, as you have pointed out, is that over the past decade, there have been a series of essentially exceptions to deferral and to the foreign tax credit system, so that we have undercut the important protection policies that those rules were designed to produce, and we increasingly find ourselves today in a situation of being subject to double taxation.

We are not merely talking about having to file additional tax forms and tax returns. We are talking about our ability to compete abroad. A foreign tax credit mechanism was essentially designed to ensure that if we earned foreign income offshore, if we paid a tax at the U.S. rate, we would get a credit up to that rate.

The overall system was critical and key to that. We could average the taxes from high and low tax jurisdictions. So, if we paid tax at a 50-percent rate in one jurisdiction and a 20-percent rate in another jurisdiction, we are going to get an average overall rate of 35 percent.

Since 1986, there have been a series of changes which have dramatically impacted our ability to average foreign tax credits. The most famous example, the most well known, is the 10–50 basket rule. Essentially, what this means is when UTC acquires an ownership interest in a foreign corporate joint venture that is less than 50 percent but greater than 10, we have to do a separate foreign tax credit calculation for that entity.

The practical impact of that is not merely that we have to file a separate tax return and do a separate computation. It is a real inhibition on our ability to compete against other companies from other countries who aren't subject to those rules.

So, when we are trying to expand in a market and make acquisitions, very often we have to do that. One of our companies, for example, the Otis Elevator Co., is in the elevator service business, and 80 percent of the elevators are located outside of the United States. So, if you want to be in the elevator service business, 80 percent of the market is outside of the United States. You are going to have to do business offshore.

When we go into a foreign jurisdiction and try to increase our market share through an acquisition, when we are looking at an acquisition, we are subject to this 10–50 basket rule. I can tell you that our competitors, the Schindler Co. from Germany, they don't have to worry about the 10–50 basket rule. So it is not merely a question of increased taxes, or an increased compliance burden, but it is directly affecting our ability to expand in international markets.

The policy of deferral is key to our ability to expand because we use the profits from non-U.S. operations to invest in expansion outside the United States.

After 1993, if we accumulate more than 25 percent of total assets in cash, it is deemed to have been repatriated and we are subject to U.S. tax. We want to use foreign cash for foreign acquisitions.

We have a lot of expenses in the United States. UTC spends $1 billion a year on R&D, and over $700 million of that is in the United States. We want to fund that with U.S. cash and not have to use U.S. cash on foreign acquisitions.

The net effect is that, I would say, we either have to adopt the territorial approach that is set forth in the consumption tax proposals or go back to a de facto territorial approach by reinvigorating the foreign tax credit rules and the deferral rules, so they can perform as they were designed to.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF KEVIN G. CONWAY, CHAIRMAN
COMMITTEE ON TAXATION
FINANCIAL EXECUTIVES INSTITUTE
AND VICE PRESIDENT, TAXES
UNITED TECHOLOGIES CORP.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

The FEI Committee on Taxation is pleased to present its views on the impact of fundamental tax reform on the international competitiveness of U.S. businesses and workers, including the effect of fundamental tax reform on imports and exports.
FEI is a professional association comprising 14,000 senior financial executives from over 8,000 major companies throughout the United States. The Tax Committee represents the views of chief tax officers from over 30 of the nation's largest corporations.

Due to the myriad of complexities found in the international tax area of our current income tax system, FEI has consistently supported various foreign tax simplification proposals that have been introduced in Congress over the last few years. Some leaders in the Executive and Legislative branches have suggested that the current Internal Revenue Code ("Code") can be repaired, or at least improved to an acceptable level with some modifications (both major and minor). Others, like yourself Mr. Chairman, have argued that our current tax system must be pulled out by its roots and replaced with an entirely new system, such as one that taxes the consumption of goods and services.

The leading consumption tax proposals would greatly simplify the international area for most taxpayers by moving from the current system that taxes "worldwide" income, to approaches that are "territorial" in nature, meaning they exempt most types of foreign income (passive investment income being a major exception). These proposals would also promote the competitiveness of U.S. multinationals versus foreign based competitors by their exemption of foreign source dividends and branch income. This would help ensure that foreign subsidiaries of U.S. companies do not pay more tax on their corporate income than their foreign competitors do in foreign markets. These proposals are also uniform in reducing the tax rates for corporations, which again helps U.S. companies compete against their foreign competitors.

In any event, we believe that the current tax system as it impacts the international area has much room for improvement. Therefore, to assist you in deciding whether to retain the current tax system with modifications, or whether to implement fundamental tax reform, we have provided a sampling below of the many inequities that currently exist in our tax system regarding the international area:

A. Improve U.S. Competitiveness

1. Retain Current § 863(b) Source Rules

Current tax law allows taxpayers who manufacture goods in the U.S. and sell the goods outside the U.S. to treat 50% of the income arising from the sale as foreign source income. The intent of this provision was to enhance the competitiveness of U.S. businesses in the global market place and generate additional jobs in the U.S. The Department of Treasury, and most recently the Administration, however, have sought in recent years to significantly curtail or eliminate this provision as a way to raise revenues for other programs. It is this sort of "rob Peter to pay Paul" approach, without regard to a coherent tax policy that has brought us to the point that we're at today.

2. Increase Allocation of R & E to U.S. Source Expense

Taxpayers that perform research and development ("R& E") in the U.S. who generate foreign source income must allocate a portion of their U.S. incurred R & E against their foreign source income in determining their foreign source income. The allocation ratio has changed numerous times over the last 20 years. For example, when the Regulations became effective in 1977, there was a phase in period during which the allocation went from 50% to 30%. In 1981 a moratorium was put in place that lasted for five years because o the

controversy surrounding the allocation methodology and impact on US corporations' competitiveness. In 1987 taxpayers were allowed to apply 50 percent of their R&E against their U.S. source income and foreign source income based on sales or gross income; from January 1, 1988 through April 30, 1988 the rate was 64%. From May 1, 1988 through 1989 the allocation was 30% and from 1990 through 1993 64% was allocated to domestic source income, the remaining 36 percent allocated between U.S. and foreign. From 1994 forward, taxpayers again may only apply 50 percent of U.S. source R&D against U.S. source income, with the remainder allocated between U.S. and foreign source.

Research programs require long-term planning and foreign jurisdictions are not likely to recognize research expenses incurred in the U.S. as proper deductions for foreign local tax purposes (in fact, the net effect may encourage taxpayers to perform research outside the U.S. in order to secure full local tax deductions). A permanent solution to the R&E allocation is required. Therefore, the law should be amended to permanently provide that 64 percent of U.S. incurred R&E is to be allocated against U.S. source income, with the remainder allocated based on gross sales or gross income.

3. Amend Rules for Allocating State and Local Income and Franchise Taxes

Treasury Regulations issued in March, 1991 (§ 1.861-8(e)(6)) generally require U.S. multinational companies to allocate a portion of their deduction for state and local taxes to foreign source income in determining their foreign tax credit limitation. This requirement ignores the fact that the U.S. Constitution proscribes State taxation of foreign source income, and results in adversely impacting the competitiveness of U.S. multinationals in world markets. It adds an additional cost of doing business that is not incurred by foreign multinationals, even if those foreign competitors are doing business in the U.S. (because they are generally able to obtain a full deduction against U.S. source income for such state taxes, while U.S. companies generally are unable to fully deduct the portion of taxes source foreign). Thus, the law should be amended to allocate all deductions for state and local income and franchise taxes against U.S. source income for FTC purposes.

4. Use Earnings & Profits (E & P) Depreciation for Asset Bases when Allocating Expenses

Taxpayers may elect to allocate interest between U.S. and foreign source income on the basis of tax book value. U.S. based assets are generally depreciated on an accelerated basis while foreign based assets utilize slower depreciation methods. U.S. based assets, therefore, will typically have lower tax bases than similar foreign based assets. This results in a disproportionately higher amount of interest being allocated against foreign source income. To correct this problem, the law should be amended for purposes of allocating interest expense to permit taxpayers to use the same depreciable methods and lives for both U.S. and foreign based assets, as used for E & P purposes.

B. Eliminate Double Taxation and Simplify Computation of the Foreign Tax Credit

1. Extend FTC Carryforward and Carryback Periods

Currently, FTCs that are not used against U.S. tax in the current year may be carried back 2 years and carried forward 5 years. The effect of the short time periods has been to cause FTCs to expire unused, thus subjecting foreign source income to double taxation and frustrating the purpose of the credit. The current rules are especially onerous for taxpayers in cyclical industries which experience substantial operating losses. In contrast, the rules for net operating losses ("NOLs") provide a 3 year carryback and 15 year carryforward period. This time frame recognizes the fact that utilization of NOL's is not a short term proposition. What the foreign rules fail to recognize is the fact that a U.S. taxpayer must have domestic taxable income in order to utilize its FTCs. Thus, we believe that the FTC carryback and carryforward periods should be amended to conform with the time periods for NOLs, i.e., 3 years carryback and 15 years carryforward.

6. *Amend Treatment of Prior Year Deficits under Subpart F*

Currently, certain foreign base company shipping income, oil related income, insurance income, and FPHC income may be reduced by post-1986 accumulated deficits in E & P attributable to activities that give rise to that same category of income. In 1988, the law was amended to allow accumulated deficits for pre-1987 years to be carried forward and reduce post-1986 foreign base company sales and services income, as well as allow 1983 to 1986 accumulated deficits to be carried forward and reduce post-1986 oil related income. Although post-1986 deficits may be carried forward indefinitely, pre-1987 accumulated deficits associated with shipping, insurance, and FPHC income may not be carried forward to reduce subsequent Subpart F income even if it is of the same type. Similarly, pre-1983 accumulated deficits associated with oil related income can not be carried forward. This is illogical and not sound tax policy. Therefore, the law should be amended to allow all pre-1987 accumulated deficits post-1962 to offset similar Subpart F income earned subsequent to 1986.

7. *Exempt Foreign Entities from the Uniform Capitalization Rules*

The uniform capitalization rules ("UNICAP") under Code Section 263A require certain costs to be capitalized to inventory and certain interest to be capitalized as a production cost. Although the legislative history to this section does not compel its application to foreign corporations not doing business in the U.S., the Treasury Regulations specifically apply such rules to foreign corporations with U.S. shareholders. However, U.S. multinationals already incur significant costs at both the head office and affiliate level to bring foreign E & P into conformity with U.S. tax principles for purposes of computing FTCs. Requiring the determination of UNICAP adjustments to such earnings merely adds additional compliance costs that are not borne by foreign based multinationals. Since UNICAP really has no relevance to foreign corporations not conducting business in the U.S., and since the revenue generated by applying these rules to foreign entities is small in relation to the administrative burden they cause, Code Section 263A should be amended to exempt foreign entities not doing business in the U.S.

C. Source Income Based on Underlying Income or Assets

1. *Extend Dividend Treatment to Disposition of Lower Tier CFCs*

Under current law, if a controlled foreign corporation ("CFC") sells its stock in another CFC, any gain is treated as passive (i.e., separate basket) Subpart F income to the U.S. shareholder. This is illogical since dividends from that same CFC to its U.S. shareholders would be given look-through treatment or, if the first tier CFC was sold, the entire gain would be dividend income. Thus, the law should be changed so that if a CFC sells or exchanges stock in a foreign corporation, any gain is treated as a dividend to the same extent that it would have been so treated under Code Section 1248 if the selling CFC were a U.S. person. As a result, these lower-tier CFC stock gains would also be eligible for look-through treatment, so that if the lower-tier CFC's earnings were general limitation income, the gain would also be treated as general basket income.

2. *Apply Look-Through Treatment on Gains from Sales of CFC Stock*

Currently, foreign source capital gains arising from the sale of a CFC's stock is separate basket income passive income. However, as stated above, it is illogical that dividends from these CFCs qualify for look-through treatment that may result in general basket treatment, while gains from sales of these CFCs do not. Thus, current law should be changed so that gains and losses from the sale of foreign corporation stock is also eligible for look-through treatment.

3. *Apply Look-Through Treatment on Gains from Sales of Partnership Interests*

Currently, gains from sales of partnership interests are also treated as separate basket passive income, even though U.S. partners owning 10 percent or more of the value of foreign partnerships can apply look-through treatment for their distributive shares of such partnership income. Consistent with the arguments above concerning sales of foreign corporation stock, gains or losses associated with the disposition of a partnership interest should be treated as a disposition of the partner's proportionate share of each of the assets of the partnership for purposes of characterizing the income or loss from the sale of the partnership interest. Moreover, in cases where less than 10 percent of the partnership is owned, look-through treatment should be allowed if the partnership interest is held in the ordinary course of the partner's active business.

4. *Amend Source Rules for Stock Sales*

Currently, gains resulting from the sale of foreign affiliates in which the U.S. shareholders have an interest of 80 percent or more is considered foreign source if the sale occurs in the foreign country in which the affiliate is actively engaged in business and the affiliate derives more than 50 percent of its income therefrom. Gain by U.S. corporations from stock sales of U.S. affiliates that are less than 80 percent owned foreign affiliates is sourced foreign only if the sale is through a fixed place of business outside the U.S. and the gain is taxed abroad at an effective tax rate of no less than 10 percent. Although it may be appropriate to source sales of portfolio stock interests based on the seller's residence, it is illogical to extend such a rule to stock sales of foreign subsidiaries representing active businesses. The better rule is to source gains on such foreign subsidiary stock sales by reference to the subsidiary's underlying income. This is the rule for more than 80 percent owned foreign corporations, and it should be extended to situations where at least 10 percent ownership is reached (consistent with the rules for claiming indirect FTCs). Therefore, the law should be amended to source all gains from stock sales of at least 10 percent owned foreign entities to that foreign jurisdiction if the sale occurs there, the affiliate is actively engaged in business there, and more than 50 percent of its income is generated therefrom.

5. *Amend Source Rules for Sales of Partnership Interests*

Currently, if a U.S. corporate partner sells its interest in a foreign partnership, any gain is generally treated as U.S. source income. However, if that partnership disposes of its foreign assets, gains will generally qualify as foreign source. Thus, the law should be amended to provide that for sourcing purposes, gains or losses associated with dispositions of 10 percent or larger partnership interests are treated as dispositions of the partner's proportionate share of each of the partnership assets. This would be consistent with the rule regarding the characterization of income from sales of partnership interests for FTC limitation purposes discussed above. Moreover, in cases where less than 10 percent of the partnership is owned, look-through treatment would be allowed if the partnership interest is held in the ordinary course of the partner's active business.

6. *Provide Look-Through Rules for So-called "10/50 Companies"*

Current law (resulting from changes provided by The 1986 Tax Reform Act ("TRA")) requires that U.S. companies who own an interest of at least 10% but not more than 50% of foreign joint ventures corporations (as opposed to foreign partnerships) must calculate separate "FTC" limitations for income earned from each joint venture corporation. Thus, a U.S. corporation owning many 10/50 Companies must calculate separate FTC limitations for each and every company that falls into this 10/50 category. Not only does this result in substantial complexity and higher costs, but it may also result in double taxation versus the situation where the U.S. shareholder has a controlling interest in the venture (i.e., 51 percent). That is because owners who receive dividends, interest, rents or royalties from controlled foreign corporations ("CFCs") can "look-through" such income to the nature or character of the payor corporation's underlying income, and include it in these general limitation basket categories instead of into separate FTC limitation baskets.

U.S. shareholders of foreign joint ventures often are unable either due to government restrictions or business practice to acquire controlling interests, especially in cases where the foreign joint venture partner is a foreign government, or the activity involved in is a government regulated industry. It is patently unfair to penalize such non-controlling joint venture owners. Instead, current law should be changed to equalize the treatment for both types of joint venture owners, by requiring look-through treatment for income (dividends, interest, rents, and royalties) earned joint ventures in which the U.S. shareholders owns at least 10% of the stock.

On a related matter, current Treasury Regulations (§ 1.904-5(h)(1)) require that payments of interest, rents, and royalties from partnerships to partners not acting in that capacity must also treated as separate basket passive income unless U.S. partner owns more than 50 percent of the partnership. Again, this result is not good tax policy. However, by extending look-through treatment to 10/50 companies as proposed above, this problem involving partnerships will be corrected.

7. Amend Rules Relating to the International Securities Industry

Current law (resulting from changes provided by The 1986 TRA) denies so-called "deferral" on dividends, interest, and capital gains on stock or securities derived from a banking or financing business or derived from insurance company investments of unearned premiums, reserves, or investments. However, it appears that this change affects not only taxpayers that intentionally "routed income through foreign countries to maximize U.S. tax benefits", but also innocent regulated insurance companies. The law should be revised to treat income earned in the active conduct of a securities dealer or banking business by a CFC of a U.S. domiciled securities dealer in the same manner as the active income of CFCs of their U.S. parents.

D. Anti Deferral Provisions

1. Treat The European Union as One Country for Subpart F Purposes

The Subpart F provisions of the Code, were enacted to deter U.S. corporations from establishing companies with minimal substance in tax haven countries. Under these provisions, U.S. corporations can be subject to taxation on deemed distributions of the foreign subsidiaries' earnings. This is in contrast with the general rule of no taxation until dividends are distributed to the U.S. parent from the foreign subsidiary. Deemed taxation can occur under Subpart F, for example, on foreign subsidiary earnings generated from cross border sales or services with the European Union ("EU"). However, this rule overlooks developments in world trade and the critical needs of U.S. global companies competing within the EU marketplace. The member countries of the EU are not tax haven countries therefore, in order to recognize the legitimate business requirements of U.S. companies operating in the EU, the Subpart F rules should be amended to allow the EU to be treated as one country.

2. Apply Same Country Exception to PRC/Hong Kong in 1997

Current U.S. tax law permits taxpayers with CFCs to distribute dividends within the same country without incurring U.S. tax on the distribution assuming that certain criteria are met. The basic purpose of this provision was to effectively allow the movement of capital within a country so that the U.S. taxpayer could reinvest the funds without needlessly incurring an additional U.S. tax burden. In July 1997, Hong Kong will revert back to the PRC. Because Hong Kong is the financial capital of the region, many businesses have established their headquarters and holding companies for their PRC operations there. Thus in order to reinvest profits and expand business, U.S. taxpayers in many instances are required to pay tax on distributions up to the holding company, only to be reinvested in the PRC, thus effectively increasing the cost of capital. We believe that the same country exception should be applied to distributions between companies incorporated in both the PRC and Hong Kong assuming that the requisite ownership rules, etc. are met. Such treatment would, in

many instances, significantly increase the competitiveness of U.S. businesses operating here.

3. *Repeal* Section 956A

Code Section 956A, implemented with the 1993 Tax Act, was intended to eliminate so-called "deferral" of U.S. income tax for U.S. shareholders of CFCs to the extent that the CFC's earnings are invested in excess passive assets rather than in active business assets. However, this section has instead had the effect of adding an additional layer of complexity to the already existing anti-deferral regime of the Code, while providing taxpayers an incentive to engage in costly, non-economical transactions in order to avoid its application. Contrary to earlier estimates, this provision has not created a positive impact on cash flows from foreign companies to U.S. parents, or resulted in more U.S. manufacturing jobs. Rather, it has created incentives for investing in assets outside the United States and should be repealed immediately.

4. *Apply Look-Through Rules for De Minimis Amounts of Separate Category Income*

Code Section 904(d)(3)(E) exempts U.S. shareholders from having to categorize income from a CFC into separate limitation categories if the CFC is considered as having a de minimis amount of so-called "Subpart F" income under the anti-deferral rules. An amount is considered as de minimis if it does not exceed the lesser of 5 percent of the CFC's gross income or $1 million. However, once that de minimis threshold is exceeded, all income, expenses, and taxes of the CFC must be categorized into the respective separate FTC categories. The problem with present law is that what constitutes Subpart F income for purposes of applying the anti-deferral rules is different from what constitutes income in the separate FTC limitation categories. As a result, the CFC may exceed the de minimis threshold for Subpart F purposes even though its income in the various separate limitation categories is insignificant or "de minimis", requiring full application of the complex FTC separate limitation rules.

This increased administrative burden applies disproportionately to those multinational companies whose CFCs' Subpart F income, although relatively small compared to their remaining incomes, nevertheless regularly exceed the annual $1 million threshold. Thus, current law should be changed so that categorization into separate FTC limitation categories is not based on Subpart F income amounts but, rather, is imposed where the aggregate amount of gross income in such separate categories exceeds a de minimis amount, defined as 5 percent or more of the CFC's gross income.

5. *Exclude CFCs from the PFIC Rules*

The Subpart F rules of the Code currently provide exceptions to the general rule of so called deferral for tax haven and foreign personal holding company ("FPHC") type income (i.e., passive income) from CFCs. The 1986 TRA added certain provisions called the Passive Foreign Investment Company ("PFIC") rules that effectively tax all income currently from foreign subsidiaries that have more than a designated amount of passive income or assets, even though the balance of the income is from active manufacturing operations. In other words, all income can be effectively tainted even though only a portion of it is from passive type activities that would have been currently taxed under the Subpart F rules. Although the PFIC rules were intended to eliminate certain identified abuses relating to U.S. investors in overseas mutual funds, they were inadvertently drafted in a manner to also cover CFCs (even though CFCs were already sufficiently regulated by the Subpart F rules). To correct at his error, the PFIC provisions should be amended so that companies subject to Subpart F (i.e., CFCs) are exempt from their application.

6. Amend Definition of PFICs

The PFIC provisions currently apply where 75 percent or more of a foreign corporation's gross income is passive, or where at least 50 percent of the foreign corporation's assets produce passive income. By using a gross income test, a foreign corporation will become a PFIC even though 99 percent of its gross receipts are from the active conduct of a trade or business, so long as its cost of goods sold exceeded its gross receipts that year and it had a dollar of passive income (like working capital interest income). This result is illogical. The PFIC provisions should be amended so that they only apply where the predominant character of the business is passive or the majority of assets is passive. This can be accomplished by changing the test to look to gross receipts rather than gross income, for example, by defining foreign corporations as PFICs if at least 75 percent of their gross receipts are passive.

E. Other Provisions and Considerations

1. Clarify Straddle Rules for Business Payables and Receivable

Although deductions are currently allowed for foreign exchange losses incurred during the year, no deduction is allowed for certain loss incurred with respect to "straddles" in order to prevent taxpayers from using commodity trading as a tax shelter. In other words, if a taxpayer takes essentially equal and offsetting positions in a commodity (i.e., a straddle), it can not recognize a loss on one position in the current year and defer the gain on the offsetting position until a subsequent year. Instead, any deduction for the loss of the straddle is deferred until there are no unrecognized gains in the other leg.

The problem with this is that the Code definition of "straddles" (under Section 1092) is so unclear that taxpayers who had no intent to enter into the types of tax-motivated transactions that led to these rules are being challenged on audit as having straddles. Specifically, some IRS agents have argued that certain payables and receivables are affected even though they were entered into in the ordinary course of business, had no tax motivation, were unrelated to each other, and were held by different tax consolidation members of a multinational company. Thus, Code Section 1092(c)(3)(B) should be amended to provide the presumption that a nonfunctional currency denominated receivable is not an offsetting position to a nonfunctional currency denominated payable If the receivable and payable were entered into in the ordinary course of business.

Additional Provisions

This is by no means an exhaustive list of all the problems currently existing in the international area of the current U.S. income tax system. In fact, both Congressmen Houghton and Levin through H.R. 1690, and Senator Pressler in his recently circulated discussion draft entitled International Tax Simplification for American Competitiveness Act of 1996, have proposed many additional provisions that would help bring some simplification to the foreign area. Some of those provisions would:

- Allow shareholders of PFICs to make mark-to-market elections, provided that the PFIC stock is regularly traded on a national securities exchange or otherwise treated as "marketable" under Treasury Regulations;

- Clarify the definition of passive income for PFIC, so that the same-country exceptions from the definition of FPHC income under Code Section 954(d) do not apply in determining passive income for purposes of the PFIC definition, and passive income does not include Foreign Sales Corporation ("FSC") income;

- Allow intangible assets for PFIC purposes to be valued at fair market value (if value can be readily obtained);

- Modify Subpart F so that (1) the Subpart F inclusion of an acquirer of CFC stock would be reduced in the year of acquisition by a portion of the deemed dividend recognized by the transferor under Code Section 1248, (2) the income inclusion to U.S. shareholders resulting from upper tier CFC stock sales in lower-tier CFCs earning Subpart F income would be adjusted to account for previous inclusions, and (3) regarding dividends out of earnings of CFCs that were previously included in the income of U.S. shareholders under Subpart F, in order to avoid multiple income inclusions, the IRS should be given regulatory authority to modify the Subpart F rules so that such dividends would be treated as distributions of previously taxed income with appropriate basis adjustments;

- Repeal the excise tax under Code Section 1491 on outbound transfers of assets to foreign corporations and replace it with full gain recognition "subject to Code Section 367 gain recognition agreements);

- Reduce the compliance burden for U.S. taxpayers under Code Section 6046 by raising the foreign corporation stock ownership threshold from 5 to 10 percent, for which ownership and other financial data has to be reported to the IRS; and

- Clarify that computer software qualifies as export property that is eligible for FSC benefits, even if the software is accompanied by a right to reproduce or is protected by patent or copyright.

Treaty Issues

The impact of tax reform on our existing tax treaty network must not be overlooked. Of course, the most recognized function of tax treaties and the principal reason they are negotiated is to eliminate double taxation of the same income, which occurs when two jurisdictions attempt to tax the same income or assets due to overlapping exercise of authority. However, most of the tax systems being proposed to replace the current U.S. income tax would be territorial in nature and exclude foreign source income from taxation (e.g., a 'flat" tax or a "goods and services" tax). Thus, the issue of double taxation would be reduced considerably if not entirely under such regimes. Nevertheless, many other benefits resulting from our tax treaty network would be jeopardized no matter what alternative tax system is chosen to replace the current one. For example, several of the more significant benefits of tax treaties include–

1) Facilitate business transactions between countries that might otherwise be inhibited by overly intrusive national taxation.

Beyond the actual tax cost, the mere exposure to another country's tax system may impose significant transactional complexities on a company venturing outside its own national borders, e.g., protracted dealings with various tax authorities. To alleviate some of these problems, treaties include a notion of "permanent establishment" ("PE") as a threshold to taxation. Under this concept, the business profits of an enterprise of one county will not be deemed to be subject to taxation by the other country unless it does business there through such a PE, i.e., unless there is a sufficient connection between the enterprise and the taxing country in terms of having a fixed place of business there, dependent agents, etc. Moreover, most of the recent treaties negotiated by the U.S. have limited the imposition of tax to the business activities attributable to the PE, as opposed to items unrelated to the PE itself (such as passive investment income and capital gains). In addition, tax treaties sometimes exempt residents of one country who visit the other for a limited period of time. This eliminates the need to prorate small amounts of income and file foreign tax returns (often more irritating than paying taxes), and encourages interaction of visitors between countries.

2) Withholding Taxes

The tax systems of most countries impose withholding taxes (at often high rates) on payments to foreigners of items such as dividends, interest, rents, and royalties. Lowering of these withholding taxes is another important function of tax treaties. If U.S. companies operating abroad can not receive reduced withholding tax rates offered by tax treaties, they often suffer excessive levels of foreign tax. This puts such U.S. companies at a competitive disadvantage relative to companies headquartered in other countries that do provide such treaty benefits. Thus, it is clear that tax treaties measurably reduce the barriers to U.S. participation in international commerce.

3) Anti-Discrimination Provisions

Almost all treaties forbid discrimination against the nationals of a treaty partner. One general effect of this is to prohibit U.S. tax on residents of treaty countries that is more burdensome than the tax imposed on similarly situated U.S. persons. Likewise, U.S. persons operating in treaty countries would also be protected under such a non-discrimination type clause. A nondiscrimination clause would generally only permit differences in the treatment of domestic and foreign taxpayers if justified by significant differences in the circumstances of those taxpayers.

4) Tax Equity

Another function of tax treaties is to ensure that equity is served and tax is imposed at least once, i.e., by targeting tax avoidance schemes such as the use of tax havens. Most U.S. tax treaties contain explicit provisions called "anti-treaty shopping". These provisions identify the group of taxpayers entitled to benefit from the treaty relief while, at the same time, also preventing other taxpayers (generally from countries not party to the treaty) from enjoying such treaty benefits. To help support enforcement, income tax treaties generally provide for exchanges of information between the tax authorities of the treaty countries. In addition, most provide a mechanism known as "competent authority", which permits a taxpayer of one country to seek the assistance of that countries tax authorities for support against adverse interpretations of the treaty by the other country's taxing authorities. Even if the U S. moves to a territorial system of taxation, such needs may not be muted since our treaty partners may still require such information exchanges.

Summary

We trust that this has given you a better understanding of the many problems that currently exist in the tax law as it applies to the international area. We sincerely hope that this will help you in your decision whether to save the current system or move toward a completely new tax framework. Thank you for this opportunity to provide our comments.

Financial Executives Institute,
Committee on Taxation

By Kevin G. Conway
Kevin G. Conway

Chairman ARCHER. Thank you, Mr. Conway.
Mr. Kaufman.

STATEMENT OF JEFFREY KAUFMAN, DIRECTOR, SERVICES TO EXECUTIVES ABROAD, COOPERS & LYBRAND L.L.P.; ON BEHALF OF SECTION 911 COALITION

Mr. KAUFMAN. Thank you very much.

My name is Jeff Kaufman. I am a partner with Coopers & Lybrand. I lead our practice of servicing Americans when they work overseas. I have been involved in this area of international tax and human resource issues for 15 years; in fact, I spent 5 years myself in Europe.

Today, I represent the Section 911 Coalition, the section of our code which represents our exclusion for foreign-earned income. The Section 911 Coalition is a group that represents a number of companies with their operations overseas, U.S. chambers of commerce overseas, and many foreign schools. These are all organizations that represent and recognize the importance of having Americans overseas and the value that brings to our economy.

I want to begin by thanking you, Mr. Chairman and Mr. Gibbons, for the support you have given to section 911 over the years, recognizing the value this brings to our economy.

It is also supported by the administration. Under the new proposals that are now before your body, there are a number of different ways foreign-earned income will be treated, including total exclusion under the Armey flat tax or under the sales tax proposal. Congress has also been looking at partial exclusions similar to what we have today under the Nunn-Domenici USA tax, as well as a situation where there would be no exclusions at all under the Bingaman proposal.

The way we tax Americans overseas is very important to our competitiveness. The United States stands alone as the only industrialized country that taxes our citizens when they work overseas. This puts us at a disadvantage.

When I work with some of my clients, for example, on proposals for a large contract in Saudi Arabia to build a factory, I work with them to build in the cost factor of the 500 U.S. engineers that might go to that plant. I have to build in the tax on their U.S.-based salary and many other costs. They receive cost of living. They will receive housing. They will receive education for their children. All of these costs are taxed in the United States.

When my client prepares a bid against a German or a Japanese or an English company, we are at a great disadvantage because of this U.S. tax. These other countries will not tax that, and there is no tax in Saudi Arabia.

The 911 exclusion helps us make up some of that loss, but since it hasn't been tied to inflation, it is beginning to be eroded in its value in giving us a more level competitive playingfield.

It is not just those 500 jobs we might lose in that contract. There have been many studies that show when that American is overseas, if they are going to bring in the equipment that is going to go into that factory, if they are going to bring in the equipment that is going to build that factory, they will go to companies they have worked with that are very likely the U.S. companies.

If we save those 500 American jobs in Saudi Arabia, it will have an exponential effect on more manufacturing jobs in America.

The Section 911 Coalition has developed two different studies, one by the accounting firm, Price Waterhouse, and the other by two professors, that emphasize the importance of the American overseas. It is going to help us to have more U.S. jobs.

Section 911 itself helped to raise revenue because it gets our people in the field selling our goods, so that we, in effect, continue to generate more jobs in the United States.

This is important for companies of all sizes. I have been working with small, medium, and large companies. Especially in the case of the small and medium-sized companies that go overseas, they need those first Americans to act as their sales representatives to get that first sale. We are not going to be competitive in the next century if America can't compete on a global basis. If we don't send the American overseas, we are not going to be competitive.

So, in conclusion, what is important to the Section 911 Coalition and to so many of our U.S. companies is that if we choose a new taxing regime, we have to consider how it will tax Americans overseas. The more Americans we send overseas, the more we increase our exports, which are a very important component of the growth of our economy. We must take that into consideration and keep at least the exclusion we have today or perhaps tie it to inflation so that in the future we don't have a reduction in the ability of our American companies to compete.

Thank you.

[The prepared statement follows:]

STATEMENT OF JEFFREY KAUFMAN, DIRECTOR
COOPERS & LYBRAND L.L.P.
ON BEHALF OF SECTION 911 COALITION

I am Jeff Kaufman Director of Services to Executives Abroad which is the group within Coopers & Lybrand that assists clients with managing the cost of relocating employees around the world and complying with tax laws here and abroad. I have worked on international tax, compensation and human resource issues affecting U.S. expatriates for over fifteen years , five of which were in Europe where I was an expatriate myself. It is a privilege to testify before this Committee and to be here on behalf of the 911 Coalition to discuss an issue of such importance to U.S. international competitiveness and the development of goodwill toward U.S. citizens and U.S. businesses around the world.

The Section 911 Coalition is a group of like-minded companies, business organizations, non-profit associations, and individuals that has come together in the past few years to call attention to the importance of the Section 911 foreign earned income exclusion for U.S. citizens working abroad. The Coalition currently has some 70 members, including representatives of more than 70 American chambers of commerce overseas and over 500 American and international schools abroad.

In recent years, exports have been the most impressive engine of growth for America's economy. Between 1986 and 1993, according to the U.S. Department of Commerce, nearly 40 percent of the growth of America's Gross Domestic Product resulted from exports of goods and services.[1] Commerce Department statistics also indicate that every $1 billion in U.S. exports creates or sustains 17,000 man-years of direct domestic employment.[2] The United States exported $701.2 billion worth of goods and services in 1994, which translates into nearly 12 million American jobs.[3]

Exports don't just happen by themselves. Independent studies and raw statistical data show a direct correlation between the number of Americans working overseas and the level of U.S. exports. You've got to put your sales people in the field. Americans abroad are the best sales people for U.S. goods and services overseas. The bottom line, is this: **Americans Abroad = U.S. Exports = U.S. Jobs.**

In the ongoing pursuit of international market share, the Section 911 exclusion has proved to be a very important factor. U.S. sales forces and service providers can only go where it is cost effective. The current Section 911 exclusion for income earned abroad is the mechanism by which the Internal Revenue Code reduces U.S. tax barriers to the deployment of sales and service industry personnel around the globe. It has a direct impact on the U.S. based support operations of the companies they work for, U.S. based suppliers and service companies that do business with their employers, as well as many other unrelated U.S. companies that develop relationships once the markets abroad grow more comfortable with our culture and learn the benefits of seeking out U.S. businesses.

Fundamental Tax Reform Alternatives' Treatment of Income Earned Abroad

The major tax reform alternatives provide widely different levels of exclusion for income earned abroad. For example:

100 % exclusion -- Armey Flat Tax & Schaeffer/Tauzin Sales Tax

Partial exclusion *(similar to current Section 911)* -- Nunn/Domenici USA Tax

No exclusion -- Bingaman R Corp Tax

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1 Trade Promotion Coordinating Committee, *National Export Strategy*, Report to the U.S. Congress, October 1994, p. 5.

2 U.S. Department of Commerce, The Advocacy Center, July 1995.

3 U.S. Department of Commerce. *U.S. Foreign Trade Update*, July 18, 1995.

Section 911 -- Our Earned Income Exclusion in Current Law

Internal Revenue Code Section 911 provides for a foreign earned income exclusion of up to $70,000 annually to Americans working overseas, thereby assisting them to compete against comparably qualified non-Americans (who pay no taxes in their home country on income earned abroad). A U.S. citizen or resident alien whose tax home is outside the United States and who is a *bona fide* resident of a foreign country or who is present in a foreign country for 11 months out of 12 (330 days in any 365 day period) may exclude from gross income up to $70,000 per year of foreign earned income, plus a housing cost amount. Originally unlimited for *bona fide* residents of a foreign country, the foreign earned income exclusion has been part of the Internal Revenue Code since 1926. Congress enacted the exclusion nearly 70 years ago in an effort to "encourage citizens to go abroad and to place them in an equal position with citizens of other countries going abroad who are not taxed by their own countries."[4]

Short History of the Current Law Exclusion -- Learning from our Mistakes

The Tax Reform Act of 1976 generally reduced the exclusion to $15,000 per year. While this cut in the exclusion did not take effect in the end, it nevertheless had a chilling effect on U.S. companies' efforts to send American workers abroad. A 1978 General Accounting Office (GAO) survey of 183 U.S. companies found that more than 80 percent of these companies felt that reducing the exclusion along the lines of the 1976 Act would result in a reduction of U.S. exports by at least five percent.[5]

Two years after the 1976 Act, the situation went from bad to worse. The Foreign Earned Income Act of 1978 repealed the foreign earned income exclusion and put in its place Section 913, composed of five factors: 1) a cost-of-living deduction based on the differential between U.S. and overseas costs of living; 2) a housing deduction; 3) a deduction for schooling expenses where a U.S.-type school was not within a reasonable commuting distance; 4) a travel expense deduction for an annual round-trip visit to the United States; 5) a deduction for work in a hardship area.

The 1978 Act, compared to prior law, represented a 23 percent reduction in the tax benefit of the exclusion. To determine the impact of this reduction, the GAO conducted a survey in 1980 of 33 key firms in four industries. The GAO found that additional costs attributable to the 1978 Act was a primary reason why these firms had decreased their employment of Americans abroad. The numbers decreased absolutely from 1979 to 1980 in three of the industries and, during the period 1976 to 1980, the relative number of Americans abroad dropped compared to third country nationals.[6]

As a result of these findings, the GAO produced the following recommendation:

> "We believe that the Congress should consider placing Americans working abroad on an income tax basis comparable with that of citizens of competitor countries who generally are not taxed on their foreign earned income."[7]
>
> The GAO went on to say that "complete exclusion or a limited but generous exclusion of foreign earned income for qualifying taxpayers . . . would establish a basis of taxation comparable with that of competitor countries and, at the same time, be relatively simple to administer."[8]

Findings in a 1980 report by Chase Econometrics provided more evidence of the dangers for U.S. competitiveness of restricting the foreign earned income exclusion. As a result of the

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[4] *Senate Report No. 781*. 82nd Congress, 1st Session, 1951, pp. 52-53.

[5] U.S. General Accounting Office, *Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas*, ID-78-13, February 21, 1978.

[6] General Accounting Office, *American Employment Abroad Discouraged by U.S. Income Tax Laws*, ID-81-29, February 27, 1981, p. 28.

[7] Ibid.

[8] Ibid.

changes in 1976 and 1978, Chase noted, a significant number of Americans working overseas would be forced to return home. Chase determined that a ten percent drop in Americans overseas would lead to a five percent drop in U.S. exports. The study went on to say that the "drop in U.S. income due to a five percent drop in real exports will raise domestic unemployment by 80,000 [persons] and reduce federal receipts on personal and corporate income taxes by more than $6 billion, many times the value of increased taxes on overseas workers."[9]

The U.S. & Overseas Tax Fairness Committee, an *ad hoc* group established in the late 1970s to defend the foreign earned income exclusion, noted in 1980 that "of all the current U.S. disincentives that discourage trade, none is easier to eliminate than the U.S. practice of taxing foreign earned income . . . and none will produce faster or more substantial results for our balance of trade."[10] In an effort to show what damage the 1976 and 1978 Acts had done as of 1980, the Committee cited the example of the U.S. construction and engineering industry operating in the Middle East. American companies in this sector "had over ten percent of the construction volume in the Middle East four years ago and now has less than two percent -- almost entirely due to the current U.S. tax treatment of overseas Americans," the Committee noted, "and industry is finding it very difficult to recapture its former standing."[11]

The message is as clear today as it was in 1980: Changes in the foreign earned income exclusion have a substantial and direct impact on the ability of U.S. companies to compete in overseas markets.

Why an Exclusion for Income Earned Abroad is Important

America's trade competitors realized long ago that encouraging their citizens to work overseas has a pronounced, salutary impact on their domestic economies. Sending their workers abroad has become an integral part of these nations' export strategies. To facilitate this "export" of their citizens (and thus the export of products and services), other governments do not tax their citizens on the money they make while working abroad. This makes these citizens extremely competitive in foreign markets.

U.S. Government tax policies, by contrast, have generally *discouraged* Americans from working abroad. Alone among the world's industrialized nations, the United States still taxes its citizens on the basis of citizenship rather than residence. Further, overseas Americans must also pay U.S. income tax on benefits, allowances, and overseas adjustments. The practical effects of this tax policy are clear: Americans overseas are at a significant competitive disadvantage and are being priced out of foreign markets because prospective employers must provide more income to compensate American workers for these additional tax burdens.

Overseas employers are faced with a choice: They must pay an American worker more than they would pay other comparably qualified nationals (so that the American may keep a comparable after-tax income) ***or*** they must utilize a tax equalization program to keep the employee whole for his or her additional tax burden. Both approaches involve additional costs to the employer -- a burden that many employers are unwilling to accept even if the American worker is more productive and has better professional qualifications than the competition.

For those companies that have a tax equalization program in place, where the company pays any actual taxes for its overseas employees, the current Section 911 exclusion helps to mitigate the tax burden mentioned above -- thereby cutting company costs and enabling it to be more competitive abroad. For companies that do *not* utilize a tax equalization program -- and most small and medium-sized companies working overseas fall into this category -- the Section 911 exclusion is most helpful to the *employee*, who is responsible for paying his own taxes. The current exclusion helps to make a difference in both cases, but the difference may still not be substantial enough to enable an American worker overseas to defend his or her job against foreign nationals.

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9 Chase Econometrics, *Economic Impact of Changing Taxation of U.S. Workers Overseas*, June 1980, p. 2.

10 U.S. & Overseas Tax Fairness Committee, Press Release, June 16, 1980, p. 4.

11 Ibid., p. 3.

The cost of hiring or maintaining an American worker is inordinately high because *non-salary*, quality-of-life items must be included in the worker's taxable income, often adding as much as 50 - 100 percent of base pay. Such "income" includes reimbursement for the cost of children's schooling, cost-of-living allowances, home leave, emergency travel, and other necessary and often expensive aspects of living overseas. Because so many overseas contracts today are decided on the basis of cost, and when companies' profit margins grow tighter and tighter, many employers (including American employers) simply aren't prepared to cover the additional tax burden to "Hire American."

A Section 911 Coalition member offered this case in point:

> A large American company recently won a multi-billion dollar, multi-year overseas contract to supply telecommunications equipment and services. The U.S.-based company would prefer to have Americans heading its overseas operations but, because the U.S. tax system effectively prices Americans out of the international job market, the company tends to hire Europeans instead.
>
> The President of this company's international operations is British, and his Vice President is Dutch. Not surprisingly, the Human Resources Director, who answers to the Vice President, is also from Holland. He has hired approximately 2,000 technical employees for this project, most of whom are Dutch. In addition, Volvos were purchased instead of U.S.-made vehicles because they are considered "more suitable" for the technical employees. If the U.S. tax system were more like those of America's trade competitors who maintain an unlimited foreign earned income exclusion, most of these 2,000+ jobs would have gone to Americans rather than Europeans, and a large number of American cars would have been exported instead of Volvos.

Section 911 makes a substantial difference in our nation's efforts to compete on the international business playing field. Without this exclusion, there is good reason to believe that many thousands of Americans currently overseas would be priced out of the global marketplace. This would be a devastating blow to America's national interests because Americans abroad:

+ Direct business and jobs to the United States;
+ Carry America's culture and business ethic to other nations;
+ Specify and purchase U.S. goods and services for overseas projects;
+ Set standards and shape ideas which guide future policies in the development of infrastructures and economies overseas.

In addition, for U.S. companies to continue expanding their market share worldwide, they must think and act globally. To stay competitive internationally, American managers need the kind of "hands on" experience that can only be gained by living and working abroad. In recent years, for example, two of the Big Three automobile companies promoted their CEOs directly from European positions to corporate headquarters. This clearly demonstrates recognition by these companies of the role that international experience plays in their economic futures.

In short, the foreign earned income exclusion for Americans working abroad helps to protect against replacement of Americans by third country nationals who pay no taxes at all in their home country on their overseas income. Given the tens of thousands of overseas business opportunities that are of interest to U.S. companies and U.S.-based institutions each year, the exclusion stands to make a substantial difference for American influence abroad, U.S. exports, U.S. jobs, and overall American competitiveness.

Who is Affected by the Foreign Earned Income Exclusion for Americans Abroad?

The loss of U.S. market share and the cutback in American jobs overseas represent a setback for American competitiveness. However, this tells only part of the story. The other part, of more immediate concern here at home, is the impact felt in communities all across the United States as jobs created or sustained by exports would disappear. ***All*** Americans abroad, whatever their background, are helping to fuel the economy in the United States. By securing employment overseas, they free up jobs for other Americans back home, thereby reducing unemployment. They also support the American economy by repatriating much of their overseas earnings back to the United States.

Most important of all, perhaps, Americans working overseas serve as the front-line marketing and sales force for U.S. exports. Unless all Americans support competitiveness through exports, our nation's trade deficit will surely continue. As noted earlier, exports are the engine of growth for the U.S. economy, and it is generally accepted that small and medium-sized companies provide the fuel for this engine. When the engine of growth is stalled out by constrictive U.S. tax laws that are no longer appropriate, Americans everywhere pay the price.

For years, supporters of the current Section 911 have emphasized that the exclusion is especially important to small and medium-sized companies operating in overseas markets. "Real world" experience has borne out that:

1) Small companies, when trying to gain a foothold overseas, are more likely than large companies (many with an established overseas presence already) to draw on U.S.-based personnel to penetrate foreign markets.

2) Small and medium-sized companies, because they lack the world-class name recognition that might provide them with open access to foreign customers, traditionally rely very heavily on Americans overseas to specify and purchase their products.

3) Small and medium-sized companies are, by necessity, much more sensitive to individual cost elements and the financial bottom line. Without the foreign earned income exclusion to help make overseas Americans more competitive with foreign nationals, relatively few of these small and medium-sized companies would be able to hire Americans to fill overseas slots.

How the Foreign Earned Income Exclusion Works for Companies that Employ Americans Abroad

The cost of hiring an American varies widely around the world depending on such factors as local housing costs, local standards of living, availability of schools and recreation facilities, remoteness and hardships, and so forth. Nevertheless, it may be instructive to look at a typical example of how the foreign earned income exclusion works. The American Business Council of the Gulf Countries, an Executive Committee member of the Section 911 Coalition, provided the following example.

> The cost for a grade school student to attend the American School in Dubai is approximately $10,000 per year -- not for an exclusive private school, but for the *only* American curriculum school there. If an employer reimburses this cost for two children, the employee has an additional $20,000 of imputed taxable "income." This places an additional tax burden on the individual of up to $8,000.
>
> If the employer chooses to make the reimbursement of this schooling cost tax-neutral to the employee, the total reimbursement cost to the company could exceed $33,000 (including the compounding effect of tax reimbursements, which are also considered taxable "income" to the employee). This represents a $13,000 (65 percent) additional cost *to the company* to provide education for the American employee's children

(compared to providing the same education for children of a comparable European employee) -- simply because of U.S. tax policy.

If the employer provides an annual trip back to the United States for home leave for the employee and family (spouse and two children), the employee has an additional $10,000 or more of taxable "income." Emergency and sympathy travel generate taxable income; cost of living adjustments are considered taxable income; hardship allowances are taxable income; tax reimbursement is taxable income.

In other words, as this typical example shows, taxable compensation that does not represent either "perks" or disposable income to the employee typically absorbs a very large part of the current $70,000 exclusion. This is a burden borne solely by Americans, significantly hampering their ability to compete in the international arena.

Conclusion

The foreign earned income exclusion for Americans working abroad is an important component of U.S. business competitiveness and will help reduce the federal deficit in the long run. Current law Section 911 generates tens of thousands of American jobs, strengthens our export position, and ***increases*** the U S. standard of living.

Perhaps more than any other provision of law, the foreign earned income exclusion for Americans working abroad helps to put U.S. citizens "in the field" around the world where they *buy* American, *sell* American, *specify* American, *hire* American, and *create opportunities* for other Americans. It has a direct impact on the competitiveness of American workers and U.S. companies operating in foreign markets -- a substantial growth area for the United States now and as we move into the twenty-first century.

To help place America on an equal footing with our trade competitors, real tax reform should provide a full exclusion for earned income abroad. If Congress ultimately decides instead to make only minor adjustments to current law then it should provide an exclusion that is no less than the current Section 911 with indexing against future inflationary losses. American jobs are on the line, especially for small and medium-sized businesses.

Chairman ARCHER. Thank you, Mr. Kaufman.
Mr. Warren.

STATEMENT OF WILLIAM WARREN, VICE PRESIDENT, TAX, TRW INC., CLEVELAND, OHIO; ON BEHALF OF EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. WARREN. Mr. Chairman and Members of the Committee, my name is William Warren. I am vice president of tax for TRW, Inc., a U.S. company based in Cleveland, Ohio, which provides advanced technology products for the worldwide automotive, space, and defense markets.

I am here today representing ECAT, the Emergency Committee for American Trade. ECAT represents over 50 large U.S. corporations with vital interests in promoting American trade through competitive U.S. tax practices and tax laws. Its members employ over 4 million people and generate over $1 trillion in annual sales. A written statement has been prepared and is submitted for the record.

The American business community must increasingly compete in a global environment. The competition is foreign companies who often receive preferential treatment from their home countries. With a U.S. Tax Code that often penalizes or discourages U.S. international business, competition is extremely difficult, and since 1986, we have grown increasingly concerned with U.S. tax policies that affect this ability.

There is particular concern with the perception by some in Congress that U.S. investments abroad are harmful to the U.S. economy. This is incorrect. International investments by U.S. companies gain worldwide market share and are essential to serve non-U.S. customers. These investments, by building U.S. competitive strength, help build a solid base for the U.S. economy, as shown in an ECAT study referenced in my written submission.

A presence in a foreign country does not mean lost employment in the United States. Because overseas operations are good customers of U.S. operations, international expansion often results in more employment in the United States. Generally, a company, such as TRW, could not compete in a foreign market by expanding operations in the United States. In our business, we must be near the customer.

TRW, like many ECAT companies, grew up in the United States and is today in the Fortune 100 with a presence in 21 countries. TRW is proud of this ability to compete globally. Our employees gain from this success. Thus, it is important that tax policies enhance the ability of U.S. companies to invest and compete globally.

Taxation of U.S. international business under the current U.S. Tax Code was developed around the basic principle of avoidance of double taxation. Fundamental tax reform must retain this concept. Unfortunately, since 1986, we have seen constant attacks on and significant erosion of this basic principle, along with an enormous rise in tax complexity in the U.S. Tax Code's international provisions.

Fundamental tax reform must take a different course. Although there are many unknowns on the effect of any specific fundamental tax reform plan on U.S. international competitiveness, we encour-

age the study of this area. We also urge that international tax reform efforts begin immediately to simplify the current Code and return to basic principles.

While we offer no specific endorsement of any outstanding fundamental tax reform proposal, we do offer the following principles. Any new tax system: Must avoid double taxation of international earnings; must be simple, practical, well considered; must replace rather than add to the present income tax burden; must have a fair transition from the current system; should encourage exports and direct foreign investments; should ensure that imports and foreign-owned businesses operating in the United States are taxed no less than our participants; and should be revenue-neutral.

In terms of immediate tax reform needs, we urge that Congress begin with the following simplification and reform efforts: Halt the expansion of subpart F and attempts to tax foreign-source income through a tax on what is commonly referred to as deferral; repeal section 956A; treat the European Economic Community as a single economic region for tax purposes; repeal the Private Foreign Investment Corp. provisions; protect the current Foreign Sales Corp. and export source rules; reverse the resourcing of U.S. expenses, such as U.S. interest expense; make the R&D tax credit permanent and ensure foreign royalties remain foreign sourced; and last, avoid tax treaty overrides through legislation.

My written testimony elaborates on these areas. Again, we appreciate this opportunity to testify.

[The prepared statement follows:]

TESTIMONY ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE BEFORE THE COMMITTEE ON WAYS AND MEANS HEARING ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX PRESENTED BY WILLIAM WARREN, VICE PRESIDENT, TAX, TRW INC.

THURSDAY, JULY 18, 1996

The Emergency Committee for American Trade ("ECAT") is pleased to offer this testimony on fundamental tax reform and international competitiveness to the Ways and Means Committee. ECAT is an organization that represents over 50 large U.S. corporations with vital interests in international tax and trade. Its member companies employ over 4 million people and generate over $1 trillion in annual sales. Its membership includes American companies who are among our largest and best competitors for world markets. I am William Warren, Vice President for Tax at TRW, Inc., an Ohio-based company which provides advanced technology products for the worldwide automotive, space, and defense markets. TRW's annual sales exceed $10 billion and its worldwide employment is in excess of 66,000.

As we approach the tenth anniversary of the 1986 Tax Reform Act, it is a particularly fitting time to consider fundamental tax reform. The Tax Reform Act was the last time Congress flattened tax rates and broadened the tax base. This was certainly a praiseworthy, albeit a somewhat temporary, accomplishment.

The Tax Reform Act's treatment of international business, however, was considerably less praiseworthy. The Act added enormous complexity and a host of new provisions which greatly increased the risk of double taxation. This was done for a number of reasons -- for example, to raise revenues and in recognition that the employees of an American-owned plant in a foreign country do not vote. But perhaps most important was the notion harbored by some in Congress that American investment abroad was tax-motivated and harmful to our economy.

This notion is *wrong*. American companies invest abroad for business reasons -- that is where the oil is, for example, or where the timber grows, or where huge infrastructure contracts are being awarded. In short, that is where the resources and markets are that spur the growth and undergird the prosperity of the American economy. America needs its companies to sell computers and software in the EU, trucks, autos, and parts in the booming economies of Southeast Asia; turbines, boilers, pipeline and engineering services for construction projects in China and the Mid-East; consumer goods in Canada and Mexico; and pharmaceuticals to the sick and elderly of the world. To do this, American business must have -- directly in the markets in question -- marketing and distribution systems, warehouses and parts depots, assembly and manufacturing operations, service and repair facilities, and the like. American business must have these things locally to meet regulatory rules, to avoid tariffs and quotas, and, most importantly, to get the customer or contract. Taxation is an after-the-fact consideration. Once it is clear an operation is needed within the EU, for example, in order to compete for European market share and serve European customers, it is appropriate to site that operation in a European tax-advantaged "development area," "coordination center," or "international zone." Our European competitors certainly do.

In addition to foreign operations, American business needs one other thing to compete effectively abroad. It needs its Government not to shackle it with tax burdens not faced by its competitors -- particularly double taxation. American companies bidding to sell, say, turbines, boilers, structural steel, engineering and construction services, and so on in connection with a hydroelectric project in, say, India, need to be taxed no more than the Japanese, Korean, German, Italian, and French companies bidding for the same business. The American bid will be too high if it must take into account both an Indian tax and double taxation imposed by the United States. Or, if we nevertheless get the business the first time, our margins will be too thin, if double taxed, to attract the capital necessary to mount the next bid.

If American business done abroad is taxed fairly here, it will be able to compete with anyone in the world. And this will be good, not bad, for our economy. The notion that domestic jobs or domestic capital are lost when American business invests abroad is wrongheaded. After all, the United States is a mature economy approaching zero population growth, and its citizens comprise only 4% of the world's population. Much of the action fueling our economy lies with the other 96%.

In 1993, ECAT published a study entitled "Mainstay II" which amply demonstrates the positive impact of foreign direct investment on the U.S. economy, based on an analysis of U.S. Department of Commerce data. The key findings of the study were that:

1. The net return on the foreign investment of American companies operating internationally is the most positive single element in the U.S. balance of payments account. In 1992 alone, the amount returned to the U.S. was almost $50 billion -- $50 billion of additional capital for jobs formation, research, and capital improvements.

2. Exports accounted for fully 89% of U.S. economic growth in a recent three-year period, and American companies with foreign operations and foreign facilities accounted for fully two-thirds of this.

3. Industries with the highest levels of foreign investment have the highest rate of exports and export growth.

4. The higher the share of U.S. direct investment in a foreign country, the more likely the U.S. is to have a merchandise trade surplus with that country. (It is no accident that Japan, whose markets are largely closed to our investment, is also largely closed to our exports -- with the resultant trade imbalance of which we are all aware.)

5. The total number of jobs created by the exports of American companies which operate abroad reached five million by 1990, according to the Department of Commerce.

A copy of the executive summary of "Mainstay II" is attached to this testimony.

With the foregoing in mind, what can Congress do to insure America's competitiveness abroad? It should certainly analyze and debate new methods of taxation, such as consumption, sales, or other flat taxes. But such reform must be well-conceived, thoroughly considered, and finely executed. That not one of our major trading partners relies exclusively on any such tax serves fair warning on the difficulties involved. A hasty mistake could dislocate a major sector or region of our economy. Accordingly, it is unlikely that fundamental reform can come quickly. In the meantime, simplification and reform of the income tax as it applies to international business, particularly reform of those provisions borne of the 1986 Tax Reform Act and its suspicions of international business, would be a major contribution. Such reform would:

(1) Halt the expansion of subpart F -- that is, halt attacks on "deferral": U.S. tax policy has always recognized that earnings produced abroad by a foreign corporation generally are not taxable in the United Sates until paid to a U.S. shareholder. Critics of this policy describe it as "deferral," and brand it a "loophole" which stimulates the "runaway" of American business to foreign locations. But American companies invest abroad for business reasons, as explained above, which are essential to the well-being of our economy. Accordingly, the premature taxation of foreign earnings hurts our competitiveness, and should not be extended.

(2) Repeal section 956A. This provision was passed in 1993 as a continuation of the attack on deferral begun in 1986. It has remained controversial since its enactment, and is almost universally opposed by American industry.

(3) Treat the EU as a single economic region for subpart F purposes. Many provisions of subpart F do not apply to operations within a single foreign country. As Europe unifies, American business has responded by operating regionally, not country-by-country. Our Internal Revenue Code should recognize this.

(4) Repeal (or revise substantially) the so-called PFIC provisions as they apply to corporations. The 1986 Tax Reform Act added a whole new statutory regime that further eroded "deferral." These provisions were originally thought to apply only to individual investors. Later they were "discovered," in what was at first described as a technical drafting error, to apply to corporations. Now American companies must run the twin gauntlets of subpart F and PFIC with respect to the earnings of their foreign affiliates. If they fail either, money generated by a foreign company in a foreign site and still residing in that foreign business is taxed in the U.S. currently.

(5) Protect the export source and FSC rules. These provisions are among the few GATT neutral, export incentives in the current Internal Revenue Code. They are understood and effective, with the export source rule in particular operating in an administratively convenient manner for both taxpayers and the IRS. These provisions are very important to many of our largest exporters, yet come up year-after-year as a potential source of revenue.

(6) Reverse the "resourcing" of U.S. expenses, particularly interest. The 1986 Tax Reform Act added new rules to sections 861-865 of the Code, which have produced hundreds of pages of 861 regulations. These rules treat expenses incurred in the U.S. "as if" they were incurred abroad. No major country permits U.S. expenses -- for example, interest paid on a U.S. loan to a U.S. bank -- to be deducted

just because complex U.S. rules "deem" them to be partially "foreign." The so-called 861 rules are one of the major causes of double taxation, and for many companies they are perhaps the major tax impediment to competitiveness.

(7) Encourage R&D American companies compete through innovation, which should be encouraged by stable, long range tax policies which stimulate investment in research and experimentation. To this end, Congress should make permanent the R&D credit, and continue treating foreign royalties and license fees as foreign source.

(8) Avoid legislative treaty overrides. Our tax policies are coordinated with a number of other countries, via treaty. General legislative pronouncements which fail to account for the integration and cooperation necessary to avoid double taxation between major trading partners are ill-considered. Congress must remember that when it announces broadly that it will "level the playing field," it is not in unilateral control of the field internationally.

(9) Recharacterize income in certain loss situations. U.S source income should be recharacterized as foreign source income where a taxpayer has suffered a reduction in foreign tax credit limitation in a prior year as a result of an overall domestic loss. This treatment would be symmetrical with that currently accorded overall foreign losses.

We know that many ECAT companies will write separately and in greater detail to the Committee about these issues.

Returning to the Committee's longer-range goal of replacing the income tax with a wholly different tax system, we note that there are a number of competing proposals, each with its benefits and detriments, and each supported by different economists and theoreticians In other words, the Committee work in this area is just beginning Nevertheless, ECAT believes that any fundamental reform must be based on the following principles:

1. Any new tax must avoid double taxation of the earnings produced abroad by American affiliates competing in world markets.

2. Any new tax must be practical and well-considered, not theoretical or experimental. The Committee must not trade the frying pan for the fire, and must adjust with prudence and foresight an economy measured in trillions of dollars and an income tax that raises over $800 billion.

3. Any new tax must replace (in whole or part) -- but not add to -- our present income tax burden.

4. Any new tax should provide for fair transition from our current system -- for example, the new system cannot tax historical overseas earnings on which foreign taxes have already been paid.

5. Any new tax should encourage exports and direct American investment in foreign markets.

6. Any new tax should insure that imports and foreign businesses participating directly in our marketplace are taxed no less than our own participants.

7. Any new tax should be essentially revenue neutral, because prudent budget policies remain fundamentally important to economic expansion.

8. Any new tax should insure that the after-tax return on U.S. R&D is not undermined.

ECAT and its member companies will be pleased to assist the Committee and to participate in the dialogue as this very important initiative proceeds. We ask that this initial statement be included in the record.

Executive Summary

This study examines the role of U.S. multinational corporations in the U.S. economy from 1980 through 1991, with an emphasis on the manufacturing sector. Most of the data relating to U.S. multinational companies and their foreign affiliates are derived from official U.S. Government statistics, principally the U.S. Department of Commerce's annual survey, "U.S. Direct Investment Abroad: Operations of U.S. Companies and Their Foreign Affiliates." Comprehensive benchmark surveys were completed in 1982 and 1989. Data for intervening years are based on slightly less detailed annual surveys. Data on international financial flows related to direct investment were obtained from U.S. balance-of-payments statistics, as reported quarterly in the "Survey of Current Business."[4] International comparisons are based primarily on Organization for Economic Cooperation and Development (OECD) data.

The study shows conclusively that multinational companies made strongly positive contributions to the U.S. balance of payments throughout the 1980's and into the 1990's. They did so during a decade characterized by a massive deterioration of the U.S. trade balance, its international payments balance, and its global financial position. Indeed, multinational companies are now the single most positive factor in the U.S. balance of payments. Had it not been for the outstanding performance of multinational companies during the 1980's, the international economic position of the United States would have been far worse, given the weaker performance of corporations oriented primarily toward the domestic market.

The report's principal factual findings are as follows:

- *The overseas business operations of U.S. multinational companies contributed a record net surplus of $130 billion in 1990 to the U.S. balance of payments.*

- *For the total period, 1982 to 1990, U.S. multinational companies contributed an average net surplus of $83 billion annually to the U.S. balance of payments.*

The report demonstrates that overseas investment by U.S. multinational companies contributes to the health of the companies, to U.S. domestic employment and to the overall strength of the U.S. economy. Following are the detailed findings of the report.

I

American Companies With Overseas Investments Have Been Waging A Hard Fight — And A Successful One — To Keep Exports Flowing From The United States.

- *On the merchandise trade account, their surpluses rose from a net surplus of $46 billion in 1984 to a net surplus of $80 billion in 1990.*

- *These trade surpluses were earned in almost every industrial sector.*

By contrast, the overall U.S. trade balance for manufactures deteriorated steadily to a deficit of $125 billion in 1987, ending the decade in 1990 with a deficit of $73 billion. Without the enormous balance of payment surpluses of multinational companies, the state of the U.S. balance of payments would have been truly calamitous with concomitant adverse effects on the U.S. economy.

- *The dramatic deterioration of the U.S. merchandise trade balance in the first half of the 1980's was driven by clearly identifiable macroeconomic forces.*

The most important factors were the overvaluation of the U.S. dollar, up 37 percent in real terms against 40 leading international competitors from 1980-1985, and a rapid growth in U.S. domestic demand in 1982-1985 relative to other industrialized countries. Similarly, the subsequent recovery in U.S. exports and welcome improvements in the merchandise trade balance can be traced to a reversal in these macroeconomic trends. Had U.S. multinational firms not made foreign investments, the trade balance would have been far worse.

- *Exports by U.S. multinational companies have risen sharply since 1985. (Real U.S. export growth averaged 14 percent annually from 1986-1991, the highest for any five-year period in U.S. history.)*

- *U.S. exports accounted for 89 percent of U.S. economic growth during 1989-1991.*

- *U.S. multinational companies accounted for approximately two-thirds of U.S. manufactured exports.*

II

The Net Return On The Foreign Investments Of U.S. Multinational Companies Is The Most Positive Single Element In The U.S. Balance Of Payments Account With The Rest Of The World.

Not only have multinational firms achieved huge surpluses on trade account, the net repatriated earnings from their overseas investments have also been consistently positive as have their overall financial transactions.

- *For 1992, their net repatriated earnings reached $48 billion. These earnings — the share actually brought home to the United States — have been the most positive single entry in the U.S. balance of payments.*

- *While returning substantial trade and balance of payments surpluses to the United States, multinational companies continue to build their operations abroad, thereby assuring future returns. They do this primarily through the reinvestment of overseas earnings and not through the exports of funds from the United States.*

III

Investments Abroad Keep American Companies Competitive.

- *Investments overseas enable multinational companies to enjoy greater economies of scale, to solidify access to foreign markets, and to sustain the worldwide research and development activities indispensable to maintaining competitiveness in an increasingly global environment.*

U.S. firms and industries that have been the most aggressive in expanding global investments have also been the most successful in expanding both their U.S. exports and global market shares.

- *Industries with the highest levels of foreign investment have the highest rate of exports and export growth.*

Exports to overseas affiliates accounted for a steadily rising share of total exports by multinational companies and are correlated strongly and positively with growth in foreign affiliate sales. This demonstrates a critically important aspect of foreign investment by multinational companies, i.e. that exports follow investment.

- *The higher the share of U.S. direct manufacturing investment in a foreign country, the more likely the U.S. is to have a merchandise trade surplus with that country. (The relative paucity of U.S. direct investments in Japan, for example, is a major reason why U.S. exports to that country are relatively small.)*

IV

Foreign Investment Serves Foreign Markets.

- *The underlying motivation for foreign direct investment is to penetrate markets otherwise commercially inaccessible to U.S. firms and then to protect or expand market share. U.S. foreign affiliates thus predominantly serve the foreign markets where they are located — or third-country markets.*

- *Excluding Canada, only 7.2 percent of total sales by U.S. foreign manufacturing affiliates were to the U.S. market in 1990 — a percentage that was remarkably stable throughout the 1970's and 1980's.*

These numbers show that the increasing imports that have been entering the United States in the period covered are rarely being produced by affiliates of American companies. Accordingly, any restrictions on U.S. investment overseas would not meaningfully reduce imports as is often contended by opponents of foreign investments. Rather than replacing domestic production, foreign manufacturing by U.S.-based multinational companies has increased the volume of American exports.

Foreign investments result in exports of intermediate parts and components and may even produce an immediate foreign demand for U.S. capital goods for new facilities or modernization. These investments establish a market for exports of products associated with the goods produced abroad and for exports where local demand exceeds local productive capacity but does not warrant major expansion. Foreign investment helps popularize U.S. trademarks and brand names and to customize products to local need. It enables U.S. companies to put in the kind of service and distribution networks that could not be supported by exports alone.

V

The Growth In U.S. Multinational Companies' Exports And International Investments Has Generated Increased Employment For Their U.S. Workers.

- *In addition to their critical contribution to the U.S. balance of payments noted above, U.S. multinational companies have been and continue to be responsible for significant employment in the U.S. economy — much of which is generated by their foreign investment.*

- *The total number of U.S. jobs created directly or indirectly by the manufactured exports of U.S. multinational companies reached 5 million in 1990, based on U.S. Department of Commerce estimates of the number of manufacturing and nonmanufacturing jobs generated per billion dollars of manufactured exports.*

During the 1980's, manufacturing multinational companies had a better record on employment than the typical large U.S. manufacturing firm. With the economic downturn and increased pressure from foreign competitors, employment by U.S. multinational company parents fell slightly from 1982-1989. That decline, however, was substantially smaller than the decline in employment by Fortune 500 companies as a whole.

Findings

The above findings demonstrate that the simple contention that multinational companies are harming the U.S. economy by shifting jobs abroad and importing cheaper products into the United States does not bear up under scrutiny. Rather, the exact opposite is true. Investment abroad by multinational companies provides the platform for growth in exports *and* creates jobs in the United States.

The study provides data to back up the fact that companies that think and act globally set the pace for U.S. exports. For such companies, their foreign investments create a constant awareness of market opportunities for U.S. exports, which might otherwise go unnoticed.

As the business and consulting economists who prepared the earlier ECAT "Mainstay" study stated: "The conclusions ... about the operations of the multinational corporation are based on sound statistics. If they clash with judgments derived from a combination of isolated incidents and intuition, they can stand their ground."

And a Renewed Warning

There are, however, clouds on the horizon. As the U.S. economy continues its slow recovery and unemployment rates continue to be a concern, proposals have been put forward to limit the ability of multinational companies to invest abroad. Proposals have also been made to restrict the economic activities of foreign multinationals in the United States.

Enactment of such measures could cripple the international competitiveness of the U.S. economy. On the one hand, the proposals would curtail needed foreign capital for the U.S. economy. On the other, they would limit the ability of U.S. multinational companies to compete globally with firms from Japan, Germany and elsewhere — firms that are increasing their global market share at the expense of U.S. firms. The U.S. share of annual outflow of direct investment has dropped from two-thirds of the worldwide total in 1967 to one-fifth in 1988-1989. Over the same period, Japan's share grew from 2 percent to 28 percent. The share of the European Community grew from 28 percent to 48 percent.

This study — by measuring the benefits that flow to the U.S. economy from the exports and foreign earnings of multinational companies — shows:

First, that investment restrictions could cut into our major surplus balance of payments account with the rest of the world; and

Second, by its analysis of how the exports of multinational companies exceed imports by tens of billions of dollars each year, that limits on investment would reduce U.S. exports. This could lead to a chain reaction, lowering the level of world trade, and diminishing the welfare of all participants.

The numbers in the report establish the positive correlation between investments abroad by multinationals and the propensity of foreign countries to import American products. This gives statistical support to the view that investments mean more access to markets.

Perhaps the most important conclusion validated by the report's data is that multilateral approaches to international trade and investment issues work well. In a foreword to an early ECAT study (and reiterated in ECAT's first "Mainstay" publication) President Dwight D. Eisenhower warned against a return to "an inept, selfish and self-defeating system of economic nationalism." The data in this new study makes even clearer the importance of maintaining the hard-won open system of global trade and investment. In particular, it details the improvement in the U.S. balance of trade that began in 1985 when governments worked together on the problem of the overvalued dollar. And it then shows how American multinationals set the pace in the turn-around in trade that followed — making the case that other difficulties can also be dealt with in a similar fashion without undue or unnecessary risk to U.S. competitiveness, domestic jobs or international economic progress.

Chairman ARCHER. Thank you, Mr. Warren.

We do have to go to vote, and I am going to have to excuse myself shortly, but I want to quickly ask a question or two and hopefully get some brief answers.

Is it true foreign countries tax their own corporations' foreign-source income only if they are operating in countries which have an income tax?

Mr. CONWAY. I would say, Mr. Chairman, that I would like to take a crack at that. The answer is no. There are situations like Japan, for example, where they have tax sparing. So that, if a Japanese company is able to take advantage of a local tax incentive, they will essentially be able to preserve that.

When they repatriate the income back to Japan, they can preserve the low taxed income. They aren't taxed up to the full Japanese rate. So they can take advantage of lower taxes outside of their jurisdiction.

Japan has a double system like the United States but it is far more business oriented and designed to encourage foreign and direct investment.

Chairman ARCHER. Then, would it be fair to say that most European countries tax foreign-source income only when their corporations operate in foreign countries that have an income tax?

Ms. DUNAHOO. I think it is impossible to make a blanket statement on that question.

Chairman ARCHER. Are there a number of countries that operate that way?

Ms. DUNAHOO. The law varies from country to country. For instance, in the Netherlands, they have a territorial system and just exempt foreign-source income, even when it is brought back and paid as dividends to the Netherlands' parent from other countries.

Chairman ARCHER. Maybe I am not making my question clear. Most all of our industrial competitors do not tax foreign-source income. But is it not also true that there is a provision in their law that says that that applies only where the foreign country in which the income is earned has an income tax? Since offshore countries have income taxes, the foreign-source income is not taxed. Is that not generally a fair statement?

Ms. DUNAHOO. That is probably true in the case of most countries.

Chairman ARCHER. OK. Mr. Warren, although you said you were not going to take a position between the various proposals, I listened carefully to what you said. I thought you said replace the current income tax. Now, that says to me that a flat tax doesn't qualify because it is still an income tax.

Mr. WARREN. Well, our position was that if you are going to enact a new tax system, it should be a complete replacement for the old system. Let us not have two systems simultaneously taxing with the added complexities.

Chairman ARCHER. So complete replacement does not mean discontinuing taxing income as the base and perhaps having two rates and having a number of deductions. But it would still be considered to be a replacement of the current income tax.

Mr. WARREN. What we are urging is simplification. Simplification is not achieved by having multiple tax systems.

Chairman ARCHER. You are hedging all of your bets. I just wanted to be sure I understood.

I am going to go vote, but I would like for you to submit for the record or perhaps testify about, how PFIC and 956A work against investment in this country, and promote investment in foreign countries because I don't think that the majority of my colleagues understand that. I personally agree with you that we should repeal PFIC and 956A. However, we need the information in the record as to precisely how these provisions work against the best interests of this country.

Mr. WARREN. Thank you, Mr. Chairman.

[The following was subsequently received:]

SUPPLEMENTAL STATEMENT
OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE
TO THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 13, 1997

At hearings last July on fundamental tax reform, Chairman Archer commented critically on the PFIC provisions of the Internal Revenue Code in questioning ECAT's witness. Staff of the Ways and Means Committee recently contacted ECAT requesting a short, supplemental statement expressing ECAT's views on PFICs. ECAT is pleased to respond as follows:

"In hearings on July 18, 1996, Chairman Archer expressed his personal view that the PFIC provisions of the Internal Revenue Code should be repealed because they work negatively against the best interest of this country. ECAT agrees.

The PFIC provisions levy a current U.S. tax on a foreign corporation with U.S. shareholders if the foreign corporation has "too much" capital or makes "too much" non-operating income. The PFIC provisions are another "anti-deferral" regime. American companies competing abroad are already subject to the anti-deferral regime of Subpart F. Now they must run the twin gauntlets of Subpart F and PFIC with respect to the earnings of their foreign affiliates. If they fail either, money generated by a foreign affiliate in a foreign site and still residing in that foreign business is taxed in the U.S. currently. This is a complicated and costly burden not borne by our competitors.

The PFIC provisions were borne of the misguided notion that American investment abroad is tax-motivated and harmful to our economy. Of course, American companies invest abroad for business, not tax reasons -- that is where the resources and markets are that spur the growth and undergird the prosperity of the American economy. America needs its companies to sell computers and software in the EU; trucks, autos, and parts in the booming economies of Southeast Asia; turbines, boilers, pipeline, and engineering services for construction projects in China and the Mid-East; consumer goods in Canada and Mexico; and pharmaceuticals to the sick and elderly of the world. To do this, American business must have -- directly in the markets in question -- marketing and distribution systems, warehouses and parts depots, assembly and manufacturing operations, service and repair facilities, and the like.

Most importantly, to do all this so as to compete effectively abroad, American businesses need *capital*. The PFIC provisions are offbase in adjudging that a U.S.-controlled foreign corporation can have "too much" capital. These provisions make no allowance for the accumulation of capital necessary, for example, to build state-of-the-art manufacturing facilities to service foreign markets, or to purchase the sophisticated equipment necessary to compete against the best the Germans, Japanese, or others have to offer.

Congress recognized a similar misstep when it repealed section 956A last year. Now it should repeal the application of PFIC to American businesses already covered by Subpart F. Or, at a minimum, repeal the portion of the PFIC provisions that apply to the accumulation of capital, while retaining that portion that applies to the generation of "too much" non-operating income (as a safeguard against the rare abuse).

If American business done abroad is taxed fairly here -- with non-duplicative, administrable provisions that recognize the legitimate capital needs inherent in a global marketplace -- American business will be able to compete with anyone in the world."

Mr. HANCOCK [presiding]. The subject is quite obvious, but there are some questions we would like to get some comments on and become part of the record.

Ms. Dunahoo—is that right, "Dunahoo"?

Ms. DUNAHOO. "Dunahoo," right.

Mr. HANCOCK. Your testimony raises an interesting issue, and that is, How will foreign governments respond to our tax restructuring efforts?

As a practical matter, how do you think it will be for the United States to enact tax restructuring legislation that is acceptable to most, if not all, of our major trading partners?

Ms. DUNAHOO. Well, I think, as I mentioned briefly in my oral statement, it is very difficult to predict how other countries will react, and they all are not likely to react in the same way.

What we have done is identify some of the major possibilities, but I think it will depend to a great extent on exactly how the fundamental tax reform is structured; for instance, whether the United States not only repeals its income tax, but also repeals withholding taxes on portfolio investment income paid out to foreign persons. If we repeal both of those, then the United States becomes, from the perspective of other countries, a potential magnet for investment capital, and it is not hard to imagine that other countries might be unsettled by a sudden outflow of capital from their countries. Obviously, the degree to which that is a risk depends on exactly how the tax system is structured.

It is difficult to predict how other countries would react in the case of treaties because treaties fulfill so many different functions in the international tax system. The one that receives the most play, really, is the reduction of withholding taxes on cross-border flows of income, and those reductions are normally negotiated as a reciprocal matter.

If the United States moved to unilaterally repeal its withholding taxes on all investment income leaving the country, then the other countries might very well feel that they have nothing additional to gain in that regard by entering into a treaty or by maintaining a treaty relationship with the United States.

On the other hand, they may think, Well, we have to reduce what are typically very high statutory withholding rates in order to continue to attract U.S. capital to their countries.

So I am afraid we aren't really in a position to offer any assurances on this issue either. I think it is something that deserves a lot more exploration and perhaps discussion with other countries.

Mr. HANCOCK. Mr. Warren, in your testimony, you cautioned the Committee against passing any legislative treaty overrides. Would you share with the Committee some of the practical problems caused by legislative treaty overrides?

Mr. WARREN. In international business, part of the international business community, we rely on the existing tax treaty network to build a system not only of fair taxation between countries based on country-to-country negotiation, but also a system to resolve international tax audit disputes through what is commonly referred to as the competent authority process.

Tax treaty overrides through legislation based on, let us call it, broad principles of overriding issues, lead to a great deal of tension

between countries. Our fear is it will make it more and more difficult to resolve existing audit issues and interpret existing statutes.

We rely on and invest in foreign countries in anticipation of certain tax rates applying to dividend flows coming back to the United States.

For a treaty to be entered into, again, based on bilateral negotiations and then overridden after 3, 4, or 5 years, or perhaps later, simply leads to tension between the two countries and trade barriers we think are not in the best interest of the United States from an economic standpoint.

Mr. HANCOCK. Also, in your testimony, you note that a restructured tax system should encourage exports and U.S. investments. I think we are all trying to get there.

Do you have any specific proposals you feel would achieve either or both of these objectives, and if so, would you share it with the Committee?

Mr. WARREN. As a company, TRW exports a number of parts and services to our foreign affiliates.

The existing Tax Code through the sourcing rule, what is commonly referred to as the 863(b) foreign sourcing rules for export sales, is certainly an incentive. We use those rules in doing sourcing studies, and it does result in direct exports from the United States.

The foreign sales corporation rules, again, go into the same studies. For example, if we have an opportunity or a need for a German affiliate to buy parts, we might be able to source those parts out of Spain, out of the United Kingdom, or out of the United States. The existing Tax Code does encourage U.S. exports of related parts, and it does generate exports. I think that is the type of rules that need to be solidified. From time to time, they do come under attack through different proposals being offered within the Congress, and I think it is important Congress understand that those rules do work, they are used, and they do generate U.S. exports.

Mr. HANCOCK. Thank you, Mr. Warren. Mr. Kaufman, how important a role does the section 911 exclusion play when U.S. businesses are recruiting employees for work in a developing country?

Mr. KAUFMAN. The section 911 exclusion plays a very important role when we are moving into developing countries. Many developing countries might have a lower tax rate in order to try to get investment within their country. So, therefore, foreign tax credits alone won't remove the U.S. tax. We need the section 911 exclusion or else the American simply costs more to go into that developing country than the German or the Japanese or the Swede or the citizen of any other country in the world. This is a very clear situation. In comparison to any other industrialized country, we are the only ones that would tax the American while they work abroad. So, without section 911, we are putting ourselves at a disadvantage when we are trying to move into those emerging markets.

Mr. HANCOCK. Mr. Conway, your testimony briefly referred to section 956A and the PFIC rules. Can you tell the Committee how these provisions have affected your particular company's business?

Mr. CONWAY. Sure. The 956A rule requires essentially that the U.S. company, like UTC, do a calculation at the end of every quar-

ter of business to determine how much cash we have accumulated in our corporations outside of the United States, and these companies are operating companies that are generating active income outside the United States Now, with the enactment of 956A, what happens is we have to do a computation to determine whether or not we exceed the 25-percent threshold because, if we do, deferral has been terminated, and we have experienced this second level of taxation.

The problem here, as I said before, is we want to use the cash generated from these offshore operations to fund our expansion into these emerging markets, and the fact of the matter is, for example, we are in the elevator service business. When we enter into these emerging markets, the way we can obtain business is through partnerships. We just can't go in and construct new buildings, so there will be new elevators. We have to compete for the existing contracts.

So we use cash to do that, and once we are in the market and we are increasing the business, we want to use the cash generated in the foreign market. We don't want to have to repatriate it back to the United States, incur an additional level of taxation, withholding tax, and then have to reinvest it back outside of the United States.

By the same token, we want to make sure that the U.S. cash that we generate is available for our U.S. needs. I refer to our research and development expenditures.

So 956A has the effect for us of partially repealing deferral, and it means that at the end of every quarter, UTC has to do a calculation. We have 300 corporations operating outside the United States who are potentially impacted by this rule, and it involves not only the tax people. You have to get finance people, business people involved in looking at the numbers to see if 956A applies. There is a tremendous opportunity cost that is associated with the complexity of our foreign international tax system that needs to be recognized. It is a major detriment to U.S. companies.

Mr. HANCOCK. Thank you very much.

Mr. Gibbons, the Ranking Member.

Mr. GIBBONS. Thank you very much.

I appreciate all of you coming here and telling us about your problems. I hate to throw cold water on anybody's parade, but having been around here a while, I don't think Congress possesses the ability to go back and to really readjust all of these very complex income tax problems that you all are concerned with and that we largely created here.

I have watched the deterioration of the process over the years, and I have become pretty convinced that Congress just will not go back and undo all the horror stories we have imposed upon you, but that we may take a chance and go for something brandnew that will give you an opportunity to compete more fairly in the international marketplace. So that is where my remarks are directed.

Ms. Dunahoo, I think you were wise to say that whatever we do, there is going to be some kind of international response to it. So I think that what we should try to do is to join the international parade as far as taxes are concerned and to be in a position where

there will be the least amount of criticism of what we do in all of that, and that is why I have gone to a destination-principle, subtraction-method, value-added tax because I think it will be the cleanest.

I don't see how any of our foreign competitors can really oppose our applying it or treat us unfairly because of that. Essentially, I think they are heading in that direction.

Mr. Warren, I would like to think Congress could go back and correct all of the horror stories that you lay out there, but it is just not in the cards. I know these folks really well. I respect them all, but I just don't think we have got the desire to go back and fight all of those battles, those rearguard actions, but I do think that there is a growing groundswell within Congress here to do that.

Mr. Kaufman, I realize we have made the American worker the most expensive to hire, the last hired, the first fired, and not only does it have an impact on American employment, but it has a huge impact on our trade position because Americans, when they are hired, tend to purchase from American concerns. They tend to design into the product, the American product, the American subcomponents, and we have played a stupid game in taxing Americans' personal income, so that we make Americans very unattractive as far as hiring is concerned in foreign environments.

So I applaud each of your coming here. I hope we can all join hands somewhere down the road and realize that we have got to move forward and we can't go back and repair the horror stories we have imposed upon you.

Thank you very much for coming and helping us with this.

Mr. HANCOCK. Thank you.

Mr. Laughlin, the gentleman from Texas.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Conway, how difficult does the Tax Code's current international tax rules make it for U.S. companies to compete overseas, and would you tell us why?

Mr. CONWAY. I think there are essentially two aspects, one procedure and one substantive.

Number one, we have to have a mechanism in place to deal with our second layer of taxation. So we have to have a tax department. We have to collect a significant amount of financial information from our overseas operations in order to comply with the laws.

In addition, we have to get the business people involved to focus on that information to make sure it is accurate, to update it, and when we have tax audits, inevitably, we get them involved in verifying all of this information. So there is a tremendous amount of time and effort that is involved in making sure we comply with the system, but more importantly, where we suffer, I think the major competitive disadvantage is when we are trying to compete in the market with, say, a company from Germany, like the Schindler Co.

If we are competing in an emerging market somewhere in Latin America or in the Far East and we are both looking at an acquisition, there are many cases where our people will come in with projects that are impacted by these rules.

Recently, I was involved in such a project. We were going to acquire a 49-percent interest in an existing business that had a good market share in a market that is important to us. I pointed out to

our business people that we were going to be at an economic disadvantage because, in doing the foreign tax credit calculation, there would be inefficiencies. We would have to do a separate calculation for this particular entity, and there are 30 entities we have to do that calculation for each year.

I am not complaining about the fact we have to do the calculation, but there is a built-in inefficiency in putting this company in a separate foreign tax credit calculation basket. If the taxes are higher than the U.S. rate, we are precluded from averaging them in. If they are lower than the U.S. rate, we wind up paying the additional U.S. tax.

Our average tax burden on that particular acquisition goes up dramatically, and I can tell you the Schindler Co., a German-based competitor, is not subject to that. So it is inhibiting our ability to compete. It is an economic factor in competing against these other companies.

The other thing we are talking about is double taxation. In fact, what we have is triple taxation. Most of our competitors outside the United States have imputation systems where the corporate tax is a credit to the shareholder tax, so that they tax income earned by a business once.

In the United States, our income is taxed potentially three times, and I recognize there is a need to raise revenue, and we can adjust the rate, but we have three levels of taxation, three tax systems to maintain. When you look at this on an operating basis, it does have a significant material adverse impact. It is not just the people in the tax department who are affected by this. It affects our ability to compete as a business.

Mr. LAUGHLIN. Mr. Kaufman, your testimony states that studies and statistical data are available to show a direct correlation between the number of Americans working overseas and the level of U.S. exports. Could you furnish the Committee with some of these statistics and the data?

Mr. KAUFMAN. Yes, I would be very pleased to, and I will make available to the Committee both of our full studies.

A number of studies were done in the seventies and also in the eighties. We have now completed two additional reports in the nineties with the most recent data available. As Congressman Gibbons commented, when you have the American overseas who is there designing that plant, bringing over the heavy equipment to dig out the area and build that plant, they are going to purchase equipment from the companies they are most familiar with. These studies show how many people benefit from Americans abroad buying from the American companies they are used to, and how that generates an enormous number of additional new jobs. We will supply these reports to the Committee.

[The following was subsequently received. The studies are being retained in the Committee's files.]

SECTION 911 SURVEY RESULTS ARE IN

Survey Finds Exclusion is Especially Important to Small & Medium-Sized Companies

The Section 911 Coalition recently announced the findings of its "American Competitiveness Survey" undertaken in 1995. With nearly 150 companies and associations responding to the survey, it represents the largest and most broad-based Section 911 survey ever conducted.

The six-page survey examined the importance of the $70,000 foreign earned income exclusion (under Section 911 of the U.S. Tax Code) and its impact on America's global competitiveness. A report prepared by economists at the Johns Hopkins University School of Advanced International Studies, Drs. Charles Pearson and James Riedel, found that:

- The Section 911 exclusion is especially important to small and medium-sized firms (including International and American schools abroad), which are at least ten times more dependent on Section 911 than are the large firms that were surveyed. Eighty-two percent of small and medium-sized firms said that a loss of the exclusion would result in a moderate (6 to 25 percent) or major (above 25 percent) change in their ability to compete abroad.

- Nearly two-thirds (65 percent) of respondents felt that their ability to secure projects and compete abroad would be improved if the current exclusion ($70,000) were raised to $100,000 -- as proposed in H.R. 57 by Rep. Bill Archer, Chairman of the House Ways and Means Committee.

- Americans abroad showed a strong tendency to source goods and services produced in the United States. Seventy-seven percent of respondents said that nationality has an effect on sourcing decisions. Among small and medium-sized firms, the number is even higher: 89 percent said their American expatriate employees prefer to Buy American.

- Compensation costs are significant in determining whether or not to hire U.S. nationals overseas, and the Section 911 exclusion is important in holding down compensation costs. Eighty percent of respondents said elimination of Section 911 would have a moderate or major negative effect on compensation costs, with 66 percent saying elimination of the exclusion would have an important negative impact on future hiring practices.

The survey results strongly suggest that the Section 911 exclusion plays a key role in America's competitiveness and the creation of U.S. jobs through exports. For further information, please contact the Section 911 Coalition.

HIGHLIGHTS OF THE PRICE WATERHOUSE STUDY

An Economic Analysis of the Section 911 Foreign Earned Income Exclusion

Price Waterhouse LLP, in a recent study prepared for the Section 911 Coalition, found that:

- The U.S. is the only major industrial country that does not completely exempt from taxation the foreign earned income of its citizens working abroad.

- Because the Section 911 exclusion is not adjusted for inflation, its real value has dropped by 43 percent since 1982. If the exclusion had been adjusted for inflation since it was set at $70,000 in 1987, the exclusion would be $94,000 as of 1995, rising to over $111,000 in the year 2000. If the exclusion is not indexed for inflation, its value will continue to decline.

- Without the Section 911 exclusion, compensation levels for Americans abroad would need to increase by an average of 7.19 percent to preserve after-tax income. Section 911 was shown to provide benefits in both low tax and high tax nations. Moreover, the exclusion represents a larger share of the compensation of *low* income than of *high* income Americans working abroad.

- A 7.19 percent increase in required compensation would result in a 2.83 percent decrease in Americans working abroad. Without Section 911, U.S. exports would decline by 1.89 percent or $8.7 billion. This translates into a loss of approximately 143,000 U.S.-based jobs. [N.B.- These figures do not include service-related jobs or indirect employment, which would likely double the number of jobs lost.]

- From a tax policy standpoint, the 911 exclusion meets the traditional standards for evaluating income tax provisions: *Fairness* -- Absent Section 911, Americans working abroad would pay much higher taxes than U.S.-based workers with the same base pay. *Economic efficiency* -- Absent 911, U.S. tax law would discourage U.S. companies from hiring Americans in overseas positions, causing foreign nationals to be hired even where Americans would, but for taxes, be preferred. *Simplicity* -- The current structure of Section 911 was specifically enacted by Congress in 1981 in reaction to the unmanageable complexity of the rules enacted in 1978.

- Section 911 also adheres to three additional tax policy standards often used to evaluate provisions that affect international income: *Competitiveness* -- The competitiveness standard, that U.S. capital and labor employed in foreign markets bear the same tax burden as foreign capital and labor in those markets, would be achieved if the U.S. excluded *all* foreign earned income (without the $70,000 cap). *Protecting the U.S. tax base* -- Section 911 applies only to income that is earned abroad for activities that are performed abroad by individuals who are not residents of the USA. *Harmonization* -- True harmonization with other nations would require an unlimited exclusion, as was in effect in the USA from 1926 to 1952.

Mr. LAUGHLIN. If our new restructured tax system adopted a territorial system of taxation, wouldn't that be preferable to the current 911 exclusion?

Mr. KAUFMAN. Yes, it would because then you would put us on an even footing with the non-American companies. So that, if we are to compete against the Japanese or the British or anyone else, we would be in the same position, and therefore, we wouldn't have a disadvantage.

Section 911 only covers some of the increased cost, not the full amount.

Mr. LAUGHLIN. To anyone on the panel, what country or countries do you think have tax and trade policies that have been developed to allow their businesses and individuals to compete most effectively in today's global markets?

Mr. WARREN. I guess I would like to answer that, if I could. For example, Germany, I might point out, does not tax foreign-source income. So German competitors that we work against and with every day can expand overseas, can compete head to head with us in the United States, for example, but when those earnings they make in the United States are repatriated back to Germany, there is no additional tax. They are excluded from further tax in Germany.

There are many other countries. Japan is an example, although it has a worldwide system of taxation. It encourages foreign investments. We have seen the results of that.

We aren't afraid to compete with companies from these countries, but the fact that they receive preferential treatment in their home countries, whereas international investments by U.S. companies are discouraged by the U.S. Tax Code, makes it very difficult to compete.

Mr. LAUGHLIN. To anyone else on the panel, as a matter of tax and trade policies, do you think our current tax restructuring effort should take into account tariffs or should it only focus on the income tax, and what is the reason for the position you take in answering this question?

Mr. CONWAY. I would suggest that we would want to take tariffs into account. I don't think we should consider taxes in isolation. I just think you have to look at the whole trade picture.

I would think we would want to take it into account, but I think in looking at taxes, what we need to do is view U.S. business as competing in the global Olympics, and we want to level the playingfield. We want to take into account tariffs, but we don't want to put American companies at a disadvantage with respect to other multinationals.

Mr. WARREN. If I could just elaborate on that, too, I would also agree that any reformation of the tax system needs to look at all taxes, not just single taxes in an isolated format. The objective needs to be to create a balanced system and raise the proper amount of revenue, of course, in a fair and simple manner, but also encourage U.S. economic activity, including international activity.

Mr. LAUGHLIN. Ms. Dunahoo, you were nodding your head. Would you like to add to the comments?

Ms. DUNAHOO. I was just agreeing with what Mr. Conway said about tariffs. I think it makes good sense to look at the systems together.

In the context of tariffs, of course, you have additional considerations regarding international trade agreements, but in the context of fundamental tax reform, it is a good suggestion.

Mr. LAUGHLIN. You have brought up the last area, and you may not want to answer, but the others or all of you may want to, and that is within international trade agreements. Do you think the impact of international trade agreements, such as GATT and NAFTA, should be reviewed as a part of our tax restructuring efforts, and why?

Mr. WARREN. I don't think it can be separated. Again, the study of tax, the existing Tax Code, is very much tied to the study of the international provisions, in particular, the overall treaty and trade agreements process, whether we are talking about trade agreements such as NAFTA or specific tax treaties.

I think all of it needs to be taken into account. Again, the objective of the United States needs to be to develop a system and encourage a system that results in increased economic activity, both in the United States and with foreign investments.

As I have indicated, we invest globally to meet the demands of customers. We can't sell to Volkswagen in Germany, for example, by building a plant in the United States, shipping the product to the east coast, putting it on a ship, shipping it to Germany, transporting it by train to a Volkswagen plant somewhere in the remote part of Germany for just-in-time inventory.

Nevertheless, our investment in Germany, in a plant in Germany, to sell to Volkswagen results in increased economic activity in the United States through sales of parts. That is the type of activity that needs to be encouraged and not discouraged, and all factors, whether we are talking tariffs, income taxes, or other trade policies, need to be considered.

Mr. CONWAY. I would just like to add that we export over $3 billion a year in goods. We are the country's 15th largest exporter. So free trade is critical to us, as important as taxes, and we want to make sure the markets are open and that that is taken into account in looking at our tax system.

Mr. HANCOCK. The gentleman's time has expired.

Mr. LAUGHLIN. Thank you, Mr. Chairman, and thank you, Mr. Gibbons, for allowing me to complete these questions.

Mr. HANCOCK. Mr. Houghton, from New York.

Mr. HOUGHTON. Yes. Thank you very much.

Ladies and gentlemen, I am delighted you are here. Thank you very much. I am sorry I have been sort of peripatetic, in and out of here, but because of the votes, I have had to do that.

I understand what you are saying. You want to be competitive and you don't want to be at a disadvantage when you are doing business overseas, but let me take the opposite approach for 1 moment.

Clearly, although you used Germany as an example, you wouldn't want to live in Germany. They have 12 percent unemployment. They have a social net that makes their competitive situation even worse than ours.

Now, are there any advantages? I know there are a lot of disadvantages of our tax system. Are there any advantages of our international tax system, any compared to Germany at this moment?

Mr. WARREN. Going back to my German example, it is very difficult to point to a net advantage of the U.S. tax system.

I can point to specific provisions of the U.S. Tax Code that make it possible for us to compete on certain types of sales, certain types of markets.

I mentioned earlier the 863(b) sourcing rules and the foreign sales corporation rules, both of which encourage U.S. exports and make a difficult, complex U.S. tax system environment possible to work in for particular types of sales.

On the other hand, we look around at our German competitors that also compete here in the United States against us on specific markets, and we know from our study of the German tax law that they can earn the income in the United States, and repatriate the earnings back to Germany without any further tax. I think that is a net disadvantage of the U.S. Tax Code.

Mr. HOUGHTON. I just have one other question, Mr. Chairman.

Maybe you could tell me in dollar amounts or percentage amounts what the impact is on your business vis-a-vis competing with a German company and an American company. In other words, is it a 10-percent disadvantage? Is it a 5-percent disadvantage? Is it a 20-percent disadvantage? Is it a wash? What is it? Tell me in specific terms.

Mr. WARREN. I have never quantified it as a percent. I think the part that is most significant to us from a financial standpoint on a bottom-line basis is the resourcing of U.S. interest expense—25 percent of our U.S. interest expense, and we have about $1 billion in debt.

Mr. HOUGHTON. Could I just interrupt? In other words, you don't have sort of a net figure?

Mr. WARREN. I do not have a net figure.

Mr. HOUGHTON. Does anyone have a net figure?

I am not trying to cut you off. I am just interested in this.

Does anybody have a net figure? Do you have any sense of what competitive dollar or percentage disadvantage this gives you?

Does Coopers in terms of any of the companies it does business with? Do you have any feeling?

Mr. KAUFMAN. If I narrowed it down to the area that I am speaking of, of the American overseas, and if you put someone into a zero tax jurisdiction, such as Saudi Arabia, you would often be putting the American company at perhaps as high as a 20-percent disadvantage when they are bidding for a contract. Employment is a large percentage of that major contract and with the $70,000 exclusion, some of the American's tax will place the U.S. firm at a cost disadvantage, but on all those other things——

Mr. HOUGHTON. So you are saying in Saudi Arabia for an American company, it has a 20-percent tax disadvantage versus a Germany company doing business in Saudi Arabia?

Mr. KAUFMAN. To have the American in Saudi Arabia, it could cost you as much as 20 percent more than the company that sends

a German in, not their total tax structure, but just about the idea of moving the American expatriate in.

Mr. HOUGHTON. Is that the worst example? Are there other examples?

Mr. KAUFMAN. When you go into the lowest tax countries or zero-tax countries, like Saudi Arabia, that is where the percentage is higher. If you go into other countries, if you send them to Hong Kong with a 15-percent tax rate, there you may be down to a 10-percent differential. Every place you go, there is a detriment.

Mr. GIBBONS. Would the gentleman from New York yield?

Mr. HOUGHTON. Yes, sir.

Mr. GIBBONS. I have calculated that we spend more money trying to collect taxes on foreign income—I am talking about the Federal Government—than we actually collect. So we have a 100-percent loss here. We penalize our businesses. We penalize our jobs. We penalize our profits, and we spend more money trying to collect the foreign tax than we actually collect.

Mr. HOUGHTON. Right. That is sometimes true here in this country, also.

Mr. GIBBONS. Well, I realize that, but we are just talking about foreign countries.

Mr. HOUGHTON. That is right. That is right.

Really, I have to run. That is the end of my questions, and I appreciate it very much, unless the other two gentlemen or lady has any comment.

Mr. CONWAY. The only thing I would add is that to the extent that a company has excess foreign tax credits, I think in some years in United Technologies, we have had excess foreign tax credits. We haven't been able to use all of our foreign tax credits, and the situation that that leads to is that the interest allocation, the allocation of interest expense and the allocation of research and development, effectively, R&D becomes nondeductible to the extent we have excess credits, and there has been some years where that has been several millions of dollars. So there is a direct measurable impact in that regard.

The thing that concerns me more are the transactions and the market opportunities that we are not pursuing because of some of these impacts.

Mr. HOUGHTON. Right. Thank you very much.

Thank you, Mr. Chairman.

Mr. HANCOCK. The gentleman from Ohio, Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman, and thank you all for being here.

It is critical we get into this. Obviously, I think there are a lot of problems in our current tax system as it relates to our international competitiveness.

Speaking as a former international trade lawyer, I used to run into those problems constantly, and it is also important that as we have this opportunity to reform our Tax Code, overhaul it in a major way, that we look at the international aspects and see what we can do to encourage exports and our competitiveness.

Amo Houghton has looked at the foreign tax issues a lot, and Mr. Gibbons has looked a lot at the international trade issues. So I am very pleased we are having this hearing.

I would like to follow up with Mr. Kaufman for 1 minute on section 911. As you noted in your testimony, it exempts $70,000. In the Saudi example, then you are assuming that the U.S. executive is receiving in excess of $70,000. Whatever that excess is, he is being taxed at a U.S. rate. Whereas, the foreign national from Germany or somewhere else has no income tax because it is territorial, and the Saudis don't have an income tax.

Mr. KAUFMAN. That is absolutely correct.

Mr. PORTMAN. OK. If we were to move to some kind of consumption tax, let us say a type of VAT tax, or a national sales tax even, what would you recommend we do with regard to 911?

Mr. KAUFMAN. Well, as I understand those taxes, we are looking at a territorial consumption tax, and therefore, if we do keep it at the borders, then when that American is in Saudi Arabia, there will not be any U.S. consumption upon which to tax them. That, then, puts us on a level playingfield with, using your example, the German.

So now when I send that engineer to work in the plant, yes, they get their base salary, they get their cost of living, housing, education, clearly above $70,000, but now it is not going to be taxed, and they are going to be in the same position as the German or the Japanese. Now we are on a level playingfield, and the American companies can be competitive.

Mr. PORTMAN. So, in all of those instances, whether it is the VAT tax or any kind of consumption tax, it doesn't apply to income. You would recommend not applying any U.S. tax; in other words, having, in essence, a territorial tax treatment.

Mr. KAUFMAN. Territorial. Then we would be in the same position as all of our competitors, and therefore, we would be removing an impediment to us to be competitive.

Mr. PORTMAN. I assume you would recommend the same thing with a flat tax?

Mr. KAUFMAN. Yes.

Mr. PORTMAN. Even though there would be the calculation of income and some mechanism to do that.

Ms. Dunahoo, under the current system, we have tax incentives for corporations. I think you have addressed this some in your testimony, as I saw, and I just wonder what your view was as to criteria we should use under, again, either a consumption-type system or a flat tax-type system, a simpler flat tax without getting into the specifics of what deductions might be available. Should we do anything special with regard to our exporting companies or with regard to our foreign investments in terms of tax incentives?

Ms. DUNAHOO. I think it is clear the consumption-based proposals that are on the table today don't contemplate an explicit export incentive, and those export incentives that are provided by current U.S. law are very important in encouraging exports, that is domestic production with exports offshore.

The point of our testimony, I think what we would like to stress, is that the potential effects of moving away from those incentives should be very carefully considered. It would be a pity if those proposals were repealed inadvertently without serious consideration of .e effects.

Mr. PORTMAN. Specifically, which ones do you think should survive in an era of either a flat tax or a consumption-type tax?

Ms. DUNAHOO. Well, the proposals that are included in current law relative to exports are the foreign sales company rules and the export source rules of section 863(b).

The International Tax Policy Forum is not advocating any particular proposal going forward. I think the Committee should take a very broad view and look at matters systemically. So I don't believe that we are taking the position that those exact provisions would need to remain. However, I think it should be carefully considered before a system is adopted that does not provide any export incentive.

Mr. PORTMAN. Any other comments about existing incentives and whether they should survive in a new era?

Mr. CONWAY. Yes, Mr. Portman. I would like to add that I think research and development is a critical area that we have to take a good look at.

As I said, we spend $1 billion a year on research and development at United Technologies, $700 million in the United States, and although we don't get the R&D credit currently because of the rules, that is something from an international standpoint that we may need to take a look at because a number of jurisdictions have R&D incentives, not only deductions, but greater than 100 percent deductions, flat-rate credit systems, and I think certainly for United Technologies and FEI member companies, R&D is the key, we think, to the future and the ability to compete not only in the United States, but around the world. So we would think that R&D would be right up at the top of the list in terms of things to look at in moving away from the current income tax system. If we need a special incentive, that would be high on the list.

Mr. PORTMAN. And the allocation for foreign research, you would like to see clarified as well. Is that 861?

Mr. CONWAY. Yes, 861–A.

Mr. PORTMAN. Any other comments?

Mr. WARREN. No. I would just also like to emphasize the importance of R&D from an international competitiveness standpoint and urge that Congress ensure that U.S. R&D is encouraged and fairly treated, both from an allocation, 861 standpoint, and from an R&D credit standpoint.

Mr. PORTMAN. The R&D comments were, of course, very timely. We are about to go into conference on that, and I appreciate your statements.

Thank you.

Mr. GIBBONS. May I ask a question here? I have listened to all of this with a great interest, and I understand the need for preserving R&D tax credits as long as we have income tax system, but I think what Chairman Archer is talking about and what I am talking about is getting rid of an income tax system. Now, under a consumption-type system, to draw a parallel, you would be expensing all of your R&D immediately under a consumption-type tax system, which beats a deduction as far as that is concerned.

So, Ms. Dunahoo, the concerns that you raised and the concerns that, I think, all of the panel shares, if you go to the proposal I am putting forward, you wouldn't have to worry about all of those

things because there would be no income tax, and you would, in effect, be expensing all of those things immediately.

From Mr. Kaufman's point of view, you wouldn't make the American the last hired, the first fired, the most expensive employee on your payroll.

I think that is where we need to go. Is there dissent on that?

Mr. CONWAY. I think I agree. Directionally, I agree with you. The only thing I would suggest is that in looking at the deduction for R&D or the immediate expensing of it, we need to be mindful that we don't need a foreign tax credit if we don't have an income tax system, but we might want to consider some kind of increased expensing recognition for R&D because of its special nature.

In other words, in Australia, it is immediately expensed, but the level of expense is 150 percent of the expenditure. So there is an additional incentive for R&D. It is given in the form of an added benefit on the expensing, not a credit. So there is a mechanism to do it, and I just think that, certainly, it is far preferable to be able to know that you are going to be able to immediately deduct the R&D that you are doing today than the situation under the current system. We just might want to see if there is a way to think about R&D as a special type of expense deduction and go beyond even 100 percent.

Mr. GIBBONS. Thank you.

Mr. HANCOCK. The gentleman from Louisiana.

Mr. MCCRERY. I just have a quick question, and I apologize. I was over on the floor debating the welfare bill, but if this has already been asked, please just say so and I will ask somebody else for the answer.

I would like for Mr. Warren, if you don't mind, to just explain how foreign investment by American companies benefit American citizens. You alluded to that in your testimony, and I think it is an important point. Would you just explain to all of us how foreign investment by American companies benefit American citizens?

Mr. WARREN. I would be happy to. Again, I am talking from the TRW perspective, our own perspective.

We have an opportunity to serve lots of customers on a worldwide basis. We compete globally for these customers. The customers are not all in the United States. Many, 25 percent of our customers are outside the United States. It is those customers that we are going after when we invest internationally.

Getting back to my German example, to serce Volkswagen in Germany, or to serve Fiat in Italy, or to sell to a Japanese company in Japan, it is not always possible, or even feasible, to build a plant in the United States and try to export the product.

Mr. MCCRERY. If I can interrupt you, I understand the business reasons for setting up shop where the market is. I want you to explain to us how that benefits American citizens in this country.

Mr. WARREN. Once we have the investment overseas, more likely than not, there are parts and services that need to be supplied to that foreign operation. Many of those parts and services come out of the United States.

We export somewhere between $500 and $600 million of parts and a number of services each year. Those lead to U.S. jobs. Those are jobs that would not be in the United States had we cited that

market to our foreign competitors. So there is a direct relationship, an absolute direct relationship.

Mr. McCrery. Thank you.

Does any other panel member want to expound on that?

Mr. Conway. Yes. I would like to add to that. At United Technologies, we have annual revenues of $22.8 billion. Of those, 55 percent are from business outside the United States. Exports are a big part. It is $3.1 billion.

As I mentioned before, if you look at our main technology base, it is here in the United States. Of that $1 billion annually of R&D, $700 million is in the United States and 60 percent of the $700 million is U.S. salaries and wages paid to U.S. engineers and researchers.

So here we have a case where a company has one-half of its revenues from the international marketplace, but its technology base is clearly in the United States. So I think we have generated a significant number of high-tech jobs, research jobs from these international tax revenues.

With Otis Elevator Co., 80 percent of the elevator market for servicing elevators is outside the United States because 80 percent of the elevators are outside the United States, and 80 percent of Otis' revenues are outside the United States, but there is significant R&D that Otis does. The United States is the number one country in terms of Otis for R&D. So I think it has had a significant positive impact in that regard.

Mr. McCrery. Are you saying your research and development operations here in the United States are supported in part by revenues from foreign operations?

Mr. Conway. There is no question about it in terms of the cash that we generate. The Otis business, for example, supports not only Otis research, but a lot of other research as well.

Mr. McCrery. So, in other words, the bottom line is when you invest overseas, you create jobs overseas, but you probably save jobs over here and create jobs over here as well.

Mr. Conway. That is right, and we charge royalties, by the way, when we license the technology and we increase the tax base.

Mr. McCrery. Thank you very much. I hope that clears up why we encourage American companies to invest overseas, to expand their operations, to grow, to create jobs here in the United States.

Thank you.

Mr. Hancock. The gentleman from New York.

Mr. Houghton. I would be interested after all is said and done where do you come down on the flat tax or the consumption tax or variations of the flat tax? Because what we are trying to do is put the income tax system side by side with another tax system, not only to help American citizens here in the United States, but also to help businesses compete abroad so that we can continue to have this extraordinary increase in international business.

Maybe each one of you would say one sentence—where are you on this?

Mr. Warren. As I indicated in my testimony, both TRW and the organization I am representing today, ECAT, have no definitive position at this time. We are looking at these proposals. We encour-

age the study of the issue. We hope to work with this Committee as that study progresses.

My message today was that we are concerned about the effect of change in this area and urge an appropriate level of study be conducted before any significant changes are adopted.

We are encouraged that studies are taking place, but we are not convinced that we understand the effect of these proposals on our ability to compete internationally in order to have a position at this time.

Mr. HOUGHTON. Mr. Kaufman.

Mr. KAUFMAN. As a representative of the Section 911 Coalition, focusing solely on how we tax Americans overseas, the best situation is the one that treats us on a territorial basis, and puts us on an even playingfield with the foreign competition. So, whichever one we choose, if it has a territorial approach, that puts us even in competition. If it doesn't go territorial, we would want at least the level of exclusion we have today and perhaps have that tied to at least inflation so it is not eroded going forward.

How will they tax the American overseas, a territorial approach is the one that is the most advantageous.

Mr. HOUGHTON. I am not quite sure what you fellows have said.

Mr. Conway, can you help us a little bit? Can you be a little more specific? Even if you are dangling by a rope by yourself, I will be with you.

Mr. CONWAY. OK. I think it is time to move forward and away from the current system we have and go to a territorial-based tax, destination-based tax. I think we need to move the debate to looking at a system that will tax income once or impose a single tax, not tax income, but impose a single tax so that we can have a tax system that is simple, manageable, and understandable, and I think definitely it has to be territorial. I would favor destination, and it has to take into account the revenue needs.

The tax system we have now, if you look at it, at these provisions in isolation, they are not bad. They represent sound tax policy. The problem we have had is when you add up all the changes we have had over the last decade. That is the problem we have today, and we can solve that with a destination-based territorial tax.

Mr. HOUGHTON. Ms. Dunahoo.

Thank you.

Ms. DUNAHOO. I am afraid we are not in a position to recommend any particular proposal at this time. The International Tax Policy Forum is a broad-based group of companies and is not a traditional trade association or lobbying organization.

I would say we very strongly support the Committee's efforts to reexamine the current system. There is a broad consensus that the current system is not ideal, but as far as whether you should move to a consumption-based system, and if so, to which one, we are undecided ourselves at this point.

Mr. PORTMAN. Mr. Houghton, I recommend you ask Mr. Gibbons. You might get the answer, a definitive answer.

Mr. GIBBONS. Mr. Houghton, could I impose on your time?

Mr. HOUGHTON. Yes.

Mr. GIBBONS. I recognize we have a group of very well-qualified people, but their principals have not made up their minds yet. I am talking about their bosses. I think we need to do a little work.

We are all talking about the same thing. We need a territorial system if we are going to compete. We need a system that is much simpler, and we do, unfortunately, have to raise revenue.

I frankly don't know how we get there with the current mess we have, and I really don't think it is possible to straighten out the current mess by going back and reforming it. I have spent 27 years trying to reform the current system. It just gets worse instead of better.

Mr. HANCOCK. Will the gentleman yield momentarily?

Mr. GIBBONS. Yes.

Mr. HANCOCK. Are you talking about the mess on the income tax or the other messes we have created?

Mr. GIBBONS. No. Well, the income tax mess right now is the main thing, but we have created a pretty good mess also with our payroll taxes, and we need a good clean change. Maybe I can contribute something after I get out of here.

Mr. HOUGHTON. Thank you.

Mr. HANCOCK. I have one final question but I am a little curious about. We are looking at something, and I have been reading a lot of investment articles in the paper, about a balanced portfolio and how people need to invest in foreign companies to balance American investments. When foreign industry stocks are down, American stocks are up, and vice versa and that type of thing.

I also have been reading a lot of information stating basically that you need to be cautious with foreign countries because they don't have any standardized accounting principles and you don't know for sure.

My question is, Is there any forum of international standardized accounting principles? Mr. Kaufman, you came up with statistics, but I understand the accounting principles are not standardized, which could very well lead to a pretty substantial margin of error in your figures. Am I correct on that?

Mr. WARREN. That has certainly been our experience as we have looked at accounting systems worldwide. They are different. They are varied, and it is then possible to compare the printed results coming in from one company from one country with another.

Mr. HANCOCK. Then I will ask another question. If, in fact, you are going to try to solve this problem of what type of a tax structure we should have, don't you first have to solve the accounting procedure approach, so you know what you are dealing with to solve the problem?

Mr. WARREN. Well, we think we can look at the existing Tax Codes, and if we understand how our competitors are taxed, even though we might not be able to precisely translate that into percentage benefits, country to country, we think we do understand the different tax systems well enough to understand there are some net advantages in these other systems, particularly the territorial-based systems.

Mr. GIBBONS. I think, Mr. Chairman, if you look at Ms. Dunahoo's constituency and Mr. Conway's constituency, they have done a fine job in analyzing the bottom line on what happens on

an international basis. I am really impressed with what they have done.

I think through OECD, the Organization for Economic Cooperation and Development, and through the fact that accounting is pretty much controlled by seven or eight major firms on international accounting, we do understand what we are doing. We can judge that our tax system is badly out of step with the rest of the world and that in order to compete, we need to get it in step with the rest of the world and perhaps lead the rest of the world as far as business practices are concerned.

Mr. HANCOCK. I would like to thank the panel for your testimony. It is very interesting. It definitely points out some additional problems, since we are just talking about the international competitiveness, and that is not getting into all of the other subjects having to do with the change of the tax law.

Thank you very much for your testimony.

Will the next panel please come forward. I want to welcome you to the Committee. We have present Barbara McLennan, Martin Armstrong, and David Raboy. For your testimony, the Committee will start with Dr. McLennan.

STATEMENT OF BARBARA N. McLENNAN, PH.D., J.D., VAN SCOYOC ASSOCIATES, INC., McLEAN, VIRGINIA

Ms. MCLENNAN. Thank you, Mr. Chairman.

My name is Barbara McLennan. I am a vice president with Van Scoyoc Associates. I am here because I have about 20 years of experience in the international trade and international tax arenas. I have worked for the Treasury Department, the Commerce Department, and in the private sector. I have a written statement for the record.

In considering the effect of taxation on international competitiveness, it is important to remember that taxes are costs. They are a burden to individuals and to business taxpayers. They do not stimulate economic activity.

Different kinds of tax, however, may vary in terms of weight and incidence of the burden, as well as in complexity and difficulty of compliance.

In addition, the effect of a new tax will vary depending on whether it is an added burden or a partial or complete replacement for other taxes. My oral remarks today will focus on consumption taxes and the purpose of border tax adjustments in international trade.

In my view, border tax adjustments in the absence of changes in U.S. investment patterns are unlikely to affect U.S. international competitiveness.

U.S. firms trade internationally because they produce goods and services that are highly valued worldwide. Export sales abroad, just as domestic and import sales, finance the expansion of value-producing jobs in the United States.

Tax policy can affect trade and competitiveness if it leads to changes in savings and investment patterns. For example, if a consumption tax is substituted for current income taxes, international business in the United States may end up being taxed more lightly because the cost of a new tax will be borne by consumers. That is what a consumption tax is.

In this situation, the basic pattern of U.S. savings and investment may be altered. Economic growth may increase, reflecting expanded production of competitive products. The United States will then export more and receive well-earned returns on its investments.

The United States and our major trading partners have long recognized that taxation should not be a tool used by countries to effect the terms of trade. This understanding has been embodied in trade agreements for which the United States has long been a major supporter.

Current U.S. trade agreements draw a distinction between direct and indirect taxes. Direct taxes such as income and Social Security taxes may not be rebated to exporters or importers. On the other hand, indirect taxes that operate through their effect on prices, like value-added or sales taxes, may be rebated.

If the United States were to adopt a new and indirect tax to replace part or all of the current income tax, it would have the right to rebate tax paid by importers or exporters.

For example, if the United States were to adopt a tax similar to a European-style value-added tax, the U.S. money supply would need to expand to avoid an economic contraction.

Firms in the short run would have difficulty passing the cost of the tax back to workers by lowering wages, so they would try to pass it forward to customers by raising prices. Monetary expansion would allow a one-time increase in the U.S. price level, and companies would be able to sell their products for higher prices.

Under a VAT, each firm would credit taxes paid on intermediate supplies against their VAT liability. Consumers would feel the burden of this tax because wages, pensions, and liquidated assets used to purchase consumer goods would not receive credit against tax liability.

If the United States should decide to allow exporter rebates, exporters would sell their products at unchanged prices, since with rebates they would avoid the burden of the new tax. Imports would also be purchased at unchanged prices, but they would be taxed the same as domestically produced goods. All goods consumed domestically, whether of foreign or U.S. origin, would be taxed the same via higher prices. There would be no effect on the exchange rate or on the dollar volume of sales due to the impact of the tax, although the substitution of a tax on consumption for all or part of our current income tax could affect investment flows.

If rebates were not allowed and imports not taxed, such as with a sales tax, exports would initially rise in price due to the tax. Imports would initially be cheaper relative to domestic goods. This would have a direct effect on exchange rates.

U.S. exports would become more costly, reflecting the tax, and, thus, in the short term, less attractive. Foreign suppliers to the United States would earn more dollars as their sales initially increase. The overall effect would be to cause the price of the dollar to fall in comparison to foreign currencies. The dollar would fall until the market again achieves equilibrium, where U.S. exports earn the same amount of foreign currency as before the imposition of the tax, and where import goods in the United States cost the same as domestic goods.

Thus, the international trading system will operate to maintain equilibrium whether or not the United States adopts a border tax adjustment as part of a new system of indirect taxation. Border tax adjustments are a mechanical means by which value-added taxes are collected and audited. Unless savings and investment patterns change, they cannot operate to give U.S. firms a competitive advantage in the international trading system.

For this reason, Mr. Chairman, I believe that fiscal policy should encourage savings and investment, and a consumption tax would likely be an improvement over the current system.

I have addressed the issue of transfer pricing in my written statement, and I will be happy to answer any questions.

[The prepared statement follows:]

Potential Impact of Consumption Taxes on International Trade and Competitiveness

by

Barbara N. McLennan

Mr. Chairman and members of the Committee, I am grateful for this opportunity to present my views on how adopting a flat tax or other consumption tax will affect US international trade and competitiveness. I have been involved in the development and execution of US international tax and trade policies over the last twenty years. As a Congressional staff member in the early 1980's and Treasury Department employee, I helped to develop legislative proposals to simplify the income tax. I was a contributor to the 1984 Treasury Department Report to the President, *Tax Reform for Fairness, Simplicity and Economic Growth*, particularly Volume 3, "Value Added Tax". At Treasury, I also conducted a number of microeconomic studies of different industries, related to the development of new regulations for intracompany transfer pricing.

Between 1989 and 1991, I served as Deputy Assistant Secretary for Trade Information and Analysis, in the US Department of Commerce. While there I testified before the Subcommittee on Oversight of the Committee on Ways and Means on possible transfer pricing abuses by foreign companies with US domestic subsidiaries. I also published a paper on "The Process of Harmonization of the Value-Added Tax in the European Community," in the *Columbia Journal of Transnational Law*.

Over the past several years I have been an attorney in the private sector, and a trade association executive in an industry dominated by large multinational corporations (both US and foreign owned). Based on this experience, I am very familiar with international tax and trade issues as seen from the private sector perspective.

Today, I am a Vice President with Van Scoyoc Associates, Inc., a Washington legislative relations firm. I am here neither on behalf of this firm, nor of any client. On the basis of my experience, I believe the effort to replace the federal income tax with a system that is simpler, fairer, and more efficient is a worthy goal for this Committee. Bearing this in mind, I wish to share with you my personal perspective on the effects of tax policy on international trade.

I. International Trade and the US Economy

The United States is the world's largest industrial economy, where people enjoy very high average living standards. The strength of our economy and the wealth it has created are the product of a free and vibrant private sector. The US economy has grown to its present size and strength because business (domestic and foreign) has provided goods and services that Americans want and for which they are able and willing to pay. Investment in productive enterprise—that is, in businesses that create goods and services that people value—creates economic growth. Growth is simply another term that describes an economy that creates jobs and high living standards.

Increasingly in recent years the US domestic economy's ability to grow has become intertwined with our ability to export and to be competitive in international trade. US firms trade internationally because they produce goods and services that are highly valued world-wide. Export sales abroad, just as domestic sales, finance the expansion of value-producing jobs in the United States.

The products and services which we export are generally our most competitive; they represent what our economy is good at producing. For the economy to grow, our most competitive sectors must lead the way. They earn the highest rates of return and profits, whether sales are made in the US or abroad. When US firms expand by producing in those areas in which we have a comparative advantage, we earn returns that can be reinvested to create new productive enterprise elsewhere in our economy.

Policies which permit the free flow of trade and investment favor economic growth, and the United States has historically been a place that welcomes productive trade and investment. Indeed, policy makers from all walks of life and both political parties have long understood that the US economy grows and our living standards improve to the extent that our leading productive sectors keep expanding. Policies that favor less productive, less competitive industries, whether tax or trade policies, do not enhance the overall economy. Policies designed to help only the few owners and employees in the less competitive industries are essentially subsidies and are widely recognized as such by international trade agreements. Indeed, the US was a leader in attempting to restrain the growth of subsidies in the recently concluded GATT agreement, to which the US is a signatory.

II. International Trade and Tax Policy

A. The Underlying Issue of Currency Exchange Rates

The United States is the world's largest importer and exporter, and the terms of international trade are often denominated in US dollars. When a US producer sells abroad, it will contract with its customers for a defined rate of exchange. US goods and services are produced by workers, plant and equipment, the costs of which are in US dollars. Foreign sales should cover these costs and also provide a reasonable rate of return, in dollars.

The value of the US dollar rests on the stability and productivity of the US economy. Assuming that supply and demand and all other factors remain equal, when the dollar weakens, US exporters selling the same amount of foreign goods would receive fewer dollars for them. This is equivalent to selling at a discount. US exporters in a depreciated dollar environment may sell more products, but they receive less in exchange for each product sold.

Normally, exporters will consider taxes paid as part of the cost of production. In a stable world trading system as envisaged by the GATT, taxation should not be a tool used by countries to affect the terms of trade. The GATT draws a distinction between direct and indirect taxes. Direct taxes, such as income and social security taxes may not be rebated to exporters or importers. On the other hand, indirect taxes that operate through their effect on prices, like value-added or sales taxes, may be rebated.

If the United States were to adopt a new indirect tax to replace part or all of the current income tax, it would have the right to rebate tax paid by importers or exporters. The fundamental impact on trade of such border adjustability will derive more from the economic impact of the change in the tax system, than the fact of its border adjustability. If a new consumption tax is substituted

for current income taxes, international business in the US may end up being taxed more lightly, because the costs of the new tax will be borne by consumers. In this circumstance, the basic pattern of US saving and investment also may be altered. Economic growth may increase, reflecting expanded production of competitive products. The US will then export more, and receive well-earned returns on its investments.

The mere fact of border adjustability cannot by itself affect the terms of international trade. This is because of the automatic adjustment mechanisms of world currency markets to the change in US taxation.

For example, if the US should adopt a new consumption tax of 20 per cent on all products and services (such as a VAT), the US money supply would need to expand to avoid an economic contraction. Firms in the short run would have difficulty passing the cost of the tax back to workers by lowering wages, so they would try to pass it forward to customers by raising prices. Monetary expansion would allow a one-time increase in the US price level of 20 per cent, and companies would be able to sell their products for 20 per cent higher prices. Under a VAT, each firm would credit taxes paid on intermediate supplies against their VAT liability. Consumers would feel the burden of the tax, as wages, pensions and liquidated assets used to purchase consumer goods would not receive credit against tax liability.

If the US should decide to allow rebates to exporters, in the manner of our European trading partners, this would not necessarily change the terms of trade. In this circumstance, exporters would sell their products at the original price (since sellers would not pay the tax), and imports would be purchased at unchanged prices. Imports, however, would be taxed on a par with domestically produced goods; all goods consumed domestically, whether of foreign or US origin, would be taxed the same via higher prices. There would be no effect on the exchange rate or the dollar volume of sales due to the direct impact of the tax, although the substitution of a tax on consumption for all or part of the current income tax could affect investment flows. Increased saving and investment could result in higher economic growth.

If rebates were not allowed and imports not taxed, exports would initially rise in price due to the tax. Imports would initially be cheaper relative to domestic goods. This would have a direct effect on the exchange rate. US exports will become more costly, reflecting the tax, and thus, in the short term, less attractive. Foreign suppliers to the US will earn more dollars as their sales initially increase. The overall effect will be to cause the price of the dollar to fall in comparison to foreign currencies. The dollar will fall until the market again achieves equilibrium—where US exports earn the same amount of foreign currency as before imposition of the tax, and where import goods in the US cost the same as domestic goods. If the US price were to increase by twenty per cent, the US dollar would be able to purchase 20 per cent less in foreign currency due to the dollar depreciation in exchange rates. After this adjustment, there would be no effect on the terms of trade, unless savings and investment patterns are altered.

In overall macroeconomic terms, international trade must balance. The US current account balance always, by definition, will be equal to the excess of investment over saving, whether or not there is a new consumption tax. If the new indirect tax does not change basic patterns of saving and investment, it will not change the balance of trade.

B. Border Tax Adjustability: its Major Purpose in International Trade

Other countries, particularly our European trading partners and Japan, raise substantial revenue from value-added taxes. Typically, these countries apply their taxes to exports, and exporters

may apply for border tax adjustments, i.e., reimbursements for indirect taxes paid. Border tax adjustability is part of the normal, technical means by which a VAT is enforced; it is not instituted for economic reasons.

Value-added tax systems in Europe are the major source of revenue for the European Community. These are large complex tax systems, imposing different and sometimes multiple rates and exemptions on different products and at different levels of the production process. They require the frequent filing of numerous forms and invoices, and are costly and difficult to administer.

Under the invoice method VAT (the system used in Europe), exporters receive their rebates by filing claims for the refunds for which they are eligible. It is consistent with the VAT invoice system of "self-policing," to require taxpayers to file claims for rebates. The VAT is an indirect tax and must rely on taxpayers to produce the paper flow on which tax collection is assessed.

Theoretically, it is not necessary for economic reasons to establish a rebate system. Indeed, much might be saved in paperwork, audits, and compliance costs if a rebate system were not established. As already noted, the automatic effect on the exchange rate of the dollar would work to insulate the normal operation of the international trading system from a new US tax. Even without a rebate system, US exporters would not pay the costs of the new tax, but they would receive depreciated dollars for their export goods. Ultimately, currency markets will adjust so that US exporters will be in the same situation as before institution of the tax.

III. Trade among Multinationals: Why Pricing Issues Will Not Go Away Under a Flat Tax.

Among the areas singled out as most complicated under the present tax code by the National Commission on Economic Growth and Tax Reform, chaired by Jack Kemp, is international taxation. The Kemp Commission has called for a territorial tax system, that is, one which does not tax the foreign earnings of resident businesses or individuals. It has urged Congress to seek a clearer, simpler, more certain determination of what is foreign income and what foreign transactions are taxable. Specifically, the Commission has singled out the need to clarify tax treatment of foreign source license fees, royalties and other intangibles so as not to discourage research and development in the United States.

If the business income tax is replaced by a flat tax, much complexity will disappear. Under a direct flat tax, there would be no research and experimentation tax credit and no foreign tax credit. Businesses would be required to pay a single tax on the difference between revenue and expenses. The costs incurred for research and for foreign tax paid would be deductible under a flat tax as expenses.

Multinational companies manufacture, buy, sell, conduct research, and own intangibles in many locations and tax jurisdictions. Under a flat tax, as under current law, they will need to determine which revenues and which expenses properly should be reported to US tax authorities.

When large multinational corporations set internal prices for transactions among controlled subsidiaries, there always will be a possibility that these internal company prices differ from the arm's length prices of the free market. Without careful rules with respect to transfer pricing, multinationals will be able to shift revenues from one jurisdiction to another to minimize their tax burdens.

Likewise, income and revenues attributed to intangibles (the license fees and royalties singled out by the Kemp Commission) will still pose a problem of definition under a flat tax. The issue of where revenues should be reported—to the US head office that owns the patents, or to subsidiary laboratories in foreign countries which perform final manufacture—will remain.

Transfer pricing will remain a problem under a consumption tax, much as it is under current law. If the US should adopt lower rates of tax than in other jurisdictions, other factors remaining equal, multinationals likely will find an incentive to place more valuable aspects of their operations here than in higher tax areas. In the absence of tax rules to the contrary, they can do this by shifting internal company revenues and expenses so that more of their profits are reported to the US tax jurisdiction. Clearly, such a situation would invite response and possibly retaliation from our major trading partners.

The United States has been grappling with transfer pricing issues for many years. Some observers believe that the current transfer pricing rules are a disadvantage for US businesses and investors, but many of these rules have been copied by tax authorities in other countries.

The 1994 revision of the Section 482 transfer pricing regulations, placed much more reliance on taxpayers. Companies with transnational business dealings are now encouraged to provide the IRS with their own transfer pricing methodologies, through voluntary advance pricing agreements. At the same time there has also been an increased emphasis on the use of penalties for failure by taxpayers to document pricing transactions. Potential IRS intrusiveness into company business affairs remains a serious issue.

IV. Conclusion

According to a Joint Committee on Taxation document issued on March 14, 1996, the vast majority of all corporate income taxes collected in 1993 came from relatively few corporations. Only four thousand companies, those with over $250 million in assets, accounted for more than 75 per cent of all corporate income tax collected. Most, if not all, of these companies are multinationals heavily engaged in international trade. As pointed out by the Kemp Commission, though the tax system is complex, international business is profitable and expanding.

Though border adjustability and transfer pricing issues will remain problems under a consumption tax, moving to such a tax from the current system may stimulate savings, investment and economic growth. Whether or not there is a border tax adjustment, increased economic growth will mean increased investment, increased international trade, more and better jobs, and an improved standard of living for our people.

Economic growth stimulated by a change in the tax system will not fall evenly across different industries. Though a new tax may be simpler and fairer in conception, it is unlikely to effect all forms of business in the same way. Numerous transition rules likely will be required to equalize the impact of various provisions. Some of these rules will undoubtedly have to devised for the international sector, today a rapidly growing source of investment, technology and employment.

Mr. HANCOCK. Thank you very much. Also, without objection, your written testimony will become a part of the record, and also for Dr. Raboy and Mr. Armstrong.

Mr. Armstrong.

STATEMENT OF MARTIN A. ARMSTRONG, CHAIRMAN, PRINCETON ECONOMICS INSTITUTE, PRINCETON, NEW JERSEY

Mr. ARMSTRONG. I am the chairman of Princeton Economic Institute. We are actually more than just merely an academic adviser. We take active roles in advising corporations around the globe. We have offices in Australia, Hong Kong, Tokyo, and London. We also have a subsidiary which is the largest foreign brokerage operation in Japan. For example, we have participated in over 250 underwritings last year in that country, and we also do a lot of direct hedge management in foreign exchange for corporations around the globe.

I would like to thank you for inviting me here to speak today. What we find is very significant, I think, from a global perspective: That the two primary causes of moving capital around today is, number one, the foreign exchange movement, and number two, taxation.

Countries have to become much more competitive, but the first issue, I think, to illustrate taxation is really the impact of foreign exchange and how it is creating changes in the domestic economy as global.

The foreign exchange movement has been as much as 40 percent over a 2-year period, ever since the Plaza Accord of 1985. I have offered an illustration of the capital flow movement from the basis of OECD data since the 1987 stock market crash. The brain wave patterns we see of the market is almost like schizophrenic since then. The volatility in everything has gone up since 1987, since we first made a G–5 attempt at using currencies to effect trade.

That has caused, number one, a significant increase in volatility and also significant changes in the way corporations are operating.

For example, it was the decline in the dollar that made our U.S. real estate bond markets and everything appear much cheaper to foreign investors; i.e., the Japanese coming in and buying U.S. companies, like Rockefeller Center, and so forth.

As they lost money on the foreign exchange, most of the assets were then sold and taken back. If you look at the actual losses that were incurred by a lot of the foreign investment in those areas, the bulk of it was foreign exchange, not the actual depreciation in the Rockefeller Center itself.

The second aspect of the foreign exchange movement we have to consider is that of total world capital flows; trade only really represents about 10 percent. The balance of that is really investment income which is tax driven.

One of the major points I would like to make today in understanding the Tax Codes is that the first panel testified to the double and triple taxation of U.S. corporations. That is absolutely paramount.

There are other things that are taking place. If you had foreign companies discussing issues here, you would find foreign operations

are often taking over U.S. companies. U.S. companies are being forced into mergers, acquisitions, and partnerships to avoid U.S. taxation on an international level.

What we see in this area is absolutely astounding on a global basis. Three of the first section-listed companies in Japan have actually stood up and resigned their citizenship in Japan and now have moved to Hong Kong. That is as if General Motors were to stand up and say we are no longer American. This is what the Tax Codes are causing on an international scale. It is absolutely monumental.

The other aspect we have to realize is how this is impacting everything also on the investment side. For example, we tax our American citizens not only on worldwide income, but also on interest income.

Prior to World War II, our government bonds were always tax free. Now we tax our American citizens if they buy a government bond. If I buy a bond, I pay 39.6 percent. If a Japanese buys it, he gets it tax free. What is taking place in the international side of capital movement is that it is like a game of musical chairs. Everyone is buying government bonds from somebody else, but nobody is buying their own.

Even the Wall Street Journal reported the holding period of a 30-year bond in the marketplace is now below 90 days. This is very serious. It is impacting volatility on a global scale.

Taxation is very, very important in this area, and one of the biggest concerns we have and criticisms we find from overseas companies, both from an investment standpoint as well about the United States, is that the U.S. Tax Code—we have provided a table in here. It looks, quite frankly, like the brain wave of a schizophrenic.

We have the most volatile Tax Code of any country in the world. You can see when corporate tax rates hit an effective rate of close to 70 percent in the sixties, I can tell you virtually every U.S. company jumped on whatever ship they could out of town.

Besides that factor, we have to really take into consideration how all of this comes back. If we look at our deficit situation and National debit, we have actually had a balanced budget in this country since 1980 from a revenue and spending perspective. If you look at Ronald Reagan's first 8-year period, you will see the national debt doubled by $1 trillion, which was exactly equal to the interest expenditures in that period. At 8 percent compounded, you double the national debt or any money in the bank in less than 10 years.

Since Ronald Reagan, the national debt has more than doubled. We went from under Reagan from 1 to 2. Now we have gone from 2 to 5. We lower taxes under Reagan. We have raised taxes since. It is not tax policy. It is simple compound interest that is absolutely killing us.

The total accumulative interest expenditures of this country since 1950 now equals 68 percent of the national debt.

Today, we collect close to $100 billion more in revenue than we actually spend on programs. It is all being absorbed by interest, and taxation is a very important role in this because up to times 40 percent of our National debt has been held by offshore investors, which means that money no longer stimulates the domestic econ-

omy, but those interest expenditures are being exported to Japan or elsewhere.

If you do a study of Japanese companies and institutions, you will find the Japanese made far more money off the investments of interest, and so forth, in the United States over the last 16 years than they did off of trade.

These are the issues I think are very critical. We do have a lot of recommendations that, briefly, we feel a consumption tax would be overwhelmingly beneficial to the Nation. You also have to seriously address the international double taxation that companies have. We believe that that should be eliminated to make the playingfield fair and even for everyone; that U.S. companies are seriously disadvantaged in the global side. We see it every day, and we are acting on a consulting role.

So those are the things we believe should be done. We do believe perhaps a merger of a flat tax and a consumption tax would be more plausible; for example, a consumption tax on the personal side eliminating all personal income taxes. On the corporate side, we feel if you were to match the income tax rate of Hong Kong of 15 percent, eliminate worldwide income, provide immediate expensing, and so forth, that would be internationally competitive, would not raise the dangers of having our operations here suddenly viewed as operating in a tax-free zone, particularly under British tax law, a lot of other European countries, also.

We do have to be a little bit respectful of how that would take place. If you did that, a lot of the foreign companies that have come here to establish plants would suddenly find out whatever plants they established here would suddenly be 100 percent taxable back home if there was a zero level of an income tax. So there are serious implications.

We would recommend, more or less, a split system, going back to the way this country really was run for the first 120 years where you do have a corporate income tax, but there were no personal income taxes.

Thank you.

[The prepared statement follows:]

July 18, 1996

Testimony of:
Martin A. Armstrong
Chairman Princeton Economic Institute
214 Carnegie Center
Princeton, NJ 08540

Mr. Chairman, members of the committee. I would like to thank you for inviting me here today to offer what information PEI has gathered from our experience in dealing with the multinational corporate and institutional sector of the global economy. As a brief background, PEI maintains offices in the US, Tokyo, Hong Kong, Sydney and London. We currently provide corporate and institutional advice under contract on global assets exceeding US$2.5 trillion, an amount equal to about half of the US national debt.

In our capacity as an advisor serving the international community in real life decision making rather than theory, PEI may be uniquely qualified in providing insight as to how and why both investment and business capital flows are affected by a nation's domestic policy objectives.

It has been our experience, that there are five key factors that provide the core stimulus behind capital flows internationally.

- **1) Foreign Exchange**
- **2) Taxation**
- **3) Labor Costs**
- **4) Inflation & Interest Rates**
- **5) Security (geopolitical & financial)**

Let me begin with foreign exchange as an illustration of how capital is being affected before discussing taxation.

Foreign Exchange fluctuations have become the number one cause of corporate losses. The percentage movement in the exchange value of currencies has become as high as 40% over a two year period. Exchange losses have impacted every sector of business in every nation to the point that the very way multinationals operate today is dramatically shifting from that of only 10 years ago. Multinationals have been forced to change pricing policy as well as the location of manufacture in an effort to reduce extreme financial risks for their shareholders. Transactions such as Rockefeller Center, MCA etc resulted in significant losses to the Japanese investors, more so by the 40% depreciation of the dollar than the actual decline in value of the underlying assets. Japan Airlines was forced to lay-off 25% of its work force last year due to the fact that their cost base was Japanese yen while their revenue was largely foreign currency denominated. In Germany, Mercedes has been forced to restructure their pricing policy as of July 1st, 1996 due to foreign exchange. Instead of pricing the product in DMarks around the world, which has cost them market share, products will now be priced in local currency thereby transferring the currency risk back to Germany.

These are but a few examples of how the more recent extreme fluctuations in the exchange value of currencies has impacted business and investment decisions on a global scale. While it may be politically preferable to manipulate currency values in an attempt to impact trade flows, in reality, trade accounts for less than 10% of the total world capital flow movement. Our warnings delivered in a letter to Congress and the White House back in 1985 cautioned against such intentional currency manipulation as enacted in the G5 September Plaza Accord. The net result of

attempts to influence trade through currency manipulation led to the 1987 Stock Market Panic. PEI's research was requested by the Brady Commission and we would like to think that we had some impact upon its findings since two of our clients were on the Commission itself. Mr. Brady later stated that he believed that currency fluctuations had played a role in the Panic of 1987. Offered here is a graphic illustration **(figure #1)** of the net capital flow movement for that period. The upper portion of the graph plots trade and the lower portion capital movement which included, stocks, bonds and real estate investment. What is important to note is that ever since 1987, the fluctuations in net capital movement have become more than 10 times as volatile when compared to the pre-1987 era.

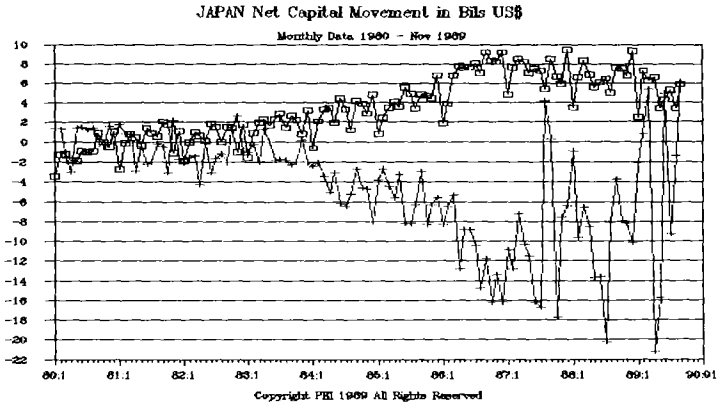


Figure #1

The second most important factor influencing net capital flow movement is none other than taxation. However, taxation is more than a pure income tax. Taxation contributions imposed on business based upon social objectives involving labor are of greater importance than the mere superficial level of corporate income tax rates alone.

It is wrong to assume that manufacturing jobs flow to merely the lowest possible labor cost. If this were true, then all manufacture should be conducted in Mexico, South East Asia or better still - Africa. In our capacity as a corporate advisor helping to make such strategic decisions as to where companies should or should not locate, there are 5 primary considerations that go into the final decision process on this level.

- **1) Rule of Law**
- **2) Labor Skill availability**
- **3) Taxation Contributions Required on Labor**
- **4) Corporate Tax Rate**
- **5) Regulation**

We have clients who have turned down what appeared to be lucrative business ventures in 3rd world nations as well as Russia or China based upon the lack of a Rule of Law that is required to secure the capital at risk. Without a solid Rule of Law, business cannot operate. Such ventures that do develop in those parts of the world depend upon government guarantees from their native country of origin in an effort to underwrite the political risk at hand.

While it is obvious that labor costs are closely associated with labor skills, what is largely overlooked are the social taxation and regulations associated with a work force. We found Asian companies who wished to open manufacturing plants within the EC made their decision based upon the level of skills available and then secondly chose the lower total cost of labor. For example, the UK attracted more than 40% of all foreign investment into Europe due to the fact that it had a skilled labor force but its cost was much less compared to that of Germany or France. This cost factor was determined not by mere wages, but included the social taxation that companies were required by law to provide. On that score, the labor costs in the UK were 40% less than Germany.

When a company did **NOT** require a major work force but instead merely needed a legal entity within the EC, then the primary deciding factor became the corporate tax rate. While the UK corporate tax rate was 19% less than Germany, they were still more than twice that of nations such as Spain and Ireland. Therefore, corporate headquarters or low skilled labor requirements tended to gravitate to the lowest possible corporate rate within the EC. This is illustrated by the impressive Irish economic growth rates of 9% compared to European economic growth rates of 2.5%. We have found that there is a correlation between high unemployment and high total taxation and regulation costs across Europe today.

Of course, regulation was a major factor as well. This we can see within our own US borders as well. Southern States are actively competing for Northern corporations and jobs. If we look at those states where regulation is the least intrusive and taxation is the most favorable, you will find the highest number of corporate relocations and new foreign business ventures within the United States.

Domestic Taxation policy must take into consideration our new global economy. We must be sensitive to being competitive not merely on labor costs, but also on the total taxation and regulation costs if we hope to avoid the dismal European example with its chronic unemployment in excess of 10% year after year. We must also keep in mind that taxation itself is largely influenced by philosophical decisions made by governments without considering the true total economic impact. For this reason, taxation has been a major factor in altering world capital flows as well as economic growth levels. When the US corporate tax rate hit nearly 70% during 1968-1969, virtually every American company began shifting manufacture offshore. Today, over 65% of the US trade deficit is made up of US companies importing their own goods manufactured somewhere else. In fact, if we allocate world trade according to the flag a company flies instead of the last port of assembly, you will find that the US has a net trade surplus in excess of $150 billion.

Much of the economic turmoil in Japan today is being caused by excessively high tax rates. In fact, three of the first section listed companies on the Tokyo Stock Exchange have renounced their Japanese heritage and moved to Hong Kong due to a 15% tax rate compared to nearly 70% in Japan. Our economy contracted from the 1960s for 12 years. Japan appears to be facing the very same long-term trend. After 6 years, the Japanese economy remains in the throws of a near depression and taxes have still not been reduced. Despite the fact that interest rates have fallen in Japan to 0.25%, there remains no interest in borrowing for domestic economic expansion.

The method of taxation through domestic social objectives is also a key factor in shifting global capital flows. For example, the US is one of the very few nations that seeks to tax their citizens and corporations on worldwide income. Most British Commonwealth nations tax worldwide income if

earned in a tax free zone. Therefore, if the US were to totally eliminate the corporate income tax, we would run the risk of corporate earnings in the US being considered as income from a tax free zone.

Furthermore, US tax code classifies income made overseas as if any overseas income is derived solely to avoid domestic taxation. The 50% and/or control rule for US companies as the sole criteria for taxation penalizes US enterprises forcing many into joint ventures simply to avoid double taxation in the US. We also discriminate against American companies trying to enter foreign markets by passing the tax burden directly to personal income even if such earnings are not distributed. Our tax code assumes that any offshore entity is merely trying to avoid taxes without testing whether or not an actual business is being developed as compared to an offshore account for investment purposes.

In addition, our prejudice against capital gains versus short-term income within our tax code provides a incentive to manufacture and develop domestic products offshore. The US is one of the few nations whose tax system punishes long-term investment while rewarding short-term speculation. Again, the capital gains taxation has exported more American jobs not because of the mere rate, but due to the fact that losses have been treated differently from short-term income while disallowing the impact of inflation indexing. Consequently, while virtually every electronic product from VCRs, CDs and assorted appliances were designed and patented in the US, their final development and manufacture have been more fairly treated by nations such as Japan. This uncompetetive social philosophy inherent within American tax code has been one of the major causes of forcing US companies offshore into joint ventures than even the net level of income tax itself.

While many will argue that corporations pay little in income tax, what is grossly ignored is the taxation of labor that is a huge direct cost to business. If we look at our own revenue statistics, you will find that the taxation contributions to the payroll tax paid by corporations is substantial - generally twice the level of corporate income taxes.

We must also take into consideration the net cost of taxation upon the nation as a whole. While it is true that the national debt doubled under Ronald Reagan moving from $1 to $2 trillion, this alone does not mean that lower taxes or Reaganomics failed. Under Bush and Clinton, the national debt has now more than doubled from $2 to $5 trillion despite raising taxes.

We must honestly review the economic facts of the past 16 years in order to understand our future. Since Ronald Reagan, we have actually had a balanced budget from the perspective of revenue vs spending. At 8% compounded, you double your money in a bank in about 8 years. The interest expenditures during the Reagan period were equal to nearly $1 trillion. Today, we actually collect about $100 billion more in revenue than Congress actually spends on programs. This is being absorbed by our interest expenditures. In fact, since 1950, the total interest expenditures paid now equal 68% of the total outstanding national debt. We are indeed becoming a Banana Republic.

At times, up to 40% of our national debt has been held by offshore investors who pay no income tax in the US. This means that domestic spending from Congress is no longer stimulating our domestic economy. If fact, an analysis of capital flows reveals that the Japanese earned more from the US on their investment income in the past 16 years than they did on trade.

By taxing interest income, we penalize Americans and overpay foreign investors exporting more capital than would otherwise take place. If we eliminate the income tax on government bonds, we could reduce the interest rate to the actual net return after taxation. This alone could result in an

instantaneous balanced budget since we currently collect more in revenue than we spend on programs with the excess being consumed by interest.

Capital is rushing around the globe today much in the same manner as it did going into the Great Depression. Herbert Hoover wrote in his Memoirs that ***"capital acted like a loose cannon on the deck in the middle of a torrent."*** In 1985, the largest futures mutual fund was $100 million. Today, $1 billion funds are a dime a dozen. Everyone is investing somewhere else to avoid local taxation. It is now estimated that over $2 trillion sits offshore, untaxed and unregulated emanating from all nations. If we eliminate the personal income tax, then America itself will become the international magnet for this vast pool of capital. Our interest rates would decline as it always does whenever excess capital emerges. This single step alone, combined with creating a tax free government bond structure, could spark untold economic growth and help to actually begin reducing our national debt rather than waiting for everything to go bust beyond the year 2000.

SUMMARY

There have been two schools of thought on debt and taxation since government was first conceived. In modern times, these two schools of thought have never stood in more contrast than by the words of two very famous men.

- **"The principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale."**
  THOMAS JEFFERSON, 1789

- **"The only part of the so-called national wealth that actually enters into the collectives possessions of modern peoples is their National Debt."**
  KARL MARX, 1873

If the purpose of this Committee is to fairly reflect upon how our tax code can be used to attract jobs and stimulate economic growth rather than employ gimmicks such as currency manipulation, special one-off tax deals or the continued denial of the damage caused by Marxism in the postwar era, then it is clear from our experience that there can be only one conclusive path.

- **1) End the discrimination against long-term investment by at least allowing capital gains to be indexed to inflation retroactively.**

- **2) Promote honest reform of the Social Security System whereas contributions made should be privately managed as is the case in many other nations. The Postal Savings System in Japan actually has on deposit in real funds nearly $10 trillion which is then managed by the private sector under the watchful eye of government. This will help reduce the cost of labor in the US, create jobs through increased savings, and result in lower payroll tax contributions for business over the long-term while safeguarding the long-term viability of these critical social programs.**

- **3) Eliminate the taxation on government bonds.**

- **4) Eliminate the personal income tax and replace it with a national sales tax of 10% as originally intended by the founding fathers with just cause.**

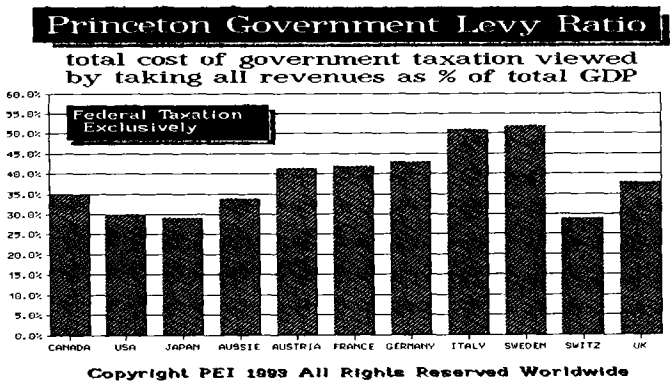
- **5) Reduce the corporate tax rate to 15% matching Hong Kong thereby transforming the US to the international magnet for capital. Allow interest paid to be deducted as a part of the cost of doing business.**

Mr. Chairman, members of the Committee:

This is a brief overview of our experience in dealing around the world on a first-hand observation basis. We strongly believe that the replacement of the current income tax system on individuals with a national sales tax in combination with a corporate tax rate of 15% will prove not merely to be revenue neutral, but also a major economic stimulus that will help our domestic economy grow while forcing major economic change around the world restoring the beacon of hope and liberty by our example.

"It is the highest impertinence of kings and ministers to pretend to watch over the economy of private people and to restrain their expense, either by sumptuary laws, or by prohibiting the importation of foreign luxuries. They are themselves always, and without exception, the greatest spendthrifts in the society. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will."

Adam Smith
Wealth of Nations 1776



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Federal Corporate Income Tax Brackets and Rates

1909-1994

Year	No Tax Below	Rate1 $	Rate2 $	Rate3 $	Rate4 $	Rate5 $	Rate6 $	Rate7 $	Rate8 $
1909-13	5t	1%							
1913-15	0	1% (No exemption after 03/01/13)							
1916	0	2%							
1917	0	6%							
1918a	2t	12% War Profits and Excess-Profits Tax: Profits over 3,000 plus 8% of invested capital subject to graduated rates.							
First Bracket: 30% Second Bracket: 65% Third Bracket: The sum, if any, by which 80% of the amount of the net income in excess of the war-profits credit exceeds the amount of the tax computed under the first and second brackets.									
1919-21a	2t	10%a							
1922-24	2t	12.5%							
1925	2t	13%							
1926-27	2t	13.5%							
1928	3t	12%							
1929	3t	11%							
1930-31	3t	12%							
"0 Exemptions after 1931"									
1932-35b		13.75%							
1936-37b		8% 2t							15% over 40t
Graduated Surtax on undistributed profits ranging from 7-27%b									
1938-39b		12.5-16% 25t							19%c over 25t
1940b		14.85-18.7% 25t					38.3% 31,964	36.9% 38,565	24% over38,656
1941b		21-25% 25t						44% 38,964	31% over38,964
1942-45b		25% 5t				27% 20t	29% 25t	53% 50t	40% over 50t
1946-49		21% 5t				23% 20t	25% 25t	53% 50t	38% over 50t
1950d		23% 25t							42% over 25t
1951d		28.75% 25t							50.75% over 25t
1952-53d		30% 25t							52% over 25t
1964		22% 25t							50% over 25t
1965-67		22% 25t							48% over 25t
1968-69e		24.2% 25t							52.8% over 25t
1970e		22.55% 25t							49.2% over 25t
1971-74		22% 25t							48% over 25t
1975-78		20% 25t						22% 50t	48% over 50t
1979-81		17% 25t				20% 50t	30% 75t	40% 100t	46% over 100t
1982		16% 25t				19% 50t	30% 75t	40% 100t	46% over 100t
1983-86		15% 25t				18% 50t	30% 75t	40% 100t	46% over 100t
1987-92f		15% 50t				25% 75t	34% 100t	39%g 335t	34% over 335t
1993		15% 50t	25% 75t	34% 100t	39%h 335t	34% 10m	35% 15m	38%h 181/3m	35% over 18m
1994		15% 50t	25% 75t	34% 100t	39%h 335t	34% 10m	35% 15m	38%h 181/3m	35% over 18m

t=thousand m=million

a. In 1919 and 1920, the war profits tax was repealed and the excess profits tax was 20%-40% of the profits over 3,000 plus 8% of invested capital (not to exceed 20% of net income over 3,000). (See Revenue Act of 1918 for details on the excess-profit & war profit taxes and credits.)

b. From 1933 to 1935, 5% of the profits above 12.5% of adjusted declared value of capital stock was imposed. From 1936 to 1939, the tax ranged from 6% to 12% on profits over 10% of adjusted declared value. From 1940 to 1945, these tax rates were 6.6% to 13.2%. In addition, profits exceeding 95% of the average net income for 1936-1939, plus adjustments, were taxed at graduated rates of 25-50% in 1941, 35-60% in 1942-43, 90% in 1944, and 95% in 1945.

c. Less adjustments: 14.025% of dividends received and 2.5% of dividends paid.

d. Additional tax of 30% of profits exceeding 85% of net income (average of 3 highest years, 1946-49) adjusted by changes in capital stock (1946-49) was imposed in 1950 (83% of next income in 1951-53). Total tax limited to 62% of excess profits net income before deduction of excess profits credit ($25,000). In 1951, the maximum excess profits tax limited to 17.25% of excess profits net income before deduction of excess profits credit of $25,000. For 1952-53 the limit was 18%.

e. Includes surcharge of 10% in 1968 and 1969, and 2.5% in 1970.

f. Rates shown effective for tax years beginning on or after 7/1/87. Income in tax years that include 7/1/87 (other than the first date of such year is subject to a blended rate.

g. This provision phases out the benefit of graduated rates for corporations with taxable income between $100,000 and $335,000. Corporations with taxable income above $335,000, in effect, pay a flat rate of 34%.

h. The 39% and 38% rates are imposed to phase out the benefits of the lower brackets for high-income corporations.

Source=ACIR (Advisory Commission on Intergovernmental Relations, US Government)

Outline:

The impact of taxation and foreign exchange on international net capital movement, investment trends and corporate decisions as to the location of manufacturing and business decisions and the need for government to consider domestic policy objectives on the flow of jobs and capital in the global context of our economy.

Suggestions:

- **1) End the discrimination against long-term investment by at least allowing capital gains to be indexed to inflation retroactively.**
- **2) Promote honest reform of the Social Security System whereas contributions made should be privately managed as is the case in many other nations. The Postal Savings System in Japan actually has on deposit in real funds nearly $10 trillion which is then managed by the private sector under the watchful eye of government. This will help reduce the cost of labor in the US, create jobs through increased savings, and result in lower payroll tax contributions for business over the long-term while safeguarding the long-term viability of these critical social programs.**
- **3) Eliminate the taxation on government bonds.**
- **4) Eliminate the personal income tax and replace it with a national sales tax of 10% as originally intended by the founding fathers with just cause.**
- **5) Reduce the corporate tax rate to 15% matching Hong Kong thereby transforming the US to the international magnet for capital. Allow interest paid to be deducted as a part of the cost of doing business.**

Mr. HANCOCK. Thank you for your testimony.
Dr. Raboy.

STATEMENT OF DAVID G. RABOY, PH.D., CHIEF ECONOMIC CONSULTANT, PATTON BOGGS, L.L.P.

Mr. RABOY. Thank you, Mr. Chairman.

My name is David Raboy. I am the chief economic consultant to the law firm of Patton Boggs, L.L.P. I am pleased to testify today on the implicatations for international competitiveness of fundamental tax reform.

I will discuss the choice of tax base and structure as it applies to international transactions, investigate the importance of border tax adjustments, and describe the effects on competitiveness from narrowing the base of taxation to achieve social goals.

My primary conclusions are as follows: The current tax structure contains an inherent artificial bias against capital investment. This results in an erosion of productivity rendering U.S. companies less competitive.

The current tax structure also impedes competitiveness through an artificial bias against private savings. There is substantial empirical evidence that even in the presence of world capital markets, a country's investment is constrained by its domestic savings rate.

In addition, when there is a domestic investment savings inbalance, the savings deficit must be made up by capital inflows from foreign savers, which increase demand for the dollar, causing a currency depreciation, and in turn making U.S. goods relatively more expensive in world markets.

Removing artificial tax distortions to private savings decisions will allow increased productive investment without countervailing currency changes.

In the savings and investment area, the flat tax, the USA tax, the VAT, and the sales tax would all have qualitatively similar positive effects on competitiveness. This is true, despite all the attempts at product differentiation and the deification of one's own proposal while simultaneously demonizing all others. These four proposals are all based on the taxation of consumption and would eliminate the current law biases. A broad-based income tax, however, would retain the distortion.

There is an area of real difference, however, and that concerns border tax adjustments. There is conventional wisdom in the economics profession that border tax adjustments are irrelevant with regard to international trade. While this may be technically true in the long run under a set of very highly restrictive assumptions, as Keynes said, "in the long run, we are all dead." To me, the more interesting analysis from a policy standpoint applies to the sectoral changes that occur in the short run.

Now, the near-term consequences of shifting to a border adjustable tax would appear to be significant. Switching from an origin-based system, like our current Code, to a destination principle will result in more exports and/or increased investment in export-producing companies during the adjustment period, and I can elaborate in the question period.

Similarly, there will be fewer imports and/or more investment flowing to import-sensitive companies. Since the system will ulti-

mately be trade neutral, if the United States were to undergo fundamental tax reform, it would seem wise to avail itself of these benefits.

There are other reasons why a destination principle tax is preferred to an origin-based one. Some of the most contentious and frustrating controversies in international taxation concern related company transfer prices. With an origin-based consumption tax, these controversies will remain. In a destination-based system, however, transfer pricing issues would be largely eliminated.

Another issue has to do with incentives regarding production facility location, the so-called runaway plan issue, and I want to stress that there are many, many influences that affect where a company will locate its facilities, but taxes are part of that mix.

Under an origin-based tax system, to the extent that there are existing incentives to locate facilities in low tax countries, they would remain. These incentives are eliminated under a destination principle consumption tax.

If Congress decides to initiate fundamental tax reform, it should choose to shift from an origin principle to a destination principle. A broad-based income tax is obviously ineligible for a border tax adjustment under GATT rules. Similarly, the flat tax would be viewed as a direct tax and, therefore, ineligible as well. The sales tax, the VAT, and the business portion of the U.S. tax would all be considered indirect taxes and, therefore, could be made adjustable at the border.

Regardless of which system is ultimately chosen, affording preferential treatment for social or other reasons to certain classes of goods or industries could result in a deterioration of international competitiveness. The economic literature concludes that a consumption tax will have adverse trade effects if preferential tax treatment such as exemption, zero rating, or lower tax rates is afforded to goods that don't enter international trade, while goods that are either appropriate for export or compete with imported goods bear the full tax burden.

Many of the goods in existing consumption tax systems that receive preferential treatment do not enter international trade, such as medical care, housing, education, and categories of food.

Real or perceived, regressivity should be dealt with outside of the consumption tax system if we are to avoid damage to the trade-sensitive sector of our economy.

Thank you, Mr. Chairman.

[The prepared statement and attachment follow:]

STATEMENT OF DR. DAVID G. RABOY
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I. Introduction

My name is David G. Raboy and I am the Chief Economic Consultant to the law firm of Patton Boggs, L.L.P. I am pleased to testify today on the implications for international competitiveness of replacing the existing Federal income tax with one of several variants of fundamental tax reform initiatives. These variants are a broader-based, flatter-rated income tax; the consumption-based tax that has come to be known as the "flat tax;" a cash flow tax similar to the USA tax; a VAT (either in subtraction or credit-invoice form); and a national sales tax (NST).

In my testimony I will 1) discuss the fundamental choice of tax base and structure as it applies to international transactions; 2) investigate the importance of border-tax adjustments; and 3) describe the effects on competitiveness from narrowing the base of taxation to achieve social goals. Each reform variant will be considered in the context of these three areas.

The primary conclusions of my testimony are:

- The current tax structure impedes competitiveness because of an inherent bias against capital investment. This results in an erosion in productivity, rendering U.S. companies less competitive.

- The four tax reform proposals that are based on the taxation of consumption -- the flat tax, the USA tax, the VAT, and the sales tax -- would all increase competitiveness by eliminating the current-law bias against capital investment. A broad-based income tax would retain the anti-capital bias.

- The current tax structure also erodes competitiveness through an artificial bias against private saving. Because international capital is not entirely mobile, a country's investment is constrained to some extent by its saving rate. In addition, when there is a domestic investment/savings imbalance, the saving deficit must be made up by capital inflows from foreign savers. Capital inflows increase the demand for the dollar, all else constant, which causes a currency appreciation, making U.S. goods relatively more expensive in world markets.

- The four tax reform proposals that are based on the taxation of consumption would all increase competitiveness by eliminating the current-law bias against private saving. A broad-based income tax would retain the anti-saving bias.

- There is conventional wisdom that states that border-tax adjustments are irrelevant in the long-run with regard to international trade. While this is technically true in the long-run under a set of highly restrictive assumptions, probably the most interesting analysis applies to sectoral changes in the "short run."

- The "short-run" consequences of shifting to a border-adjustable tax would appear to be significant indeed. Switching from an origin-based system to a destination principle will result in more exports and/or increased investment in export-producing companies during the adjustment period. Similarly, there will be less imports and/or more investment flowing to import-sensitive companies. Since the system will ultimately be trade neutral, if the United States were to undergo fundamental tax reform, it would seem wise to avail itself of these short-term benefits.

- There are other reasons why a destination principle tax is preferred to an origin-based one. Some of the most contentious and frustrating controversies in international taxation concern transfer prices. With an origin-based consumption tax, these controversies remain, indeed may be exacerbated. In a destination-based system, however, all transfer pricing issues are eliminated.

- Another issue has to do with the differential incentives regarding production-facility location (often labeled the "runaway plant" issue) under alternative border-tax adjustments. Under an origin-based tax system, even one levied on a consumption

base, there remain incentives to locate facilities in low-tax countries. These incentives are eliminated under a destination principle consumption tax. Indeed, investment may relocate to the United States.

- If the Congress decides to initiate fundamental tax reform, and shift the base of taxation from income to consumption, it should also choose to shift from an origin principle to a destination principle. This shift will be beneficial to the trade sector, will eliminate transfer-pricing controversies, and will remove distortions that encourage companies to move facilities overseas.

- A broad-based income tax is obviously ineligible for a border-tax adjustment under current GATT rules. Similarly, the flat tax would be viewed as a direct tax and therefore ineligible as well. The sales tax, the VAT, and the business portion of the USA tax would all be considered indirect taxes, and therefore could be made adjustable at the border.

- Regardless of which system is ultimately chosen, affording preferential treatment to certain classes of goods or industries which narrows the tax base could result in a deterioration of international competitiveness. The economic literature concludes that a consumption tax will have *adverse* trade effects if preferential tax treatment -- such as exemptions, zero-rating, or a lower tax rate -- is afforded to non-traded goods. Many of the goods in existing consumption-tax systems that receive preferential treatment do not enter international trade.

II. Basic Structure and Competitiveness

The current tax system has eroded the ability of U.S. industry to compete internationally by imposing artificial tax biases whose effect is to lower total factor productivity in general, and labor productivity specifically. The primary bias in the tax code is one that discourages investment and saving in our economy.

Investment

There are many factors that affect worker productivity, but most economists would agree that increased productivity requires a healthy rate of capital investment. The current tax system artificially increases the cost of capital through multiple layers of taxation on productive investment. This discourages investment, lowers labor productivity, and renders the economy less efficient than it would be were market forces not distorted.

Although the anti-capital bias is exacerbated by the complexities and arbitrary nature of the existing tax code, it is an inherent part of any tax levied on an income base. A fundamental switch to a consumption-based system would not, as some believe, subsidize investment or give the owners of capital a free ride. Rather, switching to a tax system that employs a consumption base would simply restore neutrality to society's collective decision as to how much of the nation's output to consume, and how much to invest.

This concept of neutrality regarding investment decisions appears to be one of the most misunderstood aspects of the tax reform debate, as has been most evident in arguments regarding the flat tax. The popular perception is that capital income is "exempt" under various consumption-base tax variants, and therefore workers bear the entire burden of government. This is simply not true.

Under a consumption based-tax system, all income is taxed once, but only once. Consider, for example, a VAT. The perception that capital is exempt stems from the feature that physical assets are expensed by the purchasing firm. The reason for this feature is that the value-added associated with the purchased asset has already been taxed -- when the producer of the asset sold it to the purchaser. If the purchasing firm were not allowed to expense the purchased asset, this inherent value-added would be taxed twice, resulting in a bias against investment goods, in favor of other goods which are only taxed once.

This becomes more apparent when one considers the case of a vertically integrated firm that produces its own capital assets internally. Such a firm would *not* be allowed to expense its capital assets under a VAT, because the assets would not have been previously subject to the VAT. The rule is that all value-added is taxed once but only once.

Labor compensation is not exempt from the VAT base because, since we don't have a "head tax" in this country, labor value-added has not been subject to a previous layer of tax. The treatment is symmetrical with respect to capital. Only previously taxed capital can be expensed.

The income tax is inherently biased against capital due to multiple layers of taxation. Empirical evidence increasingly establishes that a shift from an income based system to a consumption based one will increase economic efficiency and the rate of capital formation. For instance, a study by Alan Auerbach and Lawrence Kotlikoff concluded that, "[t]he consumption tax base generates significantly more long-run capital formation than either the wage tax or the income tax."[1] Substantial efficiency gains from replacing the corporate income tax with a VAT were also found in an analysis by Ballard, Scholz, and Shoven.[2] Don Fullerton and Diane Lim Rogers also researched VAT/other-tax substitutions and concluded that there were substantial efficiency gains from replacing the income tax with a VAT and even larger ones from using the VAT as a substitute for the corporate income tax.[3]

Fundamental tax reform which replaces the current income-based system with a consumption-based one will, therefore, enhance the international competitiveness of U.S. industry through a removal of the current bias against investment. Of the five reform proposals that are the subject of this hearing, four -- those that define the tax base to be consumption -- pass muster with respect to investment neutrality. Any type of reform which retains an income base will retain the existing bias against capital. Therefore, a broader-based income tax will not enhance competitiveness in this area.

The remaining four reform variants are all consumption taxes. Despite all the attempts at product differentiation and deification of one's own proposal while demonizing all competitors, a flat tax, USA tax, VAT, and a sales tax all essentially achieve the same tax base. They are all consumption-based taxes, and despite different points of taxation, rate structure, and administrative procedures, they are *qualitatively* equivalent. Any one of the four would result in increased investment, economic efficiency, and international competitiveness.

Savings

The United States has one of the lowest savings rates of all OECD countries. If the investment bias were rectified at the business level, but savings remained low, there could be an anomalous result in terms of competitiveness because of the effects of required capital inflows on the value of the dollar.

In a world where capital is mobile, investment can increase without a commensurate change in domestic savings, but only if foreign savers are willing to fund the new investment through capital inflows. In and of itself, there is nothing wrong with foreign savers purchasing U.S. financial assets. There is, however, a secondary effect.

In order to purchase U.S. assets, foreign savers have to transact in U.S. dollars. All else constant, the mirror image of a capital inflow is an appreciation of the dollar, which makes U.S. goods relatively more expensive in world markets. Even if new investment were to make the U.S. economy more efficient, if such investment were financed primarily by foreign savers, there would be at least a partially offsetting effect due to exchange rate changes. Given the vagaries of foreign exchange markets, this countervailing effect should not be overstated, but Lawrence

[1] Alan J. Auerbach and Lawrence J. Kotlikoff, *Dynamic Fiscal Modeling*, Cambridge, 1987, at 57.

[2] Charles L. Ballard, John Karl Scholz, and John B. Shoven, "The Value-Added Tax: A General Equilibrium Look at its Efficiency and Incidence," *The Effects of Taxation on Capital Accumulation*, Martin Feldstein-ed., University of Chicago Press-1987, at 47.

[3] Don Fullerton and Diane Lim Rogers, *Who Bears the Lifetime Tax Burden?*, Brookings-Washington, DC, 1993, at 230.

Summers is correct in this assessment: "The only way in which we can raise both investment and international competitiveness simultaneously is to increase national savings."[4]

In addition, there is strong empirical evidence that international capital is insufficiently mobile to render domestic savings irrelevant. There is a strong correlation between rates of domestic saving and investment in OECD countries. Therefore, rates of investment in productive capacity will be constrained by low rates of saving.

One of the more controversial areas of the tax reform debate is the effect of different tax bases on the aggregate rate of savings. There is virtually no controversy among economists concerning the proposition that an income tax is inherently biased against savings. The following example illustrates this bias. An individual earns income and pays tax. If he or she uses the proceeds for consumption, there are no additional tax consequences; but if the income is saved, the interest is taxed a second time. This well-known double taxation of savings distorts the decision to save or consume.

Whereas most economists accept the notion of the savings/consumption distortion in the income tax, there is considerable controversy regarding the effects on *saving rates* from removing this distortion. There is a well known concept in economics that the response of saving to an increase in the real after-tax rate of return to saving is a function of two countervailing forces. There is a pure substitution effect which increases the savings rate as present consumption becomes relatively more expensive, and an income effect which works in the opposite direction because individuals can save less and still achieve a target level of future consumption. Resolution of the savings response is, therefore, an empirical matter *if we are concerned with an autonomous increase in rates of return*.

In the context of a *revenue-neutral* tax reform, however, there is no income effect. By definition, in the aggregate, the same level of resources is extracted from the private sector. Therefore, the price of future consumption relative to present consumption is altered, producing a savings response, but since in the aggregate, after-tax income remains the same, there is no countervailing income response. In economic parlance, the tax changes are "compensated."

This is not controversial in the economics profession. It is part of Auerbach and Kotlikoff's model: "Since the tax policies considered here are compensated, there is no overall income effect for the private sector... ."[5] It is put succinctly by Feldstein:

> Although offsetting income and substitution effects imply that raising the rate of return has a theoretically ambiguous impact on personal saving, a compensated tax change that increases that rate of return to savers unambiguously raises national saving. Moreover, as Feldstein and Tsiang (1968) noted, the theoretical ambiguity disappears even for an uncompensated change for the vast majority of individuals who initially do no saving. For such individuals, savings would unambiguously be increased by a rise in the real net rate of interest.[6]

Therefore, in the context of revenue neutral tax reform, the subject of this hearing, a replacement of the current tax system with a consumption-base tax should lead to an unambiguous increase in the U.S. savings rate.

There is a growing body of empirical evidence that suggests that tax changes which diminish the anti-saving bias of the tax code do result in increased savings. For instance, recently an article appeared in the prestigious *Journal of Public Economics* entitled, "Do 401(k)

[4] Summers, Lawrence H. 1987. "The Impact of Tax Policy on Savings." In Charles E. Walker and Mark A. Bloomfield, eds., *The Consumption Tax: A Better Alternative?* Cambridge, MA: Ballinger Publishing Company, at 173.

[5] Auerbach and Kotlikoff, at 58.

[6] Martin Feldstein, "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving," *Quarterly Journal of Economics*, May, 1995, at 476.

Contributions Crowd Out Other Personal Saving?"[7] The study considered whether 401(k) plans resulted in new savings or simply supplanted other savings. Poterba *et al* concluded, "most 401(k) contributions represent new saving."[8] This conclusion is nothing new. One of the first researchers to study IRAs, David Wise, produced evidence from individual panel data that IRAs were effective new savings vehicles. In a study of IRA limit increases included in a National Bureau of Economic Research (NBER) volume in 1987 Wise determined:

> The primary focus of this paper, however, has been the effect of limit increases on other saving. How much of the IRA increase would be offset by reduction in non-tax deferred saving? The weight of the evidence suggests that only a small proportion of the increase would be offset by reductions in other financial assets, possibly 20% or less. Our estimates suggest that approximately 45%-55% of the IRA increase would be funded by reduction in consumption and about 35% by reduced taxes.[9]

Other studies, e.g., Feenberg and Skinner (1989)[10] and several papers by Venti and Wise, provide evidence of the net savings effects of IRAs and other tax deferred savings vehicles. In a 1991 study of a survey of 20,000 households, Venti and Wise revisited the issue of the effects of increasing IRA limits on net savings. They concluded:

> About two-thirds of the increase would be financed by reduced consumption and about one-third by reduced taxes. Very little would be financed by reducing other saving or by increasing debt.[11]

A recent paper by Martin Feldstein also confirmed that IRAs and other tax-deferred savings vehicles contribute to national savings; that is, the increase in saving exceeds the resulting loss of tax revenue. The studies previously cited all concluded that national savings has increased as a result of savings vehicles. Feldstein argues that these studies actually *underestimate* the savings effect by not including the effects on corporate tax revenues when new IRA saving is invested in corporate investments that generate income.

> Previous analysis of IRA plans and other savings incentives have miscalculated their effect on tax revenue (and therefore on national saving) by focusing exclusively on personal tax payments. Tax rules that include personal saving also have important positive effects on corporate tax revenue. The revenue loss associated with IRAs and other savings incentives is therefore smaller than generally estimated and may actually be a revenue gain.[12]

It is not only in the United States that evidence linking saving and tax incentives has been found. Burbidge and Davies recently studied the tax-deferred retirement system in Canada and found, "a strong gross correlation between tax incentives for saving and the personal saving rate."[13] This concurs with an earlier study by Carroll and Summers which explained the

[7] James M. Poterba, Steven F. Venti and David Wise, "Do 401(k) Contributions Crowd Out Other Personal Saving?", *Journal of Public Economics*, September, 1995, at 1-32.

[8] Poterba, Venti and Wise, at 2.

[9] David A. Wise, "Individual Retirement Accounts and Saving," *Taxes and Capital Formation*, Martin Feldstein-ed., University of Chicago Press, 1987, at 14.

[10] D. Feenberg and J. Skinner, "Sources of IRA Saving," *Tax Policy and the Economy*, NBER-Chicago, 1989, at 25-26.

[11] Steven F. Venti and David A. Wise, "The Saving Effect of Tax-deferred Retirement Accounts: Evidence from SIPP," *National Saving and Economic Performance*, Bernheim and Shoven-eds., University of Chicago Press, 1991, at 105.

[12] Feldstein, at 476.

[13] John B. Burbidge and James B. Davies, "Government Incentives and Household Saving in Canada," *Public Policies and Household Saving*, James Poterba-ed., University of Chicago Press, 1994, at 55.

divergence in the savings rates in Canada and the United States as resulting from the expansion in tax-deferred retirement plans in Canada.[14]

As was the case with the investment issue, four of the five candidates for tax reform considered in this hearing will increase international competitiveness by removing the anti-savings bias of the present tax code. The USA tax, with an exemption for saving at the personal level while returns to saving are taxed when spent as consumption, is savings neutral. So is the flat tax which taxes all capital returns only once at the business level. Similarly, the VAT and the sales tax are also neutral in their effects on the saving/consumption decision. Any broad-based tax which retains the concept of an income base, however, would continue the artificial distortion of savings choices.

III. Border Tax Adjustments

One of the policy issues where it is claimed that business people and those that study their decisions are most at odds is the effect of border-tax adjustments on competitiveness. The existence of this issue, of course, can be blamed on the GATT (The General Agreement of Tariffs and Trade), which allows a system of border tax adjustments. Such adjustments are allowed on "indirect taxes" (sales taxes, VATs, excise taxes, and the like), but not on "direct" taxes (income taxes, payroll taxes, and other taxes on income flows). Given a choice of adopting the "origin" principle, where taxes are levied on goods in countries where they are produced, or the "destination" principle, where taxes are levied on goods in the country in which they are consumed, the GATT adopted the destination principle. Indirect taxes like the VAT, which are applied *directly* to goods, are levied on imports and rebated on exports while direct taxes like the corporate income tax, which may *indirectly* enter the price of goods, are not applied to imports and not rebated on exports.

There is conventional wisdom that states that border-tax adjustments are irrelevant in the long-run with regard to international trade. Less sophisticated analysis simply argues that any trade effects are eliminated by changes in exchange rates. More sophisticated analysis focuses on the relative prices of traded goods and notes that the *relative* price of imports to exports (both internally and externally) is unaltered *in the long run* under both the origin and destination principles. Therefore, it is argued, border-tax adjustments have no long-run influence over a nation's trading pattern. While this is technically true in the long-run under a set of highly restrictive assumptions,[15] probably the most interesting analysis applies to sectoral changes in the "short run."

The classical theory of trade states that countries trade because they are different. They are endowed with different levels of natural resources, labor of differing qualities and costs, capital, and other factors of production, or there are differences in consumer tastes. Because they are different, countries face different trade-offs in the types and quantities of goods and services they can produce, given their differing resources. In one country a class of goods may be *relatively* less costly than in another country, therefore, "comparative advantages" may exist.

The classical theory holds that by engaging in trade with one another, countries can exploit others' efficiency and better themselves. As they begin to trade, the relative prices of the goods entering trade in each country will change until relative prices are equalized. At this "equilibrium" each country will be economically better off than it was before because there will have been "gains from trade." The faith that is required is that the free market will sort out the best solution. Therefore, countries are best served if prices of goods entering international trade are not distorted by government policies. But not just any prices -- *relative* prices. One of these countries could have higher *absolute* costs for all products entering trade and the other still could benefit from trade. The relative prices that are of importance are expressed as opportunity costs -- what must be given up in terms of one thing to produce another thing.

[14] Chris Carroll and Lawrence Summers, "Why Have Private Savings Rates in the United States and Canada Diverged?," *Journal of Monetary Economics*, September, 1987, at 249-79.

[15] See e.g. Gary Clyde Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments*, Institute for International Economics, Washington, DC, 1996, at 23, 24.

As a general principle, then, policies that artificially distort the *relative* prices of traded goods diminish economic efficiency by lessening the gains from trade. There are both internal and external relative prices to be considered. Economists define the "terms of trade" as the *external* price of exports of a country, divided by the external price of the goods that the country imports. A country is better off when the external price of exports rises relative to imports; that is, when the terms of trade improve; because obviously it can buy more with the same volume of exports -- what it sells in international markets has increased in value.

The terms of trade are not, however, the only relative prices that matter to policy makers. It is well known in the literature, for instance, that there are two countervailing effects of a tariff. There is an efficiency loss from a distortion of the internal prices facing consumers and producers after application of the tariff which disturbs the allocation of resources, and there is an improvement in the terms of trade which benefits the country. For a "small" country, one which has insufficient market share to influence world prices, by definition *no* trade policy can affect the terms of trade. But policies *will* influence internal relative prices and force consumers and producers into decisions they otherwise would not make, thus distorting the allocation of resources and lessening economic efficiency.

The standard methodology used to investigate the effects on relative prices of border-tax adjustments involves a general equilibrium model where all results are reported after the world has fully adapted to a tax change, and no mention is made of what happens during the period of adjustment. It makes a crucial assumption that the country being studied is relatively small; that is, its world market share is sufficiently small that it has no power to affect the world prices of traded goods. By definition, therefore, nothing the country does in terms of policy changes can influence the external terms of trade, but tax changes can affect the internal relative prices of traded goods facing domestic producers and consumers. These relative prices are what are tested, at equilibrium, for the differential effects of border-tax adjustments.

It also assumes that the test country produces three goods. The first good produced by the country is consumed domestically, but also can be exported (exportable). The second domestically produced and consumed good competes with imports from the rest of the world (importables). The final good is produced and consumed domestically and is neither exported nor does it face potential import competition (non-traded).

For equilibrium to occur in these models, three conditions must be satisfied. First, the domestic seller of the exportable good must be receiving the same return, after-tax, in both the home market and the external market. Obviously, if this were not the case, sellers would divert sales to where the after-tax returns were higher, and the positive or negative change in domestic supply in the home market would cause the domestic price to adjust until after-tax prices were equalized in the home and external markets. By definition, the world price is fixed, so that the domestic price of the exportable would be the price that changes to make sellers indifferent between the domestic and external markets. Second, the price of the domestically produced importable good, including tax, cannot be any different than the price of the import, including tax. Otherwise consumers would shift to the cheaper version until demand changes caused the domestic price to adjust to restore equilibrium. Third, domestic supply of the non-traded good must equal demand for there to be equilibrium.

Short-Run Implications

To see how crucial the border-tax adjustment is to the traded goods sector of an economy, consider the following example. Assume initially that a country that is "small" relative to the totality of world trade has no tax system. Because it has little market power, the country's producers are price-takers -- they are constrained to sell at "world" prices. The world price of the country's goods that compete with imports is 10. The world price of the good the country exports is 15. The ratio of the prices of exports to imports (both internally and externally) is 1.5.

The country's government, having listened to economists that have stated that border-adjustments are irrelevant, imposes a 10 percent origin-based tax. Producers of exports would like to charge 16.5 in order to maintain the same after-tax return, as before the imposition of the tax. But they can't. They are constrained to sell at a price, including tax, equal to the

world price. In order to remain competitive in world markets, exporters must reduce their return on sales to 13.64 per unit. Note that foreign purchasers are still paying 15 for the exports, so that there is nothing that would pressure exchange rates. The difference is that only 13.64 is going to the private company with the remainder going to the government.

Quite obviously, a reduction in private returns of over 9 percent is going to cause previously competitive companies to lose money. The inevitable result is a contraction in the export producing sector, either through business closures or decreased production. In fact the export sector must contract until the remaining firms find it profitable to sell exports at 13.64.

Similarly, domestic producers that compete with imports would like to charge 11 after the tax is imposed. But they can't either. Imports don't face any tax under the origin principle. If import-sensitive companies want to sell any of their goods, they will have to reduce their private return to 9.09. Again, this will drive companies out of business until sufficient contraction has been achieved that firms find it profitable to compete against imports at a 9.09 pre-tax price, to produce an after-tax price of 10. Note that since the price at the border hasn't changed, there is no pressure for exchange rates to change.

In the sector that produces goods that don't enter international trade, either as exports or as competitors with imports, the story is entirely different. These goods also face a 10 percent tax but they don't face the binding constraint of world prices. Depending on the domestic elasticity of demand, producers will be able to shift some or all of the tax to consumers in the form of higher prices.

These companies, to the extent that they have to bear some of the tax, will also see private returns drop, but not by the full amount of the tax. Trade-sensitive companies, however, will bear the full burden of the tax, due to the tyranny of world price constraints. Thus, the returns available in the traded-goods sector will drop relative to those available in the non-traded goods sector. The result will be a shift of resources out of the trade sector until equality of returns is restored. Once the relative contraction of the trade sector and the corresponding expansion of the purely domestic sector is complete, the economy will be in equilibrium.

At this equilibrium the external price of exports (including the tax) is still 15 and the price of importables to consumers is still 10. The relative price hasn't changed. Similarly, the private return to exports is 13.64, and the private return to importables is 9.09. This relative price is also 1.5.

The country's economists are proven to be right in terms of long-term neutrality. Relative prices are unaltered from the free trade equilibrium, and therefore the tax is entirely neutral with respect to the country's future trade relations. This is small comfort to the traded goods sector, however. This neutrality has only been achieved because their sector has contracted.

Now consider the situation we are in currently. We are considering replacing an origin-based tax with a destination-based system on *a revenue neutral basis*. After such a switch, the tax on non-traded goods would be the same. But since tax is rebated on exports, exporters can increase their private returns to 15, the constraining world price. Once again there is no influence on the exchange rate because the only thing that has changed is that the part of the world price of 15 that was going to the government now goes to the private company. The returns available to exporters have increased *relative* to those in the non-traded goods sector, while in *absolute* terms, the non-traded sector returns have not dropped.

In the import intensive sector, now the tax applies to imports as well as their domestic competitors. Foreign producers require the world price of 10, so the import price including tax rises to 11. Domestic producers can now raise their prices to 11 as well, and their private returns are restored to the free trade level. Here, there may be some countervailing exchange rate pressure.

The higher returns in the traded goods sector leads to an expansion, relative to the non-traded goods sector. Equilibrium occurs when all private returns are equalized. At the new equilibrium all relative prices are the same as under free trade, so the destination-based system is

entirely neutral. But this time the long-run neutrality has been achieved only because of a relative expansion of the trade sector.

The "short-run" consequences would appear to be significant indeed. Switching from an origin-based system to a destination principle will result in more exports and/or increased investment in export producing companies during the adjustment period. Similarly, there will be less imports and/or more investment flowing to import-sensitive companies. And since the system will ultimately be trade neutral, it would seem wise for the United States to avail itself of these short-term benefits.

Other Economic Effects

There are other reasons why a destination principle tax is preferred to an origin-based one. Some of the most contentious and frustrating controversies in international taxation concern transfer prices. With an origin-based consumption tax, these controversies remain, indeed may be exacerbated. Companies will have a strong incentive to artificially distort transfer prices.

In a destination-based system, however, all transfer pricing issues are eliminated. There is no incentive to artificially distort transfer prices because if a company understates an import price, it is exactly offset by the lower deduction (or tax credit), taken against the value that is taxed at final sale.

Harry Grubert and Scott Newlon made this point in a *National Tax Journal* article:

> In addition, a destination-principle consumption tax would eliminate income shifting by MNCs [multinational corporations] out of the United States through manipulation of their transfer prices. However, there would continue to be such an incentive under an origin-principle consumption tax.[16]

The transfer pricing issue was also stressed in a follow-up comment to Grubert and Newlon's article:

> Specifically, an origin-based business tax does nothing to resolve the transfer pricing problem, which has been vexing the IRS for many years, and is likely to continue as a major source of difficulty in years to come, despite the adoption of new regulations to deal with the problem.[17]

Another issue has to do with the differential incentives regarding production-facility location (often labeled the "runaway plant" issue) under alternative border-tax adjustments. As stated by Grubert and Newlon:

> In contrast to its effects under the income tax, the exemption of foreign income under a consumption tax, including exemption of receipts of foreign royalties under the destination principle, is not likely to cause a substantial "runaway plant" effect in which multinational corporations (MNCs) shift production abroad. On the contrary, MNCs would likely shift tangible investment, intangible assets and R&D to the United States. . .
>
> [U]nder the origin principle, but not under the destination principle, some incentive may remain for MNCs to locate in low-tax countries... .[18]

[16] Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal*, December, 1995, at 620.

[17] Reuvan S. Avi-Tonah, "Comment on Grubert and Newlon, 'The International Implication of Consumption Tax Proposals.'" *National Tax Journal*, June, 1996, at 260.

[18] Grubert and Newlon, at 620.

Therefore, if the Congress decides to initiate fundamental tax reform, and shift the base of taxation from income to consumption, it should also choose to shift from an origin principle to a destination principle. This shift will be beneficial to the trade sector, will eliminate transfer-pricing controversies, and will remove distortions that encourage companies to move facilities overseas.

A broad-based income tax is obviously ineligible for a border-tax adjustment under current GATT rules. Similarly, the flat tax would be viewed as a direct tax and therefore ineligible as well. The sales tax, the VAT, and the business portion of the USA tax would all be considered indirect taxes, and therefore could be made adjustable at the border.

IV. The Effects of Base Erosion on International Competitiveness

This testimony has argued that of all the tax reform variants being considered, the form that would most enhance competitiveness is a destination-based consumption tax. Regardless of which system is ultimately chosen, however, affording preferential treatment to certain classes of goods or industries which narrows the tax base could result in a deterioration of international competitiveness. This will be illustrated with reference to consumption taxes.

The economic literature concludes that a consumption tax will have *adverse* trade effects if preferential tax treatment -- such as exemptions, zero-rating, or a lower tax rate -- is afforded to non-traded goods. Since many of the goods in existing consumption-tax systems that receive preferential treatment do not enter international trade, the analysis of preferential treatment must include consideration of the trade effects.

The reasoning is straight-forward. Consider an example where non-tradeables are zero-rated under a VAT, or exempted from a sales tax. If a tax applies to traded goods but not to non-traded goods, the relative prices of exportables to non-tradeables and importables to non-tradeables would increase. Having the tax apply to tradeables but not to non-tradeables introduces a tax wedge between the two sectors. Either the cost to consumers of importables and exportables relative to non-tradeables has increased and/or the returns to businesses of importables/exportables relative to non-tradeables have decreased. In either case the result is a reduction of consumption of tradeables relative to non-tradeables and/or a relative decrease in investment flowing to the tradeable sector. Strictly because of a tax-induced relative price change, the tradeable-goods sector will contract.

This is a serious issue for policy makers when you think of the types of goods that don't enter international trade. Examples include housing, medical care, education, many types of food sold for home consumption, and other goods. The standard proposals to exempt or zero-rate housing, food, medical care, and welfare activities would apply substantially to non-traded goods.

Preferential treatment for some goods and services as a remedy for perceived regressivity has been criticized on a number of grounds. It is generally agreed that exemption, zero-rating, or lower rates are extremely inefficient and costly ways to redress regressivity; and that it is preferable to seek remedies outside the consumption-tax system through income tax credits or transfers. It is also apparent that preferential treatment causes economic inefficiency by distorting consumer and producer choices across industries. Now a third and compelling reason has been added to oppose narrowing of the tax base. The effect will be a *long-term* deterioration of a nation's trading position.

In the current round of tax reform debate, it is clear that policy makers have appreciated the necessity of maintaining a broad tax base and not employing preferential tax rates. All of the major consumption tax proposals -- the Gibbons business tax, the Armey flat tax, the Schaefer-Tauzin sales tax, the Danforth-Boren business tax, and the Nunn-Domenici business tax -- apply one tax rate to all businesses with no exclusions/zero-rating. This is the right result for many reasons including the effects on international competitiveness.

Tax Policy Forum

Value Added Taxes and International Competitiveness

by David G. Raboy

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I. Introduction

It is not uncommon for the views of academic economists and those of business people—whose actions and decisions economists attempt to study—to differ. It is, of course, somewhat of an irony in our academic era, with its models of bounded rationality, rational expectations, and other representations that suggest that business people act in their own self-interest. Yet on some key issues, business people and academic economists can apparently hold radically different views for long periods of time on the effects of policies. One policy issue on which the opinions of these two groups appear to be most at odds is the economic effects of a value added tax (VAT)—or, more precisely, the substitution of a VAT for existing business taxes—on international competitiveness.

The very existence of this issue can be traced to provisions of the General Agreement on Tariffs and Trade (GATT), which includes a system of border tax adjustments.[1] Such adjustments are allowed for *indirect* taxes (sales taxes, VATs, excise taxes, etc.), but not for *direct* taxes (income taxes, payroll taxes, and other taxes on income flows). Given the choice between adopting the "origin" principle—where taxes are levied on goods in countries where they are produced—or the "destination" principle—where taxes are levied on goods in the country in which they are consumed—the GATT adopted the latter. Consequently, indirect taxes like the VAT, which are applied *directly* to goods, are levied on imports and rebated on exports, while direct taxes like the corporate income tax, which may *indirectly* affect the price of goods, are not applied to imports and not rebated on exports.

Since the United States currently relies on origin-based direct taxes with no border adjustments, while the rest of the world is more heavily dependent on indirect taxes with border adjustments, many business people in trade-intensive sectors have argued for transformation of the U.S. tax system, despite the analysis of academic economists. To such proponents of tax changes, Martin Feldstein and Paul Krugman (1990, p. 263), for example, lecture:

> Among many businessmen, however, the case for a VAT is often stated quite differently. They view such a tax as an aid

[1] The adjustments reflect a "destination-based" system, and are as follows: taxes are forgiven on exports as they cross a country's frontier, and taxes that apply to domestically produced goods can also be levied on imports.

to international competitiveness since VATs are levied on imports but rebated on exports. The case is often stated as follows: an income tax is paid by producers of exports but not by foreign producers of the goods we import, while a VAT is paid on imports but not exports. Surely, say the proponents of this view, this means that countries that have a VAT have an advantage in international competition over countries that rely on income taxation.

In fact, this argument is wrong.

Feldstein and Krugman (1990, p. 264) go so far as to attribute to Charles McLure the view of "the competitive argument for a VAT as evident nonsense."[2]

Mainstream economic theory assumes that economic actors are "rational," that is, that they behave in predictable ways that represent their self-interest, based on available information. Why then would rational, profit-maximizing business people insistently advocate policies that apparently will not achieve their intended goals? Perhaps the information costs are so high that, given bounded rationality, it has been too expensive to educate those with errant opinions. (Presumably, the more lectures that business people receive from academic economists, the lower the transaction costs will be.) Or perhaps this is a principal-agent problem, where managers are promoting policies that do not coincide with the desires of the owners of capital. Or—just maybe—the gulf is not as wide as some economists believe.

This article attempts to reconcile these divergent views on the trade implications of VATs, and to determine what the economic literature actually says about VATs, other taxes, and international competitiveness. A first step must be to cull the plethora of issues and approaches. There is the question of the international effects of a VAT in isolation, or as a substitute for other taxes. The latter possibility raises the question of differences in tax incidence among VATs, the corporate income tax, payroll taxes, or individual income taxes. There is also the issue of the international monetary system and floating exchange rates, not to mention international capital flows.

To begin with, how should "competitiveness" be defined? Much of the popular literature considers the effects of a VAT on the trade balance (the "current account"), while much of the academic literature on trade is more concerned with the effects of tax policy on the relative prices of traded goods or the "terms of trade." The terms of trade, it is claimed, represent a nation's true economic welfare with respect to trade policy. Are the two concepts, the current account and the terms of trade, the same thing? Are they related? Used as alternative measures of the effects of policy change, will they provide the same answers? These are threshold questions. This article argues that if true economic efficiency is what we are after, then the terms of trade, or relative prices, are the best barometer for gauging the effects of policy changes.

> If true economic efficiency is what we are after, then the terms of trade, or relative prices, are the best barometer for gauging the effects of policy changes.

Once the proper barometer has been chosen, there are many separate issues that must be analyzed in order to assess the international implications of substituting a VAT for other taxes remitted by businesses. Upon sorting through these various issues, which are discussed below, my reading of the literature indicates that the following conclusions are defensible:

- All else held constant, a switch from an origin- to a destination-based tax system will increase exports somewhat and decrease imports somewhat in the short run. An overhaul of the tax system cannot be justified on this basis alone, but if there is to be a major tax change for other reasons, the destination principle should be employed.
- Although an ideal VAT (broad-based with a single rate) is neutral in its effects on trade, a narrow-based VAT with exemptions and zero-ratings could result in a deterioration of competitiveness.
- The economic efficiency gains associated with a switch from taxes that distort economic decisions to a tax that is less obtrusive will result in additional indirect, positive effects on trade.

The following section defines and provides background on the terms-of-trade concept, as well as on the current account, and explains why the former is preferred to the latter as a gauge for tax policy. The subsequent section temporarily puts aside questions of differential incidence to explore the effects of idealized "origin-based" and "destination-based" VATs on relative prices. We next examine an extremely important point that has not received proper

[2] In fact, McLure did not make this definitive statement. While arguing that a stand-alone VAT was neutral in its trade effects, he states that "it seems reasonable to believe that substituting a VAT for part of the corporate income tax might improve U.S. competitiveness in the short run" (McLure 1987, p. 41).

attention in the popular literature—the effects on trade of a VAT with a narrow base, including exemptions and/or zero-rated goods. Following that, we briefly explore the literature on the effects of substituting a VAT for existing business taxes. We then return to the subject of the current account, and, finally, offer some conclusions.

II. How Should We Judge Competitiveness? Relative Prices and International Trade

The classical theory of trade states that countries trade because they are different (Dixit and Norman 1980, Krugman and Obstfeld 1991). They are endowed with different levels of natural resources, labor of differing qualities and costs, capital, and other factors of production; or there are differences in consumer tastes. Because they are different, countries face different tradeoffs in the types and quantities of goods and services they can produce.

For instance, in one country (country A) it may be possible to choose between producing two cars or 20 televisions with equivalent resources; whereas in another country (country B), the resources employed to build two cars could only produce 10 televisions if shifted to that industry. In the absence of trade, in country A, the *relative price* of televisions to cars is 10—each car is worth 10 televisions. In country B, the relative price is five. We can say that in A, cars are *relatively* more expensive because the production of one entails giving up 10 televisions; while in B, only five televisions are foregone per car. On the other hand, televisions are relatively more expensive in B: One television is worth 20 percent of a car. In A, however, producing a television entails sacrificing only 10 percent of a car.

We can therefore say that A has a *comparative advantage* in the production of televisions, and that B has a comparative advantage in cars. Further, each can benefit from trade. Remember that internally, citizens of A require the equivalent of 10 televisions to buy one car. If, instead, they sent those 10 televisions to B, they could buy two cars. Similarly, B's citizens could internally purchase five televisions with the resources needed for one car. But if they ship that one car to A, they can buy 10 televisions.

For both countries, there are *gains from trade*. As the countries begin to trade, the relative prices in each country will change, due to increased demand for each country's export, until the relative prices are equalized somewhere between the initial levels. At this *equilibrium*, each country will be economically better off than it was before.[3]

> All else held constant, a switch from an origin- to a destination-based tax system will increase exports somewhat and decrease imports somewhat in the short run.

That, in a nutshell, is the classical theory of trade. Each country can exploit the other's efficiency and so better itself. The faith that is required is that the free market will sort out the best solution. Therefore, countries are best served if prices are not distorted by government policies. But not just any prices—*relative* prices. Country A could have higher *absolute* costs for both products, and still country B could benefit from trade. Or as Avinash Dixit and Victor Norman (1980, p. 2) put it, "If two countries engage in trade, each will have incentives to increase production, and reduce consumption, of goods in which it has the lower *relative* marginal cost *prior to trade* than the other." The gains from trade stem from a lack of distortion of *real* prices and costs in the economies of the world. Exchange rates are not relevant in this view.[4] All that matter are the *opportunity costs* — what must be given up in terms of one thing to produce another thing.

This classical theory has been challenged by some rather embarrassing observations. Notably, almost identical countries trade with each other; also, some countries export essentially the same goods to each other (two-way trade). Rather than jettison classical theory, however, new trade theorists have added to it. They developed notions of economies of scale in production (in order to be efficient it might not make sense, given the market, to have 20 countries producing wide-body aircraft or supercomputers); and of imperfect competition.[5] When added to the classical concept of comparative advantage, these concepts do fairly well to explain trade in the modern world.

Whereas some of the new trade theory questions the efficacy of free trade, and most economists would grant that interference is warranted under certain situations, the dominant view of the

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[3]This, of course, is an extremely simple example that ignores, among other things, transportation costs. For detailed discussions of the classical theory of trade, see Dixit and Norman (1980) and Krugman and Obstfeld (1991).

[4]"[T]he exchange rate . . . is immaterial for the validity of the basic gain from trade. The sole purpose of the exchange rate is to translate the comparative advantage into an actual lower cost for consumers in the other country" (Dixit and Norman 1980, p. 3).

[5]*See, e.g.*, Krugman (1980), Lancaster (1980), Harris (1984), and Helpman (1981); for comprehensive volumes, see Krugman (1990) and Grossman (1992).

new trade theorists is that, in general, the additional explanations of trade patterns enhance rather than diminish the potential gains from trade.[6] Therefore, it is still appropriate to judge government policy as to its effects on relative prices.

As a general principle, policies that artificially distort the *relative* prices of traded goods diminish economic efficiency by lessening the gains from trade. They inhibit the decisions of both consumers and producers, and artificially direct both groups into uneconomic activities. There are both internal and external relative prices to be considered. Economists define the "terms of trade" as the *external* price of exports of a country, divided by the external price of the goods that the country imports. Paul Krugman and Maurice Obstfeld (1991, p. 109) call this the "ratio at which countries exchange goods." In the economics profession there is a "presumption that the terms of trade are a relevant measure of the welfare of a trading country—but that is usually taken for granted." (Dixit and Norman 1980, p. 19). As stated by Krugman and Obstfeld (1991, p. 98):

> The general statement, then, is that *a rise in the terms of trade increases a country's welfare, while a decline in the terms of trade reduces it welfare.*

A country is better off when the external price of exports rises relative to imports, that is, when the terms of trade improve, because obviously it can buy more with the same volume of exports—what it sells in international markets has increased in value.

The terms of trade are not, however, the only relative prices that matter to policymakers. It is well known in the literature, for instance, that a tariff produces two countervailing effects. There is an efficiency loss from a distortion of the internal prices facing consumers and producers after application of the tariff which disturbs the allocation of resources, and there is an improvement in the terms of trade which benefits the country.[7] For a "small" country—that is, one that has insufficient market share to influence world prices—by definition *no* trade policy can affect the terms of trade. But policies *will* influence internal relative prices and force consumers and producers into decisions they otherwise would not make, thus distorting the allocation of resources and lessening economic efficiency.

The relevant question will be whether a VAT, or a VAT which replaces another tax, alters the internal or external relative prices of traded goods from those that would have prevailed under free trade.

Therefore, to gauge the effects of policy, this article looks at how both internal relative prices and the terms of trade differ from those that would prevail under free trade. The relevant question will be whether a VAT, or a VAT which replaces another tax, alters the internal or external relative prices of traded goods from those that would have prevailed under free trade.

III. Why Not Use the Current Account?

The current account, popularly known as the *trade balance*, is one component of a country's international accounts. It is defined as the difference between the value of exports and imports plus income received from foreign investments less income paid to foreigners from investments in the United States, plus adjustments for transfers (such as international relief efforts), and military transactions. The current account is measured in nominal units of a nation's currency.

A second component of a country's international accounts is the *capital account*, which is essentially the net of capital inflows and outflows (both private and public). Capital outflows include government currency reserves and other assets, and private assets such as stocks and bonds issued by foreign companies and governments. Capital inflows are basically official foreign government purchases of home-country assets and private purchases of domestic assets by foreigners. In addition, there is a small component of the capital account for International Monetary Fund Special Drawing Rights.

These two accounts comprise the balance of payments, which is simply an accounting identity that reflects all monetary inflows and outflows. By definition this identity must always be in balance; that is, any deficit in the trade balance must be made up by a capital inflow of equal magnitude. The excess of imports over exports must be paid for by borrowing money from foreign entities in one form or another.

Since the balance of payments must always balance, it also defines the demand for a nation's currency when exchange rates are free to float. Exports plus capital inflows essentially define the external *demand* for a country's currency (because a nation's goods

[6] *See, e.g.*, the introductory chapter in Krugman (1990).

[7] *See* Dixit and Norman (1980), pp. 23-25, and Krugman and Obstfeld (1991), Chapter 8.

and assets must be purchased in home currency), while imports plus capital outflows define the external *supply* (because home currency must be converted to foreign currency to purchase foreign goods and assets). The supply of a currency will always be equal to demand. Therefore, there cannot be a change in the current account unless there is an offsetting change in the capital account, because both are recorded in nominal terms. If imports rise, the supply of a currency increases because domestic entities need to buy foreign exchange with dollars to purchase the imports. If there is no offset, i.e., foreign entities *demand* more dollars through lending to domestic entities (e.g., purchasing dollar-denominated bonds), then there will be a demand/supply imbalance. When the supply of dollars exceeds demand, the "price" of dollars—just like anything else—will fall. A currency depreciation will occur, returning the nominal current account to its previous position. Obviously, this says nothing about the real economy or economic efficiency.

Politicians focus on the trade balance because to them it relates to jobs. The perception is that exports create jobs and imports eliminate jobs, so a trade surplus is a good thing. Of course a trade surplus also requires capital outflows—any increase in the level of exports relative to imports requires capital, which otherwise would have been invested in the United States, to be invested abroad.[8]

The best way to illustrate that the current account is not a good gauge for policy is to take a noncontroversial issue—say, tariffs—and compare the analysis of that issue with respect to the current account and relative prices.

The world has recently concluded the Uruguay GATT Round, which was designed to reduce tariff and nontariff barriers to trade in a range of sectors including manufacturing, agriculture, and services. More than 100 GATT contracting parties devoted huge amounts of resources to negotiate the reduction of trade barriers, and economic studies published by international bodies predict substantial increases in the world's wealth due to the reduction of the trade barriers accomplished by the new GATT agreement.

Everyone can agree that tariffs distort trade. Tariffs also, economists agree, artificially distort the internal relative prices facing consumers and producers, and therefore change the allocation of resources from what would exist under free trade. Economists also agree that if a country is relatively large, a tariff will change the external terms of trade. Further, there is virtually universal agreement among academic economists that—except in rare situations—tariffs make the world less efficient and less well off; therefore, tariff increases are generally opposed.

> At equilibrium, none of the relative prices facing consumers or producers changes after the imposition of the origin-based VAT. The VAT, therefore, is entirely neutral in its long-run effects on trade.

So in an era of floating exchange rates, *all else held constant*, what happens to the current account if one country increases its tariffs? *Absolutely nothing*:

> In a large class of macroeconomic models with flexible exchange rates the tariff also has no impact on the current account, because an exchange rate appreciation will immediately offset all changes from higher tariffs . . . [I]f a tariff is to reduce a current account deficit it must have the effect of decreasing the country's international borrowing (Engel and Kletzer 1986).

In other words, *nothing can change the trade balance* unless it also changes the capital account.[9]

There is nothing incorrect about this statement. It simply affirms that the current account is an accounting mechanism that measures items in nominal terms, and that there is no necessary correspondence between it and changes in the real economy, the allocation of resources, or economic efficiency. Tariffs are *real* costs, involving the extraction of real resources. The effects of this extraction cannot be masked by changes in strictly nominal phenomena, such as the movement in nominal exchange rates.[10] For this reason,

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[8] *See, e.g.*, Sinn (1990, p. 1) who notes: "The confusion is shared by countries that take pride in being world export champions without realizing that they could equally well regard themselves as capital flight champions."

[9] It may well be that trade barrier reductions will indirectly influence capital flows, but these are second-order effects caused by the first-order changes in the relative prices that determine economic decisionmaking.

[10] It is generally agreed in the literature that exchange rates are immaterial to changes in relative prices. For instance, Dornbusch (1974), considering the effects of tariffs in a model with nontraded goods, states:

> [T]he requisite adjustment is one of relative prices. . . . Indeed there is nothing in this model that will determine nominal prices or an exchange rate and the frequently encountered assumption that in the 'background' monetary and fiscal policy maintain the nominal price of home goods is an unsatisfactory way of concealing what is essentially a non-monetary economy.

the effects of tax and trade policies on real relative prices are the preferred analysis route.

Of course, the trade balance will continue to be a politically charged issue. It is the most publicly accessible image of our trading relationships, and has become politically tied to such issues as the "export of jobs," and some general feelings concerning our standing in the world. Therefore, we will revisit the current account following an analysis of the effects of VAT on relative prices.

IV. Origin-Versus Destination-Based Taxes

Much of the debate on the trade effects of a VAT concerns the prospect of substituting a VAT for other taxes on business, including the corporate income tax and the employer portion of payroll taxes.[11] Such a substitution raises several issues, including potential differences in tax incidence and the effect of switching from an origin- to a destination-based tax. We concentrate on the latter issue here. Using an ideal (broad-based with a single rate) VAT, this section analyzes, in turn, the relative-price effects of an origin-based VAT and a destination-based VAT. It then investigates any effects on the relative prices of traded goods caused by switching from an origin- to a destination-based VAT.

A. The Methodology

Several analyses (e.g., Feldstein and Krugman 1990, Grossman 1980, and Wade 1982) have been written that investigate the effects on relative prices of a VAT. All of these use approximately the same approach, which we will also use here. This standard methodology involves a general equilibrium model in which all results are reported after the world has fully adapted to a tax change, and no mention is made of what happens during a period of adjustment.

The methodology also makes a crucial assumption that the country being studied is relatively small; that is, its world market share is sufficiently small that it has no power to affect the world prices of traded goods. Rather, the country is a *price-taker*; it takes world prices as given. By definition, therefore, nothing the country does in terms of policy changes can influence the external terms of trade, but tax changes can affect the internal relative prices of traded goods facing domestic producers and consumers. These relative prices are what are tested, at equilibrium, for the effects of VAT or other taxes.

> The process of moving from the origin-based system to the destination-based one involves some short-run changes in levels of exports and imports.

The standard model assumes that the test country, and the rest of the world, produces three goods. The first good produced by the country is consumed domestically, but also can be exported (exportable). The second is domestically produced and consumed, but competes with imports from the rest of the world (importable). The final good is produced and consumed domestically and is neither exported nor faced with potential import competition (nontradable).

For equilibrium to occur, several conditions must be satisfied. First, the domestic seller of the exportable good must earn the same return, after tax, in both the home market and the external market.[12] Obviously, if this were not the case, sellers would divert sales to where the after-tax returns were higher, and the positive or negative change in domestic supply in the home market would cause the domestic price to adjust until after-tax prices were equalized in the home and external markets. By definition, the world price is fixed, so the domestic price of the exportable must change until sellers are indifferent between producing for the domestic and external markets.

Similarly, the price of the domestically produced importable good, including tax, cannot differ from the price of the import, including tax. Otherwise, consumers would shift to the cheaper version until demand changes caused the domestic price to adjust to restore equilibrium. (Recall that, by assumption, the import price before domestic tax is a world price, and cannot be changed by domestic policies or changes in domestic demand.)

Finally, domestic supply of the nontradable good must equal demand for there to be equilibrium. In this section, where we are considering an ideal VAT with no exemptions or zero-ratings, we can ignore nontraded goods. Nontradable goods will be important when a non-ideal VAT is considered. As discussed in the next section, preferential treatment is often most apparent for goods that do not enter international trade.

This model makes one final assumption. To isolate the relative-price effects of tax changes and allow changes in producer or consumer income to be ignored, it is

[11]The term "taxes on business" is used loosely here to denote the point of taxpayer compliance, not necessarily economic incidence. For instance, business remits VAT, the employer portion of the payroll tax, and the corporate income tax; therefore, these are taxes on business. This does not mean, however, that the owners of business bear the ultimate economic burden.

[12]The implicit assumption is that firms strive to maximize profits. In the real world, firms may price strategically to achieve other goals, such as an expansion of market share.

assumed that all tax revenue is distributed to consumers and/or producers in a nondistorting way that compensates them for any additional tax liability. Thus, relative-price changes, which alter incentives and therefore change economic behavior, are the only subjects of the analysis.

How useful is this model in terms of analyzing the real world? Certainly, the United States, with respect to some products, is not a small country and can influence world prices, but the fact that the model is capable of assessing changes in internal relative prices allows for an understanding of the direction of changes in distorting forces. In addition, it may be possible to adjust the model to allow for a "large country" case.[13] Judging the effects of tax changes on relative prices in a small country is probably a sufficient representation of the general effects for a large country as well. Although the assumed nondistortionary redistribution of tax proceeds is unrealistic,[14] it does allow us to isolate the pure price effects and therefore is useful for *equilibrium* analysis. Such an assumption is not equivalent to the more plausible assumption of revenue neutrality, and the differential intra-equilibrium effects will be examined later in the discussion of the path of adjustment when one moves from an origin-based tax to a destination-based one.

With these thoughts in mind, we can investigate the tax effects of various VATs on the relative prices of traded goods employing Gene Grossman's model (1980). Assume that initially the home (small) country has no tax system. Although it does not matter what system the rest of the world follows—since world prices are given and fixed—let us assume that the rest of the world has destination-based VATs.

In the initial free-trade equilibrium, the world price of imports into the home country is 10, therefore, the price of the domestically produced importable is also 10. The world price of the good that is exported is 15. Therefore, both the internal and external relative price of exports to imports is 1.5.

B. Origin-Based Taxes

This example shows that there is no change, at equilibrium, in any relative prices when a country with no prior tax system imposes an origin-based tax.

The home country imposes an origin-based VAT levied at 10 percent. What does the new equilibrium look like? An origin-based tax applies to exportables consumed domestically, actual exports, and importables produced and consumed domestically, but not to imports.

> The existence of short-run positive trade effects is, in and of itself, no reason to change a tax system, given the uncertainty of the trade effects and the administrative and compliance costs associated with the tax change.

A seller of exportables is constrained in world markets by the world price of 15. Thus, at equilibrium, the seller's return must be reduced to approximately 13.64 so that he can meet the world price after the tax is levied. Of course, the same price applies to exportables consumed domestically so arbitrage will result in an equilibrium where the return to the seller is also 13.64, and consumers pay an after-tax price of 15.

Because there is no tax on imports, they continue to enter the home market at 10. To remain competitive with imports, domestic sellers of importables, at equilibrium, will have to reduce their pre-tax price to about 9.09.

Notice that the small country assumption implies that the origin-based tax is fully borne by domestic producers constrained by world prices. The model finesses this by assuming that the tax proceeds are redistributed to producers in lump-sum fashion, so that the only thing that matters is any change in relative prices.[15]

What did the origin-based VAT do to the relative prices of traded goods facing consumers and sellers? For consumers, exportables still cost 15 and imports and importables still cost 10, so there is no change in the relative price facing consumers. Sellers receive 13.64 for exports and 9.09 for importables, leaving the ratio of returns unchanged. The relative-price ratio of exports (exportables) to importables is still 1.5 for both consumers and producers.

At equilibrium, none of the relative prices facing consumers or producers has changed after the imposition of the origin-based VAT. The VAT, therefore, is entirely neutral in its long-run effects on trade. At equilibrium, the opportunity cost of producing exportables (in terms of foregone im-

[13] In most cases the results of a large-country model will be indeterminant, because the equilibrium result depends on the relative market strengths of the country in exportable and importable markets.

[14] To be nondistorting, a lump-sum distribution exactly equal to the change in tax liability would have to be calculated for every taxpayer for each year that the tax change is in effect. The practical problems in such a calculation are enormous, and it has never been tried. Given political realities, a VAT would likely be used to pay for other tax changes in a revenue-neutral fashion.

[15] Under any assumption that does not distribute tax proceeds to producers in relation to their initial tax liability, the first-order incidence of an origin-based tax will fall on producers.

portables) is exactly the same as before the imposition of the tax, so there is no incentive to alter the pattern of trade.

C. Destination-Based Taxes

What if the country imposes a destination-based tax at the same 10 percent rate? This example shows that, as in the case of an origin-based tax, the imposition of a destination-based tax would cause no change in relative prices, compared to the no-tax scenario.

Looking strictly at the outcome *at equilibrium*, the following would be true. Exporters would charge and receive 15 per unit on the world market because the tax would be rebated. Because sellers must make the same return in the home and external markets, the VAT on exportables would be passed forward so that the after-tax price facing consumers would be 16.5 and sellers would receive 15. The world price of imports is still 10, but now the VAT would apply at the border, so consumers would face an after-tax price of 11. Domestic sellers of importables would also receive 10 so that the after-tax price is 11.

Note that, relative to the no-tax world, the destination VAT is a tax on consumption in the small-country case. Once again, the standard models assume that consumers are fully compensated for the tax via lump-sum transfers.

What are the relative prices of traded goods at equilibrium under the destination-based tax? For consumers, exportables cost 16.5 and imports (importables) 11. The relative price is still 1.5. Of course, since the sellers of exportables and importables are receiving returns equal to world prices, the sellers' relative price also remains at 1.5. Thus, under both the origin- and destination-based VATs, the relative prices of traded goods *at equilibrium* are exactly those that prevail under free trade. Both versions are trade-neutral. This is a standard result readily demonstrated in the literature.

D. The Switch

What happens if a country decides to substitute a theoretically ideal destination-based VAT for an existing ideal origin-based one? This is the central question relevant to the trade-effects debate. Based on the above, moving from one neutral system to another obviously will have no long-run trade effects, *at equilibrium*.[16] Thus, if policymakers decided, for whatever reason, to move to destination-based ideal taxes, they know that they will not create a deteriorating trade situation. But the equilibrium result does not provide the whole picture. There are, for instance, some potentially significant short-run benefits that would accrue to industry sectors that engage in international trade before final equilibrium is reached.

> The literature concludes that a VAT will have *adverse* trade effects if preferential tax treatment—such as exemptions, zero-rating, or a lower tax rate—is accorded to nontraded goods.

The process of moving from the origin-based system to the destination-based one involves some short-run changes in levels of exports and imports. In order to see this, we must look at the *first-order* changes in relative prices; that is, the prices that prevail immediately after the tax change is implemented—and before sellers have changed their prices. Then we can predict how behavior will change in the interim period before equilibrium is restored.

Under the origin-based tax, producers of exports (exportables) charged 15 on the world market but only received 13.64 in private return. The instant after the destination-based tax goes into effect, exporters will receive rebates for the tax, so the private return will increase to 15. In the first order, exportables consumed domestically are still sold to consumers at 15, but sellers are receiving 13.64 because of the tax. Clearly, there is an incentive for sellers to shift from domestic sales to exports. Also, since returns have gone up for the producers of exports (exportables), investment may flow to that sector.

To the producers of importables, *initially* nothing has changed. By definition, they have not changed their price and the tax is still the same. Therefore, the first-order relative price of exports to importables for sellers has increased to 1.65. This change in relative prices subsequently provokes changes in behavior which restore equilibrium to the relative-price level dictated by world prices over which the country has no influence.

One of these behavioral changes has already been described. Exports will increase due to the higher returns to exports relative to sales of exportables domestically. As the domestic supply of exportables decreases, the price will be bid up by consumers until the pre-tax price equals the world price, and exporters are indifferent between selling domestically or exporting.

Similarly, consumers will find imports more expensive due to the imposition of the border tax that previously only applied to domestically produced importables. Thus, the demand for importables produced domestically will increase relative to imports, and the

[16] A rigorous mathematical proof can be made for this finding.

pre-tax price of importables will rise. This, of course, increases the short-run profits of importable sellers and encourages the commitment of resources to that sector. The pre-tax price will increase to the world price, at which point consumers will be indifferent between imports and importables.

When all the adjustments have been made, the relative price of exports (exportables) to imports (importables) will once again be 1.5 for both sellers and consumers. Trade neutrality will be restored, and there will be no influences on relative prices that deviate from those that would exist under free trade. But along the way, several things will have occurred to a greater or lesser extent:

- profits to exporters and sellers of importables will have increased by some amount;
- new resources will probably have flowed to the trade sector of the economy;
- exports will have increased by some amount;
- imports will have decreased by some amount; and
- exchange rates will have changed.

The magnitude of these effects is uncertain, as is their duration, but from the standpoint of a business person involved in a trade-intensive sector, the results are positive.[17] That is why business people take the positions they do.

The existence of short-run positive trade effects is, in and of itself, no reason to change a tax system, given the uncertainty of the trade effects and the administrative and compliance costs associated with the tax change. But there are many other reasons to overhaul the existing tax system and replace it with a more economically efficient one. If policymakers were to engage in tax reform, they ought to base the new system on a destination principle so that, in addition to the economic benefits that justified the change in the first place, some short-run trade effects would also be enjoyed. Since ultimately both ideal origin- and destination-based systems are trade neutral, the tax change ought to include the switch to a destination system so as to benefit the traded goods sector in the short run.

A compelling reason has been added to oppose narrowing of the VAT base: The effects of such a narrowing will be a *long-term* deterioration of a nation's trading position.

V. Tax Preferences and Long-Run Trade Effects

The preceding section ignores the role of nontraded goods. Feldstein and Krugman (1990) have established that, at equilibrium, both an origin- and destination-based VAT are trade neutral as long as the VAT applies equally to all goods—including nontraded goods. The literature, including Feldstein and Krugman (1990), concludes, however, that a VAT will have *adverse* trade effects if preferential tax treatment—such as exemptions, zero-rating, or a lower tax rate—is accorded to nontraded goods. Since many of the goods in existing VAT systems that receive preferential treatment do not enter international trade, an analysis of preferential treatment, heretofore typically concerned only with regressivity and economic efficiency, must also include consideration of these trade effects.

Consider an example where nontradables are zero-rated. If a VAT applies to traded goods but not to nontraded goods, the relative prices of exportables to nontradables and importables to nontradables would increase. Having the tax apply to tradables but not to nontradables introduces a tax wedge between the different classes of goods. Either the cost to consumers of importables and exportables relative to nontradables will increase and/or the returns to businesses of importables/exportables relative to nontradables will decrease. In either case, the result is a reduction of consumption of tradables relative to nontradables and/or a relative decrease in investment flowing to the tradable sector. The tradable goods sector will contract strictly because of a tax-induced relative-price change.

This is a serious issue for policymakers when one considers the types of goods that do not enter international trade—e.g., housing; medical care; education; various foods, such as fluid milk, some types of fresh produce, eggs, etc., sold for home consumption; and other goods. As Feldstein and Krugman (1990, p. 276) note, "the important point is that the *de facto* and *de jure* exemptions from a VAT are likely to fall primarily on nontraded goods rather than

[17] Of course, under the small-country assumption, what business gains, consumers lose in the form of higher prices. That the models assume that consumers will be made whole through lump-sum distributions is of little comfort to policymakers. In the real world, where revenue neutrality is a likely scenario, the tax burden on some consumers will be shifted in the first order under the small-country scenario. It is unclear how a large-country scenario would play out. It should also be noted that the switch from an origin- to a destination-based tax could involve a lowering of the tax rate. If a country is running a current-account deficit, as is perennially true for the United States, then the tax base is, by definition, larger under the destination principle than under an origin-based tax. *See* Frenkel, Razin, and Symansky (1991). Accordingly, a lower rate could produce the same amount of revenue.

traded goods and services." The standard proposals to exempt or zero-rate housing, food, medical care, and welfare activities would apply to nontraded goods. Preferential treatment for nontraded goods distorts the relative prices of traded goods (importables and exportables) to nontraded goods for both consumers and producers. Feldstein and Krugman (1990, pp. 276-77) conclude:

> The effect of a selective VAT is, therefore, to increase nontradable consumption and production at the expense of tradable . . . Clearly the presence of the tax acts as a disincentive to produce traded goods. . . . A selective VAT that falls most heavily on traded goods, then, will tend to hurt the traded goods sectors of an economy—the reverse of the common belief.

John Alexander Wade III (1982) constructs a general equilibrium model—including a balance of payments equation and representation of producer supply and consumer demand—in order to study the effects of a VAT with preferential treatment for nontraded goods. While noting that both importables and exportables faced the same tax, and therefore that, initially, their relative price was undistorted, Wade concludes by predicting secondary effects which would result in a deterioration in the terms of trade at equilibrium: "The conclusion in the case of the nontraded good being zero-rated under a value-added scheme of taxation is that the imposition of the VAT or further increase in the rates of an already existing VAT will likely lead to a deterioration in a nation's terms of trade." (Wade 1982, p. 57)

Bob Hamilton and John Whalley (1986) also consider VATs with narrowed bases. Their line of investigation involves the differences between origin- and destination-based taxes when there are differences in the levels and ways goods are taxed. They provide evidence that origin- and destination-based taxes are *not* equivalent in terms of their effects on a country's terms of trade when narrow tax bases are in evidence. Although the quantitative results of switches from destination- to origin-based taxes under the scenarios investigated by Hamilton and Whalley are not large, they are not to be dismissed. This simply points out that adverse trade results may follow from narrow-based VATs, regardless of border-tax adjustments.

> It is difficult to rationalize that a VAT, with a *qualitatively* similar tax base to the existing hodgepodge of business taxes, would not also have a qualitatively similar incidence.

Preferential treatment for some goods and services as a remedy for perceived regressivity has been criticized on several bases. First, it is generally agreed that exemption, zero-rating, or lower rates are extremely inefficient and costly ways to redress regressivity; and that it is preferable to seek remedies outside the VAT system through income tax credits or transfers. Second, preferential treatment causes economic inefficiency by distorting consumer and producer choices across industries.

Now a third compelling reason has been added to oppose narrowing of the VAT base: The effects of such a narrowing will be a *long-term* deterioration of a nation's trading position. This is especially important in light of the types of taxes that are slated for replacement by a VAT. While it would be nonsensical to claim that these taxes are neutral, nonetheless the payroll tax applies to traded and nontraded sectors, as does the corporate income tax (or the individual income tax in the case of noncorporate businesses). Thus, their replacement by a destination-based VAT with a narrow base could hurt, rather than enhance, U.S. competitiveness.

VI. VATs and Other Business Taxes

So far, this article has reviewed the trade effects of VATs levied under the origin or destination principles with broad or narrow bases. This was a necessary first step in investigating the competitive effects of a substitution of a VAT for existing business taxes. Ultimately, we must return to the question of incidence. The short-term trade effects described earlier that result from shifting from an origin- to a destination-based tax will only occur if the new tax has a similar incidence to the one it is replacing.

A. Incidence

Elsewhere (Raboy 1989b), I have argued that the incidence of existing business taxes must be *qualitatively* similar to that of a VAT. The reasoning underlying this proposition is as follows. At root, a VAT, regardless of its form (credit, subtraction, addition), is a tax on a company's value added. This value added in turn is equal to the sum of payments to the factors of production: wages and benefits to labor; and interest, dividends, and gains to capital. The return to capital that is included in the VAT base may be simply the competitive return to capital or may include quasi-rents associated with innovations, or pure rents associated with less than perfect competition. Paul Conrad (1990, p. 97) has stated that with respect to the VAT, "the incidence on the factors of production (capital, land, and labor) is in propor-

tion to their shares in pretax gross national income."

Business taxes today include the corporate income tax, payroll taxes, and the individual income tax for noncorporate business.[18] Regardless of the interminable debate on the incidence of the corporate income tax, there are theoretical similarities between its base and the capital portion of value added. Most important, the corporate income tax is a tax on the competitive return to equity capital, and therefore is a component of variable cost. As such, the corporate income tax is not dissimilar from ad valorem taxes which also shift a firm's cost curves. As stated by McLure (1987, p. 49):

> A multitude of reasons exist, however, for believing that the corporate income tax can be at least partly shifted either to consumers or to labor, even in the short run. First, corporate income for tax purposes is not made up solely of economic profits; it includes the normal return to equity capital. Thus part of the tax does constitute an element of costs. Second, important portions of the corporate sector of the U.S. economy fit neither the perfect competition nor the pure monopoly mold, and oligopoly behavior is quite consistent with substantial shifting of the corporate tax . . . third, corporate goals other than profit maximization (such as avoidance of antitrust action, constrained sales maximization, or limit pricing based on long-range profit maximization) may lead to shifting of the tax. Finally, if capital is mobile internationally, the corporate tax is more likely to be borne by consumers and by land and labor.

Clearly, payroll taxes are also similar to the labor component of a VAT. Although there are obvious differences—interest is not taxed to corporations but to individuals, nonwage compensation escapes taxation, etc.—the aggregate bases of business taxes today add up to a value-added base with a great deal of preferential treatment. A basic tenet of public finance economics is that the initial point of taxation does not determine a tax's incidence. Economists' general belief is that taxes with identical bases, regardless of the point of taxation, must have the same incidence. Thus, it is difficult to rationalize that a VAT, with a *qualitatively* similar tax base to the existing hodgepodge of business taxes, would not also have a qualitatively similar incidence. As long as the incidence is similar, the short-term trade benefits described earlier will occur.

> Perhaps more important to the determination of exchange rates than actual changes in domestic savings due to tax changes are *perceived* effects in the eyes of foreign exchange traders.

B. Other Relative-Price Effects

There are other aspects of a VAT/business tax substitution that may affect comparative advantage. In classical trade theory, one explanation of comparative advantage that is frequently cited is *relative factor intensity*, which in turn can be traced to relative factor cost. Some economists have argued that replacing the corporate income tax with a VAT would significantly lower the cost of capital in the United States. For example, Gary Hufbauer (1987, p. 189) maintains that: "If the corporate income tax in the Tax Reform Act of 1986 were replaced by the VAT, the cost of capital would drop significantly." This, he concludes, could substantially enhance U.S. competitiveness.

Hufbauer's assertion echoes much of the literature on the cost of capital, which indicates that a VAT is neutral with respect to a firm's decision to use capital and labor, but that the decision is disturbed under the current tax regime due to the capital recovery provisions of the post-1986 corporate tax system. Hufbauer's argument is based on the belief that the current mix of business taxes that fall on capital and labor bases is biased against capital inputs.

VII. The VAT, the Current Account, and Exchange Rates

Throughout this article, I have stressed the importance of economic efficiency for sound tax policy. I have argued that the proper gauge for tax policy as it affects trade should be the relative prices of traded goods, and that the point of comparison should be the relative prices that would obtain under free trade.[19] Further, these relative prices are *real* prices—and the tax effects are *real* as well. Taxes represent extractions of real resources just as surely as energy costs or labor costs. Or, in the words of Hans-Wener Sinn (1990, p. 18): "It is impossible for exchange rate adjustments to compensate for tax-induced changes in relative prices." Purely nominal phenomena, like ex-

[18] Throughout the article, the term "business tax" is used to denote a tax where the check to the taxing authorities is remitted by the business. This does not mean that the owners of the business bear the ultimate burden of the tax.

[19] This is not to say that incentives affecting saving and investment should be ignored. As noted by Mutti and Grubert (1988), such effects are highly significant to trade. But here, too, it is the intertemporal relative prices, or inter-industry relative prices, that should concern policymakers.

change rates, cannot mask fundamental changes in real costs.

This would seem fairly obvious in the case of other costs facing businesses. What would be the effect if one country discovered a process to manufacture steel that used only half the electricity previously required? That country's steel industry would certainly enjoy an enhancement of its competitive position, because the cost of producing steel relative to other domestic goods would drop, as would the real costs of producing steel domestically relative to foreign-produced steel. All else held constant, the comparative advantage (or disadvantage) of steel production would change. It would be a strange conclusion indeed if this innovation was completely nullified by exchange rate changes resulting from an increase in demand for the country's steel.

Taxes on output are no different from a cost standpoint than per-unit electricity costs. Taxes can only be remitted if steel is sold, and the returns foregone to pay the tax. It is as if a certain level of physical production is transferred to the government. This is not a monetary phenomenon. To argue otherwise is to assume that the entire economy is suffering from money illusion.

A. "All Else Held Constant"

Policymakers will continue to focus on the trade balance where exchange rates do matter. And thus the statement that is currently in vogue—that tax policy cannot affect the current account—must be investigated. My conclusion is that it would be very difficult to predict the effects on the trade balance of instituting a VAT and substituting it for another tax. First, the view that such a change would not affect the trade balance is predicated on the belief or assumption that tax changes do not affect international capital flows. Second, this view is also dependent on the notion that exchange rates are primarily a function of traditional trade and capital flows, whereas the reality is that exchange rates are more influenced by asset trades than by traditional trade flows. This means that the change in the expectations of currency traders after (or in anticipation of) a tax change will influence exchange rates more than currency demand changes associated directly with exports and imports.

What precisely is meant by the statement that tax policy cannot affect the current account? It is based on the balance of payments accounting identity that essentially states:

Exports - Imports =
Capital Outflows -
Capital Inflows

In fact, the perception of fiscal and monetary policy to currency traders may be the dominant force in exchange-rate determination in this regard.

The statement that tax policy (or tariff policy, for that matter) cannot affect the trade balance is predicated on the assumption of *ceteris paribus*—all else held constant. In this case, the "all else" that is being held constant is capital flows.[20] Not surprisingly, if the right side of the equation, net capital flows, is held constant, there can be no change in the left side. Because the balance of payments is set in nominal units of currency, if, for example, a tax change increased the demand for exports, *ceteris paribus*, the dollar must appreciate to restore the left side to the same nominal position as before.

B. Capital Flows

It is conceivable that the "all else held constant" assumption is of less use here for policymakers than with respect to most other economic issues. It may be very difficult to identify the factors and transactions to hold constant because of the complex interactions of taxes and international investment decisions. There is a thriving literature on the effects of tax policy on international capital flows that runs the gamut from "no effects" to "large effects." And the various levels of effects feed through diverse conduits such as deficit reduction or tax-induced changes in savings and investment, all of which would directly affect net capital flows.

For instance, Donald Rousslang and Pieter Van Leeuwen (1990, p. 185) consider the effects of an add-on VAT on trade: "The substantial trade effects found here arise from the effect that eliminating the large federal deficit through tax increases would have on domestic interest rates and net U.S. borrowing from abroad." Similarly, Lawrence Summers (1987, p. 173) notes: "The only way in which we can raise both investment and international competitiveness simultaneously is to increase national savings." Having argued that the Tax Reform Act of 1986 moved toward a savings/investment balance by curtailing investment, Summers (1987, p. 76) suggests:

> The better way of bringing savings and investment into balance is through increases in savings. Here the major necessary step is a reduction in federal deficits. There is also a limited role for tax measures directed at encouraging private sector savings.

[20] To some this is merely an assumption. To others it is a truism: Tax policy cannot affect capital flows.

Feldstein and Krugman (1990) also stress the role of savings as the way a VAT/income tax substitution would produce short-run trade effects. Hufbauer (1987, p. 196) challenges the all else held constant approach to the balance of payments and tax policy:

> The key assumption in this analysis is that net capital flows are either determined independently of the tax structure, or that improved corporate profitability following the introduction of VAT would attract capital to the United States. . . . The line of reasoning is open to challenge. It contains a basic weakness: the assumption that tax structure makes no difference to long-run domestic savings. In my view, the value-added tax, substituted for the corporate income tax could, in the long run, enlarge domestic savings and thereby ratify an improved trade balance.

The point here is not to argue who is right or who is wrong, but rather to illustrate that there are several paths by which a VAT can affect capital flows, and therefore the exchange rate. But possibly more important to the determination of exchange rates than actual changes in domestic savings due to tax changes are *perceived* effects in the eyes of foreign exchange traders. In fact, the perception of fiscal and monetary policy to currency traders may be the dominant force in exchange rate determination in this regard.

C. Expectations and Exchange Rates

If exchange rates were primarily influenced by changes in the demand for imports and exports, then a VAT change that affected trading patterns would have a predictable effect on exchange rates. But exchange-rate determination is much more complicated, relating primarily to the actions of traders who view foreign exchange as an asset to be traded in its own right. I discuss exchange-rate determination elsewhere (Raboy 1989a and 1990), but it is worth reviewing those arguments here. Foreign exchange trading worldwide grew from $200 billion per day in 1986 to $500 billion in 1989 (Krugman and Obstfeld 1991). The growth from 1983 to 1986 was enormous as well. This growth cannot be explained by differences in merchandise trade or capital flows associated with investment in tangible assets. In fact, these latter transactions may account for only 5 to 10 percent of foreign exchange trading (Dornbusch and Frankel 1987).

What monetary policy might accompany, or be expected to accompany, a major tax reform including the addition of a VAT?

Jeffery Frankel (1989), observing Federal Reserve data, notes that most U.S.-based foreign exchange trading occurs among banks ($50 billion a day in 1986) and among brokers and other financial institutions ($34.4 billion a day in 1986). He also points out that only 11.5 percent of bank trading was with nonbank customers, and that only 4.6 percent was with nonfinancial customers. Similar results were reported for brokers and other financial institutions—both here and for foreign markets. Frankel (1989, p. 51) concludes, "Not only are these totals many times greater than the volume of international trade in goods and services, they are also many times greater than the volume of international trade in long-term capital."

The overwhelming majority of foreign exchange transactions are conducted by investors who view foreign exchange itself as an asset. Ronald McKinnon (1988, p. 86) states:

> The floating exchange rate seems to be dominated by volatile asset preferences rather than adjusting passively to balance current flows of imports and exports. In the face of uncertainty about the future purchasing power of domestic money, liquid foreign exchange assets are more easily substituted for domestic financial assets (money or bonds) than are physical assets such as real estate or stocks of commodities. Foreign bonds or bank accounts are also convenient hedges against possible shifts in domestic, political, or commercial risks. These potential capital flows through the foreign exchanges on a daily basis are huge. Since they are so much greater than the value of commodity trade, they dominate observed movements in exchange rates.

These assets primarily take the form of liquid interest-bearing instruments, and are therefore a component of net capital flows in the balance of payments. As Krugman and Obstfeld (1991) explain, the expected return to a U.S. investor on a foreign currency bond is the rate of return on the foreign bond plus the expected depreciation of the dollar against the foreign currency.[21]

Foreign exchange determination is driven by people who hold foreign exchange as assets, and their transactions are dependent on their expectations. These expectations could easily change in anticipation of a major tax change, but it is difficult to pre-

[21] Or, see Summers (1987, p. 173): "International capital markets should equalize not real rates of return but, rather, real rates adjusted for anticipated changes in exchange rates."

dict the net effect on exchange rates.

Look at all the countervailing items that could affect a trader's perceptions. If the trader perceives that the demand for exports is going to increase and/or the demand for imports is going to drop, he or she may predict a dollar appreciation. But if part of the VAT is used for deficit reduction, he or she may anticipate a dollar depreciation due to decreased U.S. borrowing. Similarly, if he or she anticipates that tax reform is going to lead to greater domestic saving, a dollar depreciation prediction may seem appropriate. But if the expectation is for increased capital inflows due to better investment opportunities, an appreciation may be the better prediction.[22]

The sum of all of the fiscal policy ramifications of the VAT/other-tax substitution will determine the expectations of the traders who buy foreign bonds and have more to do with exchange rates than the buyers and sellers of real goods and services. And we have not even discussed monetary policy! Certainly, expectations concerning the monetary policy that would accompany a VAT—including tax reform—will also be influential in foreign exchange markets.

D. Monetary Policy

It is well known that domestic monetary policy, not just central bank exchange activity, exerts a primary influence on exchange-rate motion.[23] In fact, the *expectation* of monetary changes affects current and forward exchange rates.[24] There is evidence that such expectations cause exchange-rate "overshooting." (Krugman and Obstfeld 1991).

What monetary policy might accompany, or be expected to accompany, a major tax reform including the addition of a VAT? The conventional wisdom is that the Federal Reserve would accommodate the VAT by increasing the money supply, even when a VAT is used to replace other taxes. Thus, against the expectation of an increased demand for exports (and all the possible countervailing effects involving capital flows) there would be an expansion—anticipated or real—of the money supply. This expansion would aim to accommodate a supply-shock in the amount of *the tax rate times the entire domestic economy*, many multiples of any conceivable change in the demand for exports. An anticipated increase in the money supply, of course, exerts downward pressure on the dollar.

> If preferential VAT treatment is afforded classes of goods and services to redress regressivity, the most likely affected goods will be those that do not enter international trade.

All of the potential effects of fiscal and monetary policy will combine to influence the expectations of foreign exchange investors. In all likelihood, these investors are far more important to exchange rate determination than the buyers and sellers of exports and imports, and their expectations more important than the direct effects on exchange rates from increases in domestic saving or from reductions in the federal deficit. Since the expectational effects on exchange rates contain so many offsetting forces, it would probably not be wise to base one's predictions of the effects of a VAT on the current account on an all else held constant assumption.

E. What Is the Answer?

Carl Shoup (1988) notes that the idea that exchange-rate changes would wipe out any tax-induced cost effects is not new. As an example, he refers to the 1953 Tinbergen Report to the European Community of Coal and Steel. This report, produced in an effort to determine whether to adopt a destination- or origin-based sales tax, included an equivalence theorem, which states that tax-induced trade effects would be eliminated by floating exchange rates. Shoup points out that the equivalence theorem was challenged contemporaneously, primarily along the lines noted in this article.[25]

Everything that goes around comes around. So if a policymaker views the current account as the proper measure for judging tax policy, what is he or she to make of the claim that a VAT-based tax reform cannot affect the current account because of exchange-rate adjustments? The last word belongs to Shoup (1988, p. 368):

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[22] To add to the confusion, the magnitude of any real effects is dependent on a host of empirical measures including (1) the domestic elasticity of saving, (2) the substitutability between foreign and domestic assets, (3) factor substitutability, (4) cross-elasticity between domestic and foreign goods, and (5) the initial asset holdings of foreigners (Mutti and Grubert 1988).

[23] *See, e.g.*, Krugman and Obstfeld (1991), Chapter 14, or, for a comprehensive treatment, Baillie and McMahon (1989).

[24] *See, e.g.*, Marston (1987).

[25] Shoup (1988, p. 367) cites Bulassa: "Yet since capital movements, immigrants' remittances, tourist expenditures and other nontrade items also affect exchange rates, changes in tax rates will not lead to proportionate variations in the rate of exchange. In addition, price rises following an increase in tax rates are likely to elicit capital movements responding to differences in price levels . . . thus the presumed long-run readjustment of exchange rates may never take place."

Accordingly, the only tenable position in our present state of knowledge is to assume that the destination and origin principles are neither equivalent nor wholly disequivalent (to coin a word), and that a move from the origin principle to the destination principle will probably increase exports and decrease imports somewhat, but not by as much as the tax rate alone might indicate. . . . This statement may not be of much help in designing tax policy, but it at least avoids the errors inherent in taking either of the extreme positions.

VIII. Conclusions

This article has considered various aspects of the debate concerning the trade effects of a substitution of a VAT for other business taxes in light of both the economic literature and the putative gulf between the beliefs of a wide range of business people and academic economists. I have argued that tax policy should be judged in terms of distortions in the relative prices of traded goods, rather than nominal changes in the trade balance. This argument is based on the view that undistorted relative prices provide the greatest possibility for gains from trade.

Based on my reading of the literature, I believe the following conclusions are warranted:

- At equilibrium, both an origin- and a destination-based VAT are neutral in their effects on the relative prices of traded goods.
- Switching from a pure origin-based VAT to a pure destination-based VAT would cause exports to increase in the short run and imports to decrease. At equilibrium, however, relative prices would return to the neutrality position that existed under free trade.
- If preferential VAT treatment is afforded classes of goods and services to redress regressivity, the most likely affected goods will be those that do not enter international trade. The results of zero-ratings, exemptions, or preferential tax rates for nontraded goods will be a contraction of the traded goods sector, and a worsening of the U.S. terms of trade (an adverse distortion of relative prices).
- Although a VAT is neutral with respect to relative prices, taxes that may be replaced by the VAT may distort the relative prices of traded goods through artificial distortions of factor costs, and intertemporal distortions. Therefore—at least in the short run—a VAT/other-tax substitution may remove some existing distortions in the relative prices of traded goods.
- The effects of the VAT/other-tax substitution on the current account are unpredictable, due to the overwhelming influence on capital flows of foreign exchange traders, whose expectations will be influenced by countervailing aspects of tax policy as well as by monetary policy. The view that exchange-rate appreciations will wipe out any demand influences on exportables (exports) or importables (imports) is based on a narrow assumption unsustainable in real international financial markets. ✦

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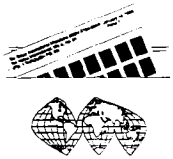

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Mr. McCrery [presiding]. Thank you, Dr. Raboy.

I just want to ask a few questions before going to my colleagues. There seems to be, and maybe I misunderstood, but there seems to be some disagreement among the panelists on the efficacy of going from an income tax system to a consumption tax in terms of encouraging foreign business to relocate in the United States.

Mr. Armstrong, I thought you said if we did away with the income tax, went to a consumption tax, you would find that those businesses would simply have to pay their domestic income tax and, in many cases, that would discourage them from coming to the United States, while the other two panelists seem to imply that going from an income tax system to a consumption-based system would encourage foreign investment.

Did I miss something there or is that a correct interpretation?

Mr. Armstrong. From my perspective, we see two types: One, if you are talking about a company that is setting up a plant. Because of the international Tax Code, for example, many British Commonwealth nations do not tax foreign income, so, therefore—however, there is a kicker to it. If it is income earned in a tax-free zone, then it is subject back. They do that for offshore investors, and so forth.

Our concern is if you had a complete zero income tax rate here and even though the company would be subject to a consumption tax in some way or another along the line, that that could be interpreted from a foreign perspective as being a tax-free zone, and I would like to point out that last April, Germany was very interesting in how it is dealing with its budget crisis.

It surrounded all of the offices of Merrill Lynch and several other banks. They attacked it as if it was a drug raid. They cutoff all the phones of Merrill Lynch, all the hand-held cellular phones that the brokers had. They went in, raided all the files, looking for German citizens putting capital offshore.

The net result of those raids effectively sent the Deutsche mark down, the Swiss franc up, and the London Financial Times reported that it was incredible the amount of capital that was suddenly leaving Germany for Switzerland.

That has not resulted in if you are in the financial industry, you are better off working out of London. You cannot do business in Germany.

If I were to go to Germany and answer a question on taxes to be more competitive and my answer can be interpreted as helping someone avoid taxes, that is a 5-year jail term for me personally now in Germany.

So you have to be very careful about the international Tax Code. My lawyers freak out just every time I even have to go to Munich. So I think there is a different side to that.

Now, a consumption tax with zero income tax, from an investment perspective—we are talking about interest income, and so forth, investments in stock markets—absolutely positive, you would have capital flowing in here. This would be like the Cayman Islands of the global economy.

Mr. McCrery. Is that what you were referring to, Dr. Raboy?

Mr. Raboy. Well, let me see if I can give an example. To me, the distinction is not consumption tax versus the income tax, but origin

principal versus destination principal within the consumption tax setup. Where that is relevant is in the discussion of a flat tax versus a USA tax or a VAT.

If I am considering whether or not to locate a facility here, or in the United States, if I am facing an origin-based system, my production is going to be taxed whether it is consumed domestically or exported, and assuming that I am facing a destination principal tax, on the other end, it is going to be taxed again.

Now, on the other hand, if I locate the facility overseas and I import back to the United States, there is no tax under the flat tax or a similar origin-based tax. So I make a calculation.

If the tax savings exceeds the transportation and/or other differential costs of locating overseas, I will locate overseas.

With a destination principal tax, however, that is not going to be the case. If I produce domestically for domestic consumption, I am taxed domestically. If I produce overseas for domestic consumption, and import back, that is going to be taxed at the border. So it is the same tax treatment whether I produce here or produce overseas.

On the other hand, if I export out, the tax is forgiven. So there is no tax-induced incentive to locate in one place or another.

Mr. MCCRERY. Dr. McLennan.

Ms. MCLENNAN. Yes. I would just like to add a few additional comments. If the United States should adopt a new system of taxation, for example, getting rid of the business income tax and substituting either a VAT or a sales tax, there is a school of thought that would state that the United States would then become a tax haven with respect to income tax.

That would presuppose our trading partners would not change their behavior with respect to their own tax systems.

I think when the United States does consider as major a change as you are considering now, you also ought to take into account what the likely effects would be on other countries with respect to their own Tax Codes. I don't expect that the United States would be alone in moving to this kind of change, and that would discount the kind of effects we are discussing here. Obviously, in theory, economists will tell you that, yes, you will go to jail if you do this or that, but in effect, I suspect that the real world isn't going to operate that way.

Mr. MCCRERY. But if we went to a system which basically made the tax consideration of a business unimportant in the calculation of where to locate investment, even if other countries went to a similar system, wouldn't you still have the same results, which is to take the tax consideration out of the equation?

Ms. MCLENNAN. Right. If you can reduce the tax consideration, then the companies that make the best products at the best prices should succeed, and we would hope our companies would be among the world leaders in that. That is what we mean by international competitiveness.

I think all of the panelists you have heard this morning indicate tax is a consideration under the current system, and that is the problem we want to address here.

Mr. McCrery. That is another question I might get you to elaborate on, but for now I will go to Mr. Houghton. Mr. Houghton, did you have questions for this panel?

Mr. Houghton. Yes. Thank you very much.

I guess the issues that I worry about are fairly simple. They have to do with cash. The United States generates about, I would say on the previous figures—I guess it was 1995—$800 billion in terms of income taxes and about $600 billion in terms of other taxes, FICA taxes, things like that.

So, all of a sudden, you sort of throw that out and you move toward a different tax system. You have got to generate at least $1.4 trillion, and it will probably be up now to $1.5 trillion or $1.6 trillion. How do you do that? That is a really tricky question because somebody sitting here or elsewhere has to make that decision.

We can talk about this thing intellectually, and we can talk about it in terms of competitive reasons, but the question is how do you make that switch. How can you make sure we don't end up with a $500 billion deficit because we have miscalculated this thing? Maybe you would like to make a comment on that, anyone.

Mr. Raboy. Well, that is the $64 trillion question, isn't it? One thing is certain. First, you would want to look at the broadest based tax system possible because the less leakage there is in the system, the more predictable the revenue take of the system is going to be.

Second, you want to reduce the fiscal drag as much as possible on the economy. You want to try to get taxes as much as possible out of the investment and work decisions of Americans. In my view, the one type of tax base that achieves both of those goals is some type of a broad-based consumption tax base. Frankly, the flat tax, the USA tax, and a VAT or national sales tax all get you in that arena.

The developers of all of those proposals were very ingenuous in that they did not allow erosion of the base. They made the base cover everything at a single rate, and I think that gives you the best chance of revenue predictability.

Mr. Houghton. Does anyone else have a comment?

Ms. McLennan. I would just like to add to what Dr. Raboy is saying, which is $1.4 trillion represents approximately 17 or 18 percent of the GDP. I believe that the $1.4 trillion also includes the amount we are spending for Social Security tax. So the income tax is really $5 or $6 trillion. That is a huge amount of revenue.

The consumption base is the broadest base we can figure for the base of a tax system, but to go to a pure tax, you know you are going to have very serious transition problems. There will be windfall profits for some individuals and tremendous losses for others. Those who have benefits under the current tax system would lose them when you go to a simple base.

On the other hand, it appears to me, at any rate, based on my experience, that the consumption-based tax is perceived in the countries that have them as fair and equitable across industries.

So I think this Committee is doing the right thing by looking at all of these proposals. You may not get a perfect proposal before you in one shot, but I think the base needs to be shifted from the current income tax base.

Mr. ARMSTRONG. We looked at some of those numbers to perhaps answer that question, and we were looking at taking the BEA numbers.

We found if you instituted a 10-percent sales tax with also a 2-percent sales tax on real estate transactions, that in combination with only a 15-percent flat or fairer type corporation tax was actually vowed revenue-neutral, and it is quite surprising if you really start putting in some of the other aspects which would be more dynamic considerations.

For example, on interest rates and what the Internal Revenue Service says itself it expects that they are close to 17 percent of the economies underground, you are never going to capture any form of an income tax from that side, from the illegal aliens or things of that nature. They will contribute to their local sales taxes, but they will never file an income tax.

So, if you look at the income tax versus a consumption tax from the total GDP perspective, the revenue would actually increase because income tax will never capture that portion the IRS says is 17 percent on underground, and the other problem is—there is a very interesting article on the front page of the New York Times today where 600 are suspected in plots to evade taxes on income. These are 600 government employees.

The income tax is, quite honestly, easier to avoid than the sales tax. It is much easier to do so. If you really look at the numbers objectively, I think you are looking at a potential, at least, of actually collecting more revenue.

Then, if you look at the income tax and its effect on interest rates, we can supply you with a study of interest rates for this country back 200 years. Every time the government raised income tax, interest rates rose basically in direct proportions. Capital invests on a net basis. It doesn't want to say, Well, fine, I will pay you 20 percent, but by the way, I want 95 percent of that back. Capital looks at whatever it is going to have on the table at the end of the day.

So, consequently, my points in my opening statement about the Japanese earning more money from us on investments versus trade is very important to understand because, in effect, we are paying more in interest expenditures on our National debt than maybe are really necessary. We are paying a higher rate to compensate Americans that are paying a very high tax rate, but foreigners are buying them who are paying zero.

Mr. HOUGHTON. But you are not suggesting the foreigners pay a tax on interest.

Mr. ARMSTRONG. No, no. They won't do it.

So what I am suggesting is you perhaps even the playingfield and at least make interest paid on government bonds tax free.

Mr. HOUGHTON. Surely.

Mr. ARMSTRONG. If you could reduce the interest rate itself on the national debt by one-third, you have a surplus, no longer a deficit. You have about a $250 billion surplus.

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

Mr. MCCRERY. Mr. Gibbons.

Mr. GIBBONS. First of all, this is a very interesting discussion.

I think, to generalize, we can all say that no matter what kind of new system we adopt, we ought to have a destination principle as far as taxes are concerned. Is that correct? Does the panel all agree with that? We ought to have a destination principle. This current system we have is just a mess and really distorts everything.

Mr. Raboy, you were kind enough to supply me with a copy of your testimony before you appeared here, and I had an opportunity to read it last night. I am intrigued with your analysis that even if in the long term a consumption tax has no impact upon trade, in a short run, it does. In that short run, how long do you think the short run is in all of that?

Mr. RABOY. I am not sure I could quantify how long it is, but I think it is significant.

When economists talk about the origin and destination principles being equivalent in the long run, there are some assumptions they are making, and when you get a little bit behind them, you see some problems.

The first assumption that is typically made is that the country adopting the tax system has no control over the world prices it is facing. In other words, there are so many companies out there competing that this country's companies can't affect the price of its exports, and similarly, they are price takers in the import market.

Well, if you say the prices you face externally are fixed, then, by definition, those ratios can never change. Therefore, the ratio of the price of exports to the price of imports, the celebrated terms of trade, by definition, can't change.

So what happens? Let's say you didn't have a tax system and you were going to impose a consumption tax and you had listened to your economists who told you that it doesn't matter what you do in terms of border tax adjustments. They say, well, our tradition is an origin system, let us do that.

I want to go out in the export market, and originally, I was charging the world price for my exports, competing with all of the other companies in the world, and I was getting that price.

The day after the tax system goes into effect, I want to maintain the same returns as I did before. So I would like to be able to charge that price, plus the amount of the tax, but I can't. Why? Because world price rules tell—because if I tried to charge the higher price, someone else will undercut me by charging the world price.

What that means is that some way, somehow, I have to reduce my private return until I can get back up to that world price.

The day after the tax goes into effect, there are a whole lot of exporters who are going to be losing money. There is nothing that has happened with exchange rates because world prices are the same.

There has to be an adjustment in the traded goods sector, both on the import side and the export side, and the only way you get to this equilibrium or this neutrality in the long run is by a contraction in the traded goods sector.

At the end of the day, the relative price of exports to imports is the same externally and internally, but only because the traded goods sector has collapsed—or not collapsed, but has been relatively reduced.

Similarly, if you switch from an origin-based system to that of a destination-based system, you ultimately get back to the same equilibrium because world prices are fixed, but the difference is you have a larger export sector. You have importers that have competed more effectively against imports in the short run, and then, ultimately, you are back to the relative price equalization. There might be some exchanges rule changes, too.

Mr. GIBBONS. Mr. Armstrong, you have more experience in exchange rates than I do. Let me pump your mind for a while.

What really controls the exchange rates? In the long, long run, probably international trade has something to do with it, but in the short run, is it more financial considerations than it is trade considerations?

Mr. ARMSTRONG. Yes. Quite frankly, trade is minimal.

Mr. GIBBONS. That is my impression.

Mr. ARMSTRONG. If you look at the United States-Japanese trade deficit, it has not changed dramatically in 2 years. Yet, the Japanese yen went up 40 percent, down 40 percent.

If you look at, for example, Nippon Life, the largest insurance company in Japan, they have a portfolio of about $1.2 trillion. If they decided to move 10 percent of their portfolio to U.S. stock markets, that is more than 2 years' worth of trade numbers.

The trade is more of a psychological impact, but in my opinion, the currency markets have been reduced to the fact of almost an international polling.

Mr. GIBBONS. An international what?

Mr. ARMSTRONG. An international poll where the markets and capital vote on the confidence of countries on a daily basis.

So, consequently, you will find with the elections with Boris Yeltsin, the dollar restrengthening because of concerns that, well, maybe if Yeltsin lost, then you are going to have problems in Europe.

So you have capital movements that are taking place for a variety of reasons, geopolitical security, financial security, rules of law. Trade is also part of it, and the other part of it is taxes and how that impacts investment, and that is the point I was trying to make about the national debt.

You really have foreigners paying no tax and penalizing Americans. Then, you look at our American corporations, we tax them in worldwide income. Nobody else does.

It seems like when you look at the broad scope of everything, Americans are the number one prejudiced people in the entire world. Nobody else is as punitive on their citizens as the United States, and it seems ironic that we are supposed to be the leader of the free world, but when it comes to the Tax Code, we seem to be absolutely backward.

Mr. GIBBONS. I apologize for taking this extra time.

I am amazed that America has done so well when I look at our system and the penalties we put on our people for jobs, taxes, and for everything else. That really concerns me. We have a very expensive system to administer.

I don't know how expensive, but it is horribly expensive, probably the most expensive system in the world to administer. I worry about America's future when I see us dragging along as economic

baggage, useless baggage, our horribly expensive tax system, and then not doing perhaps as much as we should as far as education is concerned. I think the future of our country depends upon how well we educate our minds and how efficiently we operate our economy.

I am very pessimistic that we seem to be headed in the wrong direction.

Mr. ARMSTRONG. I agree. I am always impressed by some of my European friends whose little children may be 5 or 6 years old and they are speaking four different languages.

Mr. GIBBONS. Yes.

Mr. ARMSTRONG. It is quite impressive to see, quite honestly, but I totally agree with you.

Mr. GIBBONS. Thank you.

Mr. MCCRERY. Before I call on Mr. Portman, Mr. Armstrong, do you happen to know the current percentage of public debt that is held by foreigners? You said in your testimony that we have had up to 40 percent of it.

Mr. ARMSTRONG. I would have to check the 1995 numbers. The highest number I have seen that fluctuate up to is about 42 percent.

Mr. MCCRERY. Was that recently?

Mr. ARMSTRONG. Pardon me?

Mr. MCCRERY. Was that recently?

Mr. ARMSTRONG. Yes, within the last several years. It has been coming down largely because of concerns about the dollar. It has caused a lot of foreigners to sell government bonds, particularly in the United States, also Canada. One of the largest institutions in Japan lost so much money on the foreign exchange on our bond markets here that they actually announced they are no longer going to buy government bonds from anybody in the world again.

Mr. MCCRERY. But it is still a significant portion. Is that your appreciation?

Mr. ARMSTRONG. I would only be taking a guess. I think it might be down to maybe the 25- to 30- percent area at this point.

Mr. MCCRERY. OK, thank you.

Mr. Portman.

Mr. PORTMAN. I thank the Chairman. I have really enjoyed the testimony. I have many questions, and I will try to keep it to three, one for each panelist, but feel free to chime in as I ask them.

Dr. McLennan, first, your testimony regarding border adjustability was very interesting, and I would like the two of us to have a dialog on the impact.

In essence, what you are saying is it doesn't really matter because the exchange rates will adjust, and if we have a flat tax or if we choose to have an indirect tax which we can border adjust, such as the Europeans do, that in the end we will have, in essence, the same outcome. I think Dr. Raboy is saying the quantity of trade will be adjusted, although at the end the cost will be the same because of the adjustment. How do you square that?

Ms. MCLENNAN. I don't think we are in disagreement at all. Border tax adjustability to me is just a mechanical means by which you enforce a value-added tax. We could go that way. That is a destination principle, European-style, value-added tax.

We could have a national sales tax, which would not be border adjustable. Sales taxes normally aren't, and you would have the impact on the exchange rate.

Mr. PORTMAN. Excuse me. Is that because they are considered by the GATT to be direct taxes?

Ms. MCLENNAN. No. A sales tax is also an indirect tax, but normally exporters are forgiven the sales tax. If you buy anything, for example, in the United States, if you get something from the L.L. Bean catalog, citizens of Maine add 6 percent sales tax. Nobody else pays the sales tax. There isn't a system by which you pay the sales tax and have it rebated afterward.

Mr. PORTMAN. It is not that international rules would preclude that. You indicate any indirect tax we could apply.

Ms. MCLENNAN. It is not clear that international trade agreements would make it difficult to have a border-adjusted sales tax. I have never heard of a sales tax that had border adjustability connected to it. It is just a different way of taxing the same income.

I want to add to the comments the two panelists had on the last question. I believe currency markets do adjust very quickly to changes in tax systems. If the United States were to adopt something like a value-added tax, all the other countries of the world would have sufficient notice to know that this would happen, and banks would know about it. I believe it won't be very long by the time the dollar adjusts to its new value in international trade.

Mr. PORTMAN. You went beyond that and earlier had indicated that not only would the exchange markets change, but it is likely that tax systems would change over time.

Ms. MCLENNAN. Well, that could happen, too. It may be a period of really major adjustments on the parts of lots of trading countries to a new tax system.

The other thing to remember is when the United States does something, many countries will look to the United States in a sense as a model, and there is a lot of copying in terms of policies of this nature. So you may not see that much turmoil as the theorists would have you believe at the outset. To get back to your question, border tax adjustability in itself may not have any impact, but if border tax adjustability is connected to a tax policy which encourages savings and investment, where your basic economic activities are encouraged, that in itself will have an effect on our competitiveness, and it should be a positive impact on U.S. trade and investment.

Mr. PORTMAN. If you can try to quantify that, just to play devil's advocate for 1 moment, you would say, then, based on your earlier testimony that it is much more important to move to a system that is not penalizing savings and investment——

Ms. MCLENNAN. Right.

Mr. PORTMAN [continuing]. So people can make economic decisions and not tax-related decisions. So a flat tax as an example which would be direct and not border adjustable would be a much more important factor than whether it is border adjustable or not, the fact that it is a different system.

Ms. MCLENNAN. Exactly. I think it is the overall impact.

If you do away with double and triple taxation and the complexity of compliance, all of those factors are very important and shouldn't be forgotten as a goal for the tax system.

Mr. PORTMAN. But you all differ in your degree of importance you would attach to indirect versus direct, destination versus origin?

Mr. RABOY. I am not sure. I would agree that the primary consideration should be the tax base. If we could get a flat tax or a VAT or a national sales tax or a USA tax, any of those would be terrific.

Mr. PORTMAN. Compared to the current system?

Mr. RABOY. Yes, compared to the current system.

The bias against capital and saving is probably the most——

Mr. PORTMAN. But you see a marginal, even greater improvement if you can go to something that is destination based——

Mr. RABOY. That is border adjustable, yes.

Mr. PORTMAN [continuing]. And border adjustable.

Mr. RABOY. Absolutely. Again, the reasons are because there will be short-run trade benefits, real benefits to the trade sector. You eliminate transfer pricing controversies and other locational types of disincentives.

Mr. PORTMAN. I wish I had more time, Mr. Armstrong, but maybe someone else can go into this further. This fascinates me, this notion of tax-free bonds because it would put us in a level playingfield with foreign investors and government bonds.

You mentioned the figure of $250 billion. Where do you come up with that? Our interest on the debt is, what, about $200 billion a year?

Mr. ARMSTRONG. We now, I believe, are collecting close to $100 billion more than we are spending on actual programs, which is being absorbed by interest.

Mr. PORTMAN. OK. So what would be the net effect of your proposal in terms of the government revenues' impact on the budget?

Mr. ARMSTRONG. It would really depend on how much of the national debt you could shift over.

I can tell you in the financial community, there is something else that has happened here, and that is that in 1993, the Treasury began trying to take advantage of the steep yield curve in this country, and they started shifting the national debt short term. I will be glad to provide the commission with a chart on that. We are now 70 percent.

Mr. PORTMAN. This was in 1992 or 1993?

Mr. ARMSTRONG. In 1993.

Mr. PORTMAN. OK.

Mr. ARMSTRONG. Yes.

We are now funded 70 percent, 5 years or less. One-third of the entire national debt is funded 1 year or less. All right. This is why short-term interest rates have doubled in the last 2 years, and we now have a yield curve that is practically flat.

Initially, the Treasury was doing that, trying to save on interest expenditures to bring the deficit down.

Mr. PORTMAN. Right.

Mr. ARMSTRONG. It is now backfiring, but it had a very serious impact in the financial pension fund community. What happened was that pension funds had gone out and bought mortgage-backed securities. Well, mortgage-backed securities can be recalled, and

that is what happened. So many people went out and began refinancing their mortgages.

The pension funds lost that long-term maturity and ended up being thrusted into the short term, at the same time the Treasury cut the 30-year bond auction down.

Well, at this point, you ended up with companies, for example, Coca-Cola and Disney, who were suddenly able to issue 100-year bonds, and the marketplace bought them immediately because the pension funds, their liabilities and their investments are not matched.

I believe, and I have talked to a number of people in the industry about this, if the Treasury were to take advantage of this particular point in time and perhaps issue zero coupon bonds that were tax free, you could effectively reduce your interest expenditures dramatically in the short term, which would give you more than enough time to help change the total outlook of this country, but you have to follow through. You can't use those savings and spend them, but you could save a substantial amount of money doing that right now, and there is a marketplace for them because the pension funds need the long-term maturities right now.

It is kind of a casualty thing or Keystone Cop maneuver. I don't know how this—you know, I have never seen this happen before in the 20 years that I—or 25 years that I have been doing it.

Mr. PORTMAN. I appreciate that.

I think we need a new hearing, Mr. Chairman, just on this topic.

Thank you for your testimony.

Mr. HOUGHTON [presiding]. Thank you very much.

Ladies and gentlemen, thanks very much for being with us. We certainly appreciate it.

Now, the third panel is Messrs. Boyle, Rogers, Cox, Barone, Christian, and Kostenbauder. We are delighted to have you, and if you would take your place at the table, we would appreciate it.

All right, gentlemen. Thanks very much for being with us. If you would like to give your testimony, starting with Mr. Boyle, I certainly would appreciate it.

Thanks very much.

STATEMENT OF MICHAEL P. BOYLE, CHIEF TAX COUNSEL AND GENERAL AUDITOR, MICROSOFT CORP., REDMOND, WASHINGTON; ON BEHALF OF SOFTWARE PUBLISHERS ASSOCIATION

Mr. BOYLE. Good afternoon. I am Mike Boyle, chief tax counsel and general auditor for Microsoft Corp. Thank you for the opportunity to present testimony today on behalf of the Software Publishers Association.

The SPA has 1,200-plus member companies of all sizes, large and small. These companies develop, market, and produce a wide variety of software.

Fair taxation of software revenue is a fundamental concern of our members. The efficient development and distribution of software technology products, which are key American exports, must not be unduly burdened by U.S. tax policy.

My testimony today will stress the following points: First, international double taxation of software income must be avoided; sec-

ond, current tax treaty protections against excessive foreign taxes must continue; and third, incentives for creating intellectual property and intangibles within the United States should be retained.

The software industry has grown rapidly in recent years. In 1995, the top 100 personal computer software companies had combined worldwide revenues of $16 billion. The industry employs approximately 500,000 people in the United States, and there are approximately 2 million workers in software programming jobs in this country. Exports make up a significant part of the overall revenues of the industry.

The typical software company spends a high proportion of its total revenues on research and development. The chief assets of software companies are their work force and intellectual property. A major expense is employee compensation.

A key to maintaining international competitiveness is the avoidance of international double taxation. Currently, double taxation is reduced through the foreign tax credit mechanism and reduction in foreign taxes under U.S. tax treaties. Other provisions of current law having a direct impact on competitiveness include the deductibility of employee compensation, the R&D credit, and export incentives like the foreign sales corporation provisions which, as you may know, are currently a source of controversy because of an overly narrow IRS interpretation that would deny certain software exports from receiving fringe benefits. But the goals of these provisions remain important to the software industry, and they should not be abandoned as we explore fundamental tax reform.

The tax reform proposals now under consideration would dramatically change. For example, all of the proposals would eliminate the foreign tax credit and avoid taxation by a territorial system under which foreign-source income would not be taxed. A territorial system would put tremendous pressure on the U.S. rules for determining whether income is U.S. or foreign source. If the United States taxes income as U.S. source, there will be no relief from double taxation if a foreign country taxes the same income.

The U.S. tax treaty network would be affected by the elimination of an income tax. Sales taxes and value-added taxes are not covered by income tax treaties. Loss of treaty protection would cause very serious hardship to software companies because the level of withholding taxes imposed by foreign countries would no longer be limited by treaty.

In the absence of treaties, prohibitively higher rates of withholding taxes, in some countries 40 percent or higher, would be imposed on software royalties. These rates are imposed on gross payments, not on net income, further increasing the tax burden.

Moving on to wages, the flat tax proposal would not permit a deduction for fringe benefits. The USA tax would deny any deduction for all employee compensation.

Both of these proposals cause SPA members serious concern. The software industry is heavily labor-intensive and employee compensation is often the single biggest expense of a software company.

Loss of a deduction for this expense would create an incentive to export development and production jobs outside the United States. Under all of the reform proposals, the R&D credit would be elimi-

nated. Any tax reform proposal should include measures that would continue the beneficial effect of this incentive provision.

Export incentives are intended to maintain a level playingfield with our trading partners. The national sales tax and the USA tax would exempt export income altogether from U.S. tax and are, therefore, preferable in this respect to the flat tax.

In conclusion, our members feel that if we are to maintain a worldwide competitive advantage, tax reform must ensure that international double taxation will be avoided, current tax protections against excessive foreign taxes must continue, and incentives for creating intellectual property and intangibles within the United States must be retained.

The U.S. software companies currently enjoy a commanding competitive advantage over that of every other country. Any reform to the U.S. tax system must not impair that advantage and should preserve American jobs.

I look forward to the opportunity to provide any assistance we can to this Committee as it explores the alternatives.

Thank you very much.

[The prepared statement follows:]

STATEMENT ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX

before the
HOUSE COMMITTEE ON WAYS AND MEANS
July 18, 1996

on behalf of
THE SOFTWARE PUBLISHERS ASSOCIATION

by
Michael P. Boyle
Chief Tax Counsel and General Auditor
Microsoft Corporation

I. Introduction

I am Michael P. Boyle, Chief Tax Counsel and General Auditor for Microsoft Corporation. I appreciate the opportunity to present testimony on behalf of the Software Publishers Association on the impact of various tax reform proposals on international competitiveness.

The Software Publishers Association is the leading trade association for the personal computer software industry. Its 1200-plus member companies are businesses of all sizes, large and small, that develop and market software for business, consumer, and educational applications. Perhaps more than any other industry, software manufacturers derive their revenues from the creation and transfer of products resulting from the development of intellectual property and other intangible assets -- copyrights, patents, and software programs.

In the international context, this means that the taxation of income earned from the creation of valuable software programs, as well as their transfer and use overseas, is a fundamental concern of our members. U.S. tax policy must not unfairly burden the efficient development and distribution of software technology and products, which are key American exports to the world markets. U.S. software currently enjoys a commanding competitive edge over that of every other country. Any reform of the U.S. tax system must not impair that advantage.

This testimony will first describe the scope and importance of the U.S. software industry. We will explain how the software business operates, and how its products are created and marketed. The current income tax provisions applicable to the industry will be summarized. We will then give a short summary of the provisions of current tax reform proposals that would have an impact on the international operations of software companies, and analyze potential issues that would arise under each of the proposals. Overall, the testimony is primarily intended to underscore the importance of considering the effect of any tax reform proposal on international transfers of intellectual property, software, and other valuable intangibles.

II. The Software Industry

A. *Overview*

The software industry has grown during the past several years into one of the most dynamic and rapidly expanding sectors of the U.S. economy. In the early days of computers, hardware and software were typically bundled together, and software was not available for separate purchase. With the advent of the personal computer, however, it became possible to establish independent companies that specialize in the development of software alone. These companies do not deal in hardware, but simply sell software separately to purchasers of computers and other customers. The business includes other areas as well, such as designing custom software for larger computers and mainframes.

The American software industry today is large and getting larger. In 1995, the top 100 personal computer software companies had combined worldwide revenues in excess of $16 billion. Employment in the software industry increased at a double-digit rate throughout the 1980's, and is still increasing today. The industry employs approximately 500,000 people in the U.S., and there are approximately 2 million workers in software programming jobs in this country.

Exports make up a significant part of the overall revenues of the industry. In 1995, for example, 39 percent of the software revenues of the top 100 companies was derived from exports. Several of those companies made more than half their earnings from exports.

Software is an area in which the United States currently dominates world markets. A recent survey of the global software industry by *The Economist* magazine observed: "If everything is going software, most of the world is in trouble and America is laughing." The U.S. software industry makes an estimated three-quarters of the packaged software used around the world today. The nearest rivals, Germany and the United Kingdom, together share about 10% of the market.

B. *The typical software company*

The typical software company spends a high proportion of its total revenues on researching and developing new products. Relatively little of its capital is invested in hard assets and equipment. Its chief assets are its workforce (which tends to be both highly skilled and highly compensated), its intellectual property, and its other intangible assets. Its major expense is the compensation of its employees, whose skills and creativity contribute most of the value to the products and services from which the company's revenues are derived. For many companies, exports account for a significant portion of revenues.

Most American software companies do the majority of their software development work in the United States. However, other countries are currently competing actively -- through highly lucrative tax and business incentives -- for this development work and the employment that goes with it, including Australia, India, Ireland, Israel, Singapore, and Switzerland.

C. *Creation of a software product*

A software product is initially conceived in outline form. The functions and features of the product are identified, and its technical architecture is determined. The details of the product are then designed, followed by coding and extensive testing. The product may then be "ported" -- that is, modified to be compatible with several different hardware configurations. Products destined for international markets must be translated and localized to satisfy the language and cultural requirements of various foreign countries. Software engineers employed by the software companies, as well as outside contractors, do all of this work.

When the product is ready for use, a master tape or disk of the software is created. Duplicate copies of the software product are manufactured from this master. Documentation to accompany the product is also developed; this documentation is a vital part of the final product package, because it allows the user to install and run the programs.

D. *Marketing of a software product*

Software companies market their products through several channels in order to achieve the broadest possible market coverage. Typically, marketing will be done in some or all of the following ways:

- Directly to end users through the company's own sales force;
- Through dealers;
- Through third party distributors;
- Through original equipment manufacturers that bundle the software product with their own hardware and sell the combined product; and
- Through value-added resellers that combine the product with their own software and sell the combined package.

These techniques do not vary significantly in the overseas markets. Some companies have foreign subsidiaries through which they market their products. Others rely more on third party distributors. In order to distribute the products efficiently, an intermediary may be licensed the right to reproduce and perhaps modify the software package.

III. Current Tax Provisions Applicable to International Transfers of Software

United States corporations are taxed on their worldwide income. Because foreign countries also tax the operations of companies operating within their borders, international double taxation is a constant problem. Current U.S. law seeks to relieve the potential double taxation that arises in this situation by allowing a credit against U.S. income taxes for foreign income taxes paid, subject to a number of limitations. Foreign countries also typically impose withholding taxes on income arising within their borders and paid to foreign companies, including taxes on dividends, interest, and royalties. U.S. foreign tax credits are also available for these withholding taxes. In both of these cases, however, the foreign tax credit is applicable only against U.S. tax attributable to foreign source income as defined under U.S. law. The Internal Revenue Code prescribes detailed rules for determining the source of many different

categories of income. Often, the foreign corporate tax plus the withholding tax are high enough that the U.S. foreign tax credit is limited, which may put U.S. companies at a disadvantage.

Where a U.S. corporation operates in a foreign country through a subsidiary corporation, U.S. tax on income derived from the subsidiary's active business is deferred under the "controlled foreign corporation" provisions of the Code. Such income is taxed when it is repatriated to the U.S. parent in the form of a dividend. An indirect tax credit for foreign taxes paid by the subsidiary on the active income is available to the U.S. parent when the dividend is paid. Most other income earned by controlled foreign subsidiaries is taxed currently to their U.S. shareholders.

Relief from foreign income taxes is also available under the provisions of the many bilateral tax treaties to which the U.S. is a party. Tax treaties are in place with virtually all of America's major trading partners, and limit the taxes that the foreign countries can impose on various categories of income. (The United States grants reciprocal benefits to treaty-partner residents deriving income in this country.) These treaties are by their terms limited to taxes on income and on capital, and are a significant part of the worldwide network of safeguards that gives U.S. companies a level of certainty necessary to operate across borders.

Transfer pricing rules apply to transactions between related parties. The IRS has the authority to reallocate gross income, deductions, and other tax items between related entities in order to align the terms of their transactions with those that unrelated parties, dealing at arm's length, would have agreed to. Software companies, whose products and services are almost always unique, have faced special difficulties under these rules because the absence of "comparable" transactions between unrelated parties gives rise to great uncertainty with respect to the appropriate "arm's length" terms. Also of concern to our members is the so-called "super-royalty" provision, added to the Code in 1986. Under this provision, income derived from a transferred intangible must be commensurate with the income that the intangible subsequently generates; for example, the transfer price for a software license, if characterized as a transfer of intangible property subject to the super-royalty rule, can be retroactively adjusted in future years to accord with the annual revenue derived from the software product. These adjustments can lead to unexpected results not fully consistent with the arm's length standard, will often result in double taxation, and are an additional source of significant uncertainty.

The Foreign Sales Corporation, or FSC, regime is one of the most important U.S. tax incentives for exports from the United States. These provisions were enacted to offset competitive disadvantages faced by U.S. exporters because many of our trading partners have more favorable systems for taxing exports. Under the FSC provisions, an exemption from tax is available on roughly 15%-30% of the income earned from export transactions if certain requirements are met. The purpose of the FSC rules is to encourage the development and manufacture of products in the United States and the subsequent transfer of those products overseas.

There is currently some controversy over the applicability of the FSC rules to software. The Treasury Department's temporary and proposed FSC regulations contain language that arguably is broad enough to allow computer software manufacturers to export computer software, with or without the right to reproduce, and receive FSC benefits. However, the IRS interpretation of these regulations has been to deny FSC benefits for exports of software accompanied by the right to reproduce. This interpretation discriminates against the software industry by denying this benefit, which is available to all other U.S. exporters. Our members believe that Treasury should modify its interpretation of the regulations to make it clear that these benefits are available to this important export sector of the U.S. economy. Its refusal to do so would require the enactment of remedial legislation.

A temporary tax credit for research and experimentation expenses carried out in the United States has been available for several years. Software companies devote a considerable portion of their budgets to R&D, and the credit enables them to continue the research needed to maintain their products' leadership role in the world marketplace by lowering the net cost of research. For several years, however, there has been great uncertainty over the continued extension of the credit. (For example, the Senate version of the Small Business Job Protection Act would allow the credit to lapse for one year.) This uncertainty affects the budgeting of the amount and location of research expenditures, which typically must be done some years in advance. Much of the potential benefit of the credit is lost because companies are unable to compute long-term research budgets with the certainty that the credit will be available in future years. A permanent credit would enhance competitiveness still further and encourage

companies to continue to expand their development operations in the U.S., creating additional jobs and exports.

IV. The Principal Tax Reform Proposals

A. *Overview*

Here is a brief description of the aspects of each of the major tax reform proposals that would affect the international competitiveness of the software industry.

B. *The Flat Tax*

The Flat Tax (as contained in H.R. 2060) would impose tax at a single rate on income from the sale or exchange of property or services in the U.S. and on income from the export of property or services overseas. The bill itself does not address the treatment of foreign source income, but statements made by Majority Leader Armey indicate that the Flat Tax would be a territorial system of taxation, perhaps similar to the "exemption" system used by some countries (for example, Austria and Switzerland). Income earned outside the United States would not be subject to U.S. tax. No foreign tax credits would be allowed under this system.

C. *The National Sales Tax*

The National Sales Tax would be imposed on the gross amount of payments for the use, consumption, or enjoyment in the United States of any taxable property or service. Taxable property would not include intangibles. An exemption from the tax would be provided for property purchased for export, but imports would be subject to it.

D. *The Value Added Tax (including the USA Tax)*

The Committee requested comments on two types of value added taxes, or VATs. The first is the credit-invoice method VAT, used in many countries, which would be applied to the sales price of goods or services and shown on the invoice for those goods or services. The tax would not be imposed on purchases for goods and services used in the seller's business. The VAT would also not be imposed on exports, although it would apply to imports. The rate of VAT may vary (sometimes down to zero) depending on the nature of the goods or services transferred. The treatment of royalty income derived from the foreign use of intellectual property and certain other intangibles, including software copyrights and patents, varies from country to country; our members believe that such income is comparable to income from the export of goods and should not be subject to the VAT.

The other kind of VAT is a subtraction method VAT, of which the USA Tax is an example. This VAT would be imposed on the gross profits (defined as the excess of gross receipts over business purchases) of businesses that sell or lease goods or services in the United States. Gross receipts would not include amounts derived from exports of goods and services; if "exports" are properly defined, foreign source royalties for the use of intellectual property and certain other intangibles should be excluded from the U.S. tax base. Under the USA Tax, wages and other compensation costs would not be business purchases and would not be deductible from gross receipts. (A payroll tax credit, up to the amount of the annual FICA tax liability, would be available.)

V. Issues Arising Under Each of the Reform Proposals

A. *Overview*

This section of the testimony identifies issues of importance to our members that would arise under each of the fundamental tax reform proposals described above. The intent of this section is not to advocate particular solutions to these issues, but to ensure that they are properly and fully addressed in the course of the tax reform process.

B. *Sourcing rules*

As discussed above, a significant amount of the revenues of software companies arises from operations in foreign markets. These operations typically entail the payment of foreign taxes to the countries in which those companies operate.

All of the proposals would eliminate the foreign tax credit mechanism and instead avoid double taxation by a so-called "territorial" system. In principle, such a system might be expected to be at least neutral with respect to our member companies' international competitiveness; indeed, the territorial system might improve competitiveness in cases where limitations in current law prevent a full foreign tax credit.

However, in order to achieve this result, the rules for sourcing of income need to be carefully examined. The U.S. rules are not the subject of international agreement, and it is possible for a foreign country to tax income that is considered to be from U.S. sources under U.S. rules, and therefore subject to U.S. tax. In the absence of a foreign tax credit, there would be no way to avoid double taxation in these cases. Similarly, rules for sourcing deductions would become critical, because a deduction allocated to foreign sources would be a deduction of no use for U.S. tax purposes.

Sourcing rules applicable to specific categories of income are of special concern to our members. Under current law, for example, royalties derived from the active licensing of software patents and copyrights for use overseas are foreign source income. If this rule were changed, the withholding taxes that many foreign countries impose on royalties would give rise to double taxation. The imposition of double taxation on cross-border royalties is inconsistent with international tax policy and must be avoided in drafting any tax reform proposal.

For these reasons, the successful implementation of a territorial tax system would require a careful and detailed review of the sourcing rules. In particular, it would be desirable to examine how the U.S. rules and the rules used by foreign countries (which are generally much less detailed) will interact.

C. *Problems under tax treaties*

The United States' international tax treaty network would be substantially affected by the elimination of an income tax. Sales taxes and value added taxes are not covered by treaties, and it is uncertain whether our treaty partners could be persuaded that some of the proposed replacements for the current income tax system are the equivalent of income taxes and therefore covered by the treaties. The United States might be faced with terminations of many of its treaties if treaty partners feel that the concessions they have made in reducing the tax burden of U.S. taxpayers operating in their countries are no longer balanced by reciprocal concessions by the U.S.

Loss of treaty protection would cause very serious hardship to our members because the level of withholding taxes imposed by foreign countries would no longer be limited. In the absence of treaties, prohibitively high rates of withholding taxes – in some countries, 40% or higher -- can be imposed on license payments for software copyrights and patents. These rates are imposed on gross payments, not on net income, further increasing the tax burden from operating in many jurisdictions. In addition, the expanded opportunities for foreign taxation would likely increase the administrative and compliance burdens that foreign withholding taxes generate.

The interaction between treaty problems and the move to a territorial tax system is complex and beyond the scope of this testimony. The territorial system might serve to alleviate some of the difficulties that might otherwise arise, but the problem of high foreign tax rates on foreign source royalty income would remain. In addition, the loss of the treaty system would seriously impair the ability of the U.S. government to exchange taxpayer information, negotiate solutions to bilateral tax disputes (including transfer pricing disputes), and deal with foreign tax authorities on matters of tax administration.

The Flat Tax might be considered more favorably under our income tax treaties if foreign source royalty income would be exempt from U.S. tax and the Flat Tax remains an income tax of the type covered by treaties. Because of the significant structural differences between the Flat Tax and the current tax system, however, the Flat Tax would at the very least upset the compromise solutions to double taxation problems that most treaties embody. Even this proposal, therefore, would require a detailed scrutiny of the existing tax treaty network.

D. *Exports*

Export benefits under current tax law are concentrated in the FSC regime described above. This regime, which provides tax incentives for some export income, would disappear under all of the fundamental tax reform proposals. To the extent that the National Sales Tax and VAT proposals such as the USA Tax would exempt export income altogether from U.S. tax, of course, they would in fact be a great improvement over the FSC regime. The Flat Tax, on the other hand, neither exempts exports from tax nor includes FSC rules. For an industry like ours, which exports so much of its products, FSC benefits or more substantial export exemptions are needed in order to maintain a level playing field with our trading partners.

E. *Transfer pricing*

The current U.S. transfer pricing regime under section 482 of the Code has received a great deal of attention and adjustment over the past several years. A substantial amount of work -- including multilateral negotiations at the OECD – has been devoted to arriving at a system of transfer pricing principles that are fair, workable, and subject to broad international agreement. Any tax reform proposal should be careful to preserve the consensus view that has been painstakingly developed in this area. The exemption of foreign source income from U.S. tax has the potential to save both taxpayers and the government millions of dollars in compliance and controversy costs, but only if the source rules are clearly enunciated. Transfer pricing controversies would be further alleviated by those proposals that exempt exports from U.S. tax.

F. *Employee compensation*

The Flat Tax proposal would permit a deduction for wages but not for fringe benefits. The USA Tax would deny any deduction for employee compensation. Both of these proposals cause our members serious concern. The software industry is heavily labor-intensive, and employee compensation is often the biggest single expense of a software company. Loss of part or all of a deduction for this expense would increase U.S. tax liability and increase the after-tax cost of labor, and might therefore create an incentive to export development and production jobs outside the U.S. The payroll tax credit under the USA Tax proposal would not eliminate the problem, because most software engineers earn incomes above the annual FICA limitation. Similarly, the overall lower rates would not fully compensate for the loss of the deduction and would effectively result in discrimination against labor-intensive industries.

G. *Research & experimentation credit*

Under all of the reform proposals, the research and experimentation tax credit would be eliminated. This credit is designed to preserve or increase the level of research and experimentation in the U.S. economy and the concomitant number of U.S. jobs created thereby. Our members believe that any fundamental tax reform proposals should include measures that would continue the beneficial effect of the existing incentive provisions.

H. *Scope of a sales tax*

The National Sales Tax, like many comparable state sales taxes, would not be imposed on "intangible property." However, at the state level, our members have encountered some controversy with taxing authorities over how sales apply to software products and their eligibility for the exemption. If a sales tax is adopted at the federal level, it should clarify that income derived from many types of software transactions is specifically exempt in order to avoid these disputes.

I. *Transition issues*

No tax reform proposal should be adopted without carefully considering transition issues. Many existing business structures and contractual arrangements have been developed on the assumption that the current income tax system would continue in place. A fairly extensive transition period would likely be needed if fundamental tax reform is adopted, in order to avoid upsetting the legitimate expectations of taxpayers and thereby reducing their ability to compete in the international markets.

VI. Conclusion

The impact of the fundamental tax reform proposals on the competitiveness of the American software industry will depend to a considerable extent on the resolution of the issues discussed above. If we are to maintain our worldwide competitive advantage, our members must be assured that international double taxation will be avoided; that the transfer of intellectual property and other intangibles overseas will receive tax treatment at least as favorable as that accorded to other types of exports; and that care is taken not to increase the after-tax cost of the compensation being paid to their U.S. employees, thereby preserving American jobs. Software is an important industry in which the United States is currently the world leader. Tax reform should preserve this pre-eminent position.

Mr. HOUGHTON. Thank you, Mr. Boyle.
Mr. Rogers.

STATEMENT OF JOHN E. ROGERS, DIRECTOR OF TAXES AND ASSISTANT TREASURER, FMC CORP., CHICAGO, ILLINOIS; ON BEHALF OF COALITION ON ROYALTIES TAXATION; ACCOMPANIED BY JOHN W. COX, TAX DIRECTOR, BMC SOFTWARE, INC., HOUSTON, TEXAS

Mr. ROGERS. Good afternoon, Mr. Chairman. I am John Rogers, director of Taxes and assistant treasurer for FMC Corp. FMC is headquartered in Chicago and is one of the world's leading producers of chemicals and machinery for industry, government, and agriculture. Approximately one-half of our sales, which are approaching $5 billion, are outside the United States.

I am accompanied today by John W. Cox, who is director of tax for BMC Software. BMC is headquartered in Houston and is a worldwide software developer and vendor of software solutions for automating application and data management across host-based and open-based environments. More than 40 percent of BMC's $430 million in current revenues are from exports.

FMC and BMC are members of the Coalition on Royalties Taxation, which includes in its membership U.S.-based multinational companies in a broad array of industries, a total spectrum of U.S. industry.

My testimony today will emphasize four points. First, any reform proposal must tax cross-border licensing in a way that keeps research and development activities in the United States. Second, cross-border transfers in intangibles are necessary for U.S. companies to do business in foreign markets. Third, foreign-source royalty income from these transfers should be treated in the same way as other foreign-source income. Finally, double taxation of foreign-source royalty income must be prevented and current income tax treaty benefits must be preserved.

In order to compete in foreign markets, U.S. corporations must be able to efficiently create and disseminate intangible property throughout the world. Technology development in the United States means jobs. In most businesses, these research jobs pay high salaries and provide meaningful and challenging employment opportunities. Any gaps left by U.S. companies will be filled by our foreign competitors.

In conducting their business activity worldwide, U.S. corporations routinely license intangibles to their related foreign subsidiaries and joint ventures as the most efficient way of operating in foreign markets. These licenses create foreign-source royalty income. The U.S. tax treatment of such income is crucial to preserving the U.S. development of the intangibles and the economic benefits to the United States that this investment creates.

Under current U.S. law, a company is taxed on its worldwide income. A tax credit for tax that is paid to foreign countries including withholding taxes on royalties is intended to avoid double taxation of that income.

Current tax provisions that specifically affect the competitiveness of U.S. exporters include the foreign sales corporation, or FSC

rules, which are intended to encourage U.S. exports. A temporary research credit is also available.

The current tax reform proposals provide for a territorial system of taxation under which foreign-source business income is not subject to U.S. tax. Foreign tax credit is eliminated because it is assumed that the territoriality will prevent double taxation. If a territorial tax system is adopted, it is extremely important that appropriate sourcing rules be adopted to prevent taxation in the United States of business income that is already subject to tax in a foreign jurisdiction.

Consistent with a territorial system, royalties and license fees earned in foreign countries should be exempt from U.S. taxes because they represent foreign-source business income which is already provided for by U.S. law. Otherwise, double taxation would make many typical business transactions unprofitable.

A key area that remains unresolved, though, is the impact of the tax reform proposals on the current system of U.S. income tax treaties. If these treaties no longer apply, U.S. companies doing business overseas may be severely harmed. Withholding taxes imposed on royalty income by our treaty partners will increase, but treaty protection is removed. The Coalition urges the preservation of the treaty system that is currently in place.

In conclusion, proposals for tax reform should exclude foreign-source royalties from the U.S. tax base because these royalties are already subject to tax in the countries they pay, or U.S. tax would constitute double taxation in the absence of foreign tax credits, and this would be burdensome and hamper continued development, which is important for competitiveness.

[The prepared statement follows:]

Statement
on
The Impact on International Competitiveness
of Replacing the Federal Income Tax
before the
House Committee on Ways and Means
on
July 18, 1996
on behalf of
The Coalition on Royalties Taxation
by
John E. Rogers
Director of Taxes and Assistant Treasurer
FMC Corporation

I am John E. Rogers, Director of Taxes and Assistant Treasurer for FMC Corporation. FMC, headquartered in Chicago, is one of the world's leading producers of chemicals and machinery for industry, government and agriculture. Approximately one-half of FMC's $4.5 billion 1995 revenues were from international sales. I am accompanied today by John W. Cox, Tax Director for BMC Software, Inc. BMC, headquartered in Houston, is a worldwide developer and vendor of software solutions for automating application and data management across host-based and open system environments. More than 40% of BMC's $430 million in revenues are from exports.

FMC and BMC are members of the Coalition on Royalties Taxation ("the Coalition"), which includes in its membership U.S. based multinational companies doing business in a broad array of industries, including consumer products, software, industrial manufacturing, entertainment and fast food. These companies represent America's leading exporters in their industries. They create valuable intellectual property and other intangible assets in the United States and utilize these intangibles in international commerce. (For simplicity we will refer to these assets as "intangible assets.") In order to competitively market products in foreign jurisdictions, these corporations must be able to efficiently create and disseminate intangible property throughout the world. For that reason, the members of the Coalition share a concern with how the income derived from the use of intangible assets overseas (generally represented through royalties) would be taxed under a reformed U.S. tax system.

I. The Importance of U.S.-Developed Intangibles to U.S. International Competitiveness

U.S. corporations lead the international marketplace in their respective industries in developing new technologies used to create new products, manufacturing expertise, and marketing strategies. This technology is the product of U.S. based research and development which produces market leading patents, copyrights, trademarks and business know-how. The ability to efficiently utilize these intangible assets throughout the world is a key component in the international operations of a U.S. corporation. U.S. policy should not impede the cross border dissemination of these important business assets. The National Commission on Economic Growth and Tax Reform (Kemp Commission) highlighted the need to be concerned with the tax treatment of foreign source royalties in designing a new tax system in stating that "attention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."[1]

The following testimony will focus on the manner in which intangible assets are used by U.S. multinational corporations in foreign jurisdictions and the U.S. tax ramifications of these transactions. It will also review the treatment of the development and dissemination of intangible assets under the various alternative tax proposals. The Coalition does not endorse any particular alternative taxing system; rather, our purpose is to focus attention on the importance to the U.S. economy of the efficient international dissemination of U.S.-developed intangible assets as an important issue that must be considered as a part of the tax reform process.

A. How U.S. Multinationals Utilize Intangibles Overseas

The ability of a U.S. corporation to conduct business outside the United States often requires that its foreign affiliates obtain the right to utilize intangible assets that are developed by the U.S. parent. Furthermore, in some cases, U.S. corporations may directly license the right to use intangibles to their foreign customers. As reflected by the broad membership of this Coalition,

[1] *Report of the National Commission on Economic Growth and Tax Reform*, Washington, D.C., p.18.

intangible assets are utilized in international commerce by companies doing business in a broad array of industries. U.S. corporations often license the use of intangibles to their related foreign subsidiaries for their use in manufacturing and marketing their products overseas. This license creates foreign source royalty income.

In the case of a manufacturing concern, licensing intangibles to a foreign affiliate allows a U.S. based manufacturer to compete in foreign markets. If a U.S. corporation sells U.S. manufactured products in foreign markets through foreign distribution subsidiaries, the U.S. corporation generally must license marketing intangibles to the foreign distribution subsidiary that sells the U.S. manufactured products in the local markets. In the case of a foreign subsidiary of a U.S. corporation that both manufactures and sells products in its local markets, the U.S. corporation generally must license both marketing and manufacturing intangibles to the foreign subsidiary in order to operate in the local market.

Some businesses depend on the efficient distribution of technology-based products through licensing. In the electronics and software industries, the value of the product is largely driven by the technology and other creative content contained in the product. This technology is often protected by a copyright or patent, and product distribution takes the commercial form of a license. Furthermore, the obsolescence rate of intangible assets in these industries is so high that the technology base must be continually replenished in order to retain market share. In these businesses, the primary value of the product is the intellectual property that is contained in the product. The U.S. tax treatment of income derived from the use of intellectual property is a significant economic component in determining the ability of a U.S. company to conduct profitable operations in foreign jurisdictions. Similar issues would affect publishing, music, films, television and other creative industries in the United States.

Franchising U.S. businesses in foreign markets is another industry that is dependent on the efficient dissemination of intangible assets. The "Americanization" of the global economy has allowed many businesses to expand globally through the use of franchise agreements. Under these agreements, many U.S. companies license the use of trademarks, trade names, operational plans, and store designs to a local franchisee. The local franchisee invests capital in the local business and the U.S. franchisor receives a fee for the use of intangible assets and for services performed on behalf of the franchisee.

In addition, many U.S. companies are entering new markets by forming joint ventures with a non-U.S. partner that is engaged in a compatible business in a foreign market. U.S. corporations are often required to make their intangible assets available in a local jurisdiction as part of the joint venture transaction. These transactions often result in a license of intangible assets by the U.S. corporation to a joint venture entity. It is often necessary to license intangible property to the joint venture in order to execute the business objectives of the venture.

B. Technology Investment Promotes Capital Formation and Economic Growth

Capital formation is essential to long-term economic growth, whether through investment in plant and equipment (tangible capital) or through investment in product, process, or market development (intangible capital). By enhancing production and expanding markets, capital formation increases worker productivity, reduces costs and prices, and increases international competitiveness. In order to promote long-term economic growth, tax policy should not impede the license of intangible property so as to promote both tangible and intangible capital formation.

Research and development activity is a vital element in the production of both tangible and intangible capital. The leading position of U.S. companies in their respective industries is often a function of U.S. research. These research activities focus on creating new products and improving the manufacturing process of existing products, the result of which is higher productivity and an increase in capital formation in the United States. With technology and intangible assets playing a larger role in the development of new products, it is imperative that these research activities be maintained in the United States.

Many indirect benefits are also derived from the development of intangibles that are not directly apparent in the commercial operations of a particular company. For example, when a company invests in a piece of machinery, it alone derives the benefits of using that machinery. When a company invests in new technology (or other types of "headquarters services[2]"), however, the benefits provided are not limited to the firm paying for the investment. Some of

[2] For this purpose, we consider headquarter services to include technology, know-how, patents, copyrights, trademarks, and tradenames.

the benefits spill over to competitors, to other industries, as well as into the community where the investment is located. For example, employees moving from one firm to another may share technological know-how of their former employer with their new employer. Or, as another example, a breakthrough in the development of manufacturing processes for computer components could also provide benefits for the manufacture of other machinery. When a firm does a cost-benefit analysis of undertaking investment in intangible capital, it does not factor in spillover benefits that are important to the overall economy. Thus, it is widely asserted by economists that private firms' investment in intangibles is less than optimal from the standpoint of expanding the overall economy. Tax policy should recognize the importance of the domestic development of intangible assets and the ability of a U.S. corporation to use those intangibles in foreign affiliates. *Even more than in the case of investment in tangible capital,* investment in intangible capital should not be unduly burdened by the tax system.

C. Creation of High-Skill, High Wage Employment in the United States

When the U.S. exports intangibles, it increases demand for U.S. expertise in science, engineering, management, and marketing. These occupations generally pay high salaries and provide meaningful and challenging employment opportunities. In order for economies of scale to be fully exploited, U.S. investment in intangible assets should have worldwide markets. Any impediment to the worldwide utilization of intangible assets will reduce future investment and employment in high-technology sectors. Excess taxation of royalties reduces the return to investment in intangibles and along with this taxation there will be a reduction in high paying, high-skilled employment in the United States. Any gaps left in the marketplace by U.S. companies will be filled by investment in intangibles by foreign competitors.

The increasing availability of trained scientists and engineers abroad is causing U.S. companies that once conducted all research in the United States to seriously look beyond U.S. borders. For example, the *Wall Street Journal* has reported, "U.S. professionals are starting to see job opportunities vanish as employers look for engineers and programmers in Ireland, Russia, Malaysia, India and Singapore, where there are plentiful surpluses of well educated professionals."[3] Caution must be taken in developing alternative tax systems to promote the increase of human capital in our economy and stem the movement of technology development offshore.

II. Discussion of the Current Income Tax

Under current law a U.S. corporation is taxed on its worldwide income. A foreign tax credit system is provided to avoid double taxation of income that is considered under U.S. tax rules to be earned outside the United States, referred to herein as "foreign source income." Royalty income earned by a U.S. multinational from the use of intangibles outside the United States is foreign source income. This income, when derived in the context of an active trade or business, is taxed in a manner similar to income derived from the sale of a manufactured product. For example, in applying the foreign tax credit rules, foreign source royalty income derived from a controlled foreign affiliate that is actively engaged in business outside the United States is treated as active trade or business income. Similarly, under current subpart F rules, royalty income derived from active development or licensing of intangibles is excluded from the definition of foreign personal holding company income. Thus, the active licensing income, if earned by a controlled foreign corporation, is treated as active income and is not subjected to the subpart F, PFIC or section 956A anti-deferral regime. The royalties received for the use of these intangibles are often subject to foreign withholding taxes and foreign value-added taxes in the payor's jurisdiction. Current law allows the foreign withholding tax to be credited against U.S. income tax that would be owed on these royalties.

U.S. tax law has provided a temporary research and experimentation tax credit, designed to provide an incentive for developing technology in the United States. Under current legislative proposals, there would be a 12 month period during which the research credit lapses.[4] This suspension causes U.S. companies to question the ongoing viability of the credit in making their plans for future investments in U.S. research. A permanent research credit would provide a strong incentive for U.S. corporations to expand their research activities in the United States.

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[3] *Wall Street Journal*, "Age of Angst: Workplace Revolution Lifts Output But Job Security Is Getting Harder to Come By," pg. A8, March 10, 1993. See follow up article, *Wall Street Journal*, "Like Factory Workers, Professionals Face Loss of Jobs to Foreigners," pg. A1, March 17, 1993. See also, *New York Times*, "Skilled Workers Watch Their Jobs Migrate Overseas, A Blow to Middle Class," pg. A1, August 28, 1995.

[4] See Senate version of Small Business Job Protection Act, §1203 of H.R. 3448.

Current law also provides an incentive for exporting from the United States—the foreign sales corporation (FSC) rules. The FSC rules provide an exemption from U.S. tax for approximately 15% of income derived from export sales of most U.S. products. The benefit was designed to encourage U.S. companies to manufacture or develop their product in the United States for sale or lease overseas. IRS interpretations of the application of the FSC rules to export of software could negate the incentive to develop software in the United States.[5] These rules inappropriately discriminate against software products when compared with similar products.

The title-passage rule under section 863(b) generates foreign source income from the export of U.S. manufactured products, thereby allowing U.S. corporations to more efficiently utilize foreign tax credits. Under the title passage rule, income from goods manufactured in the United States and sold overseas generally is considered to be earned half in the United States and half outside the United States. By allocating 50% of this income to foreign sources, the title passage rule allows greater utilization of foreign tax credits, thereby reducing the risk of double taxation and the cost of producing goods in the United States for export markets. Again, this foreign source income treatment promotes exports.

A. Alternative Tax Proposals:

The following is a brief description of the three alternative tax proposals under consideration followed by a discussion of the impact of these proposals on the taxation of income from intangibles.

1. Flat Tax (H.R. 2060)[6]

With respect to business income, the Flat Tax is imposed on the sale or exchange of property or services in the United States and the export of property or services. H.R. 2060 does not specify whether the proposal would subject income earned outside the United States to U.S. tax and whether foreign tax credits would be allowed to prevent double taxation of this income. It is our understanding that the proposal is expected to provide a territorial system of taxation, under which income earned outside the United States would not be subject to U.S. tax. However, export income would be subject to U.S. tax. Because income earned outside the United States would not be subject to U.S. tax, a foreign tax credit system is not included to prevent double taxation.

The Coalition believes that royalty income from the exploitation of intangibles outside the United States should be characterized as foreign source income under the Flat Tax and, thereby, not subject to U.S. tax. Because foreign source royalty income is subject to foreign withholding taxes in the jurisdiction of origin, double taxation will occur if this income is taxed again under the Flat Tax regime.

2. National Sales Tax[7]

Under a National Sales Tax, a tax would be imposed on the gross payments for the use, consumption or enjoyment in the United States[8] of any taxable property or service, whether produced or rendered in the United States. Taxable property includes any property (including leaseholds) other than intangible property. Exemptions from the tax are provided for property that is purchased for resale, used to produce other taxable property or services, or exported from the United States for use, consumption or enjoyment outside the United States. Under the National Sales Tax, the exemption of intangibles, if properly defined, will exclude royalty income from taxation.

3. Value-Added Taxes

a. Credit - invoice method VAT

Under a credit-invoice method VAT, a tax is applied to the sales price of goods or services, which is generally disclosed on the invoice. A business credit is provided for the VAT on purchases of goods and services that are used in the seller's business. VAT systems generally

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[5] See Treas. Reg. §1.927(A) -1T(f)(3); TAM 9344002 (May 27, 1993).

[6] For purposes of this testimony, we are basing our analysis on H.R. 2060, introduced by Rep. Dick Armey (R-TX) on July 19, 1995. H.R. 2060 does not provide many details as to how its flat tax system would apply to income earned by U.S. multinationals. Our discussion of specific aspects of the Flat Tax that are not included in H.R. 2060 is based on public comments made by Rep. Armey or his staff.

[7] For purposes of this testimony, we base our analysis on H.R. 3039, introduced earlier this year by Reps. Schaefer (R-CO), Tauzin (R-LA), and Chrysler (R-MI).

[8] The term "United States" includes any commonwealth, territory or possession of the United States.

exempt exports from tax and impose tax on imports. Thus, foreign source royalties would not be subject to the VAT. In addition, a VAT system may exclude certain goods, services, or classes of taxpayers by providing a "zero rating" or an exemption.

b. Subtraction method VAT9/USA Tax.

The business tax under the USA Tax is a subtraction method value-added tax and is imposed on the gross profits of firms that sell or lease property or services in the United States. Gross profits are defined as the excess of gross business receipts over business purchases. Gross business receipts do not include amounts received for property or services exported from the United States for use or consumption outside the United States. If exports are properly defined, foreign source royalties should be excluded from the U.S. tax base. Under the USA Tax, wages and other compensation costs are not considered to be business purchases, although a payroll tax credit is provided up to the amount of the FICA tax liability.

B. Discussion of Impact of Various Tax Reform Plans on Intangibles Developed in the United States and Used Overseas

1. Territorial Tax System

All of the tax reform plans discussed above provide for a territorial system of taxation. Under a territorial system, foreign source business income is not subject to U.S. tax. Territorial tax systems do not include a foreign tax credit mechanism because it is assumed that the U.S. jurisdiction of taxation is appropriately defined to avoid double taxation of foreign source business income. If a territorial tax system is adopted under fundamental tax reform, it is extremely important that appropriate sourcing rules be adopted to prevent taxation in the United States of business income that is already subject to tax in a foreign jurisdiction. Consistent with a territorial system, royalties and license fees described above should be exempt from U.S. tax because they represent business income. The treatment of these fees as foreign source business income is consistent with their treatment under current law. It is critical to preserve a tax system that avoids double taxation. If a cross border transaction is subject to taxation in both the foreign jurisdiction and in the United States, then, depending on the circumstances, it is possible that the transaction will no longer be economically viable.

2. Treatment of Exports

Both the National Retail Sales Tax and the VAT (whether credit invoice method or subtraction method) are destination-based territorial tax systems. Under the destination principle, goods and services are taxed in the jurisdiction in which the products are sold rather than the jurisdiction in which the products are produced. All major consumption taxes in force throughout the world exempt exports, including exports of intangibles, from tax.[10]

As stated previously, exempting exports from U.S. tax will help level the playing field for these products to compete in foreign markets. Foreign source royalties paid to U.S. corporations are payments for the export of intangible assets created by the corporation and, as such, these royalties should be exempt from tax under a destination principle consumption tax, like the National Sales Tax[11] or a VAT. This taxing regime is consistent with similar taxes imposed by our leading trading partners. Furthermore, the export of intangibles improves the U.S. balance of trade in the same manner as an increase in exports of tangible property. This is reflected in official government statistics published by the U.S. Commerce Department which include royalty payments from abroad as exports. According to two Treasury Department economists, exemption of foreign income under a consumption tax, including exemption of receipts of foreign royalties under the destination principle, would likely cause multinational corporations to shift tangible investment, intangible assets, and R&D to the United States.[12]

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[9] Because the business portion of Unlimited Savings Allowance (USA) Tax is a subtraction method value-added tax, we have based our analysis on the provisions of that tax, as set forth in S. 722, introduced by Senators Domenici (R-NM) and Nunn (D-GA).

[10] Under the consumption taxes imposed by Canada, Japan, Germany, the United Kingdom, France, Italy and most other industrial countries, royalties received from abroad for technology developed within their borders are not subject to tax.

[11] Even if the National Sales Tax did not follow a destination principle, it is assumed that exports of intangibles would not be subject to tax because the proposal does not subject any intangible property to tax.

[12] Grubert and Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal*, Vol. XLVIII No. 4, December 1995, p. 620.

Many economists recognize that avoiding double taxation on export transactions and utilizing tax policy to promote export activities is necessary to maintain a level playing field for domestic producers trying to compete in foreign markets, thus promoting growth and free trade. Our current income tax system recognizes this need through the foreign sales corporation (FSC) rules, which exempt approximately 15% of export sales income from U.S. tax. Clearly, a system that exempts 100% of export sales income from U.S. tax will play a far greater role in assisting U.S. exports to compete with products made by foreign trading partners that have more beneficial systems for taxing exports. Economists state that a destination principle consumption tax will minimize price distortions facing producers.[13] They stress that it is important to minimize these distortions so that producers do not relocate their production.

One of the proposed purposes of reforming our current tax system is the elimination of the complexity that plagues the current income tax. Our current international tax structure, with its complicated rules for determining the amount of foreign tax credits that may be utilized, is one of the most complicated parts of the current system. One particular aspect of this complication that would be eliminated with a destination-based system is the establishment of an "arm's-length price." Of all transfer pricing issues, nothing is more difficult than establishing the price for the transfer of intangible assets. In recent years, some of the largest and most complex cases involving taxes have involved setting the correct royalty rate for transactions between related parties. Currently, taxpayers must devote significant resources to establishing arm's-length royalties charged to related parties for the right to use intangibles. This complexity would continue under any tax that continued to tax royalties from abroad. Under the destination based system, the exclusion of royalties from abroad would eliminate dozens of pages of tax regulations and tens of millions of dollars in compliance costs incurred by the private sector as well as the government.

3. Treaties

Another area that remains unresolved is the impact of the three tax reform proposals on the current system of U.S. income tax treaties. Because these taxes may be characterized as consumption taxes, there is an issue as to whether or not the existing income tax treaties will remain in effect if these proposals are enacted. If these treaties no longer apply, U.S. companies doing business overseas may be severely harmed. The Coalition urges Treasury to use all efforts to preserve the treaty system that is currently in place.

4. Other Issues Affecting Development of Intangibles in the United States for Use Overseas

As stated previously, the exemption of foreign source royalties from U.S. tax could cause multinationals to shift development of R&D and other intangibles to the United States. However, limiting the deduction for employee compensation, as would be the case under the USA Tax, would create a conflicting disincentive to locate development activities in the United States. Activities involved in the development of these intangibles are very labor intensive and higher levels of wages are generally associated with these activities. Because wages above the FICA limit are generally provided for many of these functions, the net effect of denying a deduction for these labor costs will be to encourage firms to perform these activities outside the United States.

None of the tax reform plans provide for an R&D credit. As stated previously, the R&D credit has provided an incentive to perform research activities in the United States. If the credit is eliminated under fundamental tax reform, it is important to assure that other aspects of the new tax system encourage the development of technology in the United States, rather than overseas. Maintaining our base of innovation and technology is vital in maintaining our position as a world economic leader in the 21st century.

Conclusion

Proposals for tax reform should exclude foreign source royalties from the U.S. tax base. Because these royalties are already subject to tax in the country of the payor, U.S. tax would constitute double taxation in the absence of foreign tax credits. Burdensome taxation of foreign source royalties would hamper U.S. economic growth and competitiveness; in particular, the expansion of employment in high wage industries would suffer and these jobs could be moved overseas. Including foreign royalties in the U.S. tax base would retain much of the complexity under current law. Finally, if tax reform proposals are considered consumption taxes, international norms clearly dictate exemption of foreign source royalties from tax.

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[13] Hufbauer and Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*. Institute for International Economics (1996), pg. 24.

Mr. HOUGHTON. Thank you very much, Mr. Rogers.
Mr. Cox, do you have any testimony?
Mr. COX. No, Mr. Chairman, I do not.
Mr. HOUGHTON. OK.
Ernie.
Mr. CHRISTIAN. I am with Mr. Barone. Mr. Barone is next.
Mr. HOUGHTON. All right, good.
Mr. Barone.

STATEMENT OF SALVATORE V. BARONE, PRESIDENT, HARPER SURFACE FINISHING SYSTEMS, INC., MERIDEN, CONNECTICUT; AND CHAIRMAN, INTERNATIONAL TRADE COMMITTEE, ASSOCIATION FOR MANUFACTURING TECHNOLOGY; ACCOMPANIED BY ERNEST S. CHRISTIAN, ESQ., OUTSIDE TAX COUNSEL, ASSOCIATION FOR MANUFACTURING TECHNOLOGY

Mr. BARONE. Thank you, Mr. Chairman. I am Salvatore V. Barone. AMT, the Association for Manufacturing Technology, is a trade association of over 350 machine tool building firms throughout the United States. Most are small businesses like mine. I am accompanied by Ernie Christian who is the special outside tax counsel to AMT and is available to the Committee in helping me answer detailed tax questions.

America urgently needs the tax system rebuilt from the ground up, around a new set of design principles to compete and win in world markets.

AMT believes that America can and must compete and win in world trade. About 35 percent of the output of my industry is exported. We have 13 percent of the world market, but should have more, and 50 percent of the machine tools used in the United States are of foreign origin. How much greater would our market share be if America's tax system were not tilted against us? That is hard to say, but we and our industry's 53,000 employees would like the chance to find out.

We have evaluated three leading alternative tax systems under an International Competitiveness Index based, in part, on the following factors: Number one, expensing of business capital investment in the United States; number two, a territorial rule whereby the tax only applies in the United States, thereby allowing U.S. companies to directly compete in foreign markets on a level tax playingfield with their local competitors abroad; number three, complementary export and import adjustments; and number four, tax simplicity. The complete index and its results appear in our written testimony.

The business level portion of the USA tax by Senators Domenici and Nunn scores 100 percent on the index. It resembles a simplified version of the present corporate income tax, with expensing of capital equipment and appropriate international adjustments engrafted into it.

Because exports to foreign markets of American-made goods are not taxed, there is no tax advantage in manufacturing abroad for sale abroad. The reason for direct investment abroad is primarily to penetrate foreign markets and to establish a beachhead for exports.

A study by the Institute for International Economics provides strong statistical evidence that direct participation by U.S. companies in foreign markets enhances U.S. exports and U.S. jobs.

On the other hand, because the USA tax taxes imports, there is no U.S. tax advantage for a company to manufacturer abroad for the purpose of selling back into the U.S. market. There will be no runaway plants.

This simple business tax framework assures that foreign companies who compete in U.S. markets pay their appropriate fair share of the tax burden in this country. It is also consistent with international treaty agreements. Border tax adjustments for exports and imports are not the exclusive province of a VAT. According to a new study by Dr. Gary Hufbauer, border tax adjustments can also be included within other tax structures, such as the USA tax, which are more reflective of the American experience.

The business level portion of the flat tax scores very low on the International Competitive Index largely because it taxes exports of American-made products, while imposing no tax on foreign-made products.

The third alternative we have evaluated is the general concept of replacing the Federal income tax with a retail sales tax. Leaving aside all other considerations which may bear upon this alternative, a retail sales tax would rank very high, close to 100 percent, from an international competitiveness perspective. Even if the economic incidence or burden of the retail sales tax is in significant part borne by business, and ultimately by their employees and owners, a retail sales tax is implicitly border adjusted for exports and imports and is implicitly territorial.

In conclusion, Mr. Chairman, we at AMT strongly urge this Committee and Congress to make enactment of an internationally competitive tax system a matter of the highest national priority.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF SALVATORE V. BARONE, PRESIDENT
HARPER SURFACE FINISHING SYSTEMS, INC.
ASSOCIATION FOR MANUFACTURING TECHNOLOGY
ACCOMPANIED BY ERNEST S. CHRISTIAN, ESQ.
OUTSIDE TAX COUNSEL
ASSOCIATION FOR MANUFACTURING TECHNOLOGY

Re: The Impact on International Competitiveness of Replacing the Federal Income Tax

I. Introduction

I am Salvatore V. Barone, President of Harper Surface Finishing Systems, Inc., Meriden, Connecticut, and I am testifying today on behalf of AMT -- The Association For Manufacturing Technology, whose International Trade Committee I am honored to chair. AMT is a trade association whose membership includes over 350 machine tool building firms with locations throughout the United States. America's machine tool industry builds and provides to a wide range of industries the tools of manufacturing technology including cutting, grinding, forming and assembly machines, as well as inspection and measuring machines, and automated manufacturing systems. The majority of the association's members are small businesses.

Today's topic -- international competitiveness -- embodies the essence of your Committee's continuing series of hearings on fundamental tax restructuring: the need to concentrate on creating a new tax system that will serve the long-term national interest in a global economy.

America urgently needs a tax system rebuilt from the ground up around a new set of design principles to compete and win in world markets. That is fact one. Fact two is also obvious: the present federal income tax in the Internal Revenue Code of 1986 is almost exactly the opposite of what is needed to serve the best interests of the United States. Had one set out by design to create a tax system that works against us (and, therefore, in favor of our foreign competitors), it is hard to imagine a more successful job than the present federal income tax. It discourages saving and productive capital investment in the United States; it favors imports over exports; it makes it hard for U.S. companies to directly compete in foreign markets; and, if they do, it discourages them from bringing the money home for reinvestment in the United States.

At the very time that successful competition in world trade has become increasingly important to national well-being, we are plagued by persistent trade deficits. We have become a debtor nation, dependent on borrowing from abroad. Productivity has lagged; real wage growth has been slow; annual economic growth rates have been less than satisfactory; and federal budget deficits have continued to mount. Given the seemingly intractable nature of these failings, some people have characterized the 1990s and beyond as an "age of diminished expectations" for America. From an international perspective, some pessimists may mistakenly view world trade as exporting more U.S. jobs than American-made products.

We at the AMT do not share this pessimistic view about the future. We believe that American industry can compete and win and that successful competition in world trade is the key to the kind of enhanced economic growth on which a more secure and prosperous America depends. We say this from the perspective of the industry which produces the machinery and new manufacturing technologies used by other businesses to produce products sold here and around the world. We are at the heart of the productive process -- putting more and better factory-floor technology in the hands of American workers. We are also substantial exporters ourselves. About 35% of the output of our industry is exported. In total, we employ 53,300 people and most of these jobs are good paying manufacturing jobs using the best and newest technologies. My own company is one of the smaller members of the industry, but we employ approximately 50 people and, to date, more than 68,000 of our modern surface finishing systems have been installed worldwide. In recent years, 15 to 20% of our sales have been exports. Thus,

we are strong believers in export trade and in the benefits to America that derive from an ever-increasing flow of "American-made" goods into global markets.

We also believe that American businesses and their employees should be able to compete on a level playing field; most particularly that the tax system of the United States should not be biased against our own best interests in the global marketplace. American-made machine tools comprise only 13% of the world supply. Worse, about 50% of the machine tools used in the United States are of foreign origin. How much greater would our share of domestic and foreign markets be if the American tax system were not biased against us? It is hard to say. The same is true of American industry in general. Taxes are not the only factor as we all attempt to compete at home and abroad against foreign competitors. But we and our employees would like to have the opportunity to compete on a level tax playing field and we believe it is a matter of urgent national policy that we and they be given the chance.

It would be one thing if the anti-investment, anti-export biases in the Internal Revenue Code of 1986 were necessary -- if there were no alternative. But that is not the case. There are alternative tax systems which are not only far more congenial to successful international competition but also more fair, efficient and consistent with the best interests of the United States and the American people. We hear much about "tax fairness", but there is certainly nothing fair about a tax system, such as the present federal income tax, which impedes economic growth, costs jobs and lowers living standards.

For the most part, the pro-job, pro-growth alternative tax systems are well-known and well-developed in substantial detail. The principal ones are identified in the notice of your Committee's hearings. We applaud the Chairman and the Committee for putting the international focus on the leading alternative tax systems and we welcome the opportunity to comment on them. This Committee, this Congress, and the next, have an historic opportunity to fundamentally restructure the American tax system for the better. Just as it is vital that we not lose that opportunity, it is equally vital that we not lose sight of the world trade aspects amidst the many other concerns that bear upon taking such a monumental step.

Focusing on international trade necessarily puts a heavy emphasis on taxes paid by businesses, but, in doing so, we do not mean to diminish the importance of the way individuals are taxed under any new alternative tax system. Successful international competition depends on a higher level of personal saving and investment in the United States. Therefore, from every perspective, fundamental tax reform must begin with removing the present strong bias against saving. Individuals should either be allowed to deduct the amount they save (and later pay tax when they withdraw their deferred income from the national savings pool) or, if they are allowed no deduction, the earnings on their savings should be excluded from tax. So long as the present bias against personal saving exists, no matter how good the new international tax rules may be, the U.S. economy will not be able to compete at its full potential in the global market. Similarly, to the extent that corporations and other businesses are taxed separately from individuals, businesses should be allowed to expense capital equipment purchases. Fortunately, the present law penalty on personal saving and business capital investment is so indefensible that its elimination is now almost synonymous with fundamental tax restructuring. In one way or another, elimination of the bias against saving and investment is embodied in all the leading alternative tax proposals we have evaluated. In that respect, AMT endorses them all.

Before going on to evaluate and compare the strictly international tax rules of the leading alternatives --- most notably as related to exports, imports and taxation of foreign-source income -- AMT would like also to share with the Committee a few overall perspectives which we believe are highly relevant to choosing between the various alternatives. First, any new tax system should be considered as a whole -- the individual portion and the business portion must be considered together. In short, it must truly be a tax "system" that is internally consistent and that actually works. Indiscriminate cherry-picking of particular aspects of different proposals -- no matter how appealing they may seem in isolation -- could produce a monstrosity similar to present law. Second, the new tax system for America's future must be enactable as a whole. Not only must it be fair, it must be perceived as fair by the American people.

Further, we believe that the new tax system should truly be an "American" tax system. International comparisons are often relevant, particularly when illustrating the relative disadvantages presently imposed by the Internal Revenue Code of 1986, but the basic elements of the new tax system should be chosen on their own merits, without regard to what other countries may or may not do. For example, there is an independent rationale, well-grounded in tax policy and economics, for allowing a deduction for personal saving and business capital investment. Cross-border adjustments for exports and imports in combination with a territorial rule that excludes foreign-source income provide a logical and meritorious framework that stands on its own. The presence or absence of similar rules, in varying degrees, in other countries' tax systems is not the reason for their adoption here. Similarly, the fact that a new American tax system may have some elements in common with a foreign tax system does not mean that we are adopting that foreign tax system per se. Quite to the contrary. For example, appropriate border tax adjustments for exports and imports are not the exclusive province of the European "VAT". They can directly or indirectly be incorporated into some tax structures which are more consistent with our American experience.[1]

There is no reason why the United States should be limited by the tax experiences of other countries. There is no reason why we should not have a better tax system than anyone else -- one that is fairer, simpler, more efficient and, above all, in the long-term best interests of the United States in a global economy. You on this Committee have an historic opportunity and you should take advantage of it.

II. International Competitiveness Index

AMT has evaluated three leading alternative tax systems against a common set of criteria directly and indirectly related to international competitiveness. The criteria include all of those specified by the Chairman of this Committee in a public announcement in 1995, as well as several others. We fully endorse the Chairman's list of criteria for fundamental tax reform and agree with its emphasis on simplification and on international competitiveness. The alternative tax systems we have evaluated are: the business-level USA Tax (the Unlimited Savings Allowance System in S. 722 by Senators Pete V. Domenici and Sam Nunn); the business-level Flat Tax (in general, H.R. 2060 by House Majority Leader Armey); and the general idea of a retail sales tax.

In the cases of the USA Tax and the Flat Tax, the results of AMT's Competitiveness Index evaluations are set forth below in comparison to the present corporate income tax. Because the retail sales tax does not fit readily in this index format without further explanation, the retail sales tax is evaluated separately in connection with a later general discussion of that subject.

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[1] See Gary C. Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments* (Washington, D.C.: Institute For International Economics, 1996).

INTERNATIONAL COMPETITIVENESS INDEX

	USA Tax	Flat Tax	Present Corporate Income Tax
Expenses Capital Equipment Cost in U.S.	Yes (+1)	Yes (+1)	No (-1)
Excludes from Tax All Exports of American-Made Products	Yes (+1)	No (-1)	No (-1)
Taxes Imports of Foreign-Made Products	Yes (+1)	No (-1)	No (-1)
Is Territorial (i.e., applies only in U.S.)	Yes (+1)	Yes (+1)	No (-1)
Foreign Royalty Income Is Excluded Export Receipt	Yes (+1)	No (-1)	No (-1)
Is Neutral as Between Labor and Capital	Yes (+1)	No (-1)[2]	No (-1)
Allows Credit for Employer-Paid Payroll Tax	Yes (+1)	No (-1)	No (-1)
Solves Transfer-Pricing Problem	Yes (+1)	No (-1)	No (-1)
Is Revenue-Neutral (No overall increase/decrease in business taxes)	Yes (+1)	No (-1)	Yes (+1)
Is Simple and Efficient	Yes (+1)	Yes (+1)	No (-1)
NET SCORE (Max. 10)	**+10**	**-4**	**-8**

A. Discussion of Competitiveness Criteria in the Context of the USA Tax

Because it satisfies all the criteria within a simple and understandable framework, the USA business-level tax provides an excellent illustration of how a low-rate business tax which allows expensing of capital equipment in the U.S. can be combined with border-tax adjustments and "territoriality" to produce an essentially ideal result: a neutral, evenhanded tax that treats all businesses alike (whether corporate or noncorporate, capital intensive or labor intensive, financed by equity or by debt, large or small) and which is neither tilted for or against us when we compete in foreign markets nor for or against foreign companies when they compete in our markets.

The USA business tax is ultimate simplicity. To calculate its tax for the year, a business (1) adds up the amount of its revenues for the year from sales of products and services in the United States, (2) subtracts the amount of its deductible input costs for the year, (3) multiplies the resulting "gross profit" by the 11% tax rate, and (4) takes a credit for the 7.65% employer-paid FICA tax imposed by present law on its payroll. The payroll tax credit is a unique feature of the USA Tax and is in lieu of any deduction for wages paid to employees. Like the Treasury's Comprehensive Business Income Tax proposal in 1992, and like other proposals designed to

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[2] At the business level, it is not neutral, but tends to be neutral when combined with the individual tax, except for the absence of a payroll tax credit. In this latter respect, returns to labor are taxed more heavily than returns to capital.

eliminate the bias against equity financing, no deduction is allowed for interest.

From a world trade perspective, the highly salutary and complementary relationships between border tax adjustments and territoriality can best be illustrated by applying the USA Tax in a series of fairly typical situations.

(1) TexCorp wishes to compete in the widget market in foreign Country A either by manufacturing widgets in Country A for sale in Country A or by manufacturing widgets in the U.S. and exporting them to Country A. Because the USA Tax is "territorial", it does not apply to TexCorp's direct manufacturing and sales operations outside the U.S. Therefore, like the local widget manufacturers in Country A, TexCorp only pays the Country A tax and can compete with these foreign companies on a level tax playing field. Similarly, because exports are excluded from U.S. tax, TexCorp would only pay the Country A tax if it manufactured widgets in the U.S. and exported them into the Country A market. The U.S. tax effect is the same in both cases. What actually happens, as is fairly typical, is that TexCorp starts off by manufacturing directly in Country A in order to penetrate the market and then follows up with exports of American-made components and related product lines. In other cases, also not unusual, TexCorp might start off with exports to Country A and then follow up with some additional direct investments and operations in Country A in order to expand its export sales of American-made products in Country A. Thus, there is a complementary relationship between the export rule *and* the territorial rule. (If the tax were territorial, but exports were not excluded from tax, TexCorp would be tax-advantaged by manufacturing abroad to sell abroad.) It is also important to note that because the tax is territorial, TexCorp can bring home its profits from Country A and reinvest them in the U.S. tax-free; the same as it can reinvest its export profits in the U.S. tax-free.

(2) TexCorp also has a new technology related to widgets which, after developing a foreign market for widgets, it wishes to license to others for use in Countries B and C. In other words, TexCorp wants to export the fruits of some American ingenuity which is also a valuable product. Because of the export rule, the foreign royalty income under the license agreement is correctly excluded from tax.

(3) NewCorp wishes to sell widgets in the U.S. market. It can either manufacture the widgets abroad in Country X and ship them back into the U.S. or it can build a new plant in New England near its headquarters and manufacture the widgets there. Because of the 11% import tax under the USA Tax, there is no tax advantage for NewCorp if it manufactures abroad instead of in New England. If NewCorp manufactures a $100 widget abroad and sells it back into the U.S., an $11 import tax is paid. This is the same rate of tax NewCorp would pay it if manufactured the widget in New England. (Under a territorial rule *without* a complementary import tax, there might be "runaway" plants, but with the import tax there will be none. Thus, the synergistic combination of territoriality, an export exclusion, and an import tax provides the U.S. with all the advantages of territoriality without the disadvantages.)

(4) ForCorp, a foreign corporation headquartered in Country Y, wishes to sell widgets in the U.S. market. It could remain offshore, manufacture the widgets in Country Y and distribute them in the U.S. through a sales subsidiary or it could build a plant in Kentucky and both manufacture and sell in the U.S. Because of the 11% import tax, there is no tax advantage to ForCorp in remaining offshore.

(5) In a variation of Situation (4), ForCorp wishes to sell widgets all around the world; not just in the U.S. market. Because the USA Tax rate is only 11% and because U.S. production costs such as capital investment in the U.S. for new plants are deductible, and because of the export exclusion, the U.S. would be a very attractive place for ForCorp to locate its plant.

Not only does the combination of territoriality, an export exclusion, and an import tax produce consistent procedural or mechanical results in the tax calculation, the combination also

produces important results as a matter of economic substance: income and job creation.

A good example is the combination of territoriality and the export exclusion. A recent study by Edward Graham at the Institute for International Economics will soon be published by the Oxford University Press.[3] It shows an extraordinarily high degree of statistical correlation between the amount of direct investment by U.S. companies in a foreign country (as in Situation (1) above) and the amount of U.S. exports to that foreign country. In other words, the more U.S. companies penetrate foreign markets and gain market share by direct "on-the-ground" operations in a foreign country, the greater the amount of exports of American-made products to that country. Thus, U.S. foreign direct investment abroad is good for U.S. exports and good for U.S. jobs. The combination of territoriality, an export exclusion, and an import tax facilitates this synergistic result.

B. The Flat Tax and the Competitiveness Index

The business portion of the classic Flat Tax (H.R. 2060) does allow expensing and is territorial, and both of these characteristics are positives. But, overall, the Flat Tax does not score well under AMT's International Competitiveness Index. There are many reasons for this deficiency, as indicated in the brief presentation of the Index itself, but the most significant reasons appear to be the absence of an import tax and the absence of an export exclusion.

Without belaboring the point, a few examples may suffice. In prior Situation (1) where TexCorp had the choice to manufacture in the U.S. for export abroad or to manufacture abroad for sale abroad, under the Flat Tax it would be to TexCorp's advantage to manufacture abroad insofar as U.S. taxes are concerned. This is because the Flat Tax taxes U.S. exports. Similarly, in prior Situation (2), because the Flat Tax taxes U.S. exports, foreign royalties from licensing U.S. know-how and technology would be taxed. TexCorp might be better advised to develop the technology abroad instead of developing it here and licensing the use abroad. In Situations (3), (4) and (5), because the Flat Tax does not tax foreign imports, it would have been to the advantage of NewCorp or ForCorp to manufacture abroad for sale into the U.S.

C. General Discussion of Sales Tax Option

Setting aside all other considerations and assuming that a retail sales tax replaced the federal income tax, the resulting tax system would score very high on AMT's International Competitiveness Index -- in the area of 90 to 100%.

A retail sales tax is *implicitly* border adjustable for imports and exports and is *implicitly* territorial. These implicit or indirect characteristics arise because a tax is paid only to the extent that a retail sale occurs in the United States.

Even if, as some economic analysis suggests, the economic burden of the retail sales tax is in significant part borne by businesses (and, ultimately, their owners and employees), there is an implicit export exclusion because no tax is ever paid with respect to a sale to a non-U.S. purchaser and no tax ever enters the system potentially to be passed back to the seller. Similarly, if a U.S. company is operating and selling abroad, there is never any U.S. retail sale and no U.S. tax ever enters the chain of price-tax-volume relationships between seller and purchaser. Thus, a retail sales tax is implicitly territorial.

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[3] Edward M. Graham, *On the Relationships Among Direct Investment and International Trade in the Manufacturing Sector: Empirical Results for the United States and Japan.* Institute for International Economics, 1996. To appear in Dennis Encarnation, editor, Does Ownership Matter: Japanese Multinationals in East Asia (London: Oxford University Press, forthcoming).

On the import side, if either a U.S. company or a foreign company manufactures a product abroad which directly or indirectly finally shows up as a retail sale in the U.S., a tax liability arises. Thus, in this indirect sense, there is an implicit import tax, i.e., the retail sales tax is the same whether the product sold in the U.S. is of domestic or foreign origin.

III. Conclusion and Recommendations

AMT believes that any new tax system for America's future should be territorial, should include complementary export and import adjustments, and should relieve the bias against personal saving and business capital investment. The new tax system should also be simple.

Based on our analysis using the International Competitiveness Index, it appears that there are two fundamentally different ways of doing this. One is the USA Tax (which resembles a very simplified version of a corporate income tax with expensing and appropriate international adjustments engrafted on to it). The other is the general idea of replacing the entire federal income tax with a retail sales tax.

While the USA Tax and the retail sales tax are far apart and greatly different in many other respects, either one would have a beneficial impact on international competitiveness.

Mr. HOUGHTON. Thank you very much, sir.
Mr. Kostenbauder.

STATEMENT OF DAN KOSTENBAUDER, GENERAL TAX COUNSEL, HEWLETT-PACKARD CO., PALO ALTO, CALIFORNIA; ON BEHALF OF HIGH-TECHNOLOGY TAX RESTRUCTURING GROUP

Mr. KOSTENBAUDER. Thank you. My name is Dan Kostenbauder. I am general tax counsel for the Hewlett-Packard Co. in Palo Alto, and I am appearing and appreciate the opportunity to testify today on behalf of the High-Technology Tax Restructuring Group. This is an ad hoc group of companies that have a leadership position in the development of cutting-edge American technologies. Characteristic of the group is a very large and high level of investment in research and development.

We are not taking an overall position on any of the bills that are being considered by the Committee and Congress, but the purpose of our testimony today is to really highlight the fact that a couple of the major proposals could actually have the impact of putting a greater burden on research and development activities and the utilization of technology, and we want to stress this point and make sure it is given due consideration as these various proposals are developed.

Just as a way of background, the U.S. investment in technology has been growing fairly sharply in recent years. In 1980, total public and private R&D by the U.S. companies and government was $63 billion, and that increased to $173 billion in 1994. The preponderance of that growth was due to investment in the private sector, and the importance of R&D is it increases U.S. productivity and leads to better jobs and higher levels of economic activity.

It also is very critical in our success in global marketplaces. If we are competing just on the level of low wages, we are going to be in bad shape.

Mr. HOUGHTON. Could I interrupt you 1 minute?

Mr. KOSTENBAUDER. Sure.

Mr. HOUGHTON. What portion of that is our——

Mr. KOSTENBAUDER. Research—I quite honestly can't tell you.

Mr. HOUGHTON. All right. Thank you very much, sir.

Mr. KOSTENBAUDER. I can certainly try to find that.

So, in any event, there is a clear link between the investment and the expenditure in research and development activity and the competitiveness of U.S. companies and also our standard of living here in the United States.

A couple of general points about the tax treatment of R&D, it is important and our society tends to underinvest in research and development without further incentives. The reason for this is the benefits to society of things like the development of a polio vaccine or better communication systems. It is really a benefit that in time permeates the whole economy, the whole society, and the inventors and the developers of those technologies have certain patent protection for a certain number of years and have a certain ability to garner for themselves a reward for their efforts. They will be compensated, but society achieves a greater benefit than the individ-

uals performing the activity of research and development and so forth.

So it is very critical that to enhance the overall welfare of society that incentives be available for research and research-type activity.

Another thing that needs to be considered in the broader context is that a number of other countries certainly believe this, and they have established and have as part of their Tax Codes efforts to incentive research and development types of activities.

I would like to highlight just a couple of the major factors that are aspects of our current system, as well as the main proposed systems, and the impacts of those provisions on the aftertax cost of conducting research and development.

Certainly, under current law in the United States, although it is subject to the expiring provision status, we have had in the Code for a number of years a research and development tax credit. Clearly, that supports R&D. We have also had the section 174 expensing for research and development, which is also favorable, and beyond that, we have coupled with the way that our foreign tax credit mechanism works and the U.S. tax treaty that have been negotiated with foreign countries a generally low rate of foreign tax on royalties and other results of the income that derives from activity conducted in the United States in terms of developing intellectual property. So that tends to reduce the level of foreign tax on those types of activities.

Under both the USA tax or the flat tax, however, there is no R&D credit, and they definitely have less favorable treatment of labor cost, where there is no deduction for compensation under the USA tax and then there is no deduction at all for fringe benefits for payroll taxes under the Armey flat tax.

Also, the treatment of export income changes under both of these provisions. The USA tax would not tax exports of goods and services and would treat foreign-source royalty income as an export for that purpose. So that would be favorable.

The understanding that we have of the Armey flat tax, however, is that foreign royalties would be taxable in the United States. Again, the example we have attached to the testimony works through with some reasonable levels of assumptions, and for most companies under either system, the fundamental conclusion is that the aftertax cost of conducting R&D in the United States, as we understand those provisions today, would be higher than they are under the current tax system. So that is a very important concept, and we want to again go back and emphasize the importance of this. It translates into potentially lower levels of research and development.

Professor Brownwyn Hall has done recent research that indicates the amount of R&D undertaken is sensitive to the aftertax cost of R&D, and a consequence of the adoption of those proposals under the USA tax, it could reduce private sector R&D by up to 6 percent, and the flat tax could reduce private sector R&D by something in the range of 4 to 12 percent.

I will stop here. I see my time is up, but I think we have stressed the point.

[The prepared statement and attachment follow:]

STATEMENT OF DAN KOSTENBAUDER
GENERAL TAX COUNSEL
HEWLETT-PACKARD CO.
ON BEHALF OF HIGH-TECHNOLOGY RESTRUCTURING GROUP

Introduction

The High-Technology Tax Restructuring Group appreciates the opportunity to testify at today's hearing on international issues arising from proposals to replace the federal income tax system.

The High-Technology Tax Restructuring Group is comprised of companies that have taken a leadership position in developing cutting-edge American technologies. Member companies include Eastman Kodak, Hewlett-Packard Co., IBM, Intel Corp., Intergraph Corp., Microsoft, 3M, Motorola, Oracle, Sybase, Inc., Texas Instruments, and Xerox. While we operate in different industries, we have in common high levels of investment in U.S. research and development activities that help America compete in worldwide markets. Price Waterhouse LLP serves as technical adviser to our group.

In our testimony, we review the relationship between R&D and economic growth, the case for increasing the level of private sector R&D expenditures above what would occur under a neutral tax system, and the potential effects of tax restructuring proposals on domestic R&E activities. Our testimony does not take a position in support of or in opposition to any of the specific tax restructuring proposals that have been advanced to date. Rather, our purpose is to highlight that these tax restructuring proposals, as currently drafted, may increase the tax burden on the development and utilization of technology by U.S. companies.

R&D and Technology are Vitally Important to the U.S. Economy

U.S. investment in technology has grown sharply in recent years. Total spending on R&D in the United States has increased from $63 billion in 1980 to $173 billion in 1994.[1] R&D spending in 1994 accounted for about 2.6 percent of the nation's gross domestic product (GDP).

The private sector has been the main engine behind this growth. In 1980, private industry and the federal government each contributed about $30 billion in spending on R&D.[2] By 1994, the private sector's R&D spending had risen to more than $102 billion, far surpassing the federal government's $62 billion. Private industry's share of national R&D investment has increased from about 40 percent in 1970 to about 60 percent in 1994. Because the private sector is the main source of R&D funding in the United States, the tax treatment of income and expenditures significantly affects national levels of research.

Investment in R&D by the private sector translates into higher U.S. productivity and higher U.S. living standards. Technology allows us to produce "more with less," which is the essence of increasing productivity in the economy. A recent report by the Office of Technology Assessment that accounts for the effects of technology throughout the economy attributes at least half of all economic growth in the United States to advances in technology.[3] Thus, it is unlikely that one of the main goals of tax restructuring advocates -- to increase the national rate of economic growth -- can be achieved if the effect of tax reform

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[1]See "National Patterns of R&D Resources: 1994," National Science Foundation, at 56.

[2]See National Science Foundation, *supra*, at 56.

[3]See "The Effectiveness of Research and Experimentation Tax Credits," Office of Technology Assessment, 1995 at 2.

is to increase the tax burden on technology and thus reduce private sector R&D spending in the United States.

R&D is likely to be an even more important factor in future economic growth. Non-defense R&D expenditures as a percentage of GDP have grown steadily since 1980 for the United States and also for most our major trading partners.[4]

High-quality U.S. jobs also hinge on R&D and technological advances. Companies that invest heavily in R&D tend to have high employment growth rates, and to employ high-skilled workers at high wage rates. Technological advances also translate into higher-paying jobs in other sectors of the economy.

Technology is also a key to U.S. trade competitiveness. Investment in R&D also play a greater role in determining who will succeed in global markets. The United States is now the world's largest exporter in technology trade, measured royalty and license fees flowing into the United States for use of intellectual property. In 1994, the United States earned $22.4 billion on inflows of royalties and license fees from abroad.[5] The United States exports four times the amount it imports in technology trade, and is the only major country to have a large positive balance. Japan and Germany barely break even in technology trade.[6]

The Marketplace Does Not Fully Reward Private R&D Activities

In a market economy, companies tend to under-invest in R&D activities because they generally are not able to retain all the benefits of these activities. Patents and other intellectual property rights allow companies to capture only a portion of the benefits accruing from their R&D activities. Other companies subsequently are able to produce more efficiently by applying advances made by the technological research of other firms. For example, a broad range of manufacturing industries have used advances in computer hardware and software to help streamline production processes. The general public also benefits as higher-quality products become available at lower prices.

Because of these "spillover" effects, the total return for a particular R&D activity (taking into account benefits accruing to other companies and the general public) often is higher than for the company that initially undertakes the research. The total rate of return on R&D investment to society has been estimated at about 50 percent by the Office of Technology Assessment, while the average private rate of return is much lower -- about 20 to 30 percent.[7]

A key issue for the U.S. government is how to address the failure of a market economy to generate a socially optimal level of R&D investment. One option is to fund R&D through direct federal spending programs. A consensus has emerged, however, that private business generally does a better job of finding opportunities for technological advances than

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[4]See National Science Foundation, *supra*, at 77.

[5]See Dept. of Commerce, Survey of Current Business, June 1995, at 85.

[6]See "Multinationals and the Technology Base," Office of Technology Assessment, Sept. 1994, at 91.

[7]See Office of Technology Assessment, *Supra Note 3*, at 3-4.

government agencies. While the typical return to corporate R&D may range from 20 percent to 30 percent, the return from direct federal R&D spending is often as low as 5 percent.[8]

Alternatively, the government can seek to promote technological advances through the tax system. This generally involves far lower administrative and overhead costs for the federal government than direct spending programs.

The Current U.S. Tax System Recognizes the Importance of Encouraging R&D and Technology

The U.S. income tax since 1981 has provided an explicit incentive to boost the level of R&D above what otherwise would occur in the marketplace. Prior to its expiration July 1, 1995, the research and experimentation (R&E) tax credit under section 41 provided a 20-percent credit for the amount by which a taxpayer's qualified research expenditures -- generally comprised of wages and supplies -- for a taxable year exceeded a base amount.[9] The legislative history to the 1981 Act states that the credit was intended to stimulate R&D investment, and Congress has acknowledged its continuing importance by extending the credit six times since its inception.

Qualified R&E expenditures eligible for the section 41 credit generally may be deducted under section 174.[10] Section 174 was enacted in 1954 as a means of encouraging investment in research and reducing uncertainty over whether research expenses should be deducted currently or capitalized.

The tax systems of our leading trading partners also recognize the importance of encouraging R&D activities. Canada, France, Japan, and other countries provide an R&D tax credit. Canada's tax credit is one of the most favorable, with a 20-percent rate on all -- not just incremental -- qualified expenditures. Our trading partners also allow immediate deductions for general research expenses, and many provide for accelerated depreciation schedules for certain capital expenditures related to R&D activities.

A tax system's impact on R&D is not limited to its treatment of costs relating to the *development* of new technologies. The treatment of the *utilization* of those technologies also plays a major role in taxpayer decisions relating to R&D activities. For many high-technology companies, a key issue is how U.S. international tax rules treat income derived from exploiting the use of an intangible overseas.

In this regard, the U.S. tax system begins with the general rule that tax is imposed on a "worldwide" basis --i.e., U.S. businesses are taxed on all of their income, both U.S. and

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[8]See Office of Technology Assessment, *Supra Note 3*, at 3-4.

[9]The section 41 research tax credit expired after June 30, 1995. The High Technology Tax Restructuring Study Group supports current proposals to reinstate the research credit and allow an elective "alternative incremental research credit."

[10]Deductions allowed under section 174 are reduced by an amount equal to 100 percent of the taxpayer's research credit. In lieu of reducing section 174 deductions, taxpayers may elect to claim a reduced credit.

foreign source. Thus, income received from the sale or license of intangible assets is taxable whether from domestic of foreign sources.

Royalties received for the use of intangible assets outside of the United States generally are considered territorially to be foreign source income for purposes of the foreign tax credit. Under the so-called "look-thru" rules, foreign royalties generally are treated as "active" income with the result that low-tax foreign royalties and high-tax foreign dividends may be averaged for purposes of determining the foreign tax credit limitation. This allows increased utilization of foreign tax credits.

Withholding tax often is imposed by foreign governments on the gross amount of royalty payments. The current U.S. income tax treaty network generally serves to reduce withholding taxes on royalties to the extent possible. Withholding taxes generally are creditable for U.S. tax purposes.

Also of importance for many high-technology companies are the current-law rules requiring apportionment of domestic research expenses between U.S. and foreign source income. Domestic research expenses that are apportioned to foreign source income reduce the limitations applicable to utilization of foreign source credits. As a result, for every $100 of domestic research allocated to foreign-source income, foreign tax credits may be reduced by as much as $35 at the current 35-percent U.S. corporate tax rate. This loss in foreign tax credit is tantamount to treating the foreign-allocated portion of U.S. research expenses as nondeductible. Final section 861 R&E allocation regulations issued in December 1995 take a step toward mitigating this problem.

While the current U.S. tax system is far from perfect, some aspects of the corporate income tax, such as the recently expired research tax credit, recognize the importance of R&D and the development of U.S. technologies. U.S. international tax-law provisions contain both pro- and anti-competitive features.

Leading Tax Restructuring Proposals Would Change the Landscape

Leading proposals to restructure the U.S. tax system could have a significant impact on decisions relating to the development and utilization technologies. The "USA Tax" (S. 722) introduced by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM) and the "Flat Tax" (H.R. 2060) introduced by House Majority Leader Dick Armey (R-TX) have in common the replacement of the federal corporate income tax with a new business tax. These new business taxes in many respects would make a radical break with current law:

- **No incentive for R&D**: Neither the USA Tax nor the Flat Tax would retain the R&E tax credit. There is no explicit incentive for performing R&D activities in either bill.

  In drafting their USA Tax proposal, Senators Nunn and Domenici initially explored the question whether their proposed business tax could accommodate an R&E tax credit or some other type of incentive for research

activities.[11] It is unclear why the drafters of the USA Tax decided not to include a research credit in their bill. It is possible that the drafters were concerned that inclusion of a research credit could jeopardize the legality of border tax adjustments under the General Agreement on Tariffs and Trade (GATT). Unlike the USA Tax, however, the Armey Flat Tax does not have border adjustments; consequently, GATT considerations would not preclude inclusion of a research tax credit in a Flat Tax system.

- **Less favorable treatment for labor costs**: Both the USA Tax and the Flat Tax would provide less favorable treatment of labor expenses than the current-law income tax. In this regard, both proposals would tend to increase the cost of R&D activities.

  Under the USA Tax, businesses would not be allowed to deduct compensation of research scientists, engineers, and other employees, including salary and wage expense, pension contributions, and health and other fringe benefits. Moreover, businesses would not be allowed to deduct payroll taxes. However, employers would receive a tax credit for their share of payroll taxes.[12]

  The Flat Tax would allow a deduction for wages, salaries, and employer pension contributions, generally as under the present-law income tax. However, as under the USA Tax, there would be no deductions for payroll taxes or for health insurance and other fringe benefits provided to research scientists, engineers, and other employees.

- **Expensing for certain costs now capitalized**: Some aspects of tax restructuring proposals as they relate to R&D activities would be more favorable than current law. Both the USA Tax and the Flat Tax would allow current deductions for all business purchases. Thus, for example, amounts paid for laboratory facilities, equipment, and certain intangible assets in conjunction with R&D activities could be deducted currently rather than depreciated or amortized over a period of years.

- **Treatment of "exports"**: As described above, the USA Tax would not tax exports of goods and services. The USA Tax would treat foreign-source royalty income as an export for this purpose. Thus, a U.S. company that licensed a technology for use overseas would not include royalty income from the licensing arrangement in its taxable gross receipts.

  The Flat Tax would appear to provide less favorable treatment for foreign-source royalty income. While the statutory language of the Armey bill (H.R.

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[11] In a 10/21/94 letter to then-Treasury Secretary Lloyd Bentsen, Nunn and Domenici ask, "Would a business cash-flow tax as described which also includes an R&D tax credit similar to current code Section 41's research and development credit for wages paid for qualified research services qualify for border adjustment under GATT?"

[12] It is unclear whether the USA business tax's payroll tax credit is GATT-legal. See G. Hufbauer, Border Tax Adjustments and Fundamental Tax Reform, Institute for International Economics (1996), for a discussion of this issue.

2060) does not specifically address the treatment of royalties and license fees received from abroad, it is clear that export income as a general rule would be subject to tax. Like the current-law income tax, the Flat Tax would tax goods and services produced in the United States whether consumed domestically or abroad. Foreign withholding taxes levied on royalties and other income would not be deductible or creditable under the Flat Tax. Thus, U.S.-based R&D would be taxed at a higher level under the Flat Tax than today.

- **Impact on withholding taxes:** It is unclear whether the existing U.S. income tax treaty network would continue under the USA Tax or Flat Tax, both of which would repeal the corporate and individual income taxes. U.S. tax treaties in many cases currently serve to reduce withholding tax rates on cross-border payments for intangibles. It is possible that existing treaties -- and withholding rates -- might be jeopardized if the United States unilaterally were to eliminate its income tax system. This would raise the possibility of increasing foreign taxes by billions of dollars on the foreign operations of U.S. companies.

- **No allocation of R&E expenses**: Both the USA Tax and Flat Tax are territorial taxes. Under these systems, there would be no foreign tax credit and no allocation of R&E expenses between U.S. source and foreign source.

The Flat Tax and the USA Tax are not the only proposed models for a new tax system. The **"National Retail Sales Tax Act"** (H.R. 3039), introduced by Representatives Dan Schaefer (R-CO) and Billy Tauzin (R-LA) would replace the corporate and individual income taxes, as well as certain other federal taxes, with a retail sales tax similar to levies currently imposed in 45 States and the District of Columbia.[13] By contrast to the current income tax system, the Schaefer-Tauzin proposal contains no provisions designed to encourage R&D.

On the Whole, These Changes Could Increase the Cost of U.S.-Based R&D

The potential effects of the USA Tax and the Flat Tax can be illustrated by means of a simple example *(See Appendix)*. The example posits a U.S. multinational that spends $100 million on research in the United States, of which $42 million is qualified research expenses for purposes of the research credit.[14] Of the $100 million in total research expenses, $26 million is wages and salaries, $3.9 million is employee benefits, $2 million is payroll tax, $20 million is depreciation, and $48.11 million is for other expenses.[15]

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[13]Unlike State retail sales taxes, the Schaefer-Tauzin proposal would apply to services as well as goods.

[14]R&D reported on SEC Form 10-K by public corporations included in the COMPUSTAT database amounted to $102 billion for fiscal years ending in 1992. The IRS reports corporate taxpayers claimed $43.3 billion of qualified research expense (QRE) for tax years ending July 1, 1992, through June 30, 1993. The ratio of QRE to R&D, therefore, is estimated as 42 percent.

[15]The Office of Technology Assessment estimates that 62 percent of qualified research expense is allocable to compensation. See Office of Technology Assessment, *Supra Note 3*, at 19-20.

In 1992, the research tax credit amounted to 3.6 percent of qualified research expenses, so the hypothetical taxpayer in this example is assumed to be able to claim a research credit of $1.51 million (presuming that the research credit is extended).[16]

The taxpayer's R&D activities result in patents and other valuable intangible assets that produce U.S. income and foreign income. For purposes of this example, it is assumed that half of the income from the intangible assets is earned in the United States and the other half is attributable to foreign royalties. The taxpayer's foreign royalties are subject to an average withholding tax rate of 5 percent.[17] U.S. multinationals are required to allocate domestic research expense between U.S. and foreign sources for purposes of computing the foreign tax credit. For purposes of this example, the taxpayer allocates 25 percent of U.S. research expense to foreign sources.[18]

For simplicity, the example only includes items of income and expense directly related to R&D, and the taxpayer is assumed not to be subject to the alternative minimum tax.

Under present law, assuming extension of the expired R&D tax credit, the hypothetical taxpayer would need to earn $90.96 million to break even on $100 million of R&D if the taxpayer were in an excess foreign tax credit position, and would need to earn $98.49 million if in a deficit foreign tax credit position. The break-even return is less than the $100 million cost of R&D due to the research credit ($1.51 million) and, in the case of the excess foreign tax credit taxpayer, the utilization of foreign tax credits (in excess of the 5-percent withholding tax on the royalty). The income tax system therefore provides an incentive for private sector R&D by reducing the after-tax cost of $100 million of R&D to $90.96 million or $98.49 million, respectively, for a representative taxpayer with and without excess foreign tax credits.

The impact of the USA and Flat taxes on the cost of performing R&D in the United States can be measured by calculating the change in return required to break even on $100 million of R&D for the taxpayer in the preceding example. The 11-percent USA Tax is intended to be revenue-neutral. By contrast, the 17-percent Flat Tax introduced by Rep. Armey would raise less revenue than present law.[19] For the sake of comparability, the Flat Tax also is analyzed at a 21-percent rate, which has been determined by the Treasury Department as necessary to achieve revenue neutrality.[20]

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[16]Data provided by the IRS Statistics of Income Division based on Forms 6765 filed for tax years ending July 1, 1992 through June 30, 1993.

[17]The United States seeks to obtain a zero withholding tax rate on royalties in its bilateral income tax treaties, but many treaties provide for a 5 percent or higher rate such as the U.S. treaties with Australia, Canada, China, France, India, Italy, Japan, and Spain. See Price Waterhouse LLP, *Doing Business in the United States*.

[18]Under regulations (Treas. reg. 1.861-8), taxpayers generally may allocate 50 percent of U.S. research expense to U.S. source income and apportion the remaining 50 percent on the basis of U.S. and foreign sales.

[19]The Armey Flat Tax would initially be imposed at a 20-percent rate but would drop to a 17-percent rate after two years.

[20]See U.S. Department of the Treasury, Office of Tax Analysis," New Armey-Shelby Flat Tax Would Still Lose Money, Treasury Finds," Reprinted in *Tax Notes* (Jan. 22, 1996), at 451-61.

Under the Nunn-Domenici USA Tax, the break-even return on $100 million of R&D would be $98.06 million under the facts of the example. Thus, for the taxpayer in this example, the USA Tax would reduce the after-tax cost of R&D by 0.4 percent, or increase it by nearly 8 percent, depending on whether or not the taxpayer currently is in an excess foreign tax credit position. The potential rise in the after-tax cost of R&D primarily is attributable to the loss of the research credit and the inability to deduct compensation and payroll taxes.

Impact of USA and Flat Taxes on R&D
[See Appendix for details]

	Percent increase in "break even" rate of return of domestic R&D over present law*	
Tax Regime	*Excess foreign tax credits*	*Excess foreign tax credit limitation*
USA Tax	7.80%	-0.40%
Armey Flat Tax (17%)	14.10%	5.40%
Revenue-neutral Flat Tax (21%)	14.50%	5.70%

*Assumes extension of expired research tax credit.

Source: Price Waterhouse LLP

Under the Armey Flat Tax, the break-even return on $100 million of R&D would be $103.76 million at a 17-percent rate and $104.12 million at a 21-percent rate. Thus, for the taxpayer in this example, the 21-percent Flat Tax would increase the after-tax cost of R&D by 5-15 percent compared to present law, depending on whether or not the taxpayer is in an excess foreign tax credit position. The rise in the after-tax cost of R&D primarily is attributable to the loss of the R&D credit, the taxation of foreign royalties with no credit or deduction for foreign withholding taxes, and the inability to deduct payroll taxes and employee benefits.

Recent research by Prof. Brownwyn Hall (University of California-Berkeley and National Bureau of Economic Research) indicates that the amount of R&D undertaken by companies is sensitive to the after-tax cost of R&D. Based on an econometric analysis of R&D expenditures by U.S. companies over the last decade, Prof. Hall finds that a 1-percent increase in the after-tax cost of R&D results in a decline in private sector R&D of between 0.8 and 2.0 percent.[21] Using the lowest end of the range of results reported in this research, the USA Tax conservatively would be expected to reduce private sector R&D by 0-6 percent for a representative taxpayer, while a 21-percent Flat Tax would be expected to reduce private sector R&D by 4-12 percent.

While the effects of the USA and Flat taxes will depend on the particular circumstances of individual taxpayers, the preceding example shows that a U.S. multinational with typical facts can expect an increase in the after-tax cost of R&D, compared to present law, under the Flat Tax, and can expect either a smaller increase or no change under the USA Tax.

[21] See Brownwyn Hall, "R&D Tax Policy During the Eighties: Success or Failure?" *Tax Policy and the Economy*, vol. 7 (1993) pp. 1-36.

The Impact of Tax Restructuring on R&D and Technology Should Not be Overlooked

We commend the Ways and Means Committee for holding these hearings on tax restructuring. We agree with the overall goals of tax reform proposals -- to promote economic growth, increase savings and investment, and simplify tax administration. At the same time, we believe it is important not to overlook the potential adverse impact on the development and utilization of American technologies.

We are not the first to raise these concerns. The January 1996 report by the Kemp Commission, a 13-member panel charged with studying the current tax system and outlining recommended changes, zeros in on these concerns in its discussion of the need to simplify U.S. taxation of international activities. The report states, "attention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."[22]

The stakes are high. Any tax changes that would increase the tax burden on the development and utilization of American technology will have negative consequences for U.S. economic growth, productivity, U.S. jobs, U.S. exports, and the leadership position of U.S. companies in the technology-driven global marketplace.

We stand ready to work with the committee as the coming debate over tax reform unfolds. A common goal should be to create a tax system that encourages American businesses to pursue R&D activities in the United States and avoids tax barriers to utilizing home-grown technologies overseas.

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[22]See "Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century," The National Commission on Economic Growth and Tax Reform, January 1996.

APPENDIX

Effects of Tax Restructuring Proposals on the Tax Treatment of R&D: Example

ASSUMPTIONS			
Foreign share of return	50%		
Foreign withholding tax	5%		
	Total	Qualified	Nonqual.
R&D expenses (sec. 174)	100.00	42.00	58.00
Wages and salaries	26.00	26.00	0
Payroll tax	1.99	na	1.99
Employee benefits	3.90	na	3.90
Fixed cost (depreciation)	20.00	na	20.00
Other	48.11	16.00	32.11
U.S. apportioned R&D	75%		

Item	Present law /1/		Flat tax		USA tax
	Excess FTC	Deficit FTC	Armey-Shelby	Revenue neutral	(Nunn-Domenci)
Tax status					
Tax rate	35%	35%	17%	21%	11%
Effective rate of R&D credit	3.6%	3.6%	na	na	na
Foreign tax credit position	Excess	Deficit	na	na	na
AMT	no	no	na	na	na
Gross income	90.96	98.49	103.76	104.12	98.06
U.S. source	45.48	49.25	51.88	52.06	49.03
Foreign royalty, gross of withholding tax	45.48	49.25	51.88	52.06	49.03
Withholding tax	2.27	2.46	2.59	2.60	2.45
Research expense (sec. 174)	100.00	100.00	100.00	100.00	100.00
U.S. source	75.00	75.00	100.00	100.00	100.00
Foreign source	25.00	25.00	0.00	0.00	0.00
Components of research expense					
Wages	26.00	26.00	26.00	26.00	26.00
Payroll tax	1.99	1.99	1.99	1.99	1.99
Benefits	3.90	3.90	3.90	3.90	3.90
Fixed cost /2/	20.00	20.00	22.79	22.79	22.79
Other /3/	48.11	48.11	48.11	48.11	48.11
Qualified research expense	42.00	42.00	na	na	na
Taxable income	-7.53	0.00	6.86	7.22	-21.87
U.S. tax before credits	-2.63	0.00	1.17	1.52	-2.41
Credits	8.68	3.97	0.00	0.00	1.99
Research credit	1.51	1.51			
Foreign tax credit	7.17	2.46			
Payroll tax credit					1.99
U.S. tax after credits	-11.31	-3.97	1.17	1.52	-4.40
U.S. and Foreign tax	-9.04	-1.51	3.76	4.12	-1.94
Research expense after U.S. and foreign tax	90.96	98.49	103.76	104.12	98.06

1/ Assumes extension of expired research credit.

2/ Fixed costs generally are depreciated over 5 years under present law and would be expensed under a consumption-based tax. Steady-state ratio of depreciation to gross investment assume to be 87.7%.

3/ Amount deductible assumed not to change under USA and Flat taxes.

Mr. HOUGHTON. All right. Thank you very much.

Mr. Gibbons, do you have any questions?

Mr. GIBBONS. Well, first of all, I appreciate all of you coming and contributing to this. Since I am leaving here at the end of this term, let me give you the benefit of a little of my experience of having sat here 26 to 27 years.

I think this Committee, generally speaking, is way ahead of you. I think this Committee has generally given up on ever being able to do anything that is reasonable or sensible or economically sound with the income tax system. I think we are ready to go to a consumption tax system, and as I listen to each one of you, you are all still hanging on to that old income tax system, and I can understand why you are reluctant as business people to get out and lead the charge for a consumption tax system. But frankly, it needs to be done because I believe this Committee is ready to move in that direction if we can just get some kind of reasonable signal from the American public that they are ready to go in that direction.

I hear you talk about the United States being considered a tax haven if we get rid of our income tax system. I understand what that may mean, but are there any of you out there that believe if we get rid of our entire income tax system, even if we have to lose some of the advantages we have with our tax treaties now, that you as a company would be worse off without any income tax than you would if you have to preserve your rights under a tax treaty?

If you don't have any income tax in the United States, if we go completely to a consumption tax system, do any of you believe that even though you may lose some benefits under the current tax treaties, you would be worse off than you are if we get rid of the income tax?

Mr. CHRISTIAN. Mr. Gibbons, I have a hard time imagining that under any of the leading proposals that anyone would be worse off. The American economy, the American future, the American employees would all be better off in all respects under any of the kinds of systems that are being talked about.

If I might, since I have been privileged for many years to talk about matters with you——

Mr. GIBBONS. Yes.

Mr. CHRISTIAN [continuing]. And others of this nature, if you will take a look at the index in the AMT testimony of Mr. Barone, I think it is quite revealing. It only undertakes to evaluate the USA tax at the business level, present law, and the flat tax by the House Majority Leader.

You, of course, are aware that the USA tax at the business level and your proposal for a business or subtractive VAT are, in fact, identical. It just depends on how one wishes to look at those two proposals.

Either can be considered to be a consumption tax in the way economists define consumption tax. Under such definition, it is, in fact, income that is being taxed, the output of labor and the output of capital, but economists call such a tax a consumption tax because it does not double tax investment or saving.

So, in fact, your proposal is included within AMT's index and would rank 100 percent at the business level.

Mr. GIBBONS. Well, I want to thank you for that explanation, and I want to thank you, Mr. Christian, for allowing me to learn at your feet here.

Mr. CHRISTIAN. I didn't mean that, Mr. Gibbons.

Mr. GIBBONS. No, I do. I remember when we used to meet in executive session here and we had our tables squared out there where you are now sitting. I used to be privileged to sit next to you there while you were on the administration explaining these things to us.

So I want to apologize to all of you for the mess we have made out of the Tax Code over those years, but it wasn't because you didn't try or because you didn't give us good advice.

Mr. CHRISTIAN. I think I helped you mess it up, Mr. Gibbons. I am trying to fix it now, as you are.

Mr. GIBBONS. Well, me, too. Me, too. I think I have learned enough about it to be one of those persons that is sworn off completely of what we have been doing all of these years. I am ready to start something new. I am ready to go dry.

Thank you very much.

Mr. KOSTENBAUDER. Mr. Gibbons, if I can just address your question.

Mr. GIBBONS. All right.

Mr. KOSTENBAUDER. In the context of the points I was making about R&D and technology development activity in the United States, there is one sense in which—and again, we have systems. We are very familiar with many of the details in the current system.

Mr. GIBBONS. Yes.

Mr. KOSTENBAUDER. So there are at least a number of uncertainties about these other systems. So, acknowledging that, one of the ways in which the USA type of system which does have expensing for capital equipment and other business inputs——

Mr. GIBBONS. Yes.

Mr. KOSTENBAUDER [continuing]. But because it does not permit the deductibility of compensation, wages, fringe benefits, and other things, it can have to some degree a detrimental effect on those companies that really do have a lot of research and development because the main characteristic of research and development expenses are that they are really the good, high-paying jobs that we have for all of our bright engineers and other people who are engaged in the R&D activity.

So it is a case where under current law because those expenses are all deductible currently versus at least in the consumption tax systems, because the compensation-type expenses are not currently deductible, and they are such a big part of R&D, there very well could be a real attention as to which is more favorable. Then, when you couple it with some of these considerations about the results of R&D and the intellectual property generated outside the United States, actually bearing a higher burden because foreign governments may result to a U.S. activity by increasing the withholding rates on the royalty-type payments which generally flow back to the United States as a consequence of our abilities to generate research and development and technology that others around the

world want access to, in those kinds of contexts, it could very well be the current system might be somewhat more favorable.

Mr. GIBBONS. Well, I would say that is true if we do it as an add-on, but I propose that we do it as a replacement, that we replace the current income tax, which would really impact upon your high-paid people, and we replace the corporate income tax, not add a consumption tax to it.

Consumption tax, I think, would be a disaster if we just added on. I want to replace the income tax and the payroll taxes and the corporate income taxes, and I think when you do all of that, you have really energized your R&D development process.

I realize payroll is a very big part of R&D, but we are not taxing your payroll anymore, either as a FICA tax or as an income tax, and that should really energize your R&D here in the United States.

Mr. BOYLE. Congressmen, if I might amplify on Mr. Kostenbauder's comments on consumption taxes, many of the details of the various reform proposals are not fully fleshed out, and there is a potential which is somewhat frightening in terms of the possibility of double taxation——

Mr. GIBBONS. Yes.

Mr. BOYLE [continuing]. As well as withholding of potentially up to 40 percent, and we would be very concerned that the loss of tax treaty coverage would be a very big detriment, in particular, to the software industry.

Mr. GIBBONS. I understand where you are coming from on the tax treaties. I am familiar with them and how they impinge upon you, but it seems to me that even if we did get rid of our income tax, you would still be a lot better off than you would under the tax treaty. That is my guess, but I would be happy to explore that further with you.

Mr. Christian.

Mr. CHRISTIAN. If I might, Mr. Chairman, comment on both of the last two points. Picking up where Mr. Gibbons just amplified on what he was saying, I think Mr. Gibbons made the point that under his proposal, there is no payroll tax. Under present law, the payroll tax obviously under present law functions the same as disallowing a portion of wages.

Under the USA tax, which is very like Mr. Gibbons at the business level and to some extent was patterned after it, there is a credit for the employer payroll tax.

I would further point out in talking about R&D or software or all intellectual property that upon the export, which is the subject of today's hearings, into the world market of the fruits of United States know-how, thought, or ingenuity, there is no tax. There is no tax on the labor element. There is no tax on the capital element.

Under the USA tax, for example, which uses the credit mechanism to relieve the existing employer payroll tax, given the fact that the USA business rate is only 11 percent, the credit is the equivalent of allowing about a 76-percent deduction for wages.

I would further point out, under Mr. Gibbons' approach and the variation which is reflected in the USA approach, that no foreign royalties are taxed. No exports of any intellectual property are taxed. All deductions associated with R&D in the very broadest

sense, even exported R&D, the income from which is excluded, all of those costs are deductible in the United States. In other words, there is no longer any of this 861 allocation, even though the income is export income and not taxed. The costs are deductible in the United States against other U.S. income.

I would not dispute anything with my good friend, Dan Kostenbauder, to my right here, but I find it very hard to believe, as you do, Mr. Gibbons. At the end of the day, I find it very hard to believe that everyone in every respect is not better off under your proposal or the USA tax.

Mr. GIBBONS. Thank you.

Mr. HOUGHTON. OK. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Barone, your testimony criticizes the current Federal income tax system and its impact on international trade. Could you elaborate on what you were talking about as far as specifics and specific of the group that you are representing today?

Mr. BARONE. In terms of the tax that we pay on exports?

Mr. CHRISTENSEN. Yes.

Mr. BARONE. We find we have a difficult time even competing onshore, let alone offshore, because of the Tax Code we currently have.

Our U.S. machine tool market is just short of $7 billion, about $6.8 billion, and we lose one-half of that market to offshore competition. We find it hard to believe they can come here and compete with us at a 50-percent level, and we have a tough time getting to 30 percent in our exports. We think this is largely due to our Tax Code.

Mr. CHRISTENSEN. Mr. Kostenbauder, you made a comment talking about using the R&D credit and it should be enhancing the overall benefit of society. Hewlett-Packard probably uses the R&D credit for a number of areas. What is the main area that they use it for?

Mr. KOSTENBAUDER. Well, Hewlett-Packard's experience right now is not very favorable with the current structure of the R&D credit, quite honestly, but speaking for the broader group and for the high-tech folks, in general, our research and experimentation, technically the research and experimentation credit, applies to a broad range of activities, and certainly the range of activities that accompany Hewlett-Packard or other software companies or hardware companies, semiconductor manufacturers, pharmaceuticals, it is really the entire development process of the technology and the intellectual property, the know-how and the patents and so forth that are part of the real sort of core value of these technology companies. It is the ability to develop that. So that is the category.

I am not sure I am totally responsive to your question, but it is that fundamental portion of our activity, and for a number of these companies, the percentage of total revenue that would be spent on research and development, although I haven't seen the specific numbers for this group, I am sure would range from probably a very minimum of 5 percent to 15, 20, or 25 percent. So there is a tremendous level of research that goes into especially the activities of your more high-tech companies in the U.S. economy, and I think the total expenditure in the U.S. economy is around 2 percent, give

or take, or maybe a little below that, but somewhere around 2 percent is the total for the entire economy. So, clearly, these are more research-intensive companies.

Mr. CHRISTENSEN. If we were to move to a totally restructured tax system, would you elaborate a little bit more on your position concerning the tax treaties and how that would impact the software industry and the high-tech industry?

Mr. KOSTENBAUDER. Right. Well, the key consideration today is that the U.S. Government and Treasury Department negotiate treaties with other countries in terms of the income tax rules and typically between two countries that have income taxes.

There are a number of different things that are addressed in those treaties, a wide range of issues. One important one generally, but certainly for our industry, relates to a definition almost of doing business, so that you would not be taxed or you would have some protection against being treated as a permanent establishment, which would be treated as doing business in a foreign country. So we like to have those rules as broad as possible, so as to not have incidental activities in a foreign country generate a full tax liability there.

The other thing that is very peculiar to our industry relates typically to the treatment of royalty income. The U.S. Government has negotiated, particularly with some of our major trading partners, the Japanese and Germans and others, where there is a lot of trade relating to high-tech products and where a lot of U.S. companies will actually license the technology that we develop here and receive a royalty flow-back into the United States, the policy of the U.S. Government is to have those withholding tax rates that the foreign governments would impose as low as possible. In many cases, they are zero or 5 percent on a negotiated basis.

The statutory rules of many foreign countries can be as high as 40 percent. The U.S. rate is 30 percent on similar flows outside of the United States unless they are reduced.

One of the big factors that is beneficial for us, but also beneficial for the U.S. Treasury, is that to the extent that those foreign taxes imposed are very low on that foreign-source income from the royalty that is being used outside the—or the technology that is being used outside the United States that generates the royalty flow, that income is then fully taxed by the U.S. foreign sales corporation and it does not have a large foreign tax associated with it that would otherwise be, in a sense, fully creditable against the U.S. tax.

So, if there is a dollar of U.S. tax, instead of having a dollar of foreign tax that gets credited against that, it might only be a nickel of foreign tax, and the U.S. Treasury, of course, can get the differential.

So, in the context of one of these systems that might be developed that would in any way impair the integrity of this treaty network that has been negotiated and renegotiated for decades, it could put us in the position of having the foreign governments seeing the United States change its tax system, having the treaties no longer be really valid because we don't have anything that is denominated or considered an income tax system. They would go ahead and raise their withholding tax rates on that technology, and therefore, the U.S. foreign sales corporaion would be, in a sense,

maybe not disadvantaged by that, but all of the companies receiving those royalties would find they have now sustained a much higher increase in their foreign taxes imposed by foreign governments.

Mr. CHRISTENSEN. Thank you for your testimony, and I thank the panel for their time and testimony today.

Thank you, Mr. Chairman.

Mr. HOUGHTON. Thank you, Mr. Christensen.

I am not going to raise any questions because it is late and we certainly appreciate the fact you have been here.

I would just like to make two statements. My question really is, If you separate this into three parts, whether we do anything, what we do, and how we sell it. We have been talking about what we do, but the question for this Committee and for this Congress is whether we do anything at all, whether we have got the guts to do something, and then the last part is, of course, how do we sell this thing. The question then, the overriding issue, is how do we get some emotion into this thing, how can we tie it down to human beings so they feel politically this is the right way to go, and that, of course, is the big question, I think, you can help us with.

The second thing I would like to say is that the person I am going to miss most on this Committee is this man right over here. He has been a wonderful stimulator and a great leader in this whole area, and I just hope, Sam, that you are going to be able to hang around and lead us as you feel Ernie had led the intellectual discussions here.

So thank you very much, everybody. We appreciate it.

[Whereupon, at 1:13 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF THE
CHEMICAL MANUFACTURERS ASSOCIATION
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
ON
THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF
REPLACING THE FEDERAL INCOME TAX

The Chemical Manufacturers Association ("CMA") appreciates this opportunity to present its views on the impact on U.S. international competitiveness of replacing the Federal income tax. CMA commends Chairman Archer and the Committee on Ways and Means for holding hearings on this subject. In many respects this is the most important single issue that the Committee and the Congress must responsibly address and answer before adopting any alternative tax system.

CMA is a nonprofit trade association whose member companies represent more than 90 percent of America's productive capacity for basic industrial chemicals. Since 1991, the chemical industry has been the nation's leading exporter. The chemical industry also ranks first among all U.S. manufacturing sectors in research and development spending with an estimated $18.1 billion in 1995. Most importantly, the chemical industry provides over one million high-tech, high-wage jobs for American workers.

The importance of maintaining the international competitiveness of U.S. manufacturers and the American jobs they provide can not be over-stressed. Yet, in the more than 50 years that Congress has addressed Federal income tax reform, the importance of the Federal income tax on U.S. competitiveness has only recently been recognized. To a considerable extent the prior tax reform efforts of the Committee on Ways and Means and the Congress reflect the conditions and times in which they were developed.

When Congress addressed the bill that ultimately became the Internal Revenue Code of 1954, the United States was the world's dominant industrial nation with a virtually unlimited market for its products and exports. Although international competition had increased greatly by the late 1960's, the impact of tax reform on U.S. international competitiveness did not receive major attention in the Tax Reform Act of 1969. On the other hand, by increasing the tax burden on corporations (and disproportionately on capital-intensive manufacturing industries like the chemical industry), the Tax Reform Act of 1986 accelerated our problems in competing with foreign manufacturers and producers. Thus, we are most encouraged that the Committee on Ways and Means is now focusing on what we regard as the most critical issue presented under any tax system.

The chemical industry is an excellent example of how closely the economic health of U.S.-based manufacturing is linked to strong, competitive, and expanding foreign trade. The world-wide chemical industry is a fiercely competitive, global industry with large, well-financed foreign competitors. World-scale plants and efficient product flow are essential for any chemical company to compete in both domestic and international markets.

Of necessity, U.S. chemical companies must build foreign plants to serve growing foreign markets. These new plants become markets for U.S. products. In time, these foreign plants will produce goods that will in turn be sold in world markets, including the United States. However, the net result of our foreign trade is a larger market for U.S. products and greater job security for American workers

Over time, the U.S. chemical industry has grown from producing primarily basic commodity chemicals to producing commodity and specialty chemicals. Although our industry has grown and changed dramatically, it continues to provide over one million quality jobs for American workers. Today a substantial portion of those jobs is directly dependent on the expanded market that growing U.S. chemical exports provide.

With this in mind, the important topics for the chemical industry in assessing an alternative tax system are:

- Cost of Capital
- Research Incentive
- Taxation of Ex-U.S. Income
- Export Incentives
- Energy and Environmental Costs

CMA's views on these topics are summarized below:

Cost of Capital

It is generally recognized that the cost of capital for U.S. corporations exceeds that for its foreign-based competitors. While the cost of capital is a widely-used term, there is a significant difference of opinion on what factors impact the cost of capital. CMA believes that tax policy has a direct and significant impact on the cost of capital. Moreover, tax policy is a factor within the direct control of Congress and the President. Taxes can affect the cost of capital through tax rates, depreciation methods and capital cost recovery systems, investment incentives, taxation of foreign income, the alternative minimum tax, taxation of dividends, and the taxation of capital gains. If Congress wishes to make the U.S. more competitive, each of these critical elements must be addressed favorably and in concert.

Although the Tax Reform Act of 1986 reduced marginal corporate tax rates, it adversely affected the chemical industry by increasing U.S. cost of capital. It is important that in adopting an alternative tax system Congress should not increase the cost of U.S. capital, but, if possible, should reduce that cost.

Research Incentives

In today's competitive global environment it is simply not enough to be the low-cost producer. To be successful, U.S. companies must be first to market products that offer superior value to the customer. Research and development ("R&D") is important to the chemical industry because it can lead to increased productivity that can overcome disadvantages in capital and labor costs and also to the discovery of new products. To develop a steady stream of high-value products, a company must have the resources to invest substantial sums in R&D. Because of this, CMA strongly supports a permanent, improved R&D tax credit and favorable rules governing the allocation of R&D expenses between U.S. and foreign income under Section 861. In this respect we emphasize that temporary measures do not provide the predictability needed for the long-range planning required for modern research projects.

Taxation of Ex-U.S. Income

In today's global environment, U.S.-based multinationals must compete in world markets. There are at least five components of international competition problems:

- The ability to compete in U.S. markets against imported products.
- The ability to compete in U.S. markets against products manufactured in U.S. plants owned by foreign-based companies.
- The ability of U.S. exports to compete in the home market of foreign-based competitors.
- The ability to compete in foreign markets where both the U.S. and foreign-based competitors have local manufacturing operations.
- The ability to compete in foreign markets where neither U.S. nor the foreign-based company has local manufacturing operations.

As these fact patterns illustrate, the ability to compete internationally is a complex problem. Policy makers need to understand and to consider each of these situations to ensure that we effectively maintain our international competitiveness. For many years, U.S. tax policy has discouraged U.S.-based firms from making investments abroad. This policy disregards the fact that it is impossible to compete in many countries without first investing in local manufacturing operations. Those foreign plants translate immediately into expanded U.S. exports and the American jobs those increased exports support.

In this respect, CMA has strongly opposed efforts to tax U.S. corporations currently on the income of their foreign subsidiaries, such as the bill recently introduced by Senator Dorgan (D-ND), S-1597, "the American Jobs Act of 1996." This is substantially the same bill that Senator (then Congressman) Dorgan introduced in 1991 as H.R. 2889. CMA's statement on H.R. 2889 to this Committee noted that in 1990 U.S. chemical exports were $39 billion--then equal to the nation's total agricultural exports and significantly larger than U.S. aircraft exports of $30.1 billion in that same year. In 1990, we also enjoyed a healthy net U.S. trade surplus in chemicals of $16.8 billion. In contrast to Senator Dorgan's 1990 analysis, U.S. chemical exports accounted for $60.8 billion five years later with a net U.S. chemical trade surplus of $20.4 billion in 1995. Despite the substantial increase in both exports and imports over 1990 levels, the U.S. chemical industry maintains a net U.S. trade surplus in chemicals that is 21.4 percent greater than the 1990 level. More importantly, the U.S. chemical industry today continues to provide over one

million high-quality, high-paying jobs, while implementing major technological innovations and efficiencies.

Incentives for Exports

CMA is a strong supporter of the Foreign Sales Corporation ("FSC") incentive and believes that it has been a positive force in expanded chemical industry exports over the past decade. Congress should strengthen the overall incentive that the tax system provides for exports.

One important U.S. tax disadvantage arises from the fact the U.S. does not tax consumption, but relies primarily on income taxes for the bulk of its tax collections. Many of our world trading partners, however, rely upon a specific consumption tax-- the invoice-credit method value added tax ("VAT")-- to pay a substantial portion of their total costs of government.

As initially adopted by the 1947 General Agreement on Tariffs and Trade ("GATT") and subsequently incorporated in the 1994 WTO Agreements, a nation may make valid border adjustments of VAT taxes by imposing the VAT on imports and by rebating the tax on exports. However, a nation may not legally make border adjustments for income taxes. With border adjustments the VAT is trade-neutral and does not impair the competitiveness of a nation's manufactured products in domestic or foreign markets. This key advantage of the VAT over income taxes merits strong consideration by this Committee.

Energy and Environmental Costs

We recognize the Committee is holding a separate hearing on the impact of an alternative tax system on energy-related issues. However, we must emphasize that energy and environmental costs are key factors in determining the international competitiveness of the U.S. chemical industry. To the extent that an alternative tax system raises the costs of U.S.-based production relative to foreign-based production, U.S. manufactures will be less competitive in both domestic and world markets. This is especially true for the energy costs of the chemical industry, which uses energy both as fuel and as raw material for its production processes.

CMA is committed to a safe and clean environment. This requires very large capital expenditures for new equipment to meet environmental standards. Under the income tax system, the tax costs of these expenditures are substantial. For example, expenditures for pollution control equipment must be depreciated over the full applicable life for new investment, even though the expenditure relates to assets that have been in use for many years. There may be additional tax liability because of the alternative minimum tax and the allocation of interest to foreign source income. Any new tax system should avoid imposing added costs on these essential investments.

Conclusion

We again commend Chairman Archer and the Committee on Ways and Means for addressing in this hearing the impact on international competitiveness of replacing the Federal income tax with alternative tax systems. The impact on international competitiveness is the single most important issue for the U.S. chemical industry in assessing alternative tax systems.

CMA has confined this statement to general principles and chosen not to address specific tax proposals now before the Congress. Although several of these proposals are obviously the product of much serious, thoughtful study and hard work, they still do not contain all the specific detail required for large corporations to assess their specific impact. This is especially true with respect to the tax treatment of international operations of U.S. corporations.

Because of the very high stakes for our nation's economy, we believe the Committee should consider modifying its usual procedure in this instance. After these hearings and consultation with the Committee, the Chairman could direct the Committee staff to develop a detailed draft "mark" bill and then provide an extended period for public comment. This would enable major taxpayers to assess the actual impact of the draft proposal on their operations. In our view, the additional time for public review would in the end produce a better bill and enhance its prospects for enactment.

Comments on the
Impact of the Proposed Replacement Tax Systems on the
International Competitiveness of American Workers and Businesses

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 June 26, 1996. They are submitted for inclusion in the printed record of the hearing held on July 18, 1996 on the impact of the proposed replacement tax systems on the international competitiveness of American workers and businesses. The Tax Reform Study Group previously submitted comments for the written record of the May 1996 hearing on the impact of tax reform on state and local governments.[1] The Tax Reform Study Group is also 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, Professor, San Jose State University; substantive contributions and review were provided by William C. Barrett, Director: Tax, Export & Customs, Applied Materials, Inc.; Dan Kostenbauder, General Tax Counsel, Hewlett-Packard Company; Larry R. Langdon, Vice President - Tax, Licensing & Customs, Hewlett-Packard Company; David W. Mitchell, Hoge, Fenton, Jones & Appel, Inc.; Jerry Nightingale, Financial Advisor, Royal Alliance; Donald J. Scott, Director: Tax Compliance, Oracle Corporation; Dean Smith, Ireland, San Filippo & Company; John Webb, Vice President - Taxes, National Semiconductor Corporation.

Global Facts Must Be Considered In Reforming the Federal Income Tax System

In reforming the federal income tax code, it must be kept in mind that it was created and, despite regular modifications, works best for an era that no longer exists. The Internal Revenue Code (IRC) is based on the industrial age where tangible goods - easy to track and measure - were the key commodities. We are now living in the information age which requires a different perspective and set of rules than the industrial age.

Today, businesses and workers must deal with a global economy. While we still hear the term "international business", such a term is outdated because all business today is involved in or influenced by the global economy in some fashion. A new business formed in the U.S. may engage in international transactions in its early years, rather than later when they get "big enough." Per the OECD, the "period between start-up and internationalization is becoming shorter - often three or four years compared to five to ten years a decade ago." The OECD also reports that about 1% of small and medium sized manufacturing businesses (about 40,000 firms) are "truly global." Such firms produce about 26% of OECD exports and about 35% of Asian exports.[2]

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[1] These comments can also be found at http://www.svi.org/jointventure/tax/tax_fed.html, or 96 STN 142-36 (July 23, 1996), or State Tax Notes, Vol. 11, No. 4, July 22, 1996, pg. 253.

[2] "Helping Small Firms Adapt to the Globalised Economy," *OECD Letter*, Vol. 5/4, May 1996; http://www.oecdwash.org.

The current global environment that must be the model in the minds of tax code reformers is shaped by many realities, including the following:

- *Increasing Importance of Foreign Markets.* The level of both U.S. exports and imports continues to grow.[3] In 1980, exports represented 8.5% of the U.S. economy and 12% in 1994.[4] DRI/McGraw-Hill has predicted that the current growth in exports will lead to $1 trillion by 1998.[5] Foreign markets are growing and many U.S. companies are ready to provide goods and services to them. The Computer Systems Policy Project (CSPP) predicts that by the year 2000, about 70% of the demand for information technology will come from foreign markets.[6] The importance of the global economy to the computer industry was summarized by the CSPP as follows.

  > The ability to sell products and access technology worldwide is essential to the continued competitiveness of the U.S. computer industry and its success around the world. The industry must grow globally or die!
  >
  > . . .
  >
  > Continued success of the U.S. computer industry around the world depends on its ability to bring competitive products to market quickly. To do that, it's essential that companies be able to source technology globally - wherever it can be found - to maintain the industry's competitiveness and productivity. No country can have a monopoly on technology - its flow across international boundaries is a business reality.[7]

- *Global Competition For Technology Jobs and Tax Dollars.* Many foreign countries actively compete for U.S. businesses to locate operations in their countries, particularly those bringing technology based jobs. Incentives include tax holidays, low tax rates, direct funding from the government, and duty rate reductions. This reality must be considered in efforts to improve the international competitiveness of U.S. companies and workers. The OECD has undertaken efforts to deal with international business and tax competition to prevent competition that may be harmful to governments and businesses. A June 1996 economic communiqué of the G7 leaders noted that business and tax competition can distort trade and investment and "lead to the erosion of national tax bases."[8]

- *The Services Sector Is Growing While the Manufacturing Sector Is Declining.* The Department of Commerce reports that by the 21st century, telecommunications and information-based industries will represent about 20 percent of the U.S. economy.[9] In 1995, the "Fortune 500" was changed to include both industrial and service firms. The reasons for this change include the fact that a "new economy" has emerged with the line between manufacturing and service activities more blurred; "the digital revolution has made the distinction between manufacturing and services increasingly theoretical."[10] The services sector of the economy showed job growth from 1989 to 1991 (almost 3 million jobs added), while the manufacturing and construction sectors showed job decline (about 1.5 million jobs).[11] In 1950, services represented about 31% of GNP, while tangible goods represented about 55% of GNP. In 1990, these percentages had changed to 52% and 40%, respectively.[12]

  The growth in the services sector is not a U.S. phenomenon. In France, job growth in financing, insurance, real estate and business services grew at double the rate of overall

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3 Department of Commerce, *U.S. Foreign Trade Update*, http://www.ita.doc.gov/industry/otea/usftu/usftu.html.

4 See Aley, "New Lift For the U.S. Export Boom," *Fortune*, Nov. 13, 1995, pg. 73.

5 *Id.*

6 CSPP, "Public Policy and the U.S. Computer Industry - Freedom To Grow - Leadership Into The 21st Century," January 1995, http://www.cspp.org/reports/. The Department of Commerce reports that for advanced technology products (ATP) a trade surplus exists of $7 billion for January to April 1996. ATP represents about 500 products where the technology is from a "recognized high technology field (e.g., biotechnology)", and which represent leading edge technology in that field. See http://www.census.gov/ftp/pub/foreign-trade/Press-Release/.

7 CSPP, *supra*.

8 As reported in Massey, "G7 Leaders Spur OECD's International Tax Reform Efforts, 96 TNT 132-2, July 8, 1996.

9 Undated memorandum from the National Telecommunications and Information Administration (NTIA) within the U.S. Department of Commerce (possible date is July 1995).

10 Stewart, "A New 500 For The New Economy," *Fortune*, May 15, 1995, pgs. 166, 174.

11 U.S. Bureau of the Census, "Net Job Growth/Decline in the United States by Industry Division, http://www.census.gov/ftp/pub/epcd/ssel_tabs/images/jobchan.gif. From 1980 to 1992, the number of jobs in the manufacturing industry declined by 14.2% (about 3 million jobs), while jobs in services industries grew 78.4% (about 13.5 million jobs). U.S. Bureau of the Census, Statistical Abstract of the United States 1995, 115th Ed., Table No. 858.

12 Snell, ed., *Financing State Government in The 1990s*, National Conference of State Legislatures (NCSL), December 1993, pg. 21.

employment. At the same time, manufacturing jobs fell from 36% to 29% and agricultural jobs fell by about half. Similar patterns have occurred in the OECD countries.[13]

- *Intangible Assets - Information, Intellectual Property and Human Capital, Are Key Assets.* With the decline in the manufacturing sector and the increase in the services sector, tangible assets have somewhat declined in importance relative to intangible assets and knowledge. However, financial and economic reporting is still driven by tangible capital. U.S. Department of Commerce data reports capital expenditures by industry, but not investment in workers and intangible assets.[14] Certainly, tangible assets are much easier to measure than intangible assets, but without a focus on intangible investment in intellectual property and human capital, economic perspectives will be distorted. A tax reform focus on a system to increase capital investment (in tangible/measurable items), is not by itself appropriate. Instead, consideration must also be given to what tax and fiscal policies are appropriate to a business environment where developing human capital and protecting intellectual property is key to survival and improved growth.[15]

  Intangible assets are often difficult to fit into the taxing schemes of the current tax laws. Again, this difficulty stems from the fact that our tax rules are structured to address the industrial age, not the information age. For example, the tax law does not provide a simple answer as to whether a software developer who only transfers its software over the Internet has to deal with inventory rules, or whether software duplication and packaging is considered manufacturing. Also, the current tax law cannot clearly label a software transaction as being a sale of goods, a rental, or royalties. This failure leads to difficulties applying domestic and foreign tax rules and leads to much cost and confusion.[16]

What is Meant by "International Competitiveness?"

The term international competitiveness has different meanings to different people. To some, it may mean a focus only on exports (trade competitiveness), and not on investment outside the U.S. (multinational competitiveness). To some, it may mean solely looking at how tax rules may encourage or discourage certain activities. However, in debating how international competitiveness is impacted by major federal tax reform, a broad perspective should be taken. This perspective should also consider how domestic policies, with respect to savings incentives and fiscal problems (such as the U.S. debt and budget deficits) impact global investment and competitiveness. It should also consider the costs that businesses face in terms of a complex tax system and uncertain tax rules and how they can hinder a firm's ability to effectively compete in the global economy. (The debate should also consider the factors described in the next section of this letter.)

A 1991 Joint Committee on Taxation report includes a detailed discussion on the competitiveness of the U.S. economy. The report looks at this concept in terms of trade competitiveness, standard-of-living competitiveness and multinational competitiveness. It also discusses different measures of competitiveness and various policies, such as government regulations, technology and investment, that can impact competitiveness.[17]

Many Factors Impact International Competitiveness and Trade

While a nation's tax rules and tax infrastructure impact a company's cost of doing business and many of its decisions, many other factors are also important. These factors, many of which are briefly explained below, must be considered along with the tax rules in any reform designed to improve the international competitiveness position of U.S. companies and workers. For example, a tax rule designed to encourage exports will not help a technology company facing out-dated export controls. Similarly, the rapid technological pace at which products advance requires a legal infrastructure that can deal with this pace so that companies are not left behind in marketing their

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[13] Miller and Wurzburg, "Investing in Human Capital," *The OECD Observer*, No. 193, April/May 1995, pg. 16.

[14] For example, International Trade Administrative Data; http://www.ita.doc.gov/industry/otea/usio/.

[15] For more information on this topic, see "Investing in Human Capital," *supra*.

[16] For example, see Erickson, "Royalty Income From Software: Is It Rental or Sales Income?," *High Tech Industry*, July-August 1996, pg. 46. Also see letters submitted to the Treasury Department over the past five years by Baker & McKenzie on behalf of the Software Coalition: Tax Notes Today, 95 TNT 185-61 (Sep. 21, 1995), Tax Notes Today, 92 TNT 199-75 (Oct. 1, 1992) and October 24, 1991, Tax Notes Today, 91 TNT 237-51 (Nov. 20, 1991). For an alternative perspective on revenue characterization of software transfers, see Covington & Burling letter of December 11, 1992 to the IRS on behalf of IBM; Tax Notes Today, 92 TNT 256-20 (Dec. 24, 1992). Also see September 4, 1992 letter from Compuware Corporation to the IRS supporting the IBM's comments; Tax Notes Today, 92 TNT 189-38 (Sep. 17, 1992). Also see the Covington & Burling letter to the IRS dated June 12, 1992, Tax Notes Today, 92 TNT 165-38 (Aug. 13, 1992).

[17] Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, (JCS-6-91), May 30, 1991, pgs. 3 to 14 [hereinafter, JCS-6-91]

products worldwide because competitors are not subject to out-dated trade restrictions and other legal obstacles.

Briefly described below are some of the factors that must be considered in the entire debate on improving the international competitiveness position of American workers and businesses. The tax reform process should consider these factors in order to develop a cohesive set of policies that don't conflict with each other and thus defeat the overall goals of improving international competitiveness.

- *Education and worker training.* With the increased importance of intellectual and human capital of many businesses, relative to the importance of machinery, workers must be adequately prepared. The CSPP reported that in 1993, 74% of computer companies' revenues were derived from products that were not even in existence two years earlier.[18] Clearly, workers in such environments must be prepared for life-long learning and adaptability and have a solid technological foundation from which to grow. Development of these skills should begin in primary and secondary education; not just in college or trade schools.

- *Cross-border worker mobility.* We are accustomed to workers moving from state to state to find better jobs or to move when their employer expands. Such moves are relatively simple - visas and other paperwork are not required. In a global economy, attention should be given to making worker moves from one country to another a simpler proposition as well. The U.S. should work with other countries to stream-line worker transfers because such mobility is part of doing business in the global economy.

- *Intellectual property protections.* Clearly, protection of intellectual property of U.S. companies is an important part of being able to compete effectively in the global economy. While this is true for all types of companies with patents, copyrights, trade secrets and trademarks, it is particularly important in the software industry. Without international respect for intellectual property rights, a software company's ability to compete is greatly diminished. Software piracy must be controlled in order for U.S. software companies to be able to compete globally. Because software is one of the fastest growing industries,[19] attention needs to be given to this difficult problem.

- *Savings and investment.* The U.S., its businesses and its workers could be slowed down due to impediments to savings and investment, such as:

  - a high national dissavings in the form of our $5 trillion national debt and continual annual budget deficits;
  - double taxation of corporate earnings;
  - tax depreciation rates that are slower than those of other countries and the actual obsolescence rates of some high technology equipment;
  - high tax rates on capital investment, and lacking or distorted savings incentives (current savings incentives tend to favor home ownership relative to other types of investments);
  - reduced R&D incentives[20] and government investment in private R&D relative to other countries; and
  - anti-deferral tax provisions, such as IRC §956A and the PFIC rule's overlap with controlled foreign corporation rules, which encourage U.S. multinational firms to invest offshore.

- *Export controls.* While much debate[21] has occurred on export controls, solutions are often slow in coming. While these are difficult issues, often involving issues of national defense and security, they must be resolved in the same rapidly changing environment in which exporting businesses are trying to compete. The CSPP places the estimated cost of current export

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[18] CSPP, "Public Policy and the U.S. Computer Industry - Freedom To Grow - Leadership Into The 21st Century," January 1995, http://www.cspp.org/reports/.

[19] The Business Software Alliance (BSA) describes the computer software industry as one of the fastest growing industries and one that contributed over $36 billion to the U.S. economy in 1992. BSA, "The Computer Software Industry," January 1994.

[20] For example, the U.S. does not have a permanent research tax credit which hinders U.S. investment in R&D. Various studies have shown that an incentive and subsidy is warranted, Congress and the Administration favor a credit, yet, it is allowed to continually expire. See Cox, "Research and Experimentation Tax Credits: Who Got How Much? Evaluating Possible Changes," Congressional Research Service, June 4, 1996, for references to studies justifying some level of public support for private R&D.

[21] For background on the encryption technology debate, see S. 1726, the Commerce Promotion Act of 1996 and S. 1587, the Encrypted Communications Privacy Act of 1996; 104th Cong., 2d Sess. Also see "U.S. Offers 'Relief' From Curbs on Exports of Encryption Products," *International Trade Reporter*, BNA, Vol. 13, No. 24, pg. 973, June 12, 1996.

controls on cryptography at $60 billion and 200,000 potential jobs through the year 2000.[22] U.S. multinational firms should not have to suffer the consequences of politicized trade issues.

- *Antitrust policies.* Current antitrust policies should be reviewed and consideration given to what constitutes effective policies for U.S. companies competing in a *global* environment. While a company's actions are typically viewed in the context of how they affect U.S. competition, such actions should also be viewed as to how antitrust policy may impede the U.S. company from competing internationally. Again, difficult issues are involved, but they must be considered in the context of the topic of international competitiveness of American workers and businesses.

- *A global information infrastructure (GII).* Issues that have arisen in the U.S. regarding the national information infrastructure (NII), such as protection of intellectual property, content control and security, will also exist on the GII. The U.S. government should work with U.S. businesses and other governments to help ensure that the potential of the GII (including its business potential) is not hindered.[23]

- *A global legal infrastructure.* U.S. businesses have been burdened by a complex domestic infrastructure involving differing regulations and rules among the 50 states and often within each state as well. As the global economy grows and the above issues are addressed, consideration should be given to standardization of some processes such as registration of intellectual property, business registration, payment procedures, settlement of tax disputes, and export and import procedures.

Recognize How Other Countries Tax and Spend

The U.S. is only one of two OECD countries that does not employ a federal VAT. Thus, our tax system is "out-of-sync" with most countries. Current proposals for major reform call for replacement of the federal income tax with a consumption tax. Such a step would also keep the U.S. tax system out-of-sync with other OECD countries because they employ an income tax along with consumption taxes.[24] Before taking a drastic step to completely eliminate the U.S. income tax system, careful analysis should be made as to, 1) why other countries have both income and consumption tax systems, 2) how government spending in other countries differs from the U.S. (for example, many European countries have higher social spending on unemployment benefits, education and health care) and how that impacts their taxing decisions, 3) the ability to use the income tax system to reduce the regressivity of a consumption tax, and 4) the impact to state and local governments of replacing the federal income tax with a consumption tax.[25] In addition, tax differences between the U.S. income tax system and those of other countries, such as territorial versus worldwide tax systems, sourcing rules and foreign tax credit rules, should be considered in terms of how such differences may impede the competitiveness position of U.S. firms.

Importance of Identifying Policy Goals For the New Tax Rules

Arguably, some of the complexity of today's tax laws stems from the failure to ask the following question prior to making changes to the IRC: "Does the change support the underlying revenue and competitiveness policies of the U.S. tax laws?"

For example, international tax rules do not necessarily have similar policy objectives underlying them. This can lead to distorted incentives, such as where one rule encourages domestic investment, while other rules favor foreign investment (for example, current IRC §956A which actually encourages foreign investment in offshore plants versus the research tax credit which

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22 "Foreign Encryption Products Threaten U.S. Market, Industry Warns Lawmakers," *International Trade Reporter*, BNA, Vol. 13, No. 25, pg. 1019, June 19, 1996.

23 See OECD, "Common Vision Needed for Global Information Society," *OECD Letter*, Vol. 5/6, July 1996, and "Global Information Infrastructure and Global Information Society (GII-GIS)," OCDE/GD(96)93, for information on OECD activities in this area. See CSPP, "Perspectives on the Global Information Infrastructure," February 1995, for suggestions from several computer companies on the role of industry and government in effective development of the GII. Also see National Telecommunications and Information Administration (NTIA), "The Global Information Infrastructure: Agenda for Cooperation," 60 FR 10359, February 24, 1995.

24 OECD figures show that for 1992, OECD countries as a group relied on the following sources for tax receipts: personal income taxes 29.7%, corporate income taxes 6.8%, social security 25.0%, property taxes 5.5%, general consumption taxes, 17.1% and specific goods taxes 11.5%. 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, pg. 84.

25 See previous submission by the Joint Venture Tax Reform Study Group on the impact of tax reform on state and local government; http://www.svi.org/jointventure/tax/tax_fed.html, or 96 STN 142-36 (July 23, 1996), or State Tax Notes, Vol. 11, No. 4, July 22, 1996, pg. 253.

encourages domestic investment in R&D activities). Similarly, U.S. tax rules have not necessarily focused on the tax rules businesses face in foreign countries and how the U.S. tax rules on sourcing of expenditures, foreign tax credits, transfer pricing and labeling of transactions (such as sale of goods versus royalties) can lead to double taxation, costly controversies and non-neutrality of the tax rules (because tax implications can influence a business's investment decisions).

In reforming the tax system, time must be given to discussing what the appropriate policies should be to support the tax rules with respect to international business transactions. For example, should the rules encourage exports? be neutral as to where production occurs? follow a standard established by an international group, such as the OECD? or something else?[26] Without first having this discussion, any replacement tax rules will lead to the same complexities and distortions that currently exist in the federal income tax rules. Similarly, any efforts made to reform our current income tax rules in the international tax area (prior to major federal tax reform) should follow these same principles of first identifying, 1) what is the policy goal of the international tax rules, 2) whether the particular proposal will be within that policy goal, and 3) whether the proposal is the simplest and most effective method of reaching that goal.[27]

Finally, more efficient tax policies could stem from a better dialogue between government and industry. Government needs to listen to the experiences that companies are having in dealing with tax issues in their worldwide activities. Many of these issues can only be solved by actions on the part of Congress and the Administration to clarify or correct the U.S. tax laws, or in dealing with issues businesses face in applying both U.S. and some other country's tax laws to the same transaction.

Businesses have brought various tax rules that are not in the best interests of the U.S. economy, to the attention of Congress and the Administration. Two recent examples are, 1) the failure to clarify the IRC or regulations to enable software companies to obtain foreign sales corporation (FSC) benefits similar to that obtained by other industries, and 2) the failure to hear U.S. companies' appeal that the passive asset rule of IRC §956A and the PFIC rule's overlap with controlled foreign corporation rules actually encourage, rather than discourage, offshore plant investment. Given the rapid technological changes companies deal with today and the various complexities of doing business globally, a more efficient system must be developed for government and business to work together to maintain a set of tax rules that best serves the interests of the U.S. fisc and does not adversely impact U.S. companies and their workers. Multi-year delays in fixing problem areas in the tax law is not acceptable in the rapid technological and business development pace of today's global economy. Reform efforts should include creation of a system for quick resolution of costly tax issues and uncertainties as to how the law applies.

Problem Areas With Current Proposals and Tax Reform In General

- *Determine whether GATT-compatibility is important.* Consensus does not exist as to how important it is for a tax to be GATT-compatible. Some commentators view it as unimportant under the theory that a border adjustable tax is not an effective tool in reducing the trade deficit. In a 1992 report, the Congressional Budget Office stated that border adjustments do not improve the balance of trade because of resulting changes in exchange rates.[28] However, others, including Congressman Archer, view GATT-compatibility as an important goal for tax reform.[29] The importance of GATT-compatibility, must be further analyzed and openly

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[26] For a more detailed discussion of tax policies underlying certain foreign tax provisions of the IRC, see JCS-6-91, *supra*, pgs. 232 to 264.

[27] For example, these steps should be taken with respect to recent legislative proposals: S. 1597, 104th Cong., 2d Sess. (Dorgan) and S. 1928, 104th Cong., 2d Sess. (Levin). For an alternative perspective on this type of legislation, see Merrill and Dunahoo, "Runaway Plant' Legislation: Rhetoric and Reality," 96 TNT 131-18 (July 5, 1996).

[28] CBO, *Effects of Adopting a Value-Added Tax*, February 1992, pg. 63. Also see Esenwein, Congressional Research Service, "Consumption Taxes and the Trade Balance: The Role of Border Tax Adjustments," 95-893E, Aug. 14, 1995. This report notes that the balance of trade is affected by international capital flows, not by the flow of traded goods and services and border tax adjustments. "[A]ny changes in the product prices of traded goods and services brought about by border tax adjustments would be immediately offset by exchange rate adjustments. ... That is not to say that changes in the tax structure could not influence trade patterns. Tax policy can and does affect the composition of trade. In addition, changes in tax policy which might affect the underlying macroeconomic variables that govern capital flows (for instance, by increasing either public or private savings which in turn would lower interest rates) could affect the balance of trade. But, by themselves, border tax adjustments will not change a nation's balance of trade."

[29] Congressman Archer, "Goals of Fundamental Tax Reform," in *Frontiers of Tax Reform*, The Hoover Institute, 1996, pg. 5. Also, per Congressman Gibbons, a "border-adjustable tax system would promote the competitiveness of American companies and invigorate American exports." Gibbons, "A Revenue System for America's Future," outline to his subtraction method VAT proposal, March 27, 1996, pg. 3.

debated prior to instituting a tax that is not GATT-compatible, such as the Armey flat tax, or making an effort to ensure that a new tax is GATT-compatible if it makes no difference. This debate should consider, 1) the effect of GATT-compatibility under various trade balance scenarios, 2) the effect in the long-term versus the short-term, 3) the impact of transitioning to a GATT-compatible tax, 4) possible differences of impacts among industries, and 5) trading partner acceptance of the taxing system as GATT-compatible.

- *Determine whether a subtraction VAT is GATT-compatible.* If it is determined that GATT-compatibility is important, careful attention must be paid to the new tax to be enacted to be sure that it is truly GATT-compatible. Most of the world using a VAT uses the credit invoice VAT which is more obviously an indirect tax, relative to the subtraction VAT. As noted by former Treasury Assistant Secretary, Les Samuels, "Whether a subtraction method VAT would survive a GATT challenge is an untested issue."[30] Also, per a 1991 Joint Committee on Taxation report: "there is considerable uncertainty as to whether a subtraction-method VAT would be legal under GATT. The distinction may be made that a subtraction-method VAT, unlike a credit-invoice VAT, is not imposed on particular transactions but directly on a business, where the tax base is equal to the business's value added. In this technical respect, a subtraction-method VAT may more closely resemble a corporate income tax than a sales tax."[31] On the other hand, others believe that a subtraction VAT is likely to be GATT compatible.[32]

  In the GATT-compatibility debate, it is important to note that the current proposals call for a *variation* on a subtraction VAT. While a pure subtraction VAT might be shown to be GATT compatible, the USA subtraction VAT is not a pure subtraction VAT because of its NOL carryforward and FICA credit provisions. These provisions may indicate that it is not an indirect tax. However, if this is true, these are fixable aspects of the proposal; the key will be to fix such problems prior to enactment, rather than upon a later GATT challenge.

- *Expand the VAT debate to include the credit invoice VAT.* Almost all countries that use a VAT use the credit invoice method VAT. However, current major tax reform proposals in the U.S. all call for some form of the subtraction method VAT. Reasons for favoring a subtraction method VAT over the credit invoice VAT include:

  - The subtraction method VAT is viewed as not tolerating any special rates or exemptions, thus it will not suffer from the same problems that the income tax has (such as having over 100 special preferences).
  - In terms of computation, the subtraction method VAT looks more like the income tax and thus, will be better accepted in the U.S.

  Both of the above reasons for favoring a subtraction method VAT have serious underlying problems. First, it is not politically reasonable to assume that preferences and special rates cannot be added to a subtraction VAT - someone will surely figure out a way! In fact, it has already been shown that a subtraction method VAT can tolerate exemptions as evidenced by the Danforth-Boren business activities tax (BAT), a form of subtraction VAT introduced in 1985, which calls for an exemption for businesses with gross receipts under $100,000.[33]

  The fact that a subtraction VAT has similarities to our current income tax is both a plus and a minus. The plus is that it will rely on records businesses already have in place for state income tax and financial reporting purposes. The minus is the fact that it leads to confusion as to what is actually being taxed; it also leads to potential GATT-compatibility problems. For example, one of the common complaints voiced about a subtraction method VAT proposal, such as the USA tax, is that it is an unfair tax on labor because no deduction is allowed for labor. Such a comment likely comes about because when the tax looks so much like our income tax, we expect it to include "typical deductions," such as those for labor. However, a consumption-type VAT taxes "value-added" to goods and services acquired from another business as the goods and services move through the production and distribution chain. The key element of that "value-added" is the labor that a business applies to the goods and services as they move through the production and distribution chain (thus, there is no "deduction" for wages because it is *supposed* to be taxed under a value-added taxing scheme).

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[30] From June 7, 1995 record testimony (pg. 28) before the House Committee on Ways and Means by then Assistant Treasury Secretary (Tax Policy), Les Samuels.

[31] JCS-6-91, *supra*, pg. 304.

[32] For example, see Hufbauer and Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*, Institute For International Economics, 1996, pgs. 67 to 70. Hufbauer posits that the subtraction VAT can be attributed to individual products unlike the corporate income tax which is dependent on the business cycle and other factors. Hufbauer also suggests that the associated legislation should be drafted to indicate that the liability for the tax attaches when the goods or services are sold. The Hufbauer text contains an excellent and very complete discussion of border adjustments. Also, the sponsors of the USA proposal appear to have taken the position that it is a GATT-compatible tax.

[33] S. 2160, 103d Cong, 2d Sess.

Under the credit invoice form of a consumption type VAT, it is more clear what (and who) is being taxed and the complaint that it is an unfair tax on labor is not typically raised. Yet, where there are no exemptions or special rates, both forms of VAT raise the same amount of revenue.

A subtraction VAT may lead to GATT-compatibility problems because it is proposed to look so much like a non-GATT compatible income tax (direct tax). For example, under the USA proposal, if a business has purchases greater than revenues, a net operating loss (NOL) is generated which can be carried forward for 15 years[34] (very much like our income tax system). Under a VAT, a refund would be more appropriate when a business's purchases from other businesses exceed its sales for the year. Also, under the USA proposal, a business could transfer its NOL carryforward along with a transfer of its assets.[35] These two features make the USA business tax look more like something imposed on the business (a direct tax) rather than on the consumer (an indirect tax). Under a credit invoice VAT, these issues do not arise. A credit invoice VAT makes it clear that the ultimate consumer is paying the VAT and if purchases exceed sales for a business, the business receives a VAT refund. Also, the credit invoice VAT is known to be GATT-compatible, while the forms of subtraction VAT proposed in the current debate have not been tested under GATT (see earlier discussion).

For the reasons noted above, as well as the fact that a debate as significant as replacing the federal income tax requires an honest look at all possible options, all appropriate proposals should be on the table, including the credit invoice VAT.[36] This will lead to a more effective debate, allow for consideration of how most of the rest of the world taxes and perhaps allow for a more honest perspective of what a consumption-type VAT is and how it does indeed differ from our current income tax.

- *Renegotiation of tax treaties.* Current tax treaties deal with income taxes, not consumption taxes. Thus, the treaties will need to be renegotiated if the income tax is replaced. The time frame needed for this task, as well whether other countries would be willing and interested in renegotiating treaties with the U.S., must be considered in the tax reform debate.

- *Industry neutrality with respect to a destination-based tax.* For a variety of reasons, certain financial factors differ among industries. For example, U.S. Department of Commerce figures for 1994 show the following for two different industries:[37]

	Motor vehicles and Car bodies (SIC 3711)	Computers and Peripherals (SIC 3571, 3572, 3575, 3577)
Production workers	198,000 (est.)	67,000 (est.)
Average hourly earnings	$24.57	$13.01
Total employment	237,000 (est.)	191,000 (est.)
Capital expenditures	$2,774 million (1992)	$2,123 million (1992)
Value of shipments	$185,111 million (est.)	$70,500 million (est.)
Value of exports	$22,038 million	$30,393 million
Value of imports	$72,596 million	$46,833 million

This information indicates that these two industries vary in the amount of shipments that are exported and the amount of total workers who are production versus non-production workers. In addition, the capital expenditures for the two industries are close in amount although total shipments in the motor vehicle industry are over twice those for the computer industry. Differing exports, capital expenditures and wage bases will exist among companies within each industry as well. These differences should be given some consideration in the design of a neutral tax system so that businesses are not unfairly and unjustifiably favored or penalized under the tax system.

For example, the current design of the USA tax for businesses imposes a separate tax on the value of imports (but at the same tax rate as imposed on domestic operations). The USA tax allows businesses to reduce their tax liability by a credit equal to the FICA taxes paid. However, this credit may not be used to reduce the import tax. A capital intensive business, such as a chip manufacturer, may have zero tax liability under the business tax due to the expensing of capital equipment and the FICA credit. Such a company may likely generate NOL and FICA credit carryovers as well. At the same time, the company will owe an import tax. Thus, the tax system for such a company becomes one of zero domestic tax (with NOL and

[34] S. 722, 104th Cong., 1st Sess., §207(b).

[35] S. 722, 104th Cong., 1st Sess., §207(d)(2).

[36] Much analysis has been performed on the credit invoice VAT by two tax practitioner groups: AICPA, *Design Issues in a Credit Method Value-Added Tax for the United States*, May 1990, and ABA Section of Taxation, *Value Added Tax - A Model Statute and Commentary*, 1989.

[37] Bureau of the Census, International Trade Administration, http://www.ita.doc.gov/industry/otea.usio/95s1481.txt (95s1494.txt).

credit carryovers which may never be needed), with tax only paid in the form of an import tax. On the other hand, a company that does not rely on imports to the same degree and/or is not capital intensive, will be able to claim benefit of its FICA credit because it does have domestic business tax base. Thus, two companies could have equal domestic wage bases yet be subject to quite different tax bills. A remedy to allow for a more neutral tax would be to allow for the FICA credit to be used against any tax liability.

- *Destination-based versus origin-based tax system.* A common preference touted for a destination based tax is that it will improve the balance of trade. However, many commentators state that this is not true (see GATT discussion above). This issue is closely tied into GATT compatibility (discussed above) and should be debated with that similar issue. Included in that debate should be other factors, such as transfer pricing issues and rules, that may tend to justify one tax system over the other. For example, while transfer pricing issues would be reduced from a U.S. government perspective under a destination-based tax, transfer pricing remains an issue under an origin-based tax system. However, under a destination-based tax system, U.S. businesses may likely face heightened transfer pricing scrutiny from other countries because the pricing of U.S. exports receives no scrutiny under the U.S. tax laws, potentially making such values entering foreign countries more "suspect." State tax coordination with a federal consumption tax should also be included in this origin versus destination-based debate.[38]

- *More attention needs to be given to intangibles in taxing schemes.* Transfers of intangible assets, such as information and software, are more difficult to tax relative to the transfer of visible tangible assets. Also, while tangible assets can be seen by customs agents when the goods cross borders, the same is not true of information, software and telecommunications. With the increasing amount of revenues generated from transfers of intangibles, realistic tax schemes must be found. Such schemes should be coordinated with the rules of other countries to avoid double taxation, and unnecessary compliance burdens. For example, under the Armey flat tax, if the licensing of U.S. technology to a foreign entity is viewed as a taxable export and the foreign country also taxes the royalty income, the U.S. taxpayer will be subject to double taxation because the Armey flat tax does not allow for a foreign tax credit. As noted by the National Commission on Economic Growth and Tax Reform ("Kemp Commission"), attention must be paid to the "proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."[39]

  The current reform proposals and the tax reform debate have ignored the tax treatment of intangible assets for the most part. For example, the USA proposal includes rules on sourcing goods and services for purposes of determining if income and expenses are considered non-taxable export income, or a taxable import. However, it does not discuss how to source royalty income and royalty payments related to intangible assets, or whether such payments are considered to be for services.

  The Armey flat tax does not include sourcing rules at all. Guidance would be needed, for example, on how to determine whether licensing of an intangible asset to a foreign licensee should be viewed as a taxable export, non-taxable investment income, or non-taxable foreign income. Also, where development of an intangible occurs both inside and outside the U.S. and/or it is licensed both inside and outside the U.S., guidance will be needed as to how the costs and revenues from the intangible factor into the taxpayer's U.S. tax liability.

- *Potential problems if the U.S. becomes a tax haven.* In *The Flat Tax*, authors Hall and Rabuska note that with a 19% tax rate and expensing of investment, "foreign investment should pour into the United States."[40] While this may sound great for the U.S. economy, consideration must be given to whether such an assumption is realistic (investment in the U.S. is not solely dependent on tax considerations). Should this assumption be a possibility however, the U.S. must then factor in what possible "retaliatory" actions other countries may take to try to keep investment within their borders. Such competition for business and tax dollars might not be a beneficial outcome for both businesses and governments.[41]

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[38] For a thorough discussion on the topic of origin based versus destination based taxes and related international tax issues presented by major federal tax reform, see Grubert and Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal*, December 1995, pg. 619; Avi-Yonah, "Comment on Grubert and Newlon, "The International Implications of Consumption Tax Proposals,"" *National Tax Journal*, June 1996, pg. 259; Grubert and Newlon, "Reply to Avi-Yonah," *National Tax Journal*, June 1996, pg. 267; Avi-Yonah, "The International Implications of Tax Reform," 95 TNT 223-63, (Nov. 13, 1995); and Horowitz, "Evaluating Fundamental Tax Reform: The U.S. Multinational Perspective," 96 TNT 27-61 (Feb. 7, 1996).

[39] Report of the National Commission on Economic Growth and Tax Reform, January 1996, pg. 18.

[40] Hall and Rabushka, *The Flat Tax*, Hoover Institution Press, 1995, pg. 121.

[41] For a perspectives on this, see Slemrod, "Some Implications for American Tax Policy of Global Competition," *Tax Notes International*, 3 TNI 1039, September 1991; and Holland and Owens, "Tax, Transition and Investment, *The OECD Observer*, No. 193, April/May 1995, pg. 29.

Conclusion

With respect to consideration of the impact of major federal tax reform on international competitiveness, we encourage Congress to:

- *Recognize a changed business environment and the need for quick action to solve problems.* Identify what the global economy of today and the tomorrow looks like and how it differs from the world that shaped our existing tax laws and policies. Businesses should not be held back by unclear rules and the slowness of the government bureaucracy to fix roadblocks that hinder a business's ability to effectively compete in the global economy. If the debate is focused on what currently exists in the IRC and why rules were written the way they were years ago, it will be a useless debate.

- *Think globally, not domestically.* A key statistic cited in discussing international competitiveness is the level of U.S. exports and imports. This perspective by itself is outdated and limiting because it is easy for many high technology companies to operate almost anywhere in the world, yet still provide benefits to the U.S. economy. Perhaps the focus should be on worldwide operations and whether a U.S. business is facing any legal obstacles that are impeding its worldwide growth and how the U.S. can assist in reducing such obstacles.

  A focus on exports and imports (the trade imbalance) may also lead to "domestic tunnel vision" which similarly might lead to policies that impede the worldwide growth of a U.S. business. A decision by a U.S. firm to locate operations outside of the U.S. should first be viewed as a reasoned economic one which likely still provides some benefits to the U.S. economy.[42] Today, application of "domestic tunnel vision" is likely to apply and lead to legislation to prevent or penalize such business decisions. Such actions should be considered in terms of whether they make sense in terms of the global economy in which businesses operate today.

- *Work with businesses to better identify the appropriate policies that should underlie international tax rules.* For example, should exports be encouraged? Should investment in foreign business activities be discouraged? Should taxes be a neutral factor in these decisions? Consideration must also be given to how other countries tax international transactions and how countries can work together in the global economy and collect tax revenues in an effective and cost-efficient manner.

- *More than just tax rules need to be considered.* Approach the task of improving international competitiveness as the broad proposition that it is. That is, consider education and worker training of today's workers who must deal with rapid technological advancement and competition from skilled workers in other countries. Also consider how to protect intellectual property of U.S. businesses in the global economy, how U.S. savings and investment actions and policies impact the ability of U.S. businesses to compete globally, as well as the impact of export controls, antitrust policies, and how the global infrastructure in which businesses must operate might be streamlined through coordinated efforts of governments working together.

- *Work to preserve and further encourage this country's entrepreneurship and technological expertise.* Given the rapid changes in technology and the continuing growth potential for high technology products, U.S. policies should focus on ensuring that students are provided the skills to enable them to work in and further advance high technology industries.

- *Various tax impediments to competition exist.* Consider the broad realm of tax impediments to competition. This includes, complexity and its related compliance costs and costs of actions not taken due to tax uncertainty, lack of government commitment to R&D incentives, depreciation rates that serve revenue needs rather than business realities, double taxation of corporate income, hindrances to capital formation such as rules that prefer debt over equity, and income tax differences between U.S. rules and those of its major trading partners.

- *Start now.* Realize that the international aspects of tax reform are likely the most difficult ones and the above tasks should begin now.

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[42] For example, as noted in a 1991 Joint Committee on Taxation report, outbound investment may free up U.S. debt capital and labor for new investment opportunities in the U.S. JCS-6-91, *supra*, pg. 235.

STATEMENT ON THE IMPACT OF FUNDAMENTAL TAX REFORM ON THE INTERNATIONAL COMPETITIVENESS OF U.S. BUSINESS AND WORKERS

BY THE
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

JULY 18, 1996

Introduction

The National Association of Manufacturers wishes to express its great appreciation to the Committee's Chairman, Mr. Archer, for inviting us to present our views on the impact of fundamental tax reform to the international competitiveness of U.S. businesses and workers, including the effect of fundamental tax reform on imports and exports. NAM represents almost 14,000 member companies and subsidiaries.

As you know, the international tax area of our current income tax system includes a myriad of complexities. NAM has consistently supported various foreign tax simplification proposals that have been introduced in Congress over the last few years. A number of Congressmen and Senators, as well as officials of the Clinton Administration, have suggested that the current Internal Revenue Code ("Code") can be repaired, or at least improved to an acceptable level with some modifications (both major and minor). Others, like yourself Mr. Chairman, have argued that our current tax system must be pulled out by its roots and replaced with an entirely new system, such as one that taxes the consumption of goods and services.

Upon initial reflection, it appears that the leading tax proposals would greatly simplify the international area for most taxpayers. These proposals move away from the current system that taxes "worldwide" income, to approaches that are "territorial" in nature, meaning they exempt most types of foreign income (passive investment income being a major exception). These proposals would also promote the competitiveness of U.S. multinationals versus foreign based competitors by their exemption of foreign source dividends and branch income. This would help ensure that foreign subsidiaries of U.S. companies do not pay more tax on their corporate income than their foreign competitors do in foreign markets. These proposals are also uniform in reducing the tax rates for corporations, which again should help U.S. companies compete against their foreign competitors. The USA and flat tax proposals would be beneficial to manufacturers by providing for immediate expensing of capital investments.

However, it must be kept in mind that all of these proposals will require extensive efforts in the area of transition rules and will have a tremendous impact on businesses. Some experts advocate more of a "cold turkey" approach in which there will be a minimal transition period, while others advocate a more comprehensive and long-lasting approach. In any event, without special transition rules, the replacement of the income tax with a consumption tax would haphazardly subject many individuals and businesses to large tax penalties. In addition, without adequate transition relief, tax reform proposals could have a large and significant impact on the financial statements of many firms. Finally, business taxes under any new system should be compatible with the border adjustable systems of our trading partners so that, for example, American exports are not double taxed by the U.S. and the destination country.

Whether or not any of the tax reform proposals eventually become law, NAM believes that the current tax system as it impacts the international area has much room for improvement. Therefore, to assist you in deciding whether to retain the current tax system with modifications or to implement fundamental tax reform, we have provided a sampling below of the many inequities that currently exist in our tax system regarding the international area:

Provide Look-Through Rules for So-called "10/50 Companies"

Current law (resulting from changes provided by The 1986 Tax Reform Act ("TRA")) requires U.S. companies involved in foreign joint venture corporations (as opposed to foreign partnerships) to calculate separate foreign tax credit ("FTC") limitations for income earned from each such joint venture corporation in which U.S. owners own less than a majority interest (at least 10 percent but not more than 50 percent, i.e., so-called "10/50 Companies"). Thus, a U.S. corporation owning many 10/50 Companies must create a very large number of separate baskets. Not only does this result in substantial complexity and higher costs, it also results in a very detrimental tax situation versus controlling (i.e., more than 50 percent) owners of foreign joint ventures. That is because owners who receive dividends, interest, rents or royalties from controlled foreign corporations ("CFCs") can "look-through" such income to the nature or character of the payor corporation's underlying income, and include it in these general limitation basket categories instead of into separate limitation baskets.

U.S. owners of foreign joint ventures often are unable (through no fault of their own) to acquire controlling interests, especially in cases where the foreign joint venture partner is a foreign government or the activity involved is a government regulated industry. It is patently unfair to penalize such non-controlling joint venture owners. Instead, current law should be changed to equalize the treatment for both types of joint venture owners, by allowing look-through treatment for income (dividends, interest, rents, and royalties) earned from all foreign joint ventures owned at least 10 percent by U.S. owners.

On a related matter, current Treasury Regulations (§ 1.904-5(h)(1)) require that payments of interest, rents, and royalties from partnerships to partners not acting in that capacity must also treated as separate basket passive income unless U.S. partners own more than 50 percent of the partnership. Again, this result is not good tax policy. However, by extending look-through treatment to 10/50 companies as proposed above, this problem involving partnerships will be corrected.

Repeal Section 956A

Code Section 956A, implemented with the 1993 Tax Act, was intended to eliminate so-called "deferral" of U.S. income tax for U.S. shareholders of CFCs to the extent that the CFC's earnings are invested in excess passive assets rather than in active business assets. However, this section has instead had the effect of adding an additional layer of complexity to the already existing anti-deferral regime of the Code, while providing taxpayers an incentive to engage in costly, non-economical transactions in order to avoid its application. Contrary to earlier estimates, this provision has not created a positive impact on cash flows from foreign companies to U.S. parents, or resulted in more U.S. manufacturing jobs. Rather, it has created incentives for investing in assets outside the United States and should be repealed immediately.

Exclude CFCs from the PFIC Rules

The Subpart F rules of the Code currently provide exceptions to the general rule of so-called deferral for tax haven and foreign personal holding company ("FPHC") type income (i.e., passive income) from CFCs. The 1986 TRA added certain provisions called

the Passive Foreign Investment Company ("PFIC") rules that effectively tax all income currently from foreign subsidiaries that have more than a designated amount of passive income or assets, even though the balance of the income is from active manufacturing operations. In other words, all income can be effectively tainted even though only a portion of it is from passive type activities that would have been currently taxed under Subpart F rules. Although the PFIC rules were intended to eliminate certain identified abuses relating to U.S. investors in overseas mutual funds, they were inadvertently drafted in a manner to also cover CFCs (even though CFCs were already sufficiently regulated by the Subpart F rules). To correct this error, the PFIC provisions should be amended so that companies subject to Subpart F (i.e., CFCs) are exempt from their application.

Amend Definition of PFICs

The PFIC provisions currently apply where 75 percent or more of a foreign corporation's gross income is passive, or where at least 50 percent of the foreign corporation's assets produce passive income. By using a gross income test, a foreign corporation will become a PFIC even though 99 percent of its gross receipts are from the active conduct of a trade or business, so long as its cost of goods sold exceeded its gross receipts that year and it had a dollar of passive income (like working capital interest income). This result is illogical. The PFIC provisions should be amended so that they only apply where the predominant character of the business is passive or the majority of assets is passive. This can be accomplished by changing the test to look to gross receipts rather than gross income, for example, by defining foreign corporations as PFICs if at least 75 percent of their gross receipts are passive.

Retain Current Sourcing Rules under Section 863(b)

Current law allows taxpayers who manufacture goods in the U.S. and sell the goods outside the U.S. to treat 50 percent of the income arising from the sale as foreign sourced income. The intent of this provision is to enhance the competitiveness of U.S. businesses in the global market place and generate additional jobs in the U.S. Proposals have been made in recent years to significantly curtail or eliminate this provision as a way to raise revenues for other programs. It is this sort of "rob Peter to pay Paul" approach, without regard to a coherent tax policy, that has brought us to the point where we are today.

Repeal the 90 Percent Limit on FTCs under the Alternative Minimum Tax ("AMT")

Current law limits the ability of taxpayers to offset their corporate AMT liability by allowing FTCs to offset only up to 90 percent of such AMT. This has the likely result of taxing certain U.S. multinationals more heavily on their foreign income than their foreign competitors, or domestic companies having no foreign operations. Repealing this limitation would merely permit foreign taxes actually paid to be offset up to the amount of AMT liability on foreign source income, without affecting any U.S. source tax liability. As a result, the likelihood of double and sometimes triple taxation of foreign source income would be lessened, making U.S. multinationals more competitive internationally.

Alternatively, taxpayers could be given an election to use as their AMT FTC limitation fraction the ratio of foreign source regular taxable income to entire AMT income. This would eliminate the need to separately calculate AMT foreign source taxable income.

Amend the AMT Cost Recovery Rules

The AMT is a significant factor in reducing the competitiveness of U.S. companies. Approximately one-half of AMT revenues are generated from manufacturing and resource-based industries. These industries are cyclical in nature and compete in markets

where prices are determined by global competition. This increased tax burden cannot be passed on in the form of price increases since no other country in the world imposes such a draconian system of taxation. All of our major competitor countries provide better cost recovery for investments than does the U.S. under the AMT depreciation rules. At a minimum, the AMT cost recovery rules, regarding both depreciable lives and methods, should be conformed to those provided by the regular corporate income tax depreciation rules.

Extend FTC Carryforward and Carryback Periods

Currently, FTCs not used against U.S. tax in the current year may be carried back 2 years and carried forward 5 years. In contrast, the rules for net operating losses ("NOLs") provide a 3 year carryback and 15 year carryforward period. The shorter time periods have caused FTCs to expire unused, subjecting foreign source income to double taxation and frustrating the purpose of the credit. The current rules are especially harsh for taxpayers in cyclical industries which experience substantial operating losses. Thus, the FTC carryback and carryforward periods should be amended to conform with the time periods for NOLs, i.e., 3 year carryback period and 15 year carryforward period.

Amend Domestic Loss Recapture Rule

Currently, when a taxpayer has taxable income from U.S. sources but an overall loss from foreign sources, the foreign source loss reduces the U.S. source taxable income and U.S. tax liability by decreasing the taxpayer's worldwide taxable income on which the U.S. tax is based. When the taxpayer subsequently earns foreign source income, a potential double tax benefit (i.e., deduction for the loss but no payment of U.S. tax on subsequent foreign source income because of FTCs) is avoided under a rule requiring a recapturing of the prior tax benefit upon subsequently derived foreign source income. It does this by treating a portion of that foreign income as domestic source for FTC purposes (which reduces the allowable FTCs for the year). Current law also provides that an overall U.S. loss reduces a taxpayer's foreign source income. The U.S. loss reduces the taxpayer's U.S. tax liability and, through application of the loss against foreign income, the FTC limitation is correspondingly reduced. However, taxpayers are not allowed to recapture the prior U.S. loss by recharacterizing subsequent U.S. source income as foreign source. To prevent this inequity (and achieve tax symmetry), the law should be amended to recharacterize such subsequent domestic income as foreign source to the extent of the prior domestic loss, in order to recognize the FTC that was disallowed because of the domestic loss.

Increase Allocation of R & E to U.S. Source Expense

Taxpayers that perform research and experimentation ("R & E") in the U.S. but also generate foreign source income must allocate part of their U.S. incurred R & E against their foreign source income. The allocation ratio has changed several times over the last 20 years. For example, from 1987 through 1988, taxpayers were allowed to apply 50 percent of their U.S. incurred R & E costs against U.S. source income with the remaining allocated between U.S. and foreign source income based on gross sales or gross income; from 1989 through 1992, taxpayers could apply 64 percent of U.S. incurred R & E against U.S. source income with the remaining 36 percent allocated between U.S. and foreign; from 1993 forward, taxpayers again may only apply 50 percent of U.S. sourced R & D against U.S. source income, with the remainder allocated between U.S. and foreign source.

A permanent and more liberal solution to the R & E allocation is required. Research programs require long-term planning and foreign jurisdictions are not likely to recognize research expenses incurred in the U.S. as proper deductions for foreign local tax purposes (in fact, the net effect may encourage taxpayers to perform research outside the U.S. in order to

secure full local tax deductions). Therefore, the law should be amended to permanently provide that 64 percent of U.S. incurred R & E is to be allocated against U.S. source income, with the remainder allocated based on gross sales or gross income.

Make Permanent the R & E Credit

Innovation is the key to the international competitiveness of U.S. companies, and tax policies encouraging investment in research such as the R&E tax credit are important elements to encourage such innovation. This is particularly the case because most of the trading partners of the U.S. companies provide various forms of R&D incentives in their country. It is also very important that these tax policies are stable, reflecting the long term nature of the research process. Thus, we strongly recommend that Congress make permanent the R&E tax credit.

Modify Rules for Allocating Interest to Foreign Source Income

Taxpayers are required to allocate domestic interest expense to both foreign and domestic business activities. This is based on the theory that money is fungible and there is flexibility in obtaining and utilizing funds. However, interest expense incurred by foreign affiliates is not taken into consideration in allocating interest expense to foreign source income. To ignore foreign affiliate interest expense is inequitable and places U.S. multinational companies at a competitive disadvantage. In this regard, interest expense incurred by a U.S. subsidiary of a foreign company is allocable entirely to U.S.-source income (assuming the subsidiary's operations are conducted only in the U.S.); however, a U.S.-based multinational company that is a direct competitor in the U.S. market must allocate a portion of its interest expense to foreign-source income to the extent it has foreign assets or shareholdings. Thus, the U.S. income of the U.S. based company is overstated and overtaxed compared to the foreign-owned U.S. subsidiary. To correct this problem, the interest expense of all controlled companies (more than 50% owned) within an affiliated group, including foreign corporations, should be factored into the allocation. This would allow interest expense incurred by foreign affiliates to reduce the interest expense of the group that would otherwise be allocated to foreign-source income.

Use E & P Depreciation for Asset Bases when Allocating Expenses

Taxpayers may elect to allocate interest between foreign and U.S. sourced income on the basis of tax book value. Since U.S.-sited assets typically reflect accelerated depreciation while foreign-sited assets utilize slower depreciation methods, U.S.-sited assets will typically have lower tax bases than similarly placed in service foreign-sited assets. This results in a disproportionately higher amount of interest being allocated against foreign-sourced income. To correct this problem, the law should be amended for purposes of allocating expenses to permit taxpayers to determine basis for both U.S. and foreign-sited assets by using the same depreciable methods and lives as used for E & P purposes.

Exempt Foreign Entities from the Uniform Capitalization Rules

The uniform capitalization rules ("UNICAP") under Code Section 263A require certain costs to be capitalized to inventory and certain interest to be capitalized as a production cost. Although the legislative history to this section does not compel its application to foreign corporations not doing business in the U.S., the Treasury Regulations specifically apply such rules to foreign corporations with U.S. shareholders. However, U.S. multinationals already incur significant costs at both the head office and affiliate level to bring foreign E & P into conformity with U.S. tax principles for purposes of computing FTCs. Requiring the determination of UNICAP adjustments to such earnings merely adds additional compliance costs that are not borne by foreign based multinationals. Since UNICAP really has no relevance to foreign corporations not conducting business in the U.S.,

and since the revenue generated by applying these rules to foreign entities is small in relation to the administrative burden they cause. Code Section 263A should be amended to exempt foreign entities not doing business in the U.S.

Additional Provisions

This is by no means an exhaustive list of all the problems currently existing in the international area of the U.S. income tax system. Both Congressmen Amo Houghton and Sander Levin, through H.R. 1690, and Senator Larry Pressler, in his recently introduced International Tax Simplification for American Competitiveness Act of 1996, have proposed many additional provisions that would help to eliminate some of the complexities which plague the foreign tax area. Some of those provisions would:

- Allow shareholders of PFICs to make mark-to-market elections, provided that the PFIC stock is traded on a national securities exchange or otherwise treated as "marketable" under Treasury Regulations.

- Clarify the definition of passive income for PFICs, so that the same-country exceptions from the definition of FPHC income under Code Section 945(d) do not apply in determining passive income for purposes of the PFIC definition, and make it clear that passive income does not include Foreign Sales Corporation ("FSC") income.

- Allow intangible assets for PFIC purposes to be valued at fair market value (if value can be readily obtained).

Treaty Issues

The impact of tax reform on our existing tax treaty network must not be overlooked. Of course, the most recognized function of tax treaties and the principal reason they are negotiated is to eliminate double taxation of the same income, which occurs when two jurisdictions attempt to tax the same income or assets due to overlapping exercise of authority. However, most of the tax systems being proposed to replace the current U.S. income tax would be territorial in nature and exclude foreign source income from taxation (e.g., a "flat" tax or a "goods and services" tax). Thus, the issue of double taxation would be reduced considerably under such regimes. Nevertheless, many other benefits resulting from our tax treaty network would be jeopardized no matter what alternative tax system is chosen to replace the current one.

For example, one significant benefit of tax treaties is to facilitate business transactions between countries that might otherwise be inhibited by overly intrusive national taxation. Beyond the actual tax cost, the mere exposure to another country's tax system may impose significant transactional complexities on a company venturing outside its own national borders, e.g., protracted dealings with various tax authorities. To alleviate some of these problems, treaties include a notion of "permanent establishment" ("PE") as a threshold to taxation. Under this concept, the business profits of an enterprise of one country will not be deemed to be subject to taxation by the other country unless it does business there through such a PE, i.e., unless there is a sufficient connection between the enterprise and the taxing country in terms of having a fixed place of business there, dependent agents, etc. Moreover, most of the recent treaties negotiated by the U.S. have limited the imposition of tax to the business profits attributable to the PE, as opposed to items unrelated to the PE itself (such as passive investment income and capital gains). In addition, tax treaties sometimes exempt residents of one country who visit the other for a limited period of time. This eliminates the need to prorate small amounts of income and file foreign tax returns (often more irritating

than paying taxes), and encourages interaction of visitors between countries.

The tax systems of most countries impose withholding taxes (at often high rates) on payments to foreigners of items such as dividends, interest, rents, and royalties. Lowering of these withholding taxes is another important function of tax treaties. If U.S. companies operating abroad cannot receive reduced withholding tax rates offered by tax treaties, they often suffer excessive levels of foreign tax. This puts such U.S. companies at a competitive disadvantage relative to companies headquartered in other countries that do provide such treaty benefits. Thus, it is clear that tax treaties measurably reduce the barriers to U.S. participation in international commerce.

Almost all treaties forbid discrimination against the nationals of a treaty partner. One general effect of this is to prohibit U.S. tax on residents of treaty countries that is more burdensome than the tax imposed on similarly situated U.S. persons. Likewise, U.S. persons operating in treaty countries would also be protected under such a non-discrimination type clause. A nondiscrimination clause would generally permit differences in the treatment of domestic and foreign taxpayers only if justified by significant differences in the circumstances of those taxpayers.

Another function of tax treaties is to ensure that equity is served and tax is imposed at least once, i.e., by targeting tax avoidance schemes such as the use of tax havens. Most U.S. tax treaties contain explicit provisions called "anti-treaty shopping". These provisions identify the group of taxpayers entitled to benefit from the treaty relief while, at the same time, also preventing other taxpayers (generally from countries not party to the treaty) from enjoying such treaty benefits. To help support enforcement, income tax treaties generally provide for exchanges of information between the tax authorities of the treaty countries. In addition, most provide a mechanism known as "competent authority", which permits a taxpayer of one country to seek the assistance of that country's tax authorities for support against adverse interpretations of the treaty by the other country's taxing authorities. Even if the U.S. moves to a territorial system of taxation, such needs may not be muted since our treaty partners may still require such information exchanges.

Conclusion

We thank you for this opportunity to provide our comments and trust that this has given you a better understanding of the many problems that currently exist in the tax law as it applies to the international area. We sincerely hope that this will help you in your decision whether to revise the current system or move toward a completely new tax framework.

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.
PRESENTED TO THE
HOUSE WAYS AND MEANS COMMITTEE
BY FRED F. MURRAY, VICE PRESIDENT FOR TAX POLICY
JULY 18, 1996

ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS
OF REPLACING THE FEDERAL INCOME TAX

Mr. Chairman, and Members of the Committee:

The National Foreign Trade Council, Inc. (the "NFTC" or the "Council") is pleased to present its views on the impact on international competitiveness of replacing the federal income tax.

The NFTC is an association of businesses with some 550 members, founded in 1914 under the auspices and support of President Woodrow Wilson and 341 business leaders from across the U.S. Its membership now consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies and most of the 50 largest U.S. banks are Council members. Council members account for at least 70% of all U.S. non-agricultural exports and 70% of U.S. private foreign investment. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad.

The founding of the Council was in recognition of the growing importance of foreign trade to the health of the national economy. Since that time, expanding U.S. foreign trade and incorporating the United States into an increasingly integrated world economy has become an even more vital concern of our nation's leaders. The value of U.S. international trade (imports plus exports) as a percentage of GDP has more than doubled in recent decades: from 7 percent in the 1960's to 17 percent in the 1990's. The share of U.S. corporate earnings attributable to foreign operations among many of our largest corporations now exceeds 50 percent of their total earnings. Direct foreign investment by U.S. companies in foreign jurisdictions continues to exceed foreign direct investment in the United States (in spite of the net debtor status of the U.S.) by some $180 billion in 1994. In 1995, U.S. exports of goods and services totaled $805 billion -- 11.1 percent of GDP.[1] In 1993, 58 percent of the $465 billion of merchandise exports from the U.S. were associated with U.S. multinational corporations: $110 billion of the exports went to foreign affiliates of the U.S. companies, and another $139 billion of the exports were shipped directly to unrelated foreign buyers.[2]

Given the importance of the international economy to the United States, the Council would like to compliment the Committee on giving international issues a prominent place in this series of hearings. The NFTC would like to make its points in four principal areas of concern: (1) observations concerning the existing system of income taxation, and some suggestions concerning possible reform of the existing system, if that course of action is ultimately chosen by the Committee after careful study of the alternatives; (2) observations concerning the requisites for any new system that replaces the existing income tax system as the primary tax system of the federal government of the United States; (3) observations concerning the transition from one system to another; and (4), very importantly, observations concerning the membership of the United States in the international community of nations and the importance of maintaining its tax and trade agreements and relationships in that community.

Existing Law

United States policy in regard to trade matters has been broadly expansionist for many years, but its tax policy has not followed suit. The provisions of Subchapter N of the Internal Revenue Code of 1986 (Title 26 of the United States Code is hereafter referred to as the "Code") impose rules on the operations of American business operating in the international context that are much different in important respects than those imposed by many nations upon their companies. Some of these differences may make American business interests less competitive in foreign markets when compared to those from our most significant trading partners:[3]

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[1]U.S. Department of Commerce, "Survey of Current Business," April 1996.

[2]U.S. Department of Commerce, "U.S. Multinational Companies: Operations in 1993," June 1995, at 39.

[3]See, Financial Executives Research Foundation, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, 1996, Ch. 9.

- The United States taxes worldwide income of its citizens and corporations who do business and derive income outside the territorial limits of the United States. Although other important trading countries also tax the worldwide income of their nationals and companies doing business outside their territories, such systems generally are less complex and subject to more significant limitations under their tax statutes or treaties than their U.S. counterparts.

- The United States has more complex rules for the limitation of "deferral" (although the United States taxes the worldwide income of its companies, it permits deferral of the tax on unrepatriated foreign earnings of controlled foreign corporations, except where one of six complex series of "anti-deferral" provisions of the Code apply) than any other major industrialized country. In addition, the anti-deferral provisions of most countries do not tax active business foreign income of their companies, while those of the U.S. impose current U.S. tax on several types of active business foreign income as well as on passive foreign income.

- The current U.S. Alternative Minimum Tax (AMT) system imposes numerous rules on U.S. taxpayers that seriously impede the competitiveness of U.S. based companies. For example, the U.S. AMT provides a cost recovery system that is inferior to that enjoyed by companies investing in our major competitor countries; additionally, the current AMT 90-percent limitation on foreign tax credit utilization imposes an unfair double tax on profits earned by U.S. multinational companies -- in some cases resulting in a U.S. tax on income that has been taxed in a foreign jurisdiction at a higher rate than the U.S. tax.

- The United States has more complex rules for the determination of U.S. and foreign source net income than any other major industrialized country. In particular, this is true with respect to the detailed rules for the allocation and apportionment of deductions and expenses. In some cases, these rules are in conflict with those of other countries, and where this conflict occurs, there is significant risk of double taxation.

- The U.S. foreign tax credit system is very complex, particularly in the computation of limitations under the provisions of section 904 of the Code. These provisions require the segregation of various types of income into "baskets," and then require the application of complex separately-computed limitations to these baskets. While the theoretic purity of the computations may be debatable, the significant administrative costs of applying and enforcing the rules by taxpayers and the government is not. Systems imposed by other countries are in all cases less complex. United States policies in regard to the credit make U.S. business interests less competitive in other respects as well (e.g., see the discussion below of "tax sparing" adopted by other countries).

As merely noted above, the United States system for the taxation of the foreign business of its citizens and companies is more complex than that of any of our trading partners, and perhaps more complex than that of any other country. While that result derived from good intentions, today's global marketplace places pressures on U.S. business that were not present when our system was contrived, even during the significant changes in the 1960's when American business interests were still clearly predominant in many foreign markets.

The United States has long believed in the rule of law and the self-assessment of taxes, and some of the complexity of its income tax results from efforts to more clearly define the law in order for its citizens and companies to apply it. Other countries may rely to a greater degree on government assessment and negotiation between taxpayer and government -- traits which may lead to more government intervention in the affairs of its citizens, less even and fair application of the law among all affected citizens and companies, and less certainty and predictability of results in a given transaction. In some other cases, the complexity of the U.S. system is simply ahead of development along similar lines in other countries -- many other countries have adopted an income tax similar to that of the United States, and a number of these systems have eventually adopted one or more of the significant features of the U.S. system of taxing transnational transactions: taxation of foreign income, anti-deferral regimes, foreign tax credits, and so on. However, while difficult to predict the ultimate evolution, none of these other country systems seems prone to the same level of complexity that affects the United States system, and U.S. businesses can no longer afford the burdens of the current U.S. tax system as it applies to foreign operations.

Further, in a system that has required very significant compliance costs of both taxpayers and the Internal Revenue Service, the costs of compliance burdens associated with the international provisions of the Code are disproportionately higher relative to U.S. taxation of domestic income and to the taxation of foreign income by other countries. For example, a recent survey found that nearly 40 percent of total federal tax compliance costs were attributable to foreign-source income. The disparity may be significant given the findings that only 21.1 percent of assets, 24.1 percent of sales, and 17.7 percent of employment were related to the same income.[4]

[4]See Marsha Blumenthal and Joel B. Slemrod, "The Compliance Cost of Taxing Foreign-Source
(continued..)

Many foreign companies do not appear to face the same level of costs in their operations. The European Community Ruding Committee survey of 965 European firms found no evidence that compliance costs were higher for foreign source income than for domestic source income.[5] Lower compliance costs and simpler systems that often produce a more favorable result in a given situation are competitive advantages afforded these foreign firms relative to their American counterparts.

Short of fundamental reform -- a reform in which the United States federal income tax system is eliminated in favor of a consumption-based tax system or some other sort of system -- there are many aspects of the current system that could be reformed and improved. These reforms could also lower the cost of capital, the cost of administration, and therefore the cost of doing business for American firms.

For example, the NFTC applauds the work of Mr. Houghton (R-NY) and Mr. Levin (D-MI) of this Committee to construct a vehicle for the further consideration and ultimate passage of a number of these potential reforms: The International Tax Simplification and Reform Act of 1995, H.R. 1690 (104th Cong., 1st Sess.). A similar bill is currently being prepared in the Senate. These bills would address serious problems: the overlap between the anti-deferral regimes of the passive foreign investment company ("PFIC") rules and the rules relating to controlled foreign corporations ("CFC"); other reforms of the PFIC rules; other reforms to the CFC rules; extension of the indirect foreign tax credit of section 902 of the Code to lower tier subsidiaries; reforms related to the computation of the foreign tax credit and translation of amounts of foreign taxes, simplified foreign tax credit computations in calculation of the AMT; elimination of the section 1491 excise tax and reforms in the corresponding regimes of section 367; exemption of additional active business income from the anti-deferral rules to level the field for other business interests not now permitted deferral; extension of the carryback and carryforward periods for utilization of unused foreign tax credits, simplification of the rules applicable to joint ventures conducted through so-called "10 / 50" companies; recognition of the European Union as a single country for purposes of the anti-deferral rules, creating symmetry between previous rules designed to recapture overall foreign losses and new proposed rules applicable to overall domestic losses; and various other provisions to reduce reporting thresholds, simplify computations and calculations, expand *de minimis* rules, and reduce the amount of information required to be accumulated, processed, and stored.

Other more major, more general reforms have in the past been suggested and studied elsewhere. For example, one of those often cited and credited with potential benefits to the current income tax system is the concept of integration of the corporate and individual income tax systems of the United States. This concept was the subject of a 1992 U.S. Treasury study and also of a study under the auspices of the American Law Institute ("ALI").[6] Integration of the individual and corporate income taxes refers to various means of eliminating the separate, additional burden of the corporate income tax, in favor of a system in which investor and corporate taxes are interrelated so as to produce a more uniform levy on capital income. This conceptual model (or series of models), in addition to addressing possibly undesirable effects of the current system on corporate financial practices (relating to the differences between debt and equity financing), may also be important because most of the other developed countries have in recent decades adopted various forms of integration. As the American economy itself becomes more "integrated" into the world economy, and therefore becomes more inseparable from other national economies, it becomes more important to understand the potential advantages and disadvantages of this concept, and other types of concepts or features of foreign tax systems, for the United States and for U.S. business.

In fact, a recurring theme of this testimony is the importance of considering the United States as a member of the world community of nations, and the importance to United States business interests of providing harmony between the tax system of the United States and that of other nations where United States companies must conduct their business. The same is true as well for foreign investors who invest capital in the United States. Major dislocations may ensue in the wake of major reforms that fail to address this important, though sometimes forgotten, point.

Like the concept of integration, another possible major reform (though less sweeping than repealing the income tax) is the possible conversion of the U.S. worldwide system of taxation into one based upon "territorial" principles. In contrast to the worldwide system, which generally defers tax on earnings until

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[4](...continued)
Income: Its Magnitude, Determinants, and Policy Implications," in *National Tax Policy in an International Economy: Summary of Conference Papers*, (International Tax Policy Forum: Washington, D.C., 1994).

[5]*Id.*

[6]The ALI integration proposals would convert the separate U.S. corporate income tax into a withholding tax with respect to income ultimately distributed to shareholders. See, Alvin C. Warren, Jr., Reporter, *The American Law Institute, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration*, The American Law Institute (1993).

they are repatriated, the territorial system generally exempts foreign earnings -- usually active business income of the multinational corporation. The net effect is that a multinational would pay tax on business income only in the jurisdiction where that business income is earned. The desired treatment may be provided by statute or by treaty. A territorial system is to an extent used in more than a dozen industrialized countries, including the Netherlands, France, Germany, and Canada and most of Latin America. (Certain aspects of the U.S. system are currently territorial: the exclusion under section 911 of the Code for foreign earned income of expatriate employees is a territorial feature.)

Use of a territorial system to exempt foreign source income may ensure that U.S. businesses do not pay more in taxes on their foreign income in a particular market than their foreign competitors. But, such a system is not necessarily simple: passive investment income might still be taxed. That result would require maintenance of look-through and anti-deferral rules, and would also necessitate a foreign tax credit mechanism. Further, a territorial system places unique stresses upon income and expense sourcing rules, particularly where active business income is differentiated from passive investment income. Transfer pricing rules would also be at least as important as they are today.

Another widely-adopted practice in world commerce is that of "tax sparing." The practice arises most commonly in the context of developing countries who offer various types of tax incentives or tax holidays to induce foreign companies to make significant investments in the local economy. The concept is that a developed country, for example, may nevertheless allow a foreign tax credit for the taxes foregone by the developing country (as compared to those that would have been paid to the developing country but for the incentive or holiday). The result is a financial gain to the foreign company, and perhaps also to the developing country. Despite its interest in fostering economic growth in the developing countries, the United States has uniquely long opposed adoption of rules permitting this practice in its internal statutes and income tax treaties. Other developed countries have chosen the opposite policy -- and many developing countries have therefore continued to press for this treatment. For example, Japan significantly strengthens the competitive position of its companies in world markets outside Japan by its acceptance of tax sparing. As a result, American companies suffer a competitive disadvantage in world markets, and suffer further harm because tax treaty negotiations with these countries often fail over this provision -- a completed treaty would benefit both nations and taxpayers in many other ways as well. While the NFTC does not now encourage a change of policy on this important issue, the Council does believe it is time to carefully reconsider U.S. policy, a policy that was last debated when American interests dominated many world markets. It is well to remember the anti-competitive effects of it -- and the resulting costs to American business interests.

Before leaving these observations on the current system, it would also seem appropriate to be reminded of several important provisions of current law that serve to foster exports and the growth and prosperity of American economic interests abroad.

The leading proposals currently being considered by the Committee could have a significant impact on the economics of the development and use of technology. For example, in all three of the proposals for the USA Tax[7], the Flat Tax[8], and the National Retail Sales Tax[9], there is a significant break from the current law treatment of R&D expenditures performed in the United States. None of these three proposals would retain the R&D tax credit of section 41, and none of them would provide other direct incentives for performing R&D activities in the United States. Research and development activity is a significant component in the production of both tangible and intangible capital. The leading position of many U.S. companies in their respective industries is often a function of U.S.-based research. In fact, the ability of a U.S. corporation to conduct business outside the United States is often tied to its ability to utilize intangible assets developed by the U.S. parent. Also, in many cases, U.S. companies may directly license the right to use intangibles to their foreign customers. Whether or not these activities are competitive may often relate to the taxation of the various transactions -- the incentives to undertake the R&D in the United States in the first place and the treaty-based reductions in withholding tax rates applicable to remittance of foreign sourced royalties. As stated in the report of the National Commission on Economic Growth and Tax Reform ("Kemp Commission"), in designing a new tax system:

> "[a]ttention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."[10]

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[7]The Unlimited Savings Allowance (USA) Tax (S. 722), as proposed by Senator Nunn (D-GA) and Senator Domenici (R-NM).

[8]H.R. 2060, as proposed by Mr. Armey (R-TEX).

[9]H.R. 3039, as proposed by Mr. Schaefer (R-CO) and Mr. Tauzin (R-LA).

[10]*Report of the National Commission on Economic Growth and Tax Reform*, Washington, D.C. (1995), at 18.

Any new tax system should contain provisions which assure that the after-tax return on R&D performed in the U.S. is not undermined. For example, if a territorial tax system were to be adopted that is coupled with a repeal of the foreign tax credit, the tax reform system should contain a destination-based approach to the taxation of intangibles that would exempt foreign royalties and license fees from the U.S. tax.

For many years, regulations issued by the U.S. Treasury under section 863(b) of the Code have allowed goods that are manufactured in the U.S. and sold abroad to generate a combination of manufacturing and sales income to the same taxpayer. Such taxpayers are permitted to apply an apportionment formula, which generally treats half of the combined income as manufacturing income attributable to U.S. sources and the other half as sales income attributable to foreign sources. The amount of foreign source income generated for export transactions is crucial because foreign source income is eligible for the foreign tax credit. The source rule operates as a significant incentive for U.S. multinationals that are considering new investment -- savings attributable to the rule are often considered in the cost analysis when making a decision to locate new manufacturing facilities in the United States.

The Foreign Sales Corporation ("FSC") provisions of sections 921 through 927 of the Code are one of the most important U.S. tax incentives for exports from the United States. These provisions were adopted to offset disadvantages to U.S. exporters in relation to more favorable tax schemes allowed their foreign competitors in the tax systems of our trading partners. These provisions encourage the development and manufacture of products in the United States and their export to foreign markets.

As noted above, these incentives are important to U.S. taxpayers and to the domestic U.S. economy, and any replacement system must effectively address the same concerns.

Looking Forward Into A New System

In addition to the USA Tax, the Flat Tax, and the National Retail Sales Tax proposals noted above, other significant reform proposals have been "informally" before the Committee, or have been articulated elsewhere. In particular, much attention has been given to the invoice-method and subtraction-method Value Added Tax ("VAT").[11]

All of the major proposals currently before the Committee would completely eliminate the present federal income tax and would replace that system with a new consumption-based tax system. The first three proposals would tax only U.S. operations, and apparently would repeal most U.S. withholding taxes on income paid to foreign investors. U.S. businesses operating abroad would not be taxed on their foreign source income, and dividends paid by foreign subsidiaries to their U.S. parent companies would not be subject to U.S. tax. The foreign tax credit rules would presumably no longer be necessary under such a regime, nor would the anti-deferral rules of subpart F of the Code.

Each of the proposals would therefore address aspects of the current system noted above that cause serious cost and administrative concerns to American businesses operating abroad. But, in spite of the fact that major simplifications would occur relative to certain aspects of the present system, other complexities may be created or maintained. Under some of the systems, the tax cost of certain operations is actually increased in the new system. And, as with any major reform there will be dislocations -- there will be "winners" and "losers." Serious examination of the proposals will be required.

The proposals noted here differ in the way in which they treat export and import operations. They are either "destination-based" or "origin-based" in their approach. Under the destination principle, imports are generally taxed and exports are exempt. The consumption of goods and services within the United States is taxed under a destination-based approach. By contrast, under the origin principle, exports are generally taxed and imports are not. An origin-based tax would include within its base domestic consumption plus net exports. For example, the USA Tax and the National Retail Sales Tax are both destination-based taxes, and the Flat Tax is an origin-based tax.

Economists do not generally believe that destination-based taxes offer a long-term incentive to exports.[12]

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[11]Mr. Gibbons (D-FL), former Chairman and now Ranking Minority Member of the Committee, has proposed a subtraction-method VAT.

[12]See, Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," 48 *National Tax Journal* No. 4, December 1995, at 619; and Reuven Avi-Yonah, "Comment on Grubert and Newlon," 49 *National Tax Journal* No. 2, June 1996, at 259, 262; Gene Grossman, "Border Tax Adjustments: Do They Distort Trade?" 10 *Journal of International Economics*, February 1980, at 117-128; Martin Feldstein and Paul Krugman, "International Effects of Value-Added Taxation," *Taxation in the Global Economy*, ed. by Assaf Razin and Joel Slemrod, Chicago: University of Chicago Press, 1990, 263-278.

(continued...)

On the other hand, it may be easier ultimately to harmonize destination-based taxes (e.g., a VAT) than those that are origin-based (e.g., the Flat Tax or the income tax). That would appear to be the experience of the European Union in its efforts to date. (Of course, the Ruding Commission is not faced with an "either/ or" choice in its efforts.)

The NFTC has not yet adopted a position on the respective proposals now before the Committee. Even the more well developed proposals still require much study and further development. As the Committee moves forward in its deliberations, however, the Council would enjoy the opportunity to provide additional information to the Committee.

Transition Into A New System

Much of the public discussion that has to date surrounded the current effort to examine a total restructuring of the United States tax system has adopted an assumption of total repeal of the existing income tax -- a total repeal that some have advocated with no provision for transition from the old system to the new. The old system would simply "die" on one day, and the new replacement system would simply be started and be fully operational on the next. These assumptions are apparently based upon political concerns, and upon the further assumption that if any vestige of the current system were allowed to continue after the beginning of the new system, the unwanted old system would survive and continue in a parallel track. Despite the possible merits of the political and practical concerns that form the basis of these assumptions, there are countervailing considerations that cannot responsibly be ignored.

First, it is important to attempt to grasp the magnitude of the contemplated changes. It is not realistic to assume that the real impacts of the system can be forecasted with a high level of certainty of result. Unlike previous reforms of the income tax system[13], which only changed portions of the income tax system, the proposed changes would entirely replace the system with a new one. Some of the replacement systems are theoretic models and as yet untried. Although not free from controversy, it is at least plausibly argued that previous "major" reform efforts have produced significant and undesirable results in addition to the desirable results that drove the efforts. For example, the effects of the Tax Reform Act of 1986 on the real estate industry may have worsened the savings and loan debacle of the 1980's. It seems reasonable to assume that the effects of changes of this magnitude will have far more significant effects than those experienced before, many of which may be unanticipated in nature much less degree.

One of the concerns raised by any new system is the uncertainty caused by unanticipated issues. The present system has resulted in much litigation -- hundreds of thousands of court cases over eighty-three years of the life of the current system. It is important to note that a system of statutes which covers thousands of paragraphs of statutory language has still left so much open to argument over interpretation and application. A new system, even a simpler one, would still engender much of this same activity until, like the present system, guidance and interpretations needed by the government and the taxpayers were worked out in regulations, in the courts and in the Congress. Nevertheless, a new simpler system should attempt to lessen the amount of interpretive activity that will inevitably ensue -- and should be constructed in a way that makes resort to the regulations, the courts, and the Congress so important in the present system.

A principal issue that requires much of this interpretative activity is the definition of the base of the tax. Examples in the current income tax system that have produced much controversy are the definition of a capital gain or loss, and the classification of an individual as an employee or an independent contractor. And, among the many subissues that may arise in the context of defining the tax base, a most important area of controversy in the international context is the sourcing rules. These rules, defining the origin and destination of goods and services and other principles necessary to apply any of the proposals presently before the Committee, will be stressed by both the government and the taxpayers in their respective compliance efforts. Just as the present system has taken many years to settle, time will be required to resolve these matters in any new system.

As noted above, perhaps the most important aspects of transition will concern changes in economic behavior and vested interests of taxpayers. American companies currently have many hundreds of

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[12]{...continued}
Of course, as another famous economist pointed out, "[i]n the long term, we are all dead." The short-term consequences of shifting to a border-adjustable tax may be significant.

[13]Until the 1939 Code was effective, Congress enacted an annual revenue bill, but major principles of the law remained remarkably consistent. The first major codification and revision of the law came with the 1939 Code. A second major recodification and reform of the law came with the 1954 Code. Since the 1954 Code, Congress has enacted 32 bills making changes in primary sections of the Code, perhaps the most significant of which was the Tax Reform Act of 1986.

billions of dollars of prepaid tax assets and deferred tax liabilities on their balance sheets. Many of these companies have hundreds of millions of dollars of foreign tax credit carryovers, net operating loss carryovers, and other tax attributes that have considerable financial value. While the stated goal of a change to a consumption-based tax is to increase personal savings and investment in the United States, the short-term effects of transition will be important -- not only in terms of existing tax attributes and stock values, but also in terms of changes in markets, product lines, and consumption patterns.

Before leaving a brief consideration of the process of transition to a new system, it would also be appropriate to consider another important aspect of the process. While much of the change has been well-intentioned, change in the tax law has become an important part of daily political life. Such changes are often part of the political agendas of both of the major political parties in the United States. As the second half of this century has progressed, the process of change to the tax system of the United States has accelerated. In the 40 years since the Internal Revenue Code of 1954 was enacted, there have been more than 30 significant federal tax enactments. This amounts to substantial amendment of the system on the average of every 1.3 years.[14] In an economic environment where manufacturing plants and market penetration may require many years and hundreds of millions of dollars of capital investment, it is becoming more and more difficult to make the economic projections that planners need to make these significant decisions. Instability in the tax laws of the United States (and other nations as well) creates economic uncertainty among taxpayers, and in turn generates economic costs of lost opportunities and higher transaction costs. Uncertainty in existing law (or about pending legislation) interrupts, distorts, or stifles economic activity, adds to complexity, and forces private industry to expend additional resources on tax research and planning, compliance, and litigation. It has been estimated, for example, that uncertainty with regard to the federal taxation of wage and investment income costs the U.S. economy 0.4 percent of national income per year, and that the cost, in these terms, of taxpayer uncertainty that accompanied the tax changes embodied in the Revenue Reconciliation Act of 1993 alone cost the U.S. economy an estimated $20.5 billion.[15] Any further changes in our present tax system should have stability as a fundamental objective.

Effects on the International Agreements of the United States

The United States is an important member of the international community of nations. As important as the effects of transition from the income tax to some other form of tax system may be to U.S. taxpayers, the construction of such a system and the transition to it will have important impacts upon the relations of the United States with its trading partners and other members of the international community.

In the years since the United States adopted its income tax, many other countries have adopted an income tax, and a number of these systems tax corporate income of resident companies on a world-wide basis.[16] As the income tax is not the only tax levied by the United States government, so it is that many of these other countries also have other taxes as part of their national tax systems, and have adopted various forms of consumption taxes, principal among these being the Value Added Tax.[17] As the world economy approaches greater and greater integration, trading blocs have been formed. Two significant examples of these are the European Union and the North American Free Trade Agreement. Efforts to integrate have in turn put pressure on national governments to fit their national policies within negotiated norms; and, in the European Union, for example, great effort has been and is being made to reach a "harmonization" of tax regimes including a balancing of impacts of income and consumption based taxes in and among the member nations.[18] A shift of this magnitude in a country as important as the United States will produce ramifications in other nations, and may produce significant dislocations unless the transition is carefully planned and implemented.

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[14]See Arthur P. Hall, "The Cost of Unstable Tax Laws," *Tax Notes* (November 7, 1994), at 759.

[15]*Id.*, at 760.

[16]See, e.g., *Corporate Taxes: A Worldwide Summary*, Price Waterhouse (1995).

[17]*Id.*

[18]The focus of this hearing is that of international effects of the shift to an alternative primary tax system in the United States. It bears noting, however, that significant levels of consumption and other taxes are also imposed in the United States -- by the individual States themselves. Moving the federal government to a tax system primarily focused on a consumption based tax and away from an income tax may also produce dislocations in State government revenues, and generate some of the same concerns that exist in and with major trading blocs like the European Union.

See, *e.g.*, Holtz-Eakin, "Consumption-Based Tax Reform and the State-Local Sector," Draft (1/14/96), The American Tax Policy Institute.

A more direct impact upon both the taxpayers of the United States and the relations of the United States with its trading partners and other members of the international community would be the impact of such reforms on the treaty obligations of the United States.

An initial concern of several of the proposals would be the permissibility of border tax adjustments of a consumption-based tax under the General Agreement on Tariffs and Trade ("GATT").[19]

The United States has in force some forty-eight[20] Conventions for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income ("income tax treaties") with various jurisdictions, not including other agreements affecting income taxes and tax administration (*e.g.*, Exchange of Tax Information Agreements or Treaties of Friendship and Navigation that may include provisions that deal with tax matters). It has taken more than sixty years to negotiate, sign, and approve the treaties that form the current network.[21] A number of new agreements are being negotiated by the Treasury Department.[22] Nevertheless, the U.S. treaty network has never been as extensive as the treaty networks of our principal competitors. The U.S. treaty network covers only about 22 percent of the developing world, compared to coverage of 40 to 46 percent by the networks of Japan and leading European nations. This discrepancy has persisted for many years, even though the United States relies on the developing world to buy a far larger share of its exports than does Europe.

The typical income tax treaty provides for the elimination or at least mitigation of double taxation in a number of ways: modification or at least clarification of sourcing rules, rules affecting computation of foreign tax credits, specification of certain taxes that are or are not considered to be income taxes for the purposes of the foreign tax credit, rules allocating income to permanent establishments or establishing transfer prices, rules establishing the competent authority mechanism, and other rules in which jurisdiction to tax is relinquished. The most important form of this last relinquishment is the reciprocal reduction of withholding taxes imposed by the respective contracting states on dividends, interest, royalties, and certain other types of cross-border flows. The treaties also provide a number of "administrative" mechanisms for resolution of disputes as to state of residence, exchange of tax information between tax authorities of the two contracting states, nondiscrimination against nationals or other parties of one contracting state by the other contracting state, and the like.

The principal function of an income tax treaty is to facilitate international trade, investment, and commerce by removing or preventing tax barriers to the free flow or exchange of goods and services and the free movement of capital and persons. In making such an agreement, a contracting state acts in two capacities.

First, as a country of residence, the contracting state imposes tax on the income derived by resident individuals and legal entities (and, in countries like the United States that tax their citizens on a world-wide basis, its non-resident citizens and those legal entities organized under its laws or otherwise subject to its jurisdiction). In this capacity, the contracting state seeks to minimize the source-based taxes imposed on these taxpayers by the other contracting state, its treaty partner. If, like the United States, its system of world-wide taxation is relieved by a foreign tax credit mechanism, it will have a revenue interest in this outcome, but even in other circumstances, it will have an interest in the reduction of source-based taxes as a means of assuring fair treatment of its taxpayers and promoting their foreign trade and commerce.

Second, as a country of source, the contracting state imposes a tax on income derived by individuals and entities resident in its treaty partner. In this role, the contracting state has multiple and not always congruent interests. The source country is interested in protecting its revenues from unwarranted erosion. However, it is concerned with providing a hospitable environment for desirable inbound foreign investment, and fostering the general climate of international trade and investment. Lastly, since these

[19]See Victoria Summers, "The Border Adjustability of Consumption Taxes, Existing and Proposed," in *Tax Notes International*, June 3, 1996, at 1793, 1800.

[20]The count is somewhat imprecise -- e.g., the effects of the treaty with the former Union of Soviet Socialist Republics and its effects on the former members of that Union are not considered. Some treaties have been terminated in part, and there are a number under active negotiation or renegotiation, or that have been signed but not ratified.

[21]The current international consensus favoring income tax treaties is derived from sixty years of evolution, starting with the model income tax treaty drafted by the League of Nations in 1927, culminating in its "London Model" treaty in 1946, and carried on later by the United Nations, and the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development ("OECD"). The U.S. first signed a bilateral tax treaty in 1932 with France, which treaty never went into force. The first effective treaty, also with France, was signed July 25, 1939, and came into force on January 1, 1945.

[22]A hearing intended to be held in early September of this year is expected to deal with four treaties, and the termination of an existing one.

bilateral treaties are reciprocal agreements, a country must be willing to make concessions with respect to its source-based taxes in order to gain similar reciprocal concessions from its treaty partner. The concessions generally lead to a relaxation of domestic rules of source-based taxation of non-resident individuals and entities (e.g., a reduction of withholding tax rates).

The loss of revenue from withholding taxes, or other reductions of source-based taxation has now, after these six decades, become generally accepted as the price for obtaining for its taxpayers the benefits of neutral tax treatment with respect to their international trade, investment, and commerce. In fact, there has developed a remarkably broad, general consensus among national governments, even those who agree on few other principles, that it is in their interest to enter into income tax treaties, and almost as broad consensus as to the form of the mechanisms adopted.

Income tax treaties enable U.S. firms to compete in foreign countries, and foreign firms to establish plants in the United States and invest in American securities. Without the tax treaty network and complementary national legislation, double taxation would create an enormous barrier to the international movement of capital and technology. Likewise, the crippling of our treaty network could cause world trade to shrink because so much of it depends upon cross-border investment and open channels for movement of capital and technology. A recent study, based upon earlier data, and conducted under the auspices of the NFTC, illustrates the possible consequences of abandoning all existing U.S. tax treaties, and, in selective ways, changing U.S. tax laws to extract more revenue from inward foreign investment.

- Broadly speaking, the average foreign tax burden on income flowing to the United States, which is predominantly from direct investment and therefore subject to foreign corporate tax as well as withholding taxes, would rise from about 16.0 percent (with a treaty network) to about 23.4 percent (without a treaty network). The average U.S. tax burden on income flowing to foreign investors would similarly rise from about 9.1 percent to about 14.1 percent.

- In relative terms, the tax burdens on U.S. investment abroad and foreign investment in the United States would thus escalate by about the same amount. However, the absolute tax level is lower on foreign investments in the United States because that investment is concentrated in bank deposits and portfolio securities, which are not immediately subject to the U.S. corporate income tax.

- As a consequence of higher tax rates, international investment would implode. Using a conservative estimating procedure, it was calculated that the stocks of U.S. investment abroad and foreign investment in the United States would each shrink by about $340 billion annually, without a treaty network.

- Reduced foreign investment in the United States would curb competition in the U.S. marketplace and raise U.S. interest rates. U.S. consumers would have to pay higher prices for a smaller variety of goods, investment would be squeezed and, ultimately, growth rates would be lower. In addition, the smaller role of multinational firms would curtail U.S. exports by some $21 billion annually, which would reduce the domestic employment of those firms and their suppliers by an estimated 340,000 jobs.

- In order for the U.S. Treasury to realize any revenue gain from the non-treaty world, the Congress would need to impose a new withholding tax on interest paid to foreign investors on their U.S. bank deposits and Treasury securities. At a rate of 5 percent, the new tax would raise significant revenue, about $6.4 billion annually. However, the larger tax revenues would be more than offset by the inevitable rise in U.S. Treasury interest payments (net of associated tax reflows) on Treasury debt held by the public in this country and abroad. Higher interest payments to the public (net of tax reflows) were estimated by the model at $7.1 billion.

- If the level of international investment imploded by twice as much as the conservative estimating procedure might suggest, the U.S. Treasury would lose $0.8 billion on U.S. income payment to foreigners, and $3.2 billion on U.S. income receipts from foreign sources. In other words, the Treasury could lose up to $4.0 billion from a policy that abandoned the U.S. tax treaty network.

- In any event, U.S. multinational enterprises would be substantially worse off. Their income flows before foreign tax would contract from $279 billion to $240 billion. Their combined tax burden, counting payments both to foreign governments and the U.S. Treasury (after allowing for the U.S. foreign tax credit), would rise by $9.4 billion. The loss of income coupled with a rising tax burden would significantly impair the competitive strength of U.S. multinational enterprises relative to rival firms based in Japan and Europe.

  -- G. Hufbauer, "Tax Treaties and American Interests -- A Report to the National Foreign Trade Council, Inc." (1988).

While the preceding analysis dealt with the presence and absence of the tax treaty network in a world

where the United States maintained its present income tax system, its conclusions are illustrative of likely consequences that would result in a world in which other nations nevertheless maintained their income and withholding taxes, despite changes in the U.S. system, and in which U.S. multinational enterprises must compete. Absent a "level playing field" environment, taxes of all types on the income and capital flows on the U.S. multinational enterprise can easily escalate in proportion to the economic activity involved, and particularly where more than two jurisdictions are involved, can exceed one hundred percent.

In Conclusion

Again, the Council applauds the Chairman and the Members of the Committee for giving international issues prominence in the consideration of fundamental tax reform. The NFTC is appreciative of the opportunity to work with the Committee and the Congress in going forward into this process of consideration of various alternatives, and the Council would hope to make a contribution to this important business of the Committee.

WRITTEN STATEMENT OF J. THOMAS PEARSON, SENIOR VICE PRESIDENT, TAXATION, RJR NABISCO SUBMITTED TO THE HOUSE COMITTEE ON WAYS AND MEANS FOR THE RECORD OF THE HEARING HELD ON JULY 18, 1996, ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX

THE TREATMENT OF OVERALL DOMESTIC OR FOREIGN LOSSES UNDER A REFORMED FEDERAL INCOME TAX

Introduction

As part of the hearings on replacing the Federal income tax, the Committee on Ways and Means has examined proposed replacement systems that include an income tax with one or more rates and an income tax with unlimited savings deductions. The retention of an income tax system, in any form, would continue the need for U.S. tax rules that limit the incidence of international double taxation. Thus, presumably, a foreign tax credit ("FTC") would continue to be available to U.S.-based multinational corporations that make income tax payments to foreign governments. A reformed Federal income tax system that includes FTCs might similarly retain the current law rules for calculating the amount of foreign-source income that enters into the calculation of FTCs.[1] This statement focuses on the disparate treatment of overall domestic and foreign losses in calculating foreign-source income under current law, an area that warrants simplification in any event.

The Problem With Current Law

Section 904(f)(1) of the Internal Revenue Code (the "Code") provides that an overall *foreign* loss that reduces U.S. tax on U.S.-source income must be "recaptured," by re-characterizing subsequent foreign-source income as domestic-source income. Because there is no similar rule for an overall *domestic* loss that reduces foreign-source income, taxpayers who have made foreign tax payments with respect to such income lose the benefit of FTCs. As a result, international double taxation occurs over time, and thereby increases the cost of doing business abroad. Obviously, increasing the cost of doing business contravenes the goal of advancing U.S. competitiveness.

Previous Proposals To Provide Symmetry

The often cited solution to the problem under current law is to provide symmetry in the treatment of overall domestic and foreign losses, beginning with the "Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, introduced by former Chairman Rostenkowski and Mr. Gradison of the Ways and Means Committee – and as recently as the introduction of the "International Tax Simplification and Reform Act of 1995, cosponsored by Ways and Means Committee members, Houghton and Levin. Both of the noted proposals would achieve symmetry by increasing the complexity of the income tax system: Provision would be made for the re-characterization of domestic-source income as foreign, where an overall domestic loss has reduced foreign-source income and thereby reduced a taxpayer's FTC.

An Alternative Proposal To Achieve Symmetry <u>With</u> Simplification

As first proposed by the Treasury Department in testimony before the Ways and Means Committee in 1992, "the goal of simplification would be better served by repealing [the rule for overall foreign losses] rather than by enacting re-characterization

[1] The relative amounts of foreign- and domestic-source income are relevant because Section 904(f) limits the allowable FTC to the U.S. tax on foreign-source income, calculated by multiplying the ratio of foreign-source income to worldwide income by the pre-FTC U.S. tax.

rules for overall domestic losses." Significantly, Treasury's 1992 testimony dismisses concerns about whether repeal of the rule for overall foreign losses would erode U.S. taxing jurisdiction, and questions whether this is a realistic concern in view of safeguards such as the "branch loss recapture" rule of section 367(a)(3)(C) of the Code.

The theoretical concern identified by Treasury's 1992 testimony is whether the repeal of the rule for overall foreign losses would increase incentives to use foreign losses against U.S.-source income, while claiming FTCs to limit U.S. tax on foreign-source income. The ploy identified by Treasury involves operating foreign loss-generating businesses through foreign branches, while earning foreign source income through foreign subsidiaries eligible for deferral." As also noted by Treasury, however, there are other safeguards that weigh against this theoretical stratagem:

1. *Branch Loss Recapture Rule.*— The "branch loss recapture rule" in section 367 of the Code is specifically aimed at recapturing pre-incorporation losses of a foreign branch, where a taxpayer might otherwise incorporate a foreign branch to avoid tax on subsequent profits. This provision triggers gain recognition on the incorporation, quite apart from the possible application of current law section 904(f)(1) of the Code.

2. *Reduced Utility of FTCs Since 1986.*— The Tax Reform Act of 1986 and subsequent legislation have greatly reduced the efficacy of managing foreign losses via the scheme envisioned by Treasury, with many new provisions that weigh against the loss-branch/profitable subsidiary strategy in particular, and FTC planning in general: For example, under section 904(f)(5) of the Code, separate basket losses are allocated *pro rata* first to separate foreign basket income, before any allocation is made to U.S.-source income. As another example, the manner in which the apportionment base under the interest allocation rules takes account of stock in a foreign subsidiary results in an increased -- and unfavorable --allocation of interest expense to foreign-source income, greatly increasing the potential for double taxation. In this regard, note also that an overall foreign loss can result from the allocation of domestic expenses to income derived from a foreign subsidiary operation.

3. *Proliferation of Anti-Deferral Rules.*—In addition to the recapture rule in section 367 of the Code and the reduced utility of FTCs, one might point to the 1993 enactment of the Section 956A tax on the holding of excess passive assets by a controlled foreign corporation ("CFC"). Note also that there are five other anti-deferral regimes that could apply to a U.S.-owned foreign corporation – *e.g.*, the passive foreign investment company rules. Section 956A, in particular, operates to impose a current U.S. tax even in the case of active business income derived through a CFC.

Conclusion

If an income tax system is retained, including a FTC regime, it will be important to conform the treatment of overall foreign and overall domestic losses. In this case, symmetry can be achieved with simplification by simply repealing the rule for overall foreign losses.

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION
BEFORE THE COMMITTEE ON WAYS AND MEANS OF
THE HOUSE OF REPRESENTATIVES
SUBMITTED FOR THE RECORD
OF THE HEARING ON
THE IMPACT ON INTERNATIONAL COMPETITIVENESS
OF REPLACING THE FEDERAL INCOME TAX
JULY 17, 1996

I. INTRODUCTION.

The Securities Industry Association (the "SIA") is pleased to make this statement for the record on the impact of fundamental tax reform on the competitiveness of U.S. businesses.[1] The SIA welcomes the opportunity to comment on the tax reform proposals that Congress will be considering, and supports the efforts of the Committee on Ways and Means (the "Committee") to review the effect on international competitiveness of the various alternatives that have been proposed to replace the existing federal income tax system. From the perspective of the SIA, tax reform in the international area is essential in order to maintain the competitiveness of U.S.-based securities firms in an increasingly global economy.

Many economists have described the increasing globalization of the world economy. As we describe below, this process of globalization has been particularly rapid in the financial services industry. As U.S.-based securities firms have expanded into the global capital markets, they have transformed the securities industry into a worldwide integrated business in which U.S. firms have a leading international presence.

The international provisions of the Internal Revenue Code (the "Code"), enacted in the 1960s and last substantially debated and revised in 1986, have not kept pace with the changes in the world economy, and the place of U.S.-based companies in that economy. From the perspective both of the securities industry and of the U.S. economy as a whole, the growth of truly global operations requires a fundamental change in the assumptions upon which our tax laws are premised, particularly assumptions about the structure of the financial markets and the activities of market participants.

The SIA believes that the long-term financial viability of the U.S. financial services industry, and in particular the ability of U.S.-domiciled financial institutions to compete in the international arena, requires an environment in which all similarly-situated competitors -- U.S. and non-U.S. alike -- are subject to comparable regulatory burdens, including the burdens imposed by systems of taxation. In the absence of fundamental revision to the international tax rules of the United States, however, the growing dichotomy between contemporary commercial realities and the Code will impair the ability of U.S.-based companies to compete in the global economy, because foreign competitors generally are subject to more economically neutral rules.

For example, as a result of the subpart F and foreign tax credit anomalies described below, the effective tax burden on the U.K. subsidiary of a U.S.-based securities firm may well be significantly higher than the amount of tax actually paid by that subsidiary to the United Kingdom. Because most continental European universal banks or securities firms operate under an exemption regime that does not tax income earned abroad (or operate under a foreign tax credit regime that does not have the elaborate rules of the Code), the effective tax

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[1] The SIA is the securities industry's trade association representing the business interests of about 750 securities firms in North America, which collectively account for approximately 90 percent of securities industry revenue in the United States. SIA members—including investment banks, broker-dealers, specialists and mutual fund companies—are active in all securities markets and in all phases of corporate and public finance, serving individual and institutional investors, corporations and government entities.

burden on income from a U.K. subsidiary of such a continental European competitor is likely to be simply the amount of U.K. tax paid. This difference in home country tax regimes means that the Code imposes a significant constraint on the ability of the members of the SIA to compete in London against their continental European competitors.

To date, the members of the SIA have relied on their head starts in financial technology and in financial product expertise to develop their foreign operations. As these gaps narrow, however, the high after-tax cost of deploying capital internationally will make SIA members less globally competitive than would be the case if they operated under international tax rules comparable to those enjoyed by their global competitors.

For tax reform to be effective, that reform must be based on a thorough understanding of how different global industries operate. In addition, any new system for taxing business income of U.S.-based companies earned abroad must be simpler than the tortuously complex and arcane international tax rules of the Code. Finally, effective reform must remove the existing structural biases of the Code against international business operations.

The remainder of this statement accordingly contains three sections. Part II describes the globalization of the securities industry over the last decade, and the non-tax constraints that affect the manner in which a U.S.-domiciled securities firm is structured and operates abroad. Part III very briefly describes the principal structural defects of the Code's rules applicable to the international operations of U.S.-domiciled securities companies. Finally, Part IV turns to the various consumption-tax-based reform proposals that the Committee is considering, and discusses their potential impact on U.S.-based securities firms.

Because most current tax-reform proposals provide little guidance as to their application to financial intermediaries, Part IV suggests two structural imperatives that the SIA believes must be part of any fundamental tax reform package in order to tax the U.S.-based securities industry fairly. First, all expenses (including interest expense) related to carrying on an active securities business should be deductible by firms conducting such a business. Second, the difficulties in imposing a territorial tax system on an industry whose transactions are as multi-jurisdictional as the security industry's must be addressed. Only fundamental tax reform that incorporates these imperatives can truly promote the securities industry's competitiveness in the global securities markets.

II. THE SECURITIES INDUSTRY.

A. Globalization of the Securities Industry.

The recent and rapid globalization of the securities industry can be seen from two different perspectives. From one perspective, the industry has become global in the sense that the major firms in the industry now compete for customers outside of each firm's home jurisdiction; in fact, international expansion has been a crucial engine of growth for many securities firms domiciled within and without the United States. Another way in which to view the globalization of the securities industry is from the perspective of the transactions entered into by these firms with customers. Increasingly, such transactions are comprised of the efforts of personnel and systems located all over the world; it is now very common for a single transaction to have personnel employed by several affiliated companies in different jurisdictions participating in, and adding value to, the deal. These two global trends are discussed immediately below.

1. Competition for Customers and Business Worldwide. Historically, companies needing capital to expand their businesses looked principally to their local capital market and to the local financial institutions that could provide them with access to that market. In the past, therefore, the U.S. capital market was the principal locus of business for U.S.-domiciled securities firms, and their principal competitors were other U.S. financial institutions. The U.S. federal income tax rules applicable to U.S. financial institutions reflect this traditional domestic focus.

In recent years, however, the world's financial markets have become highly integrated and interdependent. Advances in communications and information technologies, innovations in financial products, and changes in the relevant regulatory schemes have made it possible for the world's financial institutions to conduct their business activities around the globe, twenty-four hours a day. As a result, multinational securities firms now enter into transactions and services with customers worldwide. These activities include sales and trading of securities in all of the major capital markets, and providing corporate finance and investment banking services in both developed and developing countries. This increased cross-border financial activity is both the result of, and the impetus for, the establishment of foreign operations by multinational financial institutions.[2] As part of this global transformation, U.S.-based securities firms have invested billions of dollars to establish operations in London, Tokyo, and other important financial centers in order to compete actively with other financial institutions to do business with customers based in those jurisdictions. Similarly, foreign financial institutions have expanded into markets outside their home countries, including the U.S. domestic securities market.

As a result of carrying out that active competition for customers in those important non-U.S. financial centers, members of the SIA now employ thousands of employees outside the United States. These international operations in turn contribute a substantial portion of the revenues of the worldwide group of companies to which they belong. For instance, in 1985 few, if any, members of the SIA earned as much as 10 percent of their income overseas, while in 1995 many of the larger members of the SIA derived a very significant share of their revenues from foreign operations, in some cases exceeding 50 percent of such firms' aggregate revenues.

As a consequence of these changes, U.S.- and foreign-domiciled multinational securities firms now compete directly with one another for financial services business in financial centers throughout the globe. That competition extends not only to competitive incursions into another institution's domestic markets (e.g., Swiss banks doing business in the United States, or U.S. securities firms competing in Frankfurt for German domestic securities business), but also, and more meaningfully, to third-country international financial services centers (e.g., U.S., Swiss and German institutions all competing in London).

As this trend toward globalization has progressed, U.S.-based securities firms have become recognized leaders in the global securities industry; in fact, U.S.-based securities firms are responsible in large part for the recent surge in technological and financial innovation that has resulted in globalization of the industry. Due to their expertise and technological advantages, U.S.-based securities firms have become part of the small group of multinational securities firms that dominate the global capital markets.[3] Maintaining this position of leadership is important not only for those firms and their international customers, but also for their U.S. employees and for their U.S. customers, which benefit from the innovative products and services offered by U.S.-based securities firms.[4]

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[2] Evidence of the increasingly cross-border nature of the securities markets is plentiful. For instance, the share of the aggregate capitalization of the global equity market represented by U.S. companies has gone from 52.9 percent in 1980 to 38.6 in 1995; in the global bond market, that share has also decreased, from 52.6 percent in 1985 to 43.4 in 1995. See 1996 Securities Industry Fact Book (published by the SIA). In short, the global securities market pie has grown larger, and other nations are seeking capital in increasing amounts relative to the United States. Thus, the future pre-eminence of the U.S.-based securities industry will be determined by how it can compete in a world in which the demand for capital is increasingly located outside the United States.

[3] In fact, "league tables" (i.e., rankings in the securities industry) for 1995 list 12 members of the SIA among the 15 highest ranking firms in terms of worldwide equity and debt offerings. See Investment Dealers Digest, Jan. 8, 1996, at 37.

[4] The contribution that members of the SIA make to the U.S. economy is substantial. SIA members collectively employ about 350,000 individuals. Moreover, they manage

(continued...)

2. Cross-Border Transactions. The globalization of the securities industry extends not only to the location of the industry's customers but to the very nature of the transactions and trading activities that take place every day among market participants. As technology helps to create a more efficient global market, an increasing number of interested and informed issuers, investors and traders come together to lower costs, collapse earnings differentials, hedge risks, impound new information quickly into prices, and efficiently allocate capital. The transactions that comprise global trading activities often involve the participation of personnel in several jurisdictions in order to complete a single transaction.

To take one simple example, a U.K. institutional investor wishing to purchase shares in a Mexican company may go to a London-based salesperson employed by a U.K. subsidiary of one of the members of the SIA to effect the transaction. In order to get those shares for the customer, the U.K. subsidiary typically would purchase them from or through its U.S. broker-dealer affiliate, where its Latin American equity traders are located. Research analysts covering that Mexican issuer (whose research reports formed the basis of the U.K. customer's decision to invest) in turn might be located in a Mexico City office. The U.K. subsidiary might take credit risk with respect to its customer's obligation to settle the trade, while the U.S. affiliate takes market risk in respect of trading in the security in question. Finally, the "back office" trade support and clearing functions might be located in a fourth affiliate in a different location. All of these affiliates would be joined by sophisticated electronic communications networks, so that from the perspective of the customer the trade is executed seamlessly.

B. Structure of International Securities Businesses.

Unlike the conduct of most multinational businesses, the conduct of a financial services business generally is regulated. As a result, U.S.-domiciled securities firms operate under important and substantive non-tax constraints—particularly regulatory capital and inventory funding requirements—on their operations and funding in the major financial services centers within and without the United States.

Because the treatment of interest expense is critical to financial services institutions, and because Congress has in the past viewed the allocation of interest expense by multinational companies as a potential source of abuse, it is important to appreciate that the non-tax substantive regulation of financial services companies substantially reduces the ability of U.S.-domiciled financial institutions to capitalize or operate their foreign subsidiaries to minimize their U.S. tax liabilities. The discussion immediately below demonstrates the significance of the treatment of interest expense to financial services companies and the regulatory and practical constraints circumscribing, in particular, the capitalization of foreign securities affiliates by U.S.-domiciled securities firms.

1. Regulatory Capital Requirements. U.S. industrial corporations doing business outside the United States generally are subject only to modest legal requirements as to the amount and form of capital required to be held by the entities through which that non-U.S. business is conducted. By contrast, a foreign subsidiary of a U.S.-based securities firm generally is subject to a stringent regulatory regime in the foreign jurisdiction in which that subsidiary operates.[5]

As with U.S. securities regulation, the principal purpose of foreign regulation is generally to protect the customers of a foreign securities subsidiary by ensuring that the

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(...continued)
the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans.

[5] As a practical matter, the interaction of U.S. and foreign securities regulations ordinarily impels U.S. multinational securities firms to conduct their international operation largely through subsidiaries, rather than branches.

subsidiary can fulfill its obligations to customers on a stand-alone basis. To that end, most foreign regulatory regimes will, among other matters, (i) impose net capital requirements and require the subsidiary to maintain a minimum level of capitalization at all times and (ii) in the European Community, in particular, limit the amount of credit that can be extended to other affiliated companies (so-called "large exposure" limitations). One consequence of these requirements is to restrict significantly the ability of a foreign securities subsidiary, as compared to a foreign subsidiary of a U.S. industrial company, to shift funds to related entities, whether through dividends or through other mechanisms.

2. Inventory Funding Requirements. A securities dealer finances its day-to-day operations with a much higher level of leverage than does a non-financial business (e.g., a 20:1 or 30:1 debt-equity ratio rather than a 1:1 or 2:1 debt-equity ratio). Much of this leverage is attributable, on the one hand, to a securities dealer's commercial need to carry an enormous volume of securities in inventory, and, on the other, to the dealer's ability to finance that inventory at attractive rates, typically through secured financing arrangements. A high level of leverage thus is an essential component of a securities firm's ordinary business operations. Because the amount of funding that such a firm needs is driven by its day-to-day business operations, funding requirements also vary on a day-to-day basis, and the firm therefore must constantly adjust its funding levels to reflect varying securities positions.

A foreign securities subsidiary, like a domestic U.S. firm, requires regular access to short-term funding to finance its inventory of liquid securities positions. The best source of such funding frequently is in the local market in which the subsidiary operates, because much of the subsidiary's borrowings will be collateralized by securities inventory that trades in the local market, and that market generally provides the lowest-cost funding available for such collateralized borrowings. Foreign securities subsidiaries therefore regularly operate with high levels of short-term funding from local capital markets, which funding in turn usually is secured by the collateral (e.g., inventory) being funded.

As the discussion below suggests, the current international tax rules of the Code do not fairly deal with interest expense. In light of the critical importance of interest expense to the securities industry, it is crucial that any fundamental tax reform correct these flaws.

III. FLAWS IN THE EXISTING INTERNATIONAL TAX REGIME.

To date, the success of U.S.-based securities firms has come in spite, not because, of the outdated, complex and anti-competitive international U.S. tax rules. This Part III briefly reviews some of the most important deficiencies of current law, in the hope that any fundamental tax reform recommended by the Committee will not repeat these errors.

Subpart F of the Code imposes special anti-deferral regimes on foreign investment earnings (e.g., interest and dividends) of U.S. taxpayers. The first fundamental tax hurdle faced by U.S.-based securities firms is that stocks, bonds and other securities, which give rise to investment income in the hands of most taxpayers, are simply inventory to such firms. The Code has failed to recognize this distinction, and in many cases treats U.S.-based multinational securities dealers as if they were investors, rather than bona fide active businesses, thereby subjecting significant revenues earned by such firms in the active conduct of their businesses to the anti-deferral regimes intended to discourage offshore incorporated investment vehicles. Similarly, the "investment in U.S. property" rules contained in subpart F simply do not work when applied to ordinary course-of-business activities of multinational securities groups. No industry outside the financial services sector is subject to the anti-deferral rules of subpart F in respect of its core business activities.

A second hurdle that the Code currently presents to U.S.-based securities firms is that the foreign tax credit rules of the Code—whose purpose is to prevent double taxation of the same earnings by both a foreign jurisdiction and the United States—do not operate as they were intended. For instance, the special foreign tax credit rules relating to the treatment of interest expense for multinational firms date back to 1986, and have the effect of treating U.S.-based securities firms as if they pay more foreign tax on less foreign income than is really the case, with the result that some foreign income of these firms that is subject to foreign tax is taxed a second time by the United States. While these rules apply to all U.S.

firms, they produce particularly harsh results when applied to securities firms, because such firms necessarily have high leverage and operate within a unique regulatory and market environment that restricts how and where they borrow. These rules also stand in contrast to the tax regimes applicable to foreign securities firms, which generally are not subject to any special limitations on the deduction of interest expense at all.

The SIA has developed and proposed specific amendments to the Code designed to deal with these (and other) hurdles with which the Code confronts the U.S.-based securities industry. The SIA's proposals, however, are not the focus of this statement;[6] rather, this brief discussion on the shortcomings of current U.S. tax law puts into context the discussion that follows regarding the proposals for fundamental tax reform that the Committee is considering.

IV. TAX REFORM PROPOSALS.

A. General Concerns.

The SIA believes that the foregoing discussion makes a compelling argument for revising the U.S. tax rules applicable to the international operations of U.S.-based securities firms, but leaves open to question the ideal form of such change. The alternatives under consideration by the Committee generally fall into two categories: consumption-based tax proposals of various kinds, and a modified income tax. Each of the consumption tax proposals would involve a drastic shift in U.S. tax policy as it applies to business income earned abroad, from a system that taxes the worldwide income of a U.S. taxpayer to a system that by its nature is territorial.

Each system would tax a business enterprise on its gross receipts from sales or exchanges of property or services used (in the case of destination-based systems) or produced (in the case of origin-based systems) in the United States. Excluded from income under these proposals would be gross receipts and purchases of foreign branches or affiliates, as well as dividends from foreign subsidiaries. As a result, each of the consumption tax proposals exempts from federal tax income that is earned outside the United States, regardless of whether derived from the conduct of a business or from investment, and regardless of whether earned by U.S.- or foreign-based companies. Because each of these systems excludes income earned from foreign operations from the U.S. tax base, these proposals presumably would make obsolete the Code's foreign tax credit rules and the Code's complex set of anti-abuse rules relating to unrepatriated income of U.S. controlled foreign corporations.

This radical simplification of the international tax regime is welcome in principle. That simplification may prove to be illusory however, unless certain critical issues are addressed in more detail. While most of the consumption tax proposals envision special rules for financial intermediaries, those rules are not fully developed. For example, in view of the treatment of interest expense as non-deductible for non-financial intermediaries in many of the tax reform proposals, the distinction between financial intermediaries and other taxpayers, or financial intermediation and other businesses carried out by the same taxpayer, will be essential to assessing the impact of any proposal upon the U.S. financial services industry. Similarly, and as discussed below, Congress will need to devote considerable energy to developing rules for determining where financial products or services will be treated as

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[6] Attached as an exhibit is a technical memorandum dated April 3, 1996, which was written by an ad-hoc group of SIA members. The memorandum discusses in more detail the SIA's concerns about the operation of the existing international tax regime, sets out its specific suggestions for reforming the international tax provisions of the Code and attaches an appendix with a comparative analysis of how different jurisdictions tax the international financial services activities of their financial services companies. A series of examples illustrating the application of current law to common fact patterns involving the international operations of U.S.-domiciled securities firms is attached as a second exhibit. The technical memorandum has previously been submitted to the staff of the Joint Committee on Taxation.

produced or used, particularly when value is added to a single trade by affiliates in several jurisdictions.

Finally, aside from the concern over the specifics of each of these proposals, the adoption of any one of these proposed systems of taxation would raise many additional concerns of interest to U.S. financial institutions, including (i) the potential capture by foreign countries of the business tax base foregone by the United States and (ii) the risk of undermining the current income tax treaty system, and in particular the reduced rates of foreign withholding tax provided by those treaties.

In light of the above concerns, it is impossible for the SIA to support outright any one of the packages for fundamental tax reform being considered by the Committee; each proposal being considered, in respect of how it would tax the securities industry, leaves too many questions unanswered or leaves them to be answered by future regulations. Without clear rules, any claimed gains in simplicity and competitiveness would be illusory, lost in the costs of compliance with a complex tax system with which the securities industry has no experience in dealing.

Rather than support any one of the tax reform proposals being considered, the SIA offers instead two structural imperatives that it believes must be part of any tax reform proposal that wants to promote the competitiveness of the U.S.-based securities industry. First, all expenses related to (i) carrying and trading securities and (ii) writing financial contracts, should be considered deductible by those carrying on an active securities business. Second, the difficulties attendant on any territorial tax system as applied to securities transactions (i.e., the problems associated with determining either the origin or destination or jurisdiction of use of income from such transactions) need to be addressed; without clear rules as to when income from multi-jurisdictional, multi-input transactions will be taxed, a territorial system offers no particular advantage over the current U.S. tax regime. These two imperatives are discussed below.

B. Structural Imperatives For Fundamental Tax Reform.

1. Expenses. As demonstrated above, the securities industry carries out active businesses with customers as financial advisors and as dealers in securities and financial contracts. The securities industry is similar in some respects to other industries in that a securities firm must maintain substantial positions in inventory, both in the traditional sense of securities held for resale to customers, and in the sense of contractual positions (e.g., swaps) entered into with customers that are carried on the books of swap dealer affiliates. To do so requires both substantial financing costs and extensive hedging of positions to minimize, for example, the risk of loss while holding such securities (even for a few moments) before these securities can be sold to customers.

Under most of the proposals being considered by the Committee, interest expense would be deductible by financial intermediaries, a group which includes securities firms. The proposals are silent, however, regarding the deductibility of non-interest-expense-related costs (such as option premiums on unexercised options and other costs of hedging inventory risk) incurred by U.S.-based securities firms in the ordinary course of business. These costs and expenses are not ancillary issues to securities firms, but rather go to the heart of their business operations; as a result, it is critical that all such items remain fully deductible in calculating a securities firm's tax base.

2. Origin/Use/Destination. Each of the proposals under consideration by the committee would tax a U.S.-based securities firm on its gross receipts from sales of property and services used (i.e., destination-based) or produced (i.e., origin-based) in the United States. While such rules might be straightforward to apply to industries that produce and sell tangible products, the globalization of the securities industry has resulted in an industry whose products and services cannot easily be contained within an origin- or destination-based construct.

Securities transactions in the modern global economy have many parts. Marketers, traders and "back-office" personnel all provide essential input into each

transaction. Increasingly, these inputs are located in different jurisdictions, making it difficult (if not impossible) to designate one jurisdiction as the one which has produced the product or service. In addition, the capital put at risk by a worldwide securities group in effecting a cross-border transaction might be provided several affiliates: one affiliate might take the customer credit risk, for example, while another assumes the market and hedging risk associated with a customer position. The significance of capital as a key factor in the production of income by a securities firm thus further complicates the above analysis.

It is equally difficult to assess in which jurisdiction the end result of a securities transaction is put to use (i.e., the destination of the transaction). For instance, a Swiss industrial firm wishing to hedge the U.S. dollar/Swiss franc risk related to the stock it holds in its U.S. subsidiary might enter into a currency swap with the U.K. affiliate of a U.S.-based securities firm. The jurisdiction that is the "destination" of that hedge transaction could be Switzerland or the United States, or even the United Kingdom, depending on whether the transaction is viewed on its own or by its purpose as a hedge, and if a hedge, where the risk being hedged is treated as located.

Neither the Code nor the fundamental proposals under consideration by the Committee were devised to account for these sorts of multi-jurisdictional transactions in which value is added to every trade by affiliates all over the world; instead, the focus of those rules is the physical location of a particular trade or product, which is no longer readily identifiable in a world of electronic trading of securities that are not themselves even embodied in physical certificates. Establishing the geographical source of global securities, therefore, is increasingly difficult. Even physical marketplaces (e.g., trading floors and clearing houses), in many cases, are being overtaken by virtual marketplaces (e.g., networks of computers and users) as the situs of transactions. In a world of global integrated markets and simultaneous electronic trading in many jurisdictions, the concept of a geographic source or destination of a transaction or product thus provides a weak nexus for classifying global trading activities.

An analogy for the problems presented by attempting to tax multi-jurisdictional securities transactions in a territorial tax regime are the issues presented by electronic commerce on the Internet. Like securities transactions in the global marketplace, it is impossible to tax transactions that occur on the Internet without taking into account the realities of the instantaneous global electronic marketplace. Internet transactions also involve inputs from consumers and producers all over the world, and determining which jurisdictions have a taxable nexus to such transactions is difficult. The Treasury Department and others are currently mounting efforts to provide tax rules that take into account the increasing amount of electronic commerce—commerce that is being conducted in a very different way than in the past—and make it easier to determine the situs and tax the income from such transactions.[7]

While electronic transactions on the Internet and other computer-based markets present similar problems in respect of taxation as do securities transactions in the global marketplace, one key difference between the two is that the concerns of the securities industry over the taxation of multi-jurisdictional securities transactions have been present for more than a decade, and have grown in intensity concomitant with the global growth in the securities industry. These concerns, as they relate to electronic commerce over the Internet, are still in their infancy. As applied to the securities industry, by contrast, these problems are serious concerns today, and will become even more important in any territorial-based tax system.

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[7] For instance, at an ABA Tax Section meeting on May 10, 1996, Bruce Cohen of the Treasury Department's office of International Tax Counsel stated that an issues paper is being prepared that will highlight the major tax issues in the Internet and electronic communications areas, and asked for practitioner input. 71 Tax Notes 1009, May 20, 1996. Similarly, the Federation of Tax Administrators recently held a conference to discuss nexus issues regarding, in part, taxation of transactions on the Internet. Tax Notes Today, May 14, 1996. Such concerns also are being addressed at the state level. See States Seek to Tax Internet Sales and Services, Tax Notes Today, June 18, 1996.

A proposal for tax reform that lacks clear rules for determining when (and how) income from the multi-jurisdictional, multi-input transactions that are characteristic of the global securities industry will be taxed cannot possibly treat fairly the firms in that industry. While all of the proposals under consideration by the Committee are commendable for their efforts to simply the international U.S. tax rules, none contains clear rules as to how to source the income of U.S.-based securities firms.

V. CONCLUSION.

The SIA believes that the existing international tax rules of the United States have a strong structural bias against the international operations of U.S.-domiciled securities companies. That bias is apparent when the Code's rules applicable to multinational securities firms are compared with the tax regimes under which *non-U.S. competitors* operate. That bias also is visible when the Code's treatment of the international operations of U.S. securities firms is compared to its treatment of analogous international activities of *U.S. industrial* firms. The international successes achieved to date by members of the SIA thus have come in spite, not because, of the tax environment in which those firms operate.

The SIA has tried to demonstrate in this statement that the adoption of any one of the consumption-tax-based proposals currently under consideration would, at best, not harm the U.S.-based securities industry and, at worst, would worsen the competitive position of that industry. While the current system admittedly requires significant amendments, the SIA cannot unqualifiedly support radical reform unless that reform clearly addresses how the new system would tax the international business of the U.S.-based securities industry.

Accordingly, the SIA encourages the Committee to continue its efforts to reform U.S. tax law, but hopes that the Committee will work to add much-needed clarity to what are today only sketches of possible alternative systems. If nothing else, the SIA hopes that this submission demonstrates that a tax regime modeled on the manufacture and sale of tangible property cannot simplistically be extended to the multi-jurisdictional trading of intangible financial products.

[Technical Memorandum is being retained in Committee Files.]

IMPACT OF REPLACING THE FEDERAL INCOME TAX ON MANUFACTURING AND ENERGY AND NATURAL RESOURCES

WEDNESDAY, JULY 31, 1996

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

The Committee met, pursuant to notice, at 10:15 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
July 18, 1996
No. FC-19

CONTACT: (202) 225-1721

Archer Announces Hearing on the Impact of Replacing the Federal Income Tax on Manufacturing and Energy and Natural Resources

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 impact of the proposed replacement tax systems on manufacturing and energy and natural resources. **The hearing will take place on Wednesday, July 31, 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 (either subtraction method as proposed by Rep. Gibbons or an invoice-credit method); 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; home ownership and real estate generally; agriculture; 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 domestic manufacturing and on energy and natural resources.

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 Wednesday, July 24, 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, July 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, August 14, 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 on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS_MEANS/' or over the Internet at

Chairman ARCHER. The Committee will come to order.

The Chair apologizes for the delay in starting the hearing this morning, but we never know when there is going to be a vote. I think most people here understand when those two lights come on and the two buzzers sound, we have got to get over there and vote. So with apologies to all of you, we will now begin.

The distinguished Member of the Committee, the gentleman from Missouri, Mr. Hancock, will introduce our first witness this morning.

Mr. HANCOCK. Mr. Chairman, I want to thank the Chairman, and I regret other Members are not here for the testimony that will be forthcoming. Maybe they will show up shortly. But I appreciate the opportunity to talk to you about one of the most outstanding individuals I have ever known.

On April 21, 1991, in the Springfield, Missouri, News and Leader, in my hometown of Springfield, Missouri, I read this article. It says, "15-Year Battle With IRS Brings Bittersweet Victory."

Even though I had known Mr. Johnson for 49 years, this was the first time I had ever heard of the difficulties with the Internal Revenue Service. I called Mr. Johnson and had lunch with him the next day, and he told me the story about what had happened to him and his dealings with the Internal Revenue Service.

Again, I would like to point out that Mr. Johnson never contacted me, nor did he ever ask me to take any action whatsoever on his part as a Member of the U.S. Congress. But after hearing his story, if I had not known Mr. Johnson prior to this time and completely trusted his honesty and integrity, I would not have believed in a free society this could happen to anyone.

Let me go into a little detail on my 49-year association with Mr. Johnson and his wife, Jean, whom I have also known for 49 years.

Johnny Johnson was president of the fraternity I pledged in 1947 when I entered college at Southwest Missouri State College. He was 7 years older than I, had flown B–17s for 29 missions over Germany, while our colleague, Sam Gibbons, who isn't here, was fighting the battle on the ground. Quite frankly, for an 18-year-old freshman who had never been over a thousand miles away from home, Mr. Johnson was a hero. We certainly would be better off today if freshman students had people like Mr. Johnson to consider their heroes.

He was going to school on the GI bill and carrying a paper route morning and night to pay his way. I am sure his influence on me caused me to join the U.S. Air Force as my choice of services in 1951 during the Korean war.

I have now known Mr. Johnson for 49 years. I know very few people—I know no one I respect more.

Mr. Chairman, Members of the Committee, I want to ask you for the next few minutes to put yourself in Mr. Johnson's shoes. Think about how you would have reacted if the same thing had happened to you. Listen to his story closely.

Mr. Johnson is a convicted felon. Neither Mr. Johnson nor his wife, Jean, knowingly or willfully intended to violate the income tax law. On the other hand, two Federal courts have determined the Internal Revenue agents did willfully violate the law, and they have never been prosecuted. In fact, the Justice Department is con-

tinuing to defend the agents by appealing another decision that was handed down on May 16, 1996.

Let me close by pointing out what the U.S. district judge said in his decision: "Because of the unmitigated arrogance and unprofessional conduct of the U.S. attorney from the Department of Justice, there is a word to be said about obedience to the integrity of the adversarial process." He went on ahead to say, "The U.S. attorney is a representative not of an ordinary party to a controversy, but of a sovereignty whose obligation to govern impartially is as compelling as its obligation to govern at all and whose interest, therefore, is not that it shall win but that justice shall be done." *Burger* v. *United States.* I don't know the date. I don't know the citation.

Mr. Chairman, the judge concluded, "let the process end here," 20 years after it began.

One final note, a footnote to his decision says, "Reforestation to replace the trees for paper in this case will cost more than was collected in taxes from the Johnsons in 1981."

Thank you again, Mr. Chairman. Again, I wish there were more Members of this Committee to hear the story, which is a story that supports your position completely about what needs to be done as far as our income tax law is concerned.

If anyone has any questions of me before Mr. Johnson talks, I will be more than happy to try to answer them.

Thank you.

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

INTRODUCTION OF JOHNNY JOHNSON
BY REP. MEL HANCOCK
BEFORE THE WAYS & MEANS COMMITTEE
JULY 31, 1996

I want to thank the Chairman and the Members of the Ways & Means Committee for holding this hearing and allowing me to introduce one of the most outstanding individuals I have ever known.

On April 21, 1991 in the Springfield News-Leader in my home town of Springfield, Missouri, I read this article. Even though I had known Mr. Johnson for 44 years, this was the first time I had ever heard of his difficulties with the Internal Revenue Service.

I called Mr. Johnson and had lunch with him the next day and he told me the story about what had happened to him in his dealings with the Internal Revenue Service. Again, I would like to point out that Mr. Johnson never contacted me nor did he ever ask me to take any action whatsoever on his part as a member of the United States Congress. But after hearing his story, if I had not known Mr. Johnson prior to this time and completely trusted his honesty and integrity, I would not have believed that in a free society, this could happen to anyone.

Let me go into a little detail of my 49 year association with Mr. Johnson and his wife Jean, who I have also known for 49 years.

Johnny Johnson was President of the fraternity I pledged in 1947 when I entered college at Southwest Missouri State College. He was seven years older than me, and had flown B-17's for 29 missions over Germany (while our colleague Sam Gibbons was fighting the battle on the ground with the paratroopers). Quite frankly, for an eighteen year old freshman who had never been over 1,000 miles away from home, Mr. Johnson was a hero. We certainly would be better off today if freshmen students had people like Mr. Johnson to consider their heroes. He was going to school on the GI bill and carrying a paper route morning and night to pay his way. I'm sure his influence caused me to join the United States Air Force as my choice of services in 1951 during the Korean War.

I have now known Mr. Johnson for 49 years. I know very few people who I respect more.

Mr. Chairman, and Members of the Committee, I ask you for the next few minutes to put yourself in Mr. Johnson's shoes. Think about how you would have reacted if the same thing had happened to you.

Listen to his story closely.

Mr. Johnson is a convicted felon. Neither Mr. Johnson nor his wife Jean knowingly or wilfully intended to violate the income tax law.

On the other hand, two Federal courts have determined that the Internal Revenue agents did willfully violate the law, and they have never been prosecuted. In fact, the Justice Department is continuing to defend the agents by appealing another decision handed down on May 16, 1996.

Let me close by pointing out what United States District Judge Kenneth M. Hoyt said in his decision:

> "Reforestation to replace trees used for paper in this case will cost more than was collected in taxes from the Johnsons in 1981."

Thank again to the Committee. If anyone has any questions of me before Mr Johnson is recognized, I will be glad to respond.

STATEMENT OF REP. JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON REPLACING THE FEDERAL INCOME TAX
July 31, 1996

Mr. Chairman, thank you for holding this important hearing on how replacing the federal income tax might impact America's manufacturing sector and our energy and natural resources.

Clearly, we need a tax system which is simpler and fairer for all Americans. We need a system which raises the standard of living for families, encourages Americans to save, increases capital investment and boosts our international competitiveness.

And like many Americans who are concerned both about the health of our economy and the health of our environment, I know our legacy must be that we leave a strong economy and a sound environment to our children and their children. It is absolutely critical for us to do both.

I am looking forward to hearing the input from our distinguished panelists today. I am also glad we are hearing from Mr. Johnny Johnson today, who will help us have some grasp of the intrusiveness and abuses of power that have grown out of our current tax system.

Thank you, Mr. Chairman.

Chairman ARCHER. Well, Mr. Hancock, you make an excellent beginning witness for the Committee in your articulation.

Before we hear from Mr. Johnson, I just want to say briefly to the Committee that today we continue our hearings on fundamental structural tax reform, and we will continue to examine the impact of replacing the Federal income tax as it will affect manufacturing, energy and natural resources. These sectors of our economy are extremely capital intensive. Both industries employ many Americans, but they require a tremendous amount of investment in order to keep people employed. Both are also integral to the economic future of the Nation. We really can't have long-term economic growth without a strong manufacturing and energy base. Understanding the impact of the tax system on these industries is critical to fundamental tax reform.

But before turning to the subject of that hearing, we will detour briefly to hear Mr. Johnson, whom you have beautifully introduced, so that he can tell us about his experiences—perhaps a euphemism to say untoward and unfortunate—with the IRS.

Our colleague, Mel Hancock, first brought Mr. Johnson's case to my attention and requested he be given the opportunity to appear before the Committee to tell us about his experiences. And because those provide a particularly compelling example of the breach of privacy rights that can occur when the IRS is overzealous in its enforcement of the income tax, I agreed with Mel Hancock that the Ways and Means Committee should hear Mr. Johnson's story this morning.

Given the limited number of days remaining in this session of Congress and the fact that we are going to have, I believe, a very hectic schedule legislatively in September, Mr. Johnson is scheduled to appear today since this will likely be the only opportunity we will have this year to receive his testimony.

Mr. Johnson's experiences should reinforce our resolve to change our tax system to one that eliminates the need for the aggressive methods of enforcement and intrusiveness which is part and parcel of the income tax. And, Mr. Hancock, as you mentioned, it is my goal in the years that I will continue to serve in the Congress to tear the income tax out by its roots and to get the IRS completely and totally out of the lives of every individual American. Mr. Johnson's case is emblematic of why we need to do that, why we need to be concerned about the individual freedom and privacy that we treasure so much in this country.

I will say again that Thomas Jefferson in his memoirs said one of his most notable achievements while in public office was to remove the Federal tax collector from any direct contact with the American citizen. I hope we can do that in this century.

Mr. Johnson, we are pleased to hear from you. If you have a written statement, without objection, it will be inserted in its entirety in the record, and we will be pleased to hear your oral comments and testimony. And welcome, we are delighted to have you with us. I regret the experience you have been through, but today you will have an opportunity to tell the entire country about that experience. You may proceed.

STATEMENT OF E.E. "JOHNNY" JOHNSON, SPRINGFIELD, MISSOURI

Mr. JOHNSON. First of all, I would like to thank you, Chairman Archer, and all Members of the Committee for allowing me the time here today to speak briefly about my ongoing 20-year confrontation with the Internal Revenue Service.

Now, the first thing I would hope to establish is that this is not——

Chairman ARCHER. Mr. Johnson, could you perhaps move the microphone a little bit closer to you. Because we are having a little difficulty up here being able to hear you.

Mr. JOHNSON. Yes, sir. Is this better?

Chairman ARCHER. Yes.

Mr. JOHNSON. First of all, I would like to establish that it is not my purpose today to indict the entire Internal Revenue system because I know full well here are thousands of fine, dedicated, loyal employees there. But in an organization of this size, I also believe it is quite possible to have some involved who do not measure up to the standards we would prefer.

In my particular case, I think I had the misfortune of falling into the clutches of a few people who can best be described by saying that their ignorance was overshadowed only by their arrogance. However, in trying to explain what has happened, I would say the group was not at all interested in justice—only publicity.

As this has progressed over 20 years, it seems to me that the purpose has not been to see justice done but, rather, to make an example of me for their own purposes of public relations. As a matter of fact, one agent told me in my office in Galveston, Texas, that he was not interested in right and wrong so much as he was interested in publicity for the Service.

As I said earlier, it is difficult to summarize 20 years in 5 minutes, but I will try to do that as well as I possibly can.

After this had been going on for about 1 year, I became very concerned about the direction the investigation was taking, and so I went to the president of the company I worked for, and with whom I served on the board of directors. I explained to him in detail all that was happening and what I feared was happening. He suggested that I in turn speak to two senior members of the executive committee of the board of directors of the company and bring them up to date as well.

Every contact I had with the Internal Revenue Service from then on, which covered a little more than 3 years, I reported in detail to these three gentlemen. Each time they assured me that they had total faith in what I was doing and that I had done nothing significanctly wrong and to put it behind me as quickly as I could in any way that I could. Above all, try to keep it quiet so that I could protect my job, my name, and my family.

After this had gone on for some 4 years, at the urging of these three men, my attorney, Robert White in Houston, negotiated a plea bargain with the assistant U.S. attorney in Houston to allow me to put this thing behind me, to protect my job which I had worked at for 33 years, to protect my wife, and also save a considerable amount of legal expenses for both me and the government.

The central point of this plea bargain was that it would be done quietly and with no publicity.

Three days after the plea bargain was negotiated, the first of two news releases were released by the Internal Revenue Service, both of which contained not only confidential but also false information about me. When questioned about this breach of the plea bargain at the first trial, one of the agents passed it off by saying—now, this is not a direct, word-for-word quote, but, in essence, it is what was said. She said, Well, we realized everything might not have been done just exactly correctly, but in this voluntary tax system we have, in order for it to be made to work, we must occasionally crucify a well-known taxpayer.

Fighting a battle like this for over 20 years has been trying, to say the least. My family and I have come to believe that it is almost impossible to see justice done. We have won twice before Federal judges and a jury. We won twice before the Fifth Circuit, and the first decision was overturned in the third appeal to the Fifth Circuit by the IRS on purely a jurisdictional point.

Still, the IRS continues to fight on, as Mr. Hancock said. They have appealed the second decision that I won.

Now, they insist what was done is proper, in spite of the fact that two judges and a jury have in loud and emphatic terms said "hogwash." I realize full well I probably will not live long enough—I am sorry—to clear my name. If I can prevent what has happened to me from happening to someone else, I will have been compensated.

This country has been good to me. I have had opportunities no kid from southeast Missouri could ever expect to have. And I am grateful for that. It has given me a chance to start over again. I hope I haven't appeared to be bitter because I am not. But I want this type of thing to stop.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF E.E. "JOHNNY" JOHNSON
SPRINGFILED, MISSOURI

TESTIMONY PRESENTED TO WAYS AND MEANS
JULY 31, 1996

First, I would like to thank Chairman Archer and other members of the Committee for offering me this opportunity to appear here today in the hope that I can help bring into focus practices of the Internal Revenue Service where the agency is being overly aggressive in the pursuit of its missions. Be assured it is not my intent to indict the Internal Revenue Service as a whole. They have an enormous responsibility to perform, but all organizations and individuals should have limitations. In my case, reasonable limits were clearly exceeded.

Mel Hancock and I have been close friends for some 50 years. However, I never talked with him about my problems with the Internal Revenue Service until 1991, when he called me after reading an article in the Springfield, Missouri, newspaper about the United States District Court in Houston awarding me a judgment against the United States for wrongful disclosures from my confidential IRS files. That judgement is now gone, and I am still fighting my case in litigation 15 years after the IRS destroyed my career just for its own publicity.

I think perhaps I should start my testimony by describing my personal history and then explaining what happened to me that forced me to file my case against the IRS and its agents. In order for you to understand what happened, I have to tell the story chronologically.

MY PERSONAL BACKGROUND AND EXPERIENCE

I was delayed in going to college because of World War II. I joined the Army Air Force and in due course became a B17 pilot serving in the European theatre. I guess if it had not been for World War II, I never would have gone to college, because the G.I. Bill provided veterans like me with funds to attend college.

After college I went to work for my older brother, who was a general agent in Springfield, Missouri, for the American National Insurance Company of Galveston, Texas. During 10 of the next 14 years I was the most successful salesman in American National's sales force. After those first 14 years with American National, my brother died of a heart attack, and I became the general agent. In my first year as general agent, our agency finished second in sales for American National and in the next six years we were the most productive and profitable of all the agencies in American National. By 1972, which was my twenty-first year in the insurance business, I was asked by the American National home office to move to Galveston, Texas to become the Executive Vice President in charge of worldwide insurance sales. Because of the prestige in this move and the potential for further growth, I took a 60% pay cut and moved my family from Springfield, Missouri, to Galveston, Texas.

Apart from the huge pay cut, I had a great deal of trepidation about my move to Galveston because I had no experience in a corporate headquarters and I wondered if I could exist in that atmosphere. I knew the insurance sales business and I knew that I could always return to Springfield and sell insurance. The move to Galveston required me to surrender my agency; nevertheless, I moved my family to Galveston. My first assignment out of the home office was to visit and revisit the 175 field offices of American National to instill some of the techniques that I had used in Springfield. In an effort to improve production at all these offices as rapidly as possible, I traveled five days a week for the first three years in Galveston.

With my heavy travel schedule, I was generally gone from Galveston from Sunday night to late Friday night. My goal was to meet and to get to know all the company's field personnel. I taught the sales techniques that I had used and encouraged the field force to use them. From 1972 to 1981, sales improved roughly 700% and profits rose from about $14 million to $105

million. During this time I spent a lot of the company's money on travel and entertainment and I spent a lot of my own money for this same purpose. I wanted to lay a foundation to be able to join one of these 175 agencies or perhaps acquire one or more of the agencies if I decided that I couldn't take it at corporate headquarters.

At the time of my brother's death, it became quite clear that his wife knew nothing about his personal financial affairs, and I decided that when something happened to me, my wife would not be left floundering as my brother's wife had been. So, I began to involve my wife in my business affairs. Her only employment had been shortly after we were married in 1949, as a volunteer grammar school teacher. She became the family's bookkeeper. She kept track of all my expenses, which were paid for by check, credit card or cash, and categorized them just as all bookkeepers do. In essence, when I got home from each trip, I would give my wife what I had and reconstruct it as best I could. At the end of each year, the bookkeeping workpapers that she compiled were turned over to our CPA who prepared and filed our annual income tax returns. I accept total responsibility for what later occurred; I should never have thrust so much responsibility on someone so ill-prepared for it.

When I was making my visits to the 175 field offices of American National, even though I had an unlimited expense account with the company, I spent $15,000 to $20,000 per year out of my own pocket on travel and entertainment matters. About $7,500 per year was spent in cash. I had receipts for some of the cash disbursements which I turned over to my wife for bookkeeping purposes and the other cash disbursements I identified in general terms for my wife. For example, I would tell her that I spent $190 in cash on a trip to Boston, Providence and New Haven. Unknown to me, my wife was overwhelmed by the bookkeeping process and confused by the lack of receipts for some of the disbursements. She discovered these receipts only when the monthly credit card bills came. As a consequence, my wife normally delayed keeping the books for a given month until the American Express and MasterCard bills were received for the following month. This delay made the bookkeeping process substantially more difficult for her.

During this time, I was home only on Sundays because on Saturdays I worked at the home office doing my administrative work. We never talked about the bookkeeping problems she was having and I didn't discover the magnitude of these problems until four or five years later when a routine IRS audit turned into a criminal case with me being the target of that case.

By 1981, through the tremendous efforts of many of us at American National, we had built the eighth largest life insurance company in the United States in permanent life insurance in force. I was in the enviable position of Senior Executive Vice President and served on the boards of directors of our company and numerous subsidiaries. I had over five thousand full time agents in the field worldwide, with responsibility for many thousands more employees. My salary had multiplied several times, and the fringe benefits were terrific. I reported only to the board of directors, not even to the president of the corporation. I believe I was in line to become the next CEO and Chairman of the Board of American National. In short, I felt I had about the greatest job that one could have in the insurance industry, and I loved my work.

THE IRS AUDIT AND INVESTIGATION

Early in 1976, American National was notified by the Internal Revenue Service that it would be audited. I was advised that the IRS wanted to audit several of the top officers of the company. I volunteered to be one of those audited, and several days later an agent came to my office and requested copies of my returns for 1972 and 1973. Since I had just filed my 1975 return, I asked him if he would mind auditing 1974 and 1975 also so that I would be brought up to date. This procedure had been suggested to me by a friend and executive with American National.

The initial contact I had with the Internal Revenue agent involved his requests for a lot of documents which I readily supplied. After a period of time, the auditor brought another agent with him and these agents began asking me and my wife to identify every disbursement we had made by check, by credit card and by cash, whether or not the items were deducted. After a

while, still another agent was brought into the picture. He was a Criminal Investigation Division agent.

I had no concept of what these agents were looking for. When they wanted to talk to me, I talked to them and answered any and every question they asked. After some months of this, I asked the Criminal Investigation agent, "If you folks think I have done something wrong, why don't you tell me what it is and let me see if I can explain it. If I can't explain it, if I owe you taxes, I'll pay you and we'll get on with our business." The Criminal Investigation agent's reply was: "Mr. Johnson, the only good advertising the Internal Revenue Service gets is when it brings a big one down and your name is a household word to thousands of people." I said, "Do you mean to tell me that you think you can take me to a court of law and get a conviction on me with what you have from my records?" He said, "Probably not, but I can get your name in the newspaper and that will have accomplished my purpose." I said, "Right and wrong doesn't enter into the question?" He said, "Not at all."

I became deeply concerned with what was going on, so I consulted with the company's lawyer who was involved with the audit of American National's tax returns by the IRS. He recommended that I immediately retain outside counsel,I and I retained Robert I. White of the law firm of Chamberlain, Hrdlicka, White, Williams & Johnson in Houston. At the same time I consulted with the corporation's president and told him what had been going on. It was agreed that I would report all significant development in the investigation to the company's president and to two key members of the corporation's executive committee. Thus, I would keep informed three key individuals who served with me as members of the corporation's board of directors. Over the five-year course of the investigation, I did just that.

The Criminal Investigation agents who worked on my case seemed obsessed with finding the answers they wanted rather than securing the truth. A typical example concerns interviews that were conducted at restaurants where I entertained company visitors. We regularly met and ate at one of four or five restaurants in Galveston. I had charge accounts at all of these restaurants and turned the bills in to the company for payment. I remember being told by two or three of the restaurant owners that they had received visits from the Criminal Investigation agent who was trying to develop the theory that I was entertaining personal friends and family members at the restaurant and was passing along the bills for such personal matters to the company. These owners told me that the agent said to them, "Maybe if we audited you it would improve your memory about who Johnson was really entertaining at your restaurant." Another time, a company general agent in Missouri called to advise that the Criminal Investigation agent had visited him and tried to get him to lie about the nature of certain expenditures that I had made when I had visited that general agent's office. The general agent had surreptitiously tape recorded his conversation with the Criminal Investigation agent, so we knew exactly what had occurred.

On another occasion the Criminal Investigation agent interviewed an American National home office officer about a trip that he had made with me to Honolulu. The officer permitted the Criminal Investigation agent to reduce his statement to writing and then immediately signed the statement and surrendered it to the agent, retaining a photocopy. The officer showed the photocopy to me, and I pointed out a couple of mistakes in the statement about who was at certain meetings and the purpose of the meetings. The officer readily agreed that these corrections should be made so that the statement would be correct. When he called the Criminal Investigation agent to have the corrections made, the Criminal Investigation agent said, "These changes will change the entire statement you gave--and you can't make corrections at this late time." The company officer made the pen and ink corrections to a photocopy and mailed the photocopy, by certified mail, with a transmittal letter to the Criminal Investigation agent.

Another time, my mother-in-law, who was more than seventy years old at the time, called me at the office. She was hysterical. When she finally composed herself, she stated that she had been interviewed for two hours by the most abusive man she had ever met. It turned out to be the Criminal Investigation agent.

My youngest daughter, who was in Austin attending the University of Texas, was contacted by the Criminal Investigation agent who interviewed her wanting to know what she was doing with

the money that my wife and I were sending monthly for school expenses. I never did understand why such inquiry had to be made of a seventeen year old girl when none of the items were deducted in our tax returns.

Probably forty insurance business associates were interviewed by the Criminal Investigation agent. Most of these people called me to report what was said and the attitude exhibited by the agent. The agent's constant statement was, "All we want to do is put Johnson in jail." I remember one time the Criminal Investigation agent stated to me, "I believe I could get you two years in the slammer for that statement."

NEGOTIATIONS WITH THE IRS AND DEPARTMENT OF JUSTICE

After the IRS finished its protracted and abusive investigation, it recommended that I be prosecuted for tax evasion for the years 1974 and 1975. I had no concept about the basis for such a recommendation. Working through my attorney and the CPA he engaged, it turned out that my wife, in her efforts to be a perfect bookkeeper, on several occasions in each of those two years tried to account for currency disbursements I had made on business trips for which there were no receipts by modifying the total of a disbursement on an American Express receipt. For example, my wife altered a $75 receipt to read $175. In this way she was trying to document my expenditure of $100 in cash in that city on that date. It was readily apparent from the monthly statement that came from American Express that the charge was not $175 but rather $75. In addition, my wife had listed among business disbursements checks for purely personal items such as purchasing a lawnmower for the house. She did this to supply a piece of paper to explain a currency disbursement of similar amount that had been spent in another town on a business trip. In total, these currency disbursements amounted to about $7,500 a year. Currency had actually been spent for business purposes, but through my wife's naivete she had accounted for these cash disbursements by modifying American Express receipts and by listing disbursements by check that had nothing to do with business. This was what the IRS' criminal case against me was all about.

My attorney and I were able to review each and every one of the altered American Express tickets and the checks written for personal purposes that had been classified by my wife as a business deduction. My attorney told me that if these amounts had been listed correctly as currency expended on the business trips, they would have not been questioned. However, he said, it appeared as though I was claiming as business expenses items that had not been expended or that had been expended for purely personal purposes.

In my initial review of these documents with my lawyer, I told him that I knew nothing about the modifications of the American Express tickets or the claiming of personal checks as business expenses. He asked me to take a polygraph tests about my lack of knowledge. I took the polygraph test and the examiner confirmed that I was truthful when I said that I had no knowledge of these items. My lawyer made me take a second polygraph test which I did with the same results. My lawyer and the CPA also analyzed the checks that I had cashed incident to making business trips. They were easily able to demonstrate availability of currency for purposes of paying the amounts that my wife had documented in the bookkeeping process through the altered American Express tickets and the misclassified checks for personal items.

In talking about strategy in the case, my lawyer advised me that the likelihood was that the government was going to go forward with the prosecution unless we presented the bookkeeper, my wife, who would take responsibility for the alterations and misclassifications. My lawyer said that since my wife was the person who did this, the likelihood was that she would be placed into the net with me, even though the amounts of tax involved were less than $5,000 per year for each of the years 1974 and 1975. So the strategy evolved, and the case proceeded as follows.

1. We told the IRS and the Department of Justice lawyers that the altered documents and misclassified checks were misclassified by my bookkeeper to reflect actual disbursements of currency. Then we showed that there were more than sufficient checks to cash to supply the currency spent on these trips. The dollars involved

were relatively small, slightly less than $200 a week for forty weeks a year. That's all we were talking about. Of course, taxis to and from the airports and tips accounted for most of that.

2. The Government was told that I knew nothing about these modified documents and misclassified personal checks. The polygraph tests were offered, and my attorney told the IRS and the Department of Justice lawyers that I would be willing to submit to polygraph examinations by the FBI or anybody else that the government selected.

3. We compiled and presented statements from nearly 100 insurance agents who stated that I always paid bills in cash in our after hours get togethers.

4. Despite the foregoing, the Department of Justice wrote advising that there would be a criminal prosecution for tax evasion filed against me in the United States courts in Galveston.

After further consultation with my lawyer and my wife, we decided to take a desperate gamble by disclosing to the Department of Justice that my wife was the bookkeeper who had altered the documents and misclassified the personal checks. This was done in a deposition taken in the United States Attorney's Office in Houston.

Months after the deposition was taken, we received a letter from the Department of Justice stating that, as my lawyer had predicted, both my wife and I would be indicted for tax evasion.

All the way through this process, I held weekly or twice monthly meetings with the company's president and the two members of the Executive Committee of the Board of Directors keeping them apprised of every development in the case, including the fact that there was a threat that my wife and I would be indicted for tax evasion for about $5,000 a year for 1974 and 1975.

My lawyer, Mr. White, began negotiations with the Department of Justice in an effort to make a plea bargain. The Department of Justice wrote my lawyer and advised that the Department of Justice would abandon the case against my wife, would proceed by criminal information against me for one year only, and would recommend that the case be disposed of with probation if I would plead nolo contendere (if the judge would accept it) or guilty (if the judge would not accept a nolo contendere plea).

I met with the company's president and advised him of the plea bargain offer. He advised that if the matter could be disposed of discreetly, with no adverse publicity, the plea of guilty or nolo contendere would not affect my job.

After consultation, my lawyer negotiated the following fine points of my plea bargain:

1. In order to prevent news reporters from spotting the papers filed in the court clerk's office, the U. S. Attorney agreed that I would be prosecuted under my legal name, which is a name that I have never used in my life - Elvis Eugene Johnson. My address would be reflected as 1100 Milam Street in Houston, which was the address of my lawyer's office. My Galveston address would not be mentioned, and I would not otherwise be identified in the court papers.

2. My lawyer worked with the judge and the court personnel (with agreement by the U. S. Attorney) to permit the investigation of my character, reputation and background to be conducted <u>before</u> the criminal case started. The recommendation of how to dispose of the case thus would be received by the judge before he even had a case before him.

3. Before the criminal case was filed, my lawyer and the government lawyer would meet with the judge to be certain that my case was going to be concluded with probation rather than any actual imprisonment.

4. The criminal information against me would be filed late on a Friday afternoon and would be disposed of immediately in court.

5. The U. S. Attorney agreed not to issue a news release about this case or the sentence that the judge gave me.

In considering this plea bargain, my lawyer told me on many occasions that the government would never win this case if I elected to go to trial.

But the cost of the criminal case was a consideration because it was estimated that it would cost $50,000 to win the case.

Moreover, the president of the company had assured me that I could plead guilty and keep my job as long as there was no publicity. My lawyer had structured the thing so that I could not be hurt through publicity. My wife had suffered a light stroke, which our doctor attributed to the stress from this ordeal. Half her stomach had been removed because of ulcers, and she was having severe migraine headaches almost daily. I simply could not put her through a trial. So, I decided to accept the plea bargain. On balance, I just decided to put behind me this bitter pill by pleading guilty to save my wife, to save the company embarrassment, and to save money.

The case went off exactly as scheduled late one Friday afternoon in April 1981. The pleadings were filed, and the judge heard the case and sentenced me to probation within a half hour of the time that the case started. No outsiders were in the courtroom. So when the case ended, the only information available in the clerk's office was that an Elvis Eugene Johnson of 1100 Milam Street in Houston pleaded guilty to a one count criminal information charging tax evasion in 1975 of approximately $3,500 of tax. Without access to the confidential IRS files, no one would have known that "Johnny" Johnson of Galveston and American National Insurance Company had been convicted of anything.

Immediately after the proceedings in the courthouse were concluded, I talked to the company's president and advised him that the matter was now concluded and that there would be no publicity about the fact that I had pleaded guilty. I offered to explain the plea bargain and my conviction to the Board of Directors, but the president suggested that we sleep on it over the weekend and talk on Monday. On Monday, I spoke to the president again. He told me that no one needed to convince him that I was an honest man. He said the best thing for the company was for me to stay right where I was, doing just what I had been doing. He said the matter was settled, and because there would be no publicity, there was no need to speak with the Board of Directors. He told me to put the matter behind me and get back to work. The final chapter was closed, or so I thought.

THE PRESS RELEASES AND MY DISMISSAL

On the Wednesday after I pleaded guilty and was sentenced to probation, I was at my office in Galveston when I received a call from the public relations officer of the company. He told me that a radio station reporter had just called him about a news release the station had received from the Internal Revenue Service about my pleading guilty. The news release stated:

> INSURANCE EXECUTIVE PLEADS GUILTY IN TAX CASE
>
> Galveston, Texas - In U. S. District Court here, April 10, Elvis E. Johnson, 59, plead (sic) guilty to a charge of federal tax evasion. Judge Hugh Gibson sentenced Johnson, of 25 Adler Circle, to a six-month suspended prison term and one year supervised probation.
>
> Johnson, an executive vice-president for the American National Insurance Corporation, was charged in a criminal information with claiming false business deductions and altering documents involving his 1974 and 1975 income tax returns.

In addition to the sentence, Johnson will be required to pay back taxes, plus penalties and interest.

I immediately called my lawyer who tried to get various officials of the Internal Revenue Service to withdraw the news release. My lawyer warned the IRS that the information in the press release could only have come from the confidential IRS files, and he asked them to withdraw it immediately to try to stop any further damages.

My attorney also called the Assistant U. S. Attorney who had handled the case. The Government's lawyer confirmed that he knew nothing about the press release, that he had made no press release himself, that this was the first he had heard of a news release, and that the IRS was the only other folks he could think of who might have made a news release. He concluded by saying that if I had been damaged by the news release, that I should "sue the hell out of them."

Despite my lawyer's best efforts to warn the IRS that they were unlawfully issuing news releases that included confidential information from my tax files, the Internal Revenue Service made a second news release that reiterated essentially the same information. These news releases caused the company to ask for my resignation. The controlling shareholder of the company, who was the key member of the board of directors, said that I would have been retained in my position with the company except for the publicity. Because of the publicity I "had to go," as he put it.

Assuming for the moment that the IRS needed some publicity on April 15th of 1981, it should have restricted the news release to the public record. If the IRS had issued a release that followed the information that was in the clerk's offices, my identity never would have been disclosed. No one in the Galveston area would have suspected that the man they knew as "Johnny" Johnson in Galveston had been convicted of a crime if the IRS had published the information that Elvis Johnson of 1100 Milam Street in Houston had been convicted of tax evasion.

There were numerous other erroneous and wrongful disclosures in the press releases that demonstrated the willfulness and gross negligence in the preparation of the press releases. For example, the initial press release misstated the criminal charges by referring to multiple years, when only the year 1975 had been involved in the actual prosecution. By referring to false business deductions and altered documents, the IRS illegally revealed to the public the nature of my tax problems, which may have contributed to the Board of Directors' decision to demand my termination. Another vindictive part of the press release concerned the statement that I would be "required to pay back taxes, plus penalties and interest." In fact, my civil tax liability had not even begun to be resolved.

MY LITIGATION AGAINST THE IRS AND ITS AGENTS

After my forced resignation, I returned to Springfield, Missouri, and began again at the bottom of the insurance industry as a basic salesman for American National. It is probably some measure of respect that American National continued to employ me, even though I could not continue in my position as executive vice-president in Galveston. When I stopped to consider the difference in my compensation and retirement benefits, I realized that I lost at least $5,500,000 as a result of the unlawful press releases that the IRS had issued to at least 21 media outlets in the Galveston/Houston area. My attorneys advised me that Section 6103 of the Internal Revenue Code made it unlawful to publish information from my confidential tax files. In fact, they informed me that it was a crime for IRS agents to knowingly publish information from those confidential files. When I learned that no one would do anything to punish this crime, I decided to pursue my own damages in court.

At the time back in 1981 when the press releases were issued, the Internal Revenue Code only provided for a suit against the individual agent who had violated the confidentiality sections of the Code. My lawyers also thought that a suit could be brought against the federal government under the Federal Tort Claims Act, because the information had been negligently or tortiously

released to the press. Thus, I decided to sue both the Government and the individual agents under alternative theories.

In 1986, a federal district judge in Houston granted me a partial summary judgement. His ruling was that the news releases violated the disclosure provisions of the Internal Revenue Code and that I was entitled to minimum damages of $1,000 for each of the media outlets to which the news releases had been released. We tried to discuss settlement of the case at the point, but the Government's lawyers, who were defending both the United States and the individual IRS personnel involved, insisted upon a trial. In 1991, the United States District Court in Houston awarded me a judgment against the United States Government under the Federal Tort Claims Act for damages of $10.9 million caused by the news releases. That case was appealed to the Court of Appeals for the Fifth Circuit and that Court's opinion affirmed the District Court's judgment. Thereafter, the Appeals Court wrote a second affirming opinion. Then the Fifth Circuit, en banc, wrote a third opinion holding that what had happened to me was not a tort under Texas law. Rather, it could only be some kind of a federal tort which was not covered by the Federal Tort Claims Act. The Court of Appeals sent the case back to the District Court to try my alternative claims directly against the individual IRS employees, who, by their misconduct, had damaged me.

The second trial was conducted earlier this year and the jury awarded me a verdict of actual damages of $6,000,000 and punitive damages of $3,000,000. Again, the Department of Justice has filed notices of appeal. It feels like I am on a never-ending treadmill. No matter how many times the judges or juries say they do not believe the IRS employees' version of what they claim happened, my government continues a war with me that should have been settled long ago.

The District Court entered judgment for that $9,000,000 plus interest and attorneys' fees. The judgment is against: (1) the Criminal Investigation Division agent, who admitted that he drafted the press release knowing that the information came from the confidential IRS files and who the judge decided had lied on the witness stand when he claimed that he had confirmed the press release with the Assistant U. S. Attorney; (2) the public affairs officer, who issued the press release without coordinating with the Assistant U. S. Attorney to make certain that it was accurate and should be issued; and (3) the Criminal Investigation Division agent's branch chief, the chief of the Criminal Investigation Division in the district, and the acting district director, all of whom participated in the decision to issue a second press release with the same confidential and damaging information.

In the two trials, we found out and proved that the Internal Revenue Service criminal agent and public affairs officer wrote the news release from the IRS case file without ever having looked at the public record. Moreover, they never asked the Assistant U. S. Attorney to approve the news release. Under the so-called IRS procedures, a news release was supposed to have been approved by the U. S. Attorney. So, there was a deliberate and intentional disclosure of information from the investigatory file. Even after my attorneys pointed out to the IRS that information in the first press release could only have come from the confidential IRS files, the second press release was issued without consulting the original courthouse records to see what information was public.

We had to scour the country to find former IRS personnel who would even be willing to testify against IRS employees. We finally found a former District Director and a former IRS Chief of Criminal Investigation who testified that all of the IRS personnel were willful or grossly negligent in disclosing the tax return information in this case. Amazingly, not one IRS employee other than the individual defendants came to defend what the agents had done to me. Even more amazingly, every IRS defendant stated on the witness stand that they had never bothered to read the Internal Revenue Code provisions that they had violated in order to determine whether they had any real defenses or not. Apparently, they had been on trial facing personal liability for more than 13 years, but the Justice Department had defended them to the nth degree, and the agents did not even care enough to open up the Internal Revenue Code themselves to see that what they had done was wrong.

EPILOGUE

The Department of Justice has now filed a notice of appeal on behalf of the five Internal Revenue Service workers who destroyed my career. The press releases were issued more than 15 years ago, and the IRS audit of my tax affairs began more than 20 years ago. The tortoise-like pace of the judicial process and the Government's unwillingness to settle this case without pursuing every avenue of appeal have left my wife and me without any real remedy. I am now 74 years old, and I fear that even if I recover on my judgment, my time is running short.

After I was forced to resign from American National, I seriously considered suicide because everything that I had worked for in my life from the beginning had been destroyed. I know that there was an appearance of wrongdoing on my part but the absolute truth is I was as innocent in this tax case as a baby. I have been convicted of a crime and I accept that because my tax return was wrong. I couldn't substantiate the cash disbursements that had been made. I pleaded guilty.

However, as the District Judge pointed out in his opinion, this was not a major crime, and the U. S. Attorney and my attorney had reached an agreement in the form of a plea bargain that disposed of the matter in a way that permitted the government to have a statistic of a conviction but at the same time permitted me to go about my life in a productive way. The breaches of the Internal Revenue Code's provisions about not disclosing confidential tax return information were done wantonly, and yet no one has ever prosecuted the Internal Revenue Service agents. I say no one. The District Judge who held the jury trial earlier this year grilled the United States Attorney outside of the hearing of a jury concerning the obvious conflicts of interest in defending the IRS agents after what they had done. The Assistant U. S. Attorney had no answer for this.

Let me say in closing that my country has been good to me. I had opportunities as a farm boy from Southeast Missouri, as a result of being in the Armed Forces during World War II, that I could never have dreamt of as a child. I hope I have been successful in telling my story without sounding bitter toward the government. I told you at the beginning that I was in the United States Army Air Force during World War II. In fact, I flew 29 bombing missions over Europe, and my planes were shot down twice. The rest of my original squadron was not so lucky, and they didn't make it home. The United States of America is my home, and I am still proud to say so.

After I was forced to resign from my job in 1981, I was fifty-nine years old. I am now seventy-four, still working full time trying to sell insurance, just thankful to live in a country where we all have opportunities.

Once again, thank you, Chairman Archer and the Members of the Ways and Means Committee for this opportunity to tell my story. I will be glad to answer any questions the Members of The Committee may have.

Chairman ARCHER. Mr. Johnson, thank you so much for coming and giving us the benefit of your story. It is true Congress has put into the Tax Code so many complexities and so many powers to the IRS that it is very, very difficult to exercise those powers properly, equitably, and in a way that is always considerate of the taxpayer. I appreciated your comments that there are a number of people, many people, in the IRS who do their job as best they can. But it does open the door for potential abuse because the power is so enormous. The old saying of Lord Acton is always true, that power corrupts and absolute power corrupts absolutely. All of us in this country should be concerned about that.

I often ask witnesses before this Committee, "What would you pay not to have to deal with the IRS every year?" And the least valuable answer has been, "What I pay my tax preparer." I am surprised that that is the lowest answer because it ought to at least involve all the preparation work that goes into getting the information ready to send it to the tax preparer, which is worth something.

But we had a middle-income lady from Connecticut testifying here a couple of months ago, and when I got to her and asked her that question, she said, I would give my first-born child. And I think that certainly after your experience you would have given an answer similar to that.

The one thing I think is ignored so much in our society is what is the value of individual freedom and privacy. Different people put different dollar values on that. I am not sure you can put a dollar value on it. It is the basic treasure, the basic foundation piece for this country. And inevitably, with this enormous amount of power, the pressure that is there to bring results will, I fear, continue to lead us into the kind of situation you have told us about today. But I agree with you and I hope your appearance will be helpful in preventing this from happening to anybody else.

Could you tell the Committee just briefly what the facts were about the allegation against you?

Mr. JOHNSON. Surely. I do not mean to sit here today and appear to be blameless. But when my brother died in 1965 from a heart attack, his wife was totally, absolutely naive insofar as his financial condition, what he was doing, what he had and what he didn't have, and what money he made and so on. I was determined that that would not happen to my wife when something happened to me, and so I involved her in my bookkeeping process. She had no work experience. She had no training. I thought in my helter-skelter life I was living that I had her trained to the point she could do this.

When I moved into the home office in Galveston, I was traveling 5 and 6 days a week, and I recounted, reconstructed for her as best I could what I did, what my expenses were, and so on. She never one time confided in me that she was completely confused, and she did such things as put a "1" in front of a "75" on an American Express credit card. There were some 8 or 10 of those, I believe, over a 4-year period.

She as honestly and as fairly as she could tried to cover expenses I had had with items of record that did not actually add up. I learned about this after the Internal Revenue Service started the audit, for which, I might add, I volunteered. They came to audit

the company, and in the process, as some of you undoubtedly know, they audit some of the top officers. We were to be audited for the years of 1972 and 1973. At the suggestion of a good friend of mine who was an executive of American National, when the auditor came for my records for 1972 and 1973, I asked him to also audit my 1974 and 1975 records. Also, I had nothing to hide, I thought. And so from the expenses I actually had that were covered incorrectly by my wife's bookkeeping methods, which I found out about after the IRS started talking about bringing a criminal indictment against both of us, the sum of money involved was a few thousand dollars on which I would have owed less than $3,500 additional tax.

Chairman ARCHER. And what happened to that $3,500? Did you tender payment of those taxes?

Mr. JOHNSON. Yes, sir.

Chairman ARCHER. Mr. Johnson, thank you.

Mr. Hancock may inquire.

Mr. HANCOCK. Thank you, Mr. Chairman.

Johnny, you indicated the Department of Justice had filed notice of appeal on behalf of the five IRS employees whom two judges and juries found to have willfully and knowingly violated U.S.Code, section 6103. Unauthorized disclosure of confidential tax return information is a felony punishable by a fine of up to $5,000 or 5 years in prison, or both.

To your knowledge, has the Federal Government ever taken any action to prosecute these individuals for what they did?

Mr. JOHNSON. Absolutely none, as far as I know.

Mr. HANCOCK. Did either of the judges who heard your case have anything to say about what the Internal Revenue Service did here?

Mr. JOHNSON. Well, both judges said that the agent was obviously a liar. He swore a lie under oath.

Out of the hearing of the jury, Judge Hoyt asked the U.S. attorney if he had explained to his five clients the penalties of section 6103. He said he had not. All five said they had not read them, and so as far as I am concerned, nothing has been done or even considered where they are concerned.

Mr. HANCOCK. Thank you, Mr. Chairman. I know Mr. Johnson. I have heard the story. I would like for the other Members to have the opportunity to ask questions they consider pertinent.

Chairman ARCHER. Mr. Coyne.

Mr. COYNE. I have no questions.

Chairman ARCHER. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Johnson, I have read your prepared statement for the Committee, and I commend you for your courage. You know, it probably wouldn't be so bad of an experience if you were the only American this had happened to. But it is extremely tragic that all of us on this Committee in a hearing and in our day-to-day lives representing Americans around this country have heard this same story too many times. In this very room, we heard of people who had their lives broken just like you have, lost their businesses just like you have, and I know much has been made about your plea of nolo contendere, that the judge converted it to a plea of guilty.

Can you simply tell us whether the threats of criminal indictment of your wife had any influence on your decision to enter that plea?

Mr. JOHNSON. It was one of the very important considerations because my wife had had a stroke, which was attributed to the stress from this situation. She had had one-half of her stomach removed with ulcers. She was having migraine headaches on a daily basis. And I frankly had grave concern about her being able to go through a trial.

Mr. LAUGHLIN. As one who was merely an infant during World War II but understands your courage in fighting nazism, I have formed the opinion in reading your statement, as well as Judge Hoyt's judgment, that what you and your wife experienced was very similar to the experience that the Jews and the other people that were subjected to Gestapo treatment, was very similar to your own treatment. As one who fought nazism, do you share the opinion I form from the judge's statement?

Mr. JOHNSON. That has occurred to me, yes, sir.

Mr. LAUGHLIN. Now, I know Mr. Hancock asked you this question, but we have had two Federal judges who have rendered judgments on your behalf and cited the violation of the U.S. Code dealing with release of confidential information. Has anyone from the Justice Department come forward and given any indication that they are going to prosecute any of the IRS agents for violating the Federal law?

Mr. JOHNSON. Not at all, and it is remarkable, I think, in that through the two trials, not one single person from the Internal Revenue Service other than those accused have stepped forward to defend their actions.

Mr. LAUGHLIN. Would you agree with me that in your case the IRS agents involved in the press release calculated that through the use of the press release their conduct would override the judgment of the Federal judge in this case who thought it was fair to keep your plea and the sentence confidential?

Mr. JOHNSON. Oh, absolutely. One time the special agent was in my office, and I said, If you think I have done something wrong, why don't you tell me what it is? Let me see if I can explain it. If I can't explain it, if I owe you something, I will pay you and we will get on with our business.

His reply to me was to look me straight in the face and say, Mr. Johnson, you have to realize the only good advertising the Internal Revenue Service gets is when they bring a big one down, and he said your name is a household word to thousands of people. I said, Right and wrong doesn't enter into it? He said, Not at all, winning does.

Mr. LAUGHLIN. Would you agree with the opinion I formed in reading the judge's opinion that the arrogance of the IRS in doing the press release, in fact, caused you to lose a 30-year record of a reputation of integrity and honesty?

Mr. JOHNSON. There is not even a shadow of doubt. It is the sole cause.

Mr. LAUGHLIN. Mr. Chairman, those are all the questions I have, but I would, as a departing Member of the Congress, suggest that perhaps the Internal Revenue Service and the Department of Jus-

tice be called before a public hearing to explain why they have not brought criminal action against the employees of the Federal Government who have violated a Federal law. This law has a very good reason for being in existence, and that is to protect Americans from their own government.

Mr. Johnson, thank you very much not only for your courage in fighting this case, but for your courage in serving in the military forces to defeat the Nazis in World War II.

Thank you very much.

Chairman ARCHER. Mr. Collins.

[No response.]

Chairman ARCHER. Mr. Johnson.

Mr. JOHNSON of Texas. I want to associate myself with Mr. Laughlin's remarks and the fact that we fought for this country for the freedoms we adore, and if we don't protect them, something is wrong. I think it is a travesty that any agency would come after an individual citizen the way they have come after you, and I appreciate your testifying before us this morning.

Thank you.

Mr. JOHNSON. Thank you, sir.

Chairman ARCHER. Mr. Jacobs.

Mr. JACOBS. Mr. Johnson, when you filed your suit under the statute against those agents, do you know who paid their attorneys' fees?

Mr. JOHNSON. I have no idea. No, sir.

Mr. JACOBS. Let me ask you, you tell us in your testimony there may have been some appearance of wrong on your part, but you actually spent the money correctly and it was deductible, as I understand it.

Mr. JOHNSON. Yes, sir. That is my belief.

Mr. JACOBS. Now, put the case where these same IRS agents knew that but obviously don't like you and obviously meant to do you harm when they revealed this information in violation of the Federal law. Put the case that they knew perfectly well you took proper deductions and that you had not violated the Federal Income Tax Code. And let's say the court ordered your attorneys' fees to be paid. Who do you think should pay those attorneys' fees, the ones who meant to do you wrong or your fellow taxpayers, the government itself?

Mr. JOHNSON. I would love to see the people who were involved, who did what they did, be brought to pay those fees.

Mr. JACOBS. Right. I hope this is a little hint to my colleagues here, because since about the time they came after you in the early eighties, I have had a bill before Congress and I have had amendments before this Committee that have provided not honest mistakes by the IRS agents, but where they meant to hurt somebody, where they meant to use their authority or, to use the legal term, acted ultra vires, in the color of authority but above authority to harm another person for whatever reason, using that material. But instead of your fellow taxpayers paying your attorneys' fees, the ones who did the wrong would lose the boats in their driveways or their automobiles or whatever, and I keep hearing the same thing. It would have a chilling effect on IRS agents doing their duty.

Well, to me, that is like saying if you pass a murder law, it will have a chilling effect on American citizens because they will be afraid to shake hands with someone for fear it might kill him.

Nobody should be insulted, nobody should be insulted if he is doing his duty or she is doing her duty correctly simply because there is a law that would charge that person fines if he or she did or whoever does his duties incorrectly.

What I am trying to say is, it is one thing for your fellow taxpayers with their money to indemnify honest mistakes by IRS agents, but it is quite another to force them to pay the attorneys' fees, in essence to indemnify the intentional wrongdoing by an IRS agent. That is it in a nutshell. It has been adopted by this Committee two or three times only to die in the cave of the bones over in the body. The Washington Post goes berserk about it. I am having a chilling effect on IRS agents.

I just hope this testimony today might reinvigorate my effort to make clear to Members of Congress the distinction between honest mistakes, which probably ought to be indemnified by the government or the taxpayers, and dishonest mistakes, which should result in the punishment of the so-and-so or so-and-sos who did it.

Do you agree with that?

Mr. JOHNSON. I certainly do.

Mr. JACOBS. Well, Mr. Chairman, I rest my case.

Mr. HANCOCK. Would the gentleman yield?

Mr. JACOBS. Yes, sure.

Mr. HANCOCK. In your first question, when you first started, you asked if Mr. Johnson knew who paid the agents' legal fees.

Mr. JACOBS. Yes.

Mr. HANCOCK. I don't know for sure about this, but I understand that the Justice Department has handled the entire defense. Now, they may have other attorneys that they have hired, but am I correct on that?

Mr. JOHNSON. I believe that is correct. Yes, sir.

Mr. HANCOCK. So the taxpayers have paid the legal defense——

Mr. JACOBS. Right. Well, then, I tell my colleague from Missouri and I tell my Chairman, I not only rest my case but put it to sleep with that answer.

Chairman ARCHER. Mr. Houghton.

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

Mr. Johnson, good to see you. Clearly, from your testimony, you have been wronged. It is tragic. As a citizen and as a public employee, I am truly sorry about this. But you said there are some good IRS people as well as a few bad ones, and also you hope other people in the future will not suffer the same fate. So it seems to me the only course of action now is to fire these people and to pursue that.

However, at the same time, I understand the Department of Justice has filed a notice of appeal on behalf of the five Internal Revenue agents. What is the basis of that? Are they just going to stick up for their own?

Mr. JOHNSON. Sir, I must confess I am very naive in the way the law is administered, and I don't know what their basis is. I haven't seen a copy of the appeal as yet. And so I—there has not been an appeal. Mr. Steed tells me there has been a notice of appeal filed.

Mr. HOUGHTON. Thank you, Mr. Chairman. That is it.

Chairman ARCHER. Ms. Dunn, do you wish to inquire?

Ms. DUNN. Thank you very much, Mr. Chairman.

Mr. Johnson, I just want to thank you for coming to testify before our Committee this morning, and it has been, indeed, a sad story. Those of us who are interested in being responsible and accountable folks who work on behalf of our constituents within the government want to apologize for everything you have gone through.

I had the good fortune to have had a conversation a week or so ago with my colleague, Mel Hancock, who talked to me about your involvement in the community. And so I would like to ask you—you didn't talk much about what you are doing these days, but I would really be interested in your letting us know what you are doing on the volunteer end of things.

Mr. JOHNSON. Well, in 1983, I helped start an organization in the State of Missouri called the Make-A-Wish Foundation. It grants wishes to children who have life-threatening illness. We have granted, I believe, something over 400 wishes at a cost of approximately $3,000 per wish. I believe I have personally been involved in either 75 or 76 of those wishes.

I also serve on the board of the Ozark Counseling Service, which provides counseling for indigent families, primarily children.

About 2 weeks ago, I believe it was, I donated my 101st pint of blood. A short time ago, 2 years ago, I believe it was, I was given the Jefferson Award for being the outstanding humanitarian in our city that year.

Ms. DUNN. With all the difficulties the IRS has put you through, what would be your wish, Mr. Johnson?

Mr. JOHNSON. That no one else has to do it.

Ms. DUNN. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. And let me thank Mr. Hancock for his concern for an old friend that has gone through this horror story.

In talking with you yesterday and again reviewing your notes, I find we have much in common. You served your country well and came back and went to school under the GI bill, and based on that opportunity, you built yourself a business. I fought in Korea, came back home, went to school on the GI bill, became an assistant U.S. attorney, and both of us have felt this same response from the Internal Revenue Service. You went through this horror story, and I found myself on the Nixon enemy list for 7 years and audited. On the first audit I overpaid, much less broke the law. Please imagine my embarrassment as a former assistant U.S. attorney being warned that anything that I say would be held against me.

As you can see, the problem we do face is really bipartisan. It had gone through Nixon, Carter, Reagan, and Bush. Thankfully, yesterday, President Clinton signed the Taxpayer Bill of Rights, which hopefully, while it doesn't help you that much, should send a signal to the IRS that we have oversight responsibility.

Your courage has been mentioned, and I don't know exactly where that came into the exchange, but your case is presently on appeal, isn't it?

Mr. JOHNSON. Yes, sir.

Mr. RANGEL. And was your testimony discussed with your lawyer before you came here this morning? Are you testifying with the advice of your attorney?

Mr. JOHNSON. Oh, yes. Yes, sir.

Mr. RANGEL. So he didn't suggest anything you might say today, in response to questions, would adversely affect your appeal?

Mr. JOHNSON. No, sir.

Mr. RANGEL. He did not?

Mr. JOHNSON. He did not. No, sir.

Mr. RANGEL. Well, Mr. Chairman, I didn't know Mr. Johnson was going to appear until I spoke with Mr. Hancock yesterday, but believe me, I have a half a dozen people I have known that have had their lives destroyed by the abusive behavior of the Internal Revenue Service. If you could suggest how I could get on this agenda, I would welcome the opportunity to bring in some cases that have been affected by similar, if not comparably destructive, types of behavior. I really didn't see how this fell in line with the agenda. However, if we could have just one person to come in from the various districts, I think that would send a strong signal to the IRS that we are concerned.

Would we be able to work out other cases like this and bring them before the Committee?

Chairman ARCHER. Mr. Rangel, I don't know how long the list would be if we let every Member on the Committee——

Mr. HANCOCK. Mr. Chairman, Mr. Chairman, how many people have actually obtained a punitive judgment against the Internal Revenue Service and against the individual agents? I am not talking about having problems with the Internal Revenue. I am talking about actually obtained a Federal court judgment.

Mr. RANGEL. I have a lady in New York, my God, what she has gone through——

Mr. HANCOCK. Yes, but has she obtained a judgment, sir?

Mr. RANGEL. It has been terrible. It has wrecked her life and——

Mr. HANCOCK. Has she obtained a judgment against the Internal Revenue Service?

Mr. RANGEL. Yes. Her lawyers said they have done everything. Her marriage is over and her kids are now in jeopardy. Really, if you hear exactly what has happened to this lady—not to take away from Mr. Johnson's problems, but——

Mr. HANCOCK. Would you cite me the case, please, sir, so I could look it up? Maybe I would be able to help her.

Mr. RANGEL. I would have to ask her lawyers whether or not I could discuss her name and the case publicly, but if the lawyers would permit it, I would like to bring her here so that all Americans would know we have a big job to do. This woman is a very dear friend of mine.

So I would ask unanimous consent to be able to bring her—it has been reported in the papers, but I am not authorized to name her by name. As a well-known New Yorker, other Members of Congress know exactly who she is. I now ask unanimous consent to be able to bring her to start off the next hearing.

Chairman ARCHER. I am afraid the gentleman's request is not appropriate. If it were, we would have unanimous consent requests

to bring witnesses before the Committee at every hearing that we have.

Mr. RANGEL. I ask unanimous consent that it cuts off after my unanimous consent is granted. [Laughter.]

Chairman ARCHER. Well, let the Committee stipulate that there are others who have problems that certainly are similar to Mr. Johnson's.

Let me comment to the gentleman from New York that unfortunately, and I'm advised by legal counsel, that the Taxpayer Bill of Rights not only would not help Mr. Johnson in his current situation but it also would not help any other individual in the future who had his identical situation. We need to look further into this.

The big problem here is there are already criminal and civil sanctions in the law, under section 6103, and they have apparently been violated as evidenced by the testimony Mr. Johnson has given us. But they have not been enforced by the executive branch.

You know, it's like the old story between Jackson and Marshall where Jackson said about Marshall's decision, the Chief Justice has rendered his decision, now let him enforce it. And we depend in general understanding only, that the executive branch will enforce the law.

I yield briefly to Mr. Laughlin.

Mr. LAUGHLIN. Mr. Chairman, I certainly agree with the gentleman from New York, Mr. Rangel, but his request would not be necessary if the Justice Department would enforce this law. You make the point and that's why I said in my comment that I think we need to have someone from the Justice Department before this Committee to find out why they are not enforcing this particular law.

Chairman ARCHER. OK. Mr. McCrery.

[No response.]

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Johnson, thank you for coming today.

I greatly appreciate your story. Being an insurance agent myself, I wanted to find out more about your career as far as how you made your way from a sales agent to a general agent to the corporate headquarters. And along this line of questioning, I wanted to find out about the amount of money you had to give up to move into corporate headquarters.

It is my understanding from a reading of your testimony and then from talking to my friend, Congressman Hancock, that you were pretty much slated to be the next chairman of this company. And even though you have said it's a little bit late for all the money, hopefully the money that eventually will come to you, and God willing it will be there, will go to benefit something that is very important to you and, if not yourself, your family, and charities.

How much money over the last 30 years, if you added up the sale of the company, the mergers and the acquisitions, and the various things that you've given up, do you think has been lost to you in personal wealth?

Mr. JOHNSON. Under those circumstances, sir, I would have to estimate about $15 million.

Mr. CHRISTENSEN. That is $15 million?

Mr. JOHNSON. Yes, sir.

Mr. CHRISTENSEN. Assuming you would have been the chairman of the company, as you were the first person in line to receive that next appointment, and has the company you used to work for merged with another company in the meantime?

Mr. JOHNSON. Yes, sir, they have.

Mr. CHRISTENSEN. Several mergers?

Mr. JOHNSON. They have bought small companies, several small companies. They are a major company themselves.

Mr. CHRISTENSEN. And what is their size now in billions?

Mr. JOHNSON. In actual rankings of the industry I do not know. They have about $40 billion in insurance in force and about $6.5 billion in assets.

Mr. CHRISTENSEN. I guess the thing I get most upset about is the fact that, still today, the Department of Justice and Janet Reno and Margaret Richardson's organization continue to file appeals, notice of appeals; that the second trial that came in was $6 million in actual damages and $3 million in punitive damages; that they refused to pay this amount, not even coming near the amount that would compensate you, let alone the time and anguish you have gone through over the last 30 years; and embarrassment to your family and your name, which nothing can take away.

I guess I would just hope if there are Department of Justice officials or IRS officials in this room today who read the record, that this would serve notice, I would hope, that this would never happen again. As you have said, this would be the beginning of the end of these kind of practices against Americans when their own government is fighting them. But you have admitted and you have paid over 10 or 15 or 20 years ago the pittance of $3,500 and what it has caused you in anguish.

I apologize on behalf of our government and I thank you for your testimony and I hope, too, this would never happen again. But, in light of the fact that the Department of Justice is the perpetrator of this crime and the IRS continues to file notice of appeals, continues to circumvent the law, continues to fly in the face of what two Federal judges have said is the right thing to do in the law, I don't see this administration doing anything to help the plight of the American taxpayer and for that I say, I'm sorry.

Mr. JOHNSON. Thank you, sir.

Mrs. JOHNSON [presiding]. Mr. Neal.

Mr. NEAL. Thank you, Mrs. Johnson.

Just a quick question, Mr. Johnson—and I think it is the most distressing detail that you've offered—would you repeat again what the IRS agent said when he came to your office, when you said, Why don't we just see if we can work this out?

Mr. JOHNSON. I said he had come back numerous times, he and another fellow. And on this one occasion, after it had been going on for about 1 year and all the other audits that were involving officers of the American National Insurance Co. were completed, he kept coming back. I said to him one morning, If you think I have done something wrong, why don't you tell me what it is so I can see if I can correct it. If I can't explain it, if I owe you something, I will pay you and we will get on with our business. He said, Mr.

Johnson, you must realize the only good advertising the Internal Revenue Service gets is when they bring a big one down and he said, your name is a household word to thousands of people.

I said, Do you mean to tell me you think you can take me to a court of law and convict me of wrongdoing on the basis of what you have? And he said, Oh, I don't think that. I could put your name in the paper, that's what I'm after.

Mr. NEAL. Thank you.

Mr. HANCOCK. Would the gentleman yield?

Mr. NEAL. Yes, I will.

Mr. HANCOCK. The news release was released 3 days after this convicted felon pled guilty to one charge to be able to try and save his career and also to protect his wife. It was released 3 days after the revenue department and after Justice, I suppose whomever they are, had agreed not to publicize it. That was on April 13. I don't know whether that means anything or not.

Thank you.

Mr. CHRISTENSEN. Would the gentleman yield?

Mr. Johnson, this person who said that, is he still in the employment of the Internal Revenue Service?

Mr. JOHNSON. I have no idea. He has been listed as a potential witness at both of the trials. He and the other agent have been listed as potential witnesses and neither have ever shown. I have no idea.

Mr. CHRISTENSEN. Do you have any idea if he is still—any idea of where he is currently?

Mr. JOHNSON. No, sir, I have no idea.

His name is Walter O'Connoll.

Mr. CHRISTENSEN. Walter who?

Mr. JOHNSON. Walter O'Connoll.

The other agent involved was Dudley Baker.

Mr. CHRISTENSEN. Thank you, Mr. Johnson.

Mrs. JOHNSON. We do have to vote right now, but before we do I would like to ask you a few questions that would require really very brief answers but I do want them on the record.

First of all, you indicated in your 1975 tax deficiency that your deficiency was only $3,500. Why do you think the IRS prosecuted criminally rather than letting you pay? Now, you have addressed that to some extent, is there anything you would have to add to that answer?

Mr. JOHNSON. Nothing other than I think they were looking for publicity. At the first trial, Judge John Singleton said——

Mrs. JOHNSON. Has anyone from the IRS ever acknowledged to you that what they did was wrong?

Mr. JOHNSON. No, ma'am.

Mrs. JOHNSON. Thank you.

I want to ask a couple of other questions of my colleague because I want to be sure they are on the record.

Representative Hancock, have you and Mr. Johnson ever had any financial dealings or business relationships with one another?

Mr. HANCOCK. Well, back about 15 years ago or longer than that, maybe 25 years ago, we jointly owned one of the best bird dogs that ever hunted in southwest Missouri. I trained it and kept it and Johnny bought the feed.

Then about in 1968, I was licensed under Johnny, Johnny is a good recruiter, he is one of the best ever in the whole United States, and I was licensed to sell insurance and also to sell mutual funds through his agency.

Upon coming into the Congress, those licenses had to be terminated. You know, as a Member of Congress, I can't hold a license. Other than that, no. And it was straight commission sales and no other financial dealings whatsoever, in any way, with Mr. Johnson.

Mrs. JOHNSON. Thank you.

There is a fine line, of course, that Members of Congress must walk and in inquiring into matters involving ongoing litigation, have you ever discussed the substance of Mr. Johnson's case with any Federal official?

Mr. HANCOCK. I have brought Mr. Johnson's case to the attention of Mrs. Richardson, the Director of Internal Revenue Service, on the basis of an inquiry, Have you ever been briefed on the case? I have never discussed it with her in any way except that inquiry.

I also have a letter from her whose response is, Yes, she has been briefed. Congressman Henry Hyde asked me to call Justice and ask a representative of the Justice Department to be here at this hearing to hear Mr. Johnson. I did make that telephone call. I pointed out the only reason I was making the call and the only things that were discussed was a little bit of what was the written document. No opinions were expressed in any way whatsoever.

Mrs. JOHNSON. Are you concerned about retribution from the Internal Revenue Service for the role you are playing in trying to bring Mr. Johnson's case to public attention?

Mr. HANCOCK. Five years ago when this first came up and when I brought it to the attention of a few Members of Congress, that was a concern, yes. Frankly, I am concerned.

Mrs. JOHNSON. But to date it hasn't materialized?

Mr. HANCOCK. It hasn't materialized yet. However, I understand a Member of Congress who just walked out of here said he understands it is kind of routine for retiring Members of Congress to get audited. I don't have anything to hide. I may get audited.

Mrs. Johnson, I am not concerned that the Internal Revenue Service or Department of Justice is going to come after me. I don't think they will. I am concerned about my estate. Quite frankly, I am in the process right now of developing and completing an estate tax return in detail, so my wife and my family will have a complete record of the things that I have in my head that are not on paper.

Yes, I am concerned.

Thank you.

Mrs. JOHNSON. Thank you, Mr. Hancock, it is important to get those things on the record.

Mr. Johnson, it is appalling what you have gone through. It is outrageous what government has done to you and it is impressive what you have contributed in your life, both as a private citizen, volunteer, and as a businessman, father, and community person. I commend you for the quality of the life you have lived and, believe me, we will be looking very, very carefully at how we can hold the Internal Revenue Service far more accountable for the actions of agents that were inappropriate and illegal.

We started looking at that before the last Taxpayer Bill of Rights. We were not able to complete that in time to keep that bill moving but it is high on our agenda, and we will not let this hearing be the end of this matter.

I do have to go vote. When we return, we will move to the next panel.

Thank you.

Mr. JOHNSON. Thank you very much, ma'am.

[Recess.]

Mr. ENGLISH [presiding]. I will call this hearing back to order, please. We will return to the second panel and we appreciate all of you participating and your patience in lieu of some of the things going on, on the floor of the House.

I would like to give each of you an opportunity to offer your opening statement and then as we have some other Members here and I have a number of questions, we will have an opportunity to offer you some direct questions.

I would first like to recognize Hon. W. Henson Moore, who is no stranger to this institution, and he is currently president and chief executive officer of the American Forest and Paper Association.

STATEMENT OF HON. W. HENSON MOORE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN FOREST AND PAPER ASSOCIATION; AND FORMER MEMBER OF CONGRESS

Mr. MOORE. Thank you, Mr. Chairman.

Our trade association is the national trade association that represents the building products and paper industry. We account for 7 percent of the U.S. manufacturing output. We rank among the top 10 manufacturers in 46 States, employing some 1.6 million Americans. This hearing is focusing on manufacturing and natural resources, and certainly this industry fits that mold.

We look at what is going on in the world today in the case of global competition, and we certainly spend an awful lot of time worrying about our competitors around the world. Technological advances we need to do to stay on top, and then the environmental cost and the environmental protection costs we must implement to be able to meet the legal requirements in this country cause us to have to continuously reinvest large amounts of capital.

As a matter of fact, we are one of the most capital sensitive and capital intensive industries in the country. And such things as the need to reduce the capital gains tax, the need to repeal the alternative minimum tax, and the high cost of estate taxes are things that are wrong with the current law that frustrate the ability of this industry to be able to form the capital necessary to meet the high capital cost demands for protecting the environment and maintaining our competitive advantage.

This industry is one that has another facet to it of interest which needs to be looked at when you reform the Tax Code. It normally takes somewhere between 20 and 80 years, depending upon what part of the country you are in, from the time an investment is made in a tree farm until the owner of that farm reaps any benefits.

And during that time period, he's spending money on the front-end expenses to put the trees in, managing and maintaining and

protecting the timber, property taxes, interest expenses, and then during that time of 20 to 80 years while he's waiting to get some of that money back, he runs a host of uninsurable risks of nature, such as fire, and storm and insects and disease, along with the full gamut of economic risks associated with any long-term investment.

So, this industry is a little bit different natural resource industry when you look at the time line it takes and the faith it takes for somebody to make an investment in this industry and be around to reap the benefits of it.

For these reasons, we have concluded that the efforts of the Chairman of this Committee and the Members of this Committee to look into tax reform and, perhaps even tear out by the roots, as the Chairman has said, the existing tax system for another one, is a proposition we strongly support.

Unfortunately, the marginal changes we've been waiting for and looking for in alternative minimum tax, and capital gains and estate taxes just don't seem to be coming. Perhaps it is time we reform the Tax Code in general. Our most serious concern, the thing we are really the most interested in is because of our competitiveness—we are the largest industry in the world, nobody produces more building products or more paper than the United States does—for us to maintain our competitive position, to gain in exports which we are currently doing, and to keep up with technology and protect the environment requires so much capital that that is the focal point for us in terms of looking at a reform of the Tax Code: Capital formation.

Something needs to be done to make it easier and more attractive in relation to our competitors around the world to be able to form capital and spend and recoup capital in these industries that employ people such as ours and require the tremendous capital investments that we have.

And, certainly in looking at a new Tax Code, we think that boosting the supply of savings in this country is very important, again, to reduce the cost of capital. If we can have a greater savings rate in the country, our capital costs will be more competitive than they are currently. Capital investment, as I indicated, immediate expensing of all capital investments is something being talked about. We strongly support that as being a much better way to go about recouping the capital we gather and then spend in this industry.

Border adjustability, such as the exclusion of export sales from the tax base, as is done in the USA tax proposal, is something we also think is important, as we are major exporters. We want to export even more in the future.

Eliminating the deduction for compensation of employees as some have talked about doing is something we think would be a mistake and also eliminating the whole mortgage interest deduction is something we think would not necessarily be a good idea. But, basically anything that helps us form capital cheaper and better and helps boost the savings rate in the country is something we are basically interested in and would be supportive of.

There are some transition issues that need to be looked at, such as the unrecovered cost of capital assets and inventory as you move from the system we have now into a new one, as well as the exist-

ing tax attributes, such as net operating losses and tax credit carryovers, as these were important and were part of the figuring of the cost of capital investment in the industry at the time we made them.

But, Mr. Chairman, we are very supportive of your efforts. We would like to be very encouraging of your efforts. We certainly stand ready to work with this Committee at any time to indicate how we think or to be of assistance to the Committee as you go through some very difficult deliberations as this becomes a very serious effort, perhaps, in the next Congress.

[The prepared statement follows:]

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TESTIMONY OF
THE HONORABLE W. HENSON MOORE
PRESIDENT AND CEO
AMERICAN FOREST & PAPER ASSOCIATION (AF&PA)

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JULY 31, 1996

ON
THE EFFECT OF TAX RESTRUCTURING
ON MANUFACTURING, ENERGY AND NATURAL RESOURCES

Thank you, Mr. Chairman. My name is Henson Moore, President and CEO of the American Forest & Paper Association (AF&PA). I am pleased to be here today to present a preliminary assessment of the implications that sweeping tax reform measures would have for the forest products industry. AF&PA is a national trade association representing producers of paper, pulp, paperboard and wood products, as well as the growers and harvesters of this nation's forest resources. The forest products industry provides 7 percent of U.S. manufacturing output and ranks among the top 10 manufacturing employers in 46 states. More than 1.6 million people are directly employed by the forest products industry. At the same time, this many-faceted business is also a natural resource-based industry which is responsible for planting, growing, and harvesting trees -- a basic renewable resource. This hearing, with its focus on manufacturing and natural resources, provides a special opportunity to highlight the unique nature and concerns of this industry, and I appreciate the opportunity to share AF&PA's members' views.

The Ways and Means Committee has already seen several important facets of this industry in the faces of witnesses who have appeared before this committee in the 104th Congress. Chester and Lonnie Thigpen, father and son Tree Farmers, whose family business covers 850 acres in Montrose, Mississippi, have testified, as has Andy Sigler, Chairman and CEO of Champion International Corporation, one of the world's leading manufacturers of pulp, paper and wood products, based in Stamford, CT. These witnesses represented just two of the vital forces at work in today's forest products industry.

The U.S. forest products industry is an inter-dependent network of small and large businesses ranging from private tree farmers and independent logging contractors to manufacturers and distributors of paper, pulp, lumber and building products. Woodland owners rely on manufacturers to provide a ready market for the trees they grow. Likewise, manufacturers need these trees to assure a reliable supply of raw materials for the products they manufacture.

We applaud the Ways and Means Committee's efforts, and your personal commitment, Mr. Chairman, to explore the ramifications of fundamental tax reform, and this industry intends to be an involved participant in the debate. The forest products industry has a vital stake in the on-going tax restructuring debate given the unique problems we face. This industry depends on a sustainable source of fiber for its pulp, paper, and solid wood mills. And yet, current tax policies create disincentives to the implementation of sustainable forestry principles, as well as a disincentive to the capital formation necessary for continued investment in sophisticated plant and equipment. Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code discourages that investment in a number of ways. Compared to our major industrial competitors, the U.S. tax code is significantly less favorable for investment.

That is why the forest products industry supports changes approved by this Committee and this Congress earlier this year that would encourage economic growth and investment. We strongly support the proposal to reduce the capital gains tax for individuals and corporations. This would encourage long-term investment and risk taking, lower the country's cost of capital, and enhance the international competitiveness of U.S. producers. For the U.S. forest products industry, a lower capital gains tax rate will encourage private landowners to invest in timber growing enterprises to meet the country's future demand for timber.

We also strongly support repeal of the Alternative Minimum Tax (AMT). The AMT is clearly not working the way Congress intended. This tax falls most severely on cyclical and capital intensive industries. It raises the cost of capital and penalizes capital intensive companies. Instead of acting as a backstop to ensure that truly profitable companies don't escape paying their fair share of tax, AMT has become an almost permanent penalty on capital investment. We must address the problems created by the AMT in order to generate economic growth, strengthen global competitiveness and create new jobs.

The burden of overly high estate taxes on family-owned businesses must be eased. Estate tax reform is particularly important to the more than 7 million people who own most of the nation's productive timberland. Many of these 7 million landowners are also close to retirement age, and without estate tax reform many of their properties will be broken up into smaller tracts or harvested prematurely just to pay estate taxes.

The United States is blessed with an abundant and infinitely renewable resource -- almost 490 million acres of timberland which can be planted, harvested and replanted on a sustainable basis for hundreds of years to come. And with AF&PA's Sustainable Forestry Initiative℠, our members -- who own approximately 90 percent of the industrial forestland in the United States -- are voluntarily, visibly and significantly changing the practices of forestry on industrial forestland. Yet the tax code must recognize the unique aspects of investing in this renewable resource (a 20 to 80 year holding period and the risks from fire and disease, in addition to general market risks).

The forest products industry is also one of the best examples of the positive effect of investment on productivity. As a result of this industry's investment, productivity has improved dramatically, costs are down, and the industry is a strong global competitor. That doesn't mean, however, that we can become complacent. Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code discourages that investment in a number of ways -- high tax rates on capital gains and the alternative minimum tax to name two. Compared to our major industrial competitors, the U.S. tax code is significantly less favorable for investment.

AF&PA has performed a preliminary analysis of two of the major tax reform proposals -- a flat tax (such as the one introduced by House Majority Leader Dick Armey) and an income tax with an unlimited savings deduction (such as the USA tax system introduced by Senators Domenici and Nunn), and we are working to assess the implications of other proposals. Based on this preliminary assessment of the Armey and USA proposals, association and industry economists and tax experts found a number of favorable components. However, any new tax system also raises some significant issues and concerns. My testimony will focus on those particular issues and potential implementation problems related to the unique characteristics of this industry.

Capital Intensive, Internationally Competitive Industry

The pulp and paper segment of the industry is one of the most capital intensive and internationally competitive manufacturing industries in the world. Each employee in the pulp and paper business is supported by $123,000 of plant and equipment. Just since 1980, the industry has invested more than $130 billion in new pulp and paper production and pollution prevention equipment. This amount accounts for about ten cents of every sales dollar from paper

products, the highest reinvestment rate of any U.S. manufacturing industry. The U.S. forest products industry is also a good example of the role investment plays in creating good, high-paying jobs.

The future growth of this country's forest products industry lies in export markets, but the U.S. has recently shifted from being a net exporter to a net importer of forest products. One problem is that overseas suppliers, many of whom are given generous tax breaks and other subsidies, have a competitive advantage over U.S. producers. Some foreign countries have taxes, such as value-added taxes, that, in effect, reduce the after-tax cost of manufacturing goods for export and increase the after-tax cost of imports. Foreign governments also provide indirect and direct subsidies of various forms (such as reduced borrowing costs, reduced labor costs and reduced property taxes) to manufacturing companies.

U.S. forest products must successfully compete in the global market, and tax reform must play an important role in creating an economic environment which will help "level the playing field" for American companies competing in the global marketplace.

For the pulp and paper industry, maintaining international competitiveness is a necessity -- not a luxury. Because of its high level of fixed investment, this industry must achieve extremely high operating rates in order to remain profitable--levels that have averaged 92% over the past 30 years. Consequently, even a small loss in international competitiveness can jeopardize operating rates and cause a downward spiral.

Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code directly discourages that investment through tax penalties such as the Alternative Minimum Tax (AMT), high rates of tax on capital gains, and double taxation of corporate earnings. Moreover, compared to our international trading partners, the U.S. tax code is significantly less favorable for investment.

Planting, Growing and Harvesting Trees

The forests on which this industry depends are a unique and invaluable national resource that can be managed to provide commodities and services. However, good stewardship and wise use of the land is essential to the continued prosperity and vitality of the forest products industry.

Timber growing is unique when compared to every other economic activity. It takes between 25 years and upwards of 75 years for a tree to be ready for harvest. This extraordinarily lengthy holding period requires an unusually strong commitment from investors because capital is literally locked into the ground during the growing period with very little market liquidity. Moreover, timber growing initially requires heavy front-end expenses and, later, on-going expenses from managing, maintaining and protecting the timber, as well as for property taxes and interest.

Over the entire growing period, timber is subject to a host of risks of nature, like fire, storm, insects, and disease, plus the full gamut of economic risks associated with long term investments. Acts of nature are not insurable, so this variable adds to the risk and unpredictability of timber as an investment. Therefore, fair capital gains treatment is essential to making forestry an economically viable investment. Additionally, since much of this land is held by individuals, the current estate tax rules often force liquidation of either the land or the trees just to pay the taxes upon death. Private forest land owners are obviously very sensitive to all factors that affect the economics of long-term forestry investments, especially U.S. tax policy.

Timber harvests on public forests have declined more than 50% from the levels of the mid-late 1980's. With the nation now looking to the private sector for the "working forest" of today and tomorrow, the country's interests require a policy framework that supports private forestry investments. To do otherwise would force both small and large timber growers out of

the business of growing trees -- threatening the country's future timber supply and the future availability of products on which the American people have come to rely.

Industry Recommendations/Concerns Regarding Tax Reform

o Provisions designed to boost the supply of savings should be included in any tax reform system. Much concern has been expressed over the relatively low rates of U.S. savings, and many economists believe that stronger savings will translate into increased investment, which in turn is the key to future growth. Both the flat tax and USA proposals would effectively remove the current penalty against savings, using different approaches.

o Capital investment is the key to higher productivity and the creation of new and better jobs. Immediate expensing of all capital investments is an essential ingredient of any tax system designed to stimulate economic growth and strengthen international competitiveness. Eliminating or at least minimizing penalties for capital investment is another essential ingredient of any tax system redesign that is intended to stimulate economic growth and strengthen international competitiveness.

o Border-adjustability, such as the exclusion of export sales from the tax base as provided in the USA proposal, is another essential component of a tax reform system which will strengthen global competitiveness and create new jobs. Under the Armey flat tax, however, there is no rebate of taxes on exports, and the foreign tax credit is eliminated. Thus, this latter proposal further tips the scales against U.S. producers trying to compete in international markets.

o Eliminating the deduction for compensation would also have an effect on our industry. If, under any tax system, a deduction for compensation is disallowed, the negative impact on job creation should be eased by allowing a compensating credit, such as a credit for Social Security taxes.

o Another industry concern is the home mortgage interest deduction. Under the Armey flat tax proposal, households would not be permitted to deduct mortgage interest expenses. The USA tax would preserve mortgage interest deductibility, but would not allow non-mortgage interest outlays to be deducted. An analysis by the economic consulting firm DRI/McGraw-Hill estimates that the market value of an average home would drop by 15% if the Armey tax proposal was implemented without a phase-in period. New home construction would also drop sharply during the initial years of the new tax structure, according to DRI, but then would recover in response to an anticipated easing or mortgage interest rates.

Transition Issues/ Recommendations

The introduction of any major tax reform poses formidable transition questions. Therefore, our preliminary analysis also poses more questions than answers at this point.

A particularly significant transition issue for this industry is the handling of unrecovered costs of capital assets and inventory, as well as existing tax attributes such as net operating losses (NOLs) and tax credit carryovers.

Basic equity and fairness requires drafters of new proposals to allow recovery of both. Unrecovered costs relate to property which either produced income subject to tax under the income tax, or <u>will</u> produce income subject to tax under the <u>new</u> system. Thus, taxpayers should be allowed to recover the costs of producing the income. Likewise, taxpayers have the expectation that they will carry over tax attributes, since Congress has historically provided transition relief when major changes were made to the tax code.

We believe a simple yet fair approach for allowing recovery of unrecovered costs of property and tax attributes is as follows:

- o While we recognize that the write-off period may need to be related to the impact on revenue, we nonetheless believe that full recovery of these costs should be allowed as a basis no less beneficial than allowed under current law. Specifically, unrecovered basis and AMT credits that have been generated due to the draconian depreciation scheme of AMT should be allowed to fully offset tax liabilities under the new system.

- o With respect to tax attributes, we believe that NOL's should be converted into credits and that all credits should be utilizable ratably over the same write-off period as unrecovered costs of property.

Thank you for the opportunity to testify today, Mr. Chairman. Again, we applaud the Committee's efforts to tackle this important issue and embark on what will undoubtedly be a lengthy debate. On behalf of the American Forest & Paper Association, I assure you the U.S. forest products industry intends to remain engaged and involved as a commentators and information resources as the efforts of this Committee continue to restructure, simplify and improve our tax code.

Mr. ENGLISH. Thank you, Mr. Moore, and we very much appreciate your time here and your statement.

The Chair would recognize for a statement, Paul Sullivan, chairman of the committee on taxation of the American Petroleum Institute and vice president and General Tax Counsel of the Exxon Corp.

Welcome, Mr. Sullivan.

STATEMENT OF PAUL SULLIVAN, CHAIRMAN, COMMITTEE ON TAXATION, AMERICAN PETROLEUM INSTITUTE; AND VICE PRESIDENT AND GENERAL TAX COUNSEL, EXXON CORP.

Mr. SULLIVAN. Thank you, Mr. Chairman, and good afternoon.

I am Paul Sullivan, vice president and general tax counsel of Exxon Corp., and chairman of the general committee on taxation of API, the American Petroleum Institute, and I am here today on behalf of API.

I would like to thank the Committee for the opportunity to comment on a topic of profound importance to our industry as well as to all the taxpayers of this country. We will be submitting a more detailed statement for the record of these hearings.

As the Committee requested in the hearing notice, I am addressing the various tax reform proposals as total replacements for the current income tax, not as add-on taxes.

The API applauds the Committee and the sponsors of the various tax reform proposals for moving toward the taxation of consumption, rather than the taxation of income. API, like Chairman Archer, has concluded that a properly designed consumption tax is preferable to an income tax. In that regard, we have developed a set of design principles by which to evaluate the effectiveness of any consumption tax proposal. Those principles are set out in our written statement.

While we are supportive in principle of moving toward the taxation of consumption, we urge the Committee to proceed with caution. Because the income tax has been embedded in our economy for more than 80 years, business decisions have been and continue to be premised on economic assumptions that are spawned by that system. Therefore, any radical change is going to have profound implications for the structure of business, the financing of business and business operations, themselves. And those implications must be thoroughly understood before moving to any new system.

This is especially true in the capital intensive oil and gas industry where the results of decisions taken today may take a decade or more to manifest themselves.

For example, here are several issues that we have been wrestling with as we consider the various proposals. First, the tax treatment of imports of all basic commodities for further manufacturing will have significant ripple effects on the economy. Because more than one-half of the crude oil used in the United States is imported, this issue is of major concern to our industry. One of the proposals, the USA tax, imposes a nondeductible import tax which would have a negative effect on the price of energy to consumers. We believe any import tax should be fully creditable or deductible in order to be on a parity with the value-added taxes of our trading partners.

Second, because our industry must operate where we have access to economically recoverable reserves, and significant domestic sources have been foreclosed to oil and gas development, the tax treatment of international operations is critical to our continued ability to supply the Nation's hydrocarbon energy needs.

Third, because our industry's projects require large amounts of capital and are high-risk ventures, the tax treatment of the financing and structuring of these ventures is an essential element of decisions whether to proceed. We are concerned about the impact of these proposals on our access to efficient sources of capital, whether through traditional capital markets or partnerships, joint ventures, and other business structures.

Not only must the Federal tax implications of any proposal be considered, but also, State income tax integration, U.S. financial accounting treatment and securities market effects must be thoroughly understood. Further, consideration must be given to the place of the United States in the global economy. The protections afforded by the current income tax treaty system will have to be replaced by newly negotiated treaties throughout the world.

Time does not permit an exhaustive delineation of all of our concerns. But we believe these few examples illustrate the need for a cautious and deliberative process, one that looks not only at all of the effects, once a new system is in place, but also addresses fair and equitable transition from our current system to any replacement system.

The Committee has asked us to evaluate these proposals in their pure conceptional form. I hope API's testimony demonstrates why, without considering the specific details of a fully developed legislative proposal, we cannot make a considered choice among the several options. At the same time, let me emphasize that while we have identified a number of issues, none of these problems are insurmountable. We are eager to work with the Committee as you continue to develop a replacement for the current system.

Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL SULLIVAN, CHAIRMAN COMMITTEE ON TAXATION AMERICAN PETROLEUM INSTITUTE AND VICE PRESIDENT AND GENERAL TAX COUNSEL EXXON CORP.

INTRODUCTION

1. Background

This statement is submitted by the American Petroleum Institute (API) for the record of the July 31 hearing of the House Ways and Means Committee regarding the effects of various tax reform proposals on manufacturing and energy and natural resources. API represents approx.mately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing. API appreciates the opportunity to comment on a topic of profound importance to our industry.

Various consumption tax proposals have been offered recently as complete substitutes for the current income tax system. This statement will focus on the business tax aspects of 1) the Armey Flat Tax ("Flat Tax"), 2) the Nunn/Domenici Unlimited Savings Allowance Tax ("USA Tax"), 3) a European-style credit-invoice value added tax ("CIVAT"), 4) the Schaefer/Tauzin National Sales Tax ("NST"), and 5) our current income tax system. API takes no position at this time as to whether the current income tax system should be completely replaced, but there is no doubt that as presently codified, it imposes wasteful and unnecessary burdens on the economy. We commend the Committee and the sponsors of the various proposals for their efforts to improve our tax system and for moving toward the taxation of consumption rather than the taxation of income.

2. Problems With Our Current Income Tax

Over the years, changes to the Internal Revenue Code ("Code") and the regulations thereunder have created the most complex income tax system in the world. Because of this complexity, unreasonable compliance and collection costs (both to the government and to taxpayers) impair the efficiency of the system; obscure or conflicting aspects of the Code and regulations fail to become operative as intended; and administrative implementation of complex provisions often takes years, creating long periods of uncertainty for taxpayers as to their tax obligations.

The current income tax system is biased against savings and investment, and in favor of consumption. It taxes corporate generated income twice. For example, in the case of a dividend, once when the income from which the dividend is generated is earned and again when the dividend is received by the shareholder. Moreover, because recovery of capital costs is spread over time there is effectively a tax on the capital investment itself.

Our income tax system is neither "territorial" nor "border adjustable". Therefore, it does not allow domestic and foreign produced goods to compete on an equal basis in domestic or foreign markets. Rather, the U.S. foreign tax system acts to inhibit American competitiveness. U.S. corporations are taxed on worldwide income, while many foreign corporations are not. U.S. anti-tax deferral rules are the most restrictive in the world; unnecessarily complicated mechanics of the foreign tax credit limitation further reduce the effectiveness of the credit as a means to avoid double taxation; and the volume and frequency of changes in the foreign tax area continue to add compliance costs and destabilize the ability of U.S. businesses to compete worldwide.

Most of our trading partners have some form of value added tax (almost exclusively a CIVAT) that permits the tax, under the rules of the General Agreement on Tariffs and Trade (GATT), to be rebated on exports. Our income tax cannot be rebated on our exported goods (domestically produced goods must bear the burden of our income tax as well as local taxes in foreign markets), while goods imported into the U.S. do not bear the VAT imposed in their country of origin. Whatever comes out of this tax reform

process should have as one of its goals to improve the ability of U.S. companies to compete internationally.

3. Principles of a Properly Designed Tax System

API believes that properly designed consumption taxes are preferable to income taxes. In studying consumption taxes over a number of years, we have developed a set of principles by which we evaluate alternative consumption tax proposals. They include the following:

- Minimize economic distortions;
- Ensure that foreign and domestically produced goods compete equally in the market place;
- Permit the current deduction of capital expenditures;
- Impose only one rate or as few rates as possible;
- Facilitate recovery of taxes in the marketplace;
- Exclude from the base separately stated excise taxes, including sales and use taxes; royalty payments to federal and state governments; and non cash exchanges;
- Be relatively easy to comply with and administer; and
- Make the tax rate or amount of tax clear to the ultimate consumer.

4. Concerns with Changing to a New Tax System

While we are supportive in principle of moving towards the taxation of consumption, we urge the Committee to proceed with caution. Because the income tax has been embedded in our economy for more than eighty years, business decisions have been, and continue to be, premised on economic assumptions spawned by that system. Therefore, any radical change will have profound implications for the structure of business, the financing of business, and business operations themselves, and these implications must be thoroughly understood before moving to any new system. This is especially true in the capital intensive oil and gas industry, where the results of decisions may take a decade or more to manifest themselves.

For example, the tax treatment of imports of all basic commodities for further manufacturing will have significant ripple effects on the economy. Because more than half of the crude oil used in the United States is imported, this issue is of major concern to our industry. One of the proposals (USA Tax) imposes a nondeductible import tax that would increase the price of energy to consumers. We believe that any import tax should be imposed in a manner designed to put a new tax system on a parity with the VATs of our trading partners.

Our industry must operate where we have access to economically recoverable reserves. As significant domestic sources have been foreclosed to oil and gas development, the tax treatment of international operations is critical to our continued ability to supply the nation's hydrocarbon energy needs. In addition, since our industry's projects require large amounts of capital and are high risk, long lead-time ventures, the tax treatment of the financing and structuring of these ventures is an essential element of decisions whether to proceed. We are concerned about the impact of these proposals on our access to efficient sources of capital, whether through traditional capital markets or partnerships, joint ventures, or other business structures.

Not only must the federal tax implications of any proposal be considered, but state tax integration, U.S. financial accounting treatment, and securities market effects must also be thoroughly understood. Finally, consideration must be given to the place of the United States in the global economy. A unilateral change in the basic taxation of inbound and outbound transactions by the U.S. will require that new treaties be negotiated in order to maintain the protections afforded U.S. companies by the current income tax treaty system. These include: elimination of double taxation due to overlapping exercise of authority; facilitation of business transactions between countries that might otherwise be inhibited by overly intrusive national taxation; reduction of high rate withholding taxes imposed by many countries on payments to foreigners of items such as dividends, interest, rents, and royalties; and other provisions designed to lessen the burden on international commerce of varying national taxation systems.

The Flat Tax, USA Tax, CIVAT, and NST, all of which are different forms of consumption based taxes, fully or partially satisfy several of API's eight criteria outlined above. However, each also falls short on some of the criteria or leaves issues open to concern. A discussion of each proposal follows.

Armey Flat Tax Proposal (H.R. 2060)

1. General Characteristics

One particular strength of the Flat Tax is that it permits an immediate deduction for capital expenditures. This criteria is very important to capital intensive businesses, such as the oil and gas industry. Another strength of the Flat Tax is that it has a single tax rate (as does the USA Tax and NST), which should contribute to simplicity. However, although the Flat Tax appears simple to comply with and administer, there are a number of areas where the application of the tax is unclear.

2. Territoriality and Border Adjustability

The Flat Tax is an improvement over the current system in that it is "territorial" in nature (as are the USA Tax and NST). This means that tax is generally imposed only on activities within the U.S. In this regard, U.S.-based multinationals spend an inordinate amount of time and resources attempting to comply with the current income tax system, which taxes companies on their worldwide as well as U.S. sourced income. The foreign provisions of the current income tax system are extremely complicated to comply with, including the rules regarding multiple baskets and categories of income, and the resulting incremental revenue to the U.S. government from taxing these foreign operations does not appear to justify the time and expense incurred by either taxpayers or the government. Thus, Congressman Armey should be applauded for proposing a "territorial" approach to taxation.

The Flat Tax is also an "origin-based" taxing system, as opposed to a "destination-based" system. This means that imports into the U.S. are exempt from taxation, but any exports leaving the U.S. would still be taxable. (On the other hand, the USA Tax and NST are destination-based systems and would tax imports and exempt exports.) All other factors being equal, net importers would seem to benefit under an origin-based system such as the Flat Tax, while net exporters would likely be injured.

3. Deductibility of State and Local Taxes

The treatment of excise or other taxes imposed on businesses by state and local governments is another issue of great importance to the petroleum industry. Excise taxes, including severance taxes, environmental taxes, and sales and use taxes, are imposed at almost every stage of our operations and on almost every product because we act as a collection agent for the government. It is unclear whether all of these taxes would be deductible under the Flat Tax. Thus, before adopting a new tax system based on the Flat Tax, we ask for clarification that deductions would be permitted for all excise taxes. This principle also applies to income and franchise taxes, as well as property taxes, paid to

states and local municipalities. Disallowing deduction of these taxes would create unfair distortions between sectors of the economy. For example, disallowing a deduction for property taxes may have little effect on a corporation dealing principally in services. However, property taxes may represent a significant factor in determining the net profit for a corporation whose business requires the ownership of extensive real property.

4. Deductibility of Leases and Royalties

Although the Flat Tax clearly permits the expensing of business acquisitions, it should clarify that lease and royalty payments made to federal and state governments are also deductible. In addition, if distinctions are made between active and passive income, with the criterion for classification being the immediate use of property in the business, there must be an allowance for the common practice in the oil and gas business of mineral interests that are not immediately developed. Leases may be purchased with the expectation of finding oil or natural gas quickly, but it may then take several years of seismic testing and test borings to determine when and if the leased property will actually become an active part of the business. During this period, oil and gas interests should not be considered passive investments.

5. In-Kind Exchanges

One issue that is still unclear under the Flat Tax is the treatment of non-cash exchanges. Under current law, tax-free exchanges are a common and important part of the oil and gas business. Inventory exchanges of equivalently (or nearly equivalently) valued barrels of oil or product are everyday occurrences involving extremely high volumes that permit the efficient transportation and supply of crude oil and product throughout the country. Certainly, compensatory cash payments for value differences on these exchanges should be taken into account for tax purposes, but the full value of the exchanged products must not be considered as a taxable transaction.

USA Tax Proposal (S.722)

1. General Characteristics

The USA Tax satisfies several of the API criteria for evaluating taxing systems. Like the Flat Tax, it would encourage investment in durable business assets by allowing the immediate deduction of capital expenditures. API also favors this proposal for recognizing that excise taxes should be excluded from the tax base and for establishing one tax rate for business.

Several aspects of the USA Tax appear easier to comply with and administer than the present income tax system. Allowing immediate expensing of capital equipment is a great simplification compared to the current complex depreciation rules. Since the USA Tax is also a "territorial" system, businesses would no longer have to incur many of the administrative and compliance costs of the current system relating to foreign operations. In certain respects the USA Tax would help to minimize economic distortions as compared to the current system. Our present income tax system contains a large number of complex deductions and credits, many of which create competitive distortions in particular business sectors. Different rules apply depending upon whether a business operates in corporate or partnership form. The USA Tax is more neutral because it would allow much fewer deductions and would apply to all business sectors and forms of business organizations, but there is considerable uncertainty as to how the taxation of partnerships would affect the industry practice of forming joint ventures for high cost, high risk projects.

2. Deductibility of the Import Tax

There are also several areas in which the Nunn-Domenici proposal does not meet API's criteria. The proposal would impose an 11 percent tax on the value of imports. Because the proposed import tax would not be deductible, when an importer sells an

imported good in the United States, the importer would be subject to the 11 percent consumption tax on the already paid import tax. This double taxation would create an unwarranted economic distortion by precluding foreign and domestic goods from competing equally in the marketplace. Consideration should be given to whether an import tax is imposed at all on intermediate purchases of goods that will be incorporated into a final product. This is especially the case for raw materials, such as crude oil, that generally have already been subject to high foreign taxes (which would no longer be creditable against U.S. tax under the USA proposal).

The USA Tax system is particularly detrimental to importers by failing to allow the import tax to be either deducted in arriving at the taxable base, or fully credited against net liability as occurs with most credit-invoice VAT systems. While most commentators focus on the payroll tax credit as the key to border adjustability, the real focus should be on the national tax treatment provisions of GATT because, as currently drafted, the USA Tax appears to penalize imports. If a destination-based system such as the USA Tax is ultimately adopted, this major error must be corrected.

3. Tax Visibility

API is also concerned that the USA Tax is not structured in a manner which would facilitate recovery in the marketplace. As is the case with the current income tax, the USA Tax would be imposed on the net income of a seller of goods, rather than on the product sale. Such a system also makes the amount of tax less clear to the ultimate consumer than would be the case with a tax that could be separately stated as a specific percentage of gross sales price.

4. Treatment of Non-Cash Exchanges, State Taxes, Payroll Tax Credit

Further analysis and discussion is warranted regarding many other aspects of the USA Tax proposal. For example as noted in our discussion of the Flat Tax, API believes that non-cash exchanges should be excluded from the tax base. Also, careful consideration must be given to the consequences of the proposed elimination of deductions for state income taxes and the replacement of the wages-paid deduction with a payroll tax credit.

Credit-Invoice Value Added Tax

1. In General

A CIVAT on sales of all goods and services appears to more closely adhere to the principles API has identified for a properly structured consumption tax. A CIVAT is imposed as a multistage sales tax collected at each point in the production and distribution process. A business subtracts the tax paid on its purchases, including capital goods, from the tax due on its sales. If the difference is a positive number, the business remits that amount to the government; if it is negative, as may occur in the case of exported goods, the business claims a refund. Compared to the current income tax, the CIVAT has the advantage of encouraging saving and investment. It does not burden capital outlays, nor does it discriminate against U.S. industry either in the U.S. or abroad.

2. Effective and Neutral Revenue Source

From an economic standpoint, a separately stated CIVAT on the sale of goods and services appears to be the least damaging way of raising revenue. It does not burden capital outlays, nor does it discriminate against U.S. industry either in the U.S. or abroad. It does not favor either capital or labor intensive industries. Wages, rent, interest and profits, i.e., the return of entrepreneurship, each bear the same direct tax burden. A CIVAT levied at the same rate on all consumption should not cause a significant distortion in consumption choices since the relative cost of goods and services would be the same after imposition of the tax as before. A broadly-based CIVAT would not unduly burden the products of any one sector of the economy. Any regional distortions would tend to be minimized since no specific product or geographic region of the country would be the

focus of the tax. A uniform CIVAT applied to goods and services would induce fewer distortions within particular industries than other taxes.

3. Border Adjustability

A CIVAT is neutral with respect to goods produced domestically and abroad. Not only are U.S. manufactured goods not burdened with the tax when they are exported, but imports must also bear the same tax as comparable domestically produced goods. This border adjustment feature of the CIVAT, permitted under GATT rules, means that the tax does not handicap U.S. manufacturers, nor does it act to distort consumers' decisions whether to buy domestic or imported goods. Some economists argue that border adjustable taxes are not necessary because monetary exchange rates will adjust to accommodate the change in U.S. taxation. While this may be true in the long run (and not everyone agrees), in the short run the adjustment period could be very harmful to U.S. competitiveness.

4. Differences With Other Taxing Systems

Under the CIVAT, the tax liability of a firm is equal to the tax imposed on its sales net of a credit for the tax it has paid on purchases for business use. Under subtraction-method consumption taxes like the Flat Tax or the USA Tax, liability is determined by applying the tax rate directly to the firm's value added, or the difference between its sales and its purchases. CIVAT is a tax on a product while the other taxes are based on a business's books of account, similar to the current income tax system. From that underlying distinction flow a number of practical differences that API concludes favor the CIVAT.

Most commentators agree that while a single rate consumption tax, without exemption, is preferable, the overwhelming weight of political experience shows that the United States would not adopt a single rate consumption tax with no exceptions. Not one of the more than 45 countries which now have consumption taxes has a single-rate, no-exemption tax. Most have both exemptions and multiple rates. The CIVAT readily accommodates these features. Because the tax a business pays on purchases is credited against the tax it owes on sales, businesses are encouraged to register as taxpayers and to get invoices from their suppliers to document the tax paid. Also, a CIVAT would reach previously untaxed income in the underground economy, since all consumer consumption would be taxed when goods and services are purchased.

National Sales Tax Proposal (H.R. 3039)

1. In General

The NST proposal is fairly easy to understand since it is similar to the various sales tax systems in place in 45 out of the 50 states in the U.S. It is intended to replace the current income tax, estate and gift tax, and most general revenue federal excise taxes. The tax would be imposed at a 15 percent rate on the sale of goods, including both tangible personal property and real property, and services, including financial services such as brokerage fees, banking fees, and insurance fees. Although the NST is intended to be compatible with current state sales tax systems, none of the 45 states that currently have a sales tax in place tax services as extensively as is envisioned under the NST. A lot of work will have to be done with the various state taxing authorities before they will become convinced to administer a uniform NST on behalf of the federal government.

Businesses would collect tax on all their taxable sales of goods and services and remit the tax to the government. Since purchases of inventory for resale are not taxable, the complex inventory rules of the current income tax system would be eliminated. Purchases of equipment and real property used in the production of taxable goods and services are also not taxable, so there would be full expensing of capital assets. As stated above in the discussion of the Flat Tax and USA Tax, the ability to immediately expense capital assets is extremely important to a capital intensive industry like the oil and gas industry.

2. Border Adjustability and Territoriality

Like a CIVAT, the NST is neutral with respect to goods produced domestically and abroad. Not only are U.S. manufactured goods not burdened with the tax when they are exported, but imports must also bear the same tax as comparable domestically produced goods. This border adjustment feature of the NST, which like the CIVAT should be permitted under GATT rules, means that the tax does not handicap U.S. manufacturers, nor does it act to distort consumers' decisions whether to buy domestic or imported goods. The NST, also like the Flat Tax, USA Tax, and CIVAT, is a territorial system, which would help give U.S. multinationals a level playing field with their international competitors.

3. Definitional Problems

Although the proponents of the NST may intend that businesses above the retail level will be outside the tax system, this will likely not happen. Although the NST exempts goods and services "purchased to produce taxable goods and services", it never defines that term. Thus, it is questionable whether headquarters expenses, financial services, or many other kinds of purchases will be judged to "produce taxable goods and services". API is also concerned about the treatment of transactions within a controlled group of business organizations, as well as research and development and pollution control or environmental remediation. Will these items be excluded from the sales tax?

4. Other Concerns

The NST bill would repeal the retail and manufacturer excise taxes, but it does not repeal the environmental trust fund taxes. This issue is of particular concern to our industry because many of these taxes are imposed on our products. Not only would these taxes be imposed, but they would also be in the base of the sales tax on our products. State excise taxes would also be included in the base, as proposed, and this would again be a major problem for our industry. Finally, the NST will allow sellers an option to collect and remit tax from purchasers even for exempt sales, which will then require such purchasers to verify their right to refunds.

Transitional Issues

1. In General

While transitional issues will arise in the context of all tax reform proposals, they become especially critical where, for example, there is a significant shift in the basis of taxation from income to consumption. Capital intensive industries, such as the petroleum industry, have made long-term investment decisions relying on the existing tax structure. Changes in that structure would impact different companies, often in direct competition, in an arbitrary and often inequitable manner. The most obvious examples of transitional issues occur in the areas of capital outlays and borrowings. For example, a capital asset (or inventory) purchased immediately prior to the enactment of certain of the consumption-based taxes would be denied recovery of all but a miniscule fraction of its cost, whereas the same asset purchased immediately following enactment would be permitted an immediate 100% recovery against the tax base. In a similar manner, borrowings based on the anticipation of an interest deduction could become a significant burden on a highly leveraged business after enactment of a consumption tax.

2. Depreciation

The proposed USA Tax Act partially addresses the transition issue but stops far short of providing equitable relief necessary for business taxpayers. The issue of unrecovered basis is addressed in the USA Tax Act through a system of amortization which substantially lengthens the recovery period under current law. This lengthened and arbitrary classification of unrecovered costs into four groups appears based on misconceptions regarding complexity and revenue costs. Continuing the current method

for unrecovered basis of assets placed in service prior to tax reform would be preferable to inserting another new capital cost recovery regime. In a recent paper delivered by Robert E. Hall and Alvin Rabushka on their flat tax proposal (The Flat Tax: A Simple Progressive Consumption Tax, Hoover Institution; May 11, 1995), the authors indicate that a 1.1% temporary increase in the tax rate would be all that is necessary "if Congress chose to honor all the unused depreciation from investment predating tax reform . . ." Permitting current law business deductions to be carried out, thus honoring prior business plans and commitments, is necessary to avoid inequitable distortions.

3. Interest on Pre-Reform Debt

Transitional rules that consider only lost depreciation deductions fall far short of measures necessary to ensure the success of tax reform. A continuation of current law interest deductions for pre-reform debt can be as vital to a business as cost recovery. If the interest deduction is offset by interest income on the particular pre-reform debt (i.e., pre-reform obligations continue to be both tax deductible to the debtor and taxable to the lender), there would be no significant revenue impact to the Treasury. Ignoring a continuation of the interest deduction results in arbitrary windfall gains and losses without any apparent justification.

4. Carryover of Other Tax Attributes

Among other items of significant impact to business are net operating loss and capital loss carryovers, business credit, foreign tax credit, and minimum tax credit carryovers as well as other pre-reform adjustments, such as those required under Section 481 of the Code. The USA Tax attempts to solve this problem with a further complex overlay to the depreciation recovery rule. Operating and capital losses are simply a result of the annual accounting convention for tax payment determinations. Their carryforward is a valid claim on future tax payments that would take into consideration the length of business cycles in various industries and other issues of timing. There is no valid distinction between unused business credits and future deductions for depreciation and, in fact, credits are a specific and distinct Congressional incentive upon which business has relied. The Alternative Minimum Tax was intended as an advanced payment of federal income tax. Therefore, unrecovered credits require a reimbursement mechanism. Transitional rules must include a provision clearly permitting the Internal Revenue Service to make appropriate adjustments to ensure that no taxpayer takes a double deduction for any cost, or suffers a double inclusion of any income.

Summary

Reform of the current U.S. tax system is a worthy goal, especially the movement from taxation of income to taxation of consumption. Each of the alternative consumption tax proposals makes important contributions to the reform effort. Any major upheaval such as complete replacement of the current income tax system will, however, require careful analysis of all possible implications. We have lived with this tax system for over eighty years and businesses have structured their affairs within it. Any fundamental change, unless carefully orchestrated, could cause massive turmoil, particularly in the transition period from the old system to the new. At the same time, it should be emphasized that while API has identified a number of issues, none of these problems are insurmountable. We are eager to work with the Committee as it continues to develop a replacement for the current income tax system.

Mr. ENGLISH. Thank you, Mr. Sullivan. I am going to ask the remaining individuals on the panel to suspend until after the vote currently on the floor. When we return we will hear from Michael C. Linn, chairman of the tax committee of the Independent Petroleum Association of America, and I am happy to say president of the Meridian Exploration Corp. near my district in Pittsburgh, Pennsylvania; Paul Huard, senior vice president of policy and communications for the National Association of Manufacturers, and someone who has on a number of occasions testified before this panel; and Richard L. Lawson, president of the National Mining Association.

And for the moment, the Committee will suspend until we have an opportunity to return.

Thank you.

[Recess.]

Mr. CHRISTENSEN [presiding]. Welcome back to the Committee.

We will now hear from Mr. Linn.

STATEMENT OF MICHAEL C. LINN, CHAIRMAN, TAX COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; AND PRESIDENT, MERIDIAN EXPLORATION CORP., PITTSBURGH, PENNSYLVANIA

Mr. LINN. Thank you, Mr. Chairman.

The complexity of the current Tax Code as it affects the oil and gas industry is mind-boggling. Tax restructuring is a most laudable goal and, if accomplished properly, we believe will be good for the U.S. economy, including the oil and gas industry.

I appear today on behalf of 5,500 independent oil and gas producer members of the Independent Petroleum Association of America, where I serve as chairman of the tax committee. Independents, as you may know, are the major force in developing America's oil and gas natural resources. We drill 85 percent of the Nation's wells, produce more than 66 percent of our domestic natural gas supply, and 50 percent of our domestic oil production in the lower 48 States.

My company, Meridian Exploration, is based in Pittsburgh, Pennsylvania, and operates more than 800 wells in Pennsylvania, West Virginia, New York, Kentucky, and Texas.

Since 1980, we have drilled over 1,500 wells in the Appalachian Basin, usually with joint venture partners who are either other oil and gas companies, natural gas distribution companies, or large family trusts. That method of financing projects is common to the independent in the United States.

Independent's toughest business challenge is raising capital to finance drilling and production projects. An astonishing 58 percent of the financing for our projects does come from internally generated funds. But for the remainder, we must compete with oil and gas investments around the world. The acreage available for exploration has increased in the former Soviet Union, Eastern Europe, China, and other countries deciding to open new areas to exploration and production. This has led to vastly increased competition for exploration and development investment funding.

If I'm able to get across one message to you today it is that as you reform the American tax system and, thus, taxation of our in-

dustry, we need to end up with a system that makes the taxation of natural resources and our ability to raise capital more competitive with the rest of the world.

The domestic oil producing industry has downsized. As imports have climbed to record levels, domestic production has sunk to a 45-year low. In a real emergency there is simply not enough rigs, trained crews, and needed equipment to rapidly expand the domestic oil production.

For reasons both geopolitical and geological, America's ability to produce its own domestic oil and natural gas supplies continues to erode.

When we look at other countries, from Russia to Canada to Venezuela, their governments go to great lengths to encourage natural resource development. We are the only country in the world that restricts these strategic industries from developing the Nation's resource base. The government must adopt four key policy goals: Reform the Tax Code, reform environmental regulation and key resource legislation, develop a spirit of cooperation between all government levels and our industry, and explain the importance of a strong energy policy to the public.

At the State level there is an appreciation of the need to lower the tax burden on the oil and gas industry and to spur production at no cost to the taxpayer. Several States have, on their own, increased exploration and production by reducing the tax burden on these activities.

Oklahoma, Texas, Louisiana provide exemptions from the State severance tax to maintain existing production from stripper wells and encourage new drilling. Louisiana, as a result of this program, has increased economic activity directly to net the State Treasury in just over 1 year of operation an additional $4.9 million in increased revenues from sales tax, payroll tax, and royalty increases. Local governments in that State received an additional $6.8 million.

Countries that are developing their resource base provide considerable encouragement to come and do business with them because they recognize it is in their national interest to be as energy sufficient as they can. The United Kingdom arguably has one of the most developed and conducive fiscal environments relative to capital cost recovery for the oil and gas industry. This tax regime is paying dividends in increased oil and gas exploration and production.

In February 1996, oil production from the United Kingdom was 2.6 million barrels per day. This is approximately 40 percent of the U.S. production for the same period. A recent study by Petro Consultants, Ltd., indicated that recently the United Kingdom finished second only to Saudi Arabia in hydrocarbon discoveries in the world.

Instead of altering the Tax Code to erode natural resource industries, our leaders should encourage capital investment in developing the Nation's resource base. We support the following proposals which we believe are necessary to ensure a competitive United States based oil and gas industry.

We need a reformation of the alternative minimum tax. We need to reform the percentage depletion allowance. We also need to re-

form the net income limitations on percentage depletion to allow marginal producers in production to maintain its current status.

We would request a tax credit for marginal producers, in addition to the reform of the depletion allowance, and also a credit to encourage new drilling.

We need to expand the enhanced oil recovery credit and to allow geological and geophysical costs to be expensed. These are some of the few things that need to be modified in our current Tax Code.

Again, we think it is laudable to look at the entire Tax Code and the tax system, as we proceed next year in reforming America's tax system. I urge you to remember that we need to end up with a system that does make taxation of natural resources and our ability to raise capital more competitive with the rest of the world.

Thank you.

[The prepared statement follows:]

Written Statement
Michael C. Linn
President, Meridian Exploration Corp.
representing
Independent Petroleum Association of America (IPAA)
before the
Committee on Ways and Means
U.S. House of Representatives
July 31, 1996

Mr. Chairman, Members of the Committee:

My name is Michael C. Linn. I am the President of Meridian Exploration Corporation and Chairman of the Independent Petroleum Association of America's Tax Committee.

My company, Meridian Exploration, is based in Pittsburgh, Pennsylvania, and operates in excess of 800 wells in Pennsylvania, West Virginia, New York, Kentucky and Texas. Since I joined the company in 1980 until now, we have drilled over 1,500 wells in the Appalachian Basin. A majority of these wells were drilled with joint venture partners who were either other oil and gas companies, natural gas distribution companies, large family trusts or general partners who raised partnership monies for investment.

I am here today speaking on behalf of the Independent Petroleum Association of America (IPAA), a national trade association representing more than 5,500 independent oil and gas producers. Independents are the major force in developing America's oil and natural gas resource base. We drill 85 percent of the nation's wells, produce more than 66 percent of our domestic natural gas supply and 50 percent of our domestic oil production in the lower 48. Although independents range in size from small one person companies to very large public firms, the typical independent is a highly efficient small business. The typical company responding to our survey for the 1996 Profile of Independent Producers has been in business for 22 years and has gross revenues of just under $2.9 million.

First, I thank you and the committee for the opportunity to appear today as you examine the impact of the proposed replacement tax systems on natural resources. I commend you for your willingness to tackle the tough, thorny issues involved in restructuring the present federal tax system. The complexity of the current tax code as it affects the oil and gas industry is mind boggling. Tax restructuring is a most laudable goal and, if accomplished properly, we believe will be good for the U.S. economy including our domestic oil and gas industry. We believe the oil and gas industry is critical to the health of the U.S. economy. When our industry suffers, it puts our consumers and our economy at risk.

The IPAA is beginning a thorough study of the impact of the leading proposals to replace the current federal tax system. We will not have the results of that study available until late fall of this year. However, I do wish to raise significant policy issues affecting the oil and gas industry for the committee to consider as you move to reform America's tax system.

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Need for Capital

Independent oil and gas producers tend to call ourselves Wildcatters and have a heritage of taking calculated risks. We analyze data from geologists, crunch numbers from accountants, and make sales pitches to anyone with the capital to finance our ventures. But in today's global economy, we must consider a plethora of geopolitical factors that potentially affect our bottom line before wholeheartedly committing our blood, sweat and children's college education funds to new drilling programs or acquisitions. You may think I am being a bit overly dramatic when I speak of my children's education funds, but our recent survey shows that the most frequently mentioned source of capital for the financing of independents' projects was from internally generated funds. In fact, our survey indicates that an astonishing 58% of the financing for our projects is derived from internally generated funds, either from our earnings or those of our oil and gas partners earnings.

International Competitiveness for Capital to Finance Projects

A recent article in the Oil and Gas Journal noted that "terms of participation in exploration and development have improved worldwide from the point of view of international oil and gas companies in the past decade." Acreage available for exploration has increased as the former Soviet Union, Eastern Europe, China and other countries decided to open new areas. This has led to vastly increased competition for exploration and developments investment funding.

If I am able to get across one message to you today it is that if you reform America's tax system and thus the taxation of our industry, we need to end up with a system that makes the taxation of natural resources, and thus our ability to raise capital, more competitive with the rest of the world.

The Rise in Gasoline Prices -- A Warning Sign

Given the furor over gasoline prices just a few months ago, political leaders must give more attention to the domestic oil industry's long-term problems. Like it or not, our problems are your problems. And, just as was the case this spring, the American people will turn to Washington for action. Now is the time to act, not in the face of another crisis. Earlier this year, on January 16th, Energy Secretary Hazel O'Leary described the next energy crisis as being "imminent." According to industry reports, "we no longer have much cushion left in most of the world wide oil supply and demand, let alone in the U. S." And, as you know, it is crude oil and natural gas that fuels the world economy.

Let me first say that there are many who share our vision that America needs an improved energy policy; some point to increased reliance on alternative fuels, such as wind and solar energy. They might have a point far down the road when the technology is advanced and competitive enough to help America. But what can we do today as our energy supply is fueled by oil?

We must increase our domestic production of crude oil to stabilize our energy resource base. Fifteen years of inconsistent and ill-advised federal policies that have discouraged domestic production and refining of crude oil has placed us in the position of depending on foreign imports for over 50 percent of the oil needs in America. As our dependency rises, we are edging towards the maximum amount of crude which can conveniently be imported into the U.S. without increasing the chance for environmental harm.

Some public officials and others in the media acted surprised by the recent upswing in gasoline prices. We don't like to say "We told you so," but in fact we did. When world oil prices plunged to the low-teens in late 1993 to early 1994, independent oil and natural gas producers asked Congress and the Clinton administration to work with us to preserve domestic oil production. Over 90,000 U.S. oil workers have lost their jobs since the Persian Gulf crisis. Businesses have teetered on the brink of bankruptcy. Hundreds of thousands of U.S. oil wells have lost money. And oil imports sky-rocketed, pushing the U.S., for the first time in its history, into reliance on imports for more than half of its consumption. We warned back then that America eventually would be vulnerable to the kind of price spike we experienced beginning in early spring.

During the 1993 price plunge, we hoped the federal government would take advantage of low prices to purchase oil for the Strategic Petroleum Reserve, thus stabilizing prices and preserving domestic production capability. Not so. We were told that our industry had to survive or fail in the world oil marketplace. In effect, Congress told us to downsize, lay off people, delay needed equipment repairs or upgrades and cancel new purchases. Although we have been downsizing since 1986, we had no choice. More good-paying jobs were lost, on top of the 500,000 industry jobs wiped out in the preceding six years.

You can imagine how we felt as prices recovered and we tentatively started to bring back our workforce, only to see policymakers reversing themselves and pushing oil reserves sales from the Strategic Petroleum Reserve to manipulate the marketplace. All the while, the industry has had to withstand false, grand-standing accusations of industry collusion and criminal anti-trust behavior regarding the rise in crude oil and gasoline prices.

The domestic oil producing industry is downsized, cut to the bone, running some equipment on borrowed time and a prayer, just to keep afloat. We are running short of offshore drilling rigs, yet no new ones are being built. As imports have climbed to record levels, domestic production has sunk to a 45-year low. In a real emergency, there simply are not enough rigs, trained crews and needed equipment to rapidly expand domestic oil production. You can't mobilize the industry overnight to respond. That's why America needs a new energy policy in place now.

Crude Oil Policy and National Security

Some policymakers recognize the very real long-term problem confronting all of us, so we weren't alone in sending the alarm. In March, nearly two dozen members of Congress took to the floor of the House of Representatives to warn the American people, long before the uptick in gasoline prices, that our inadequate energy policy was making this nation vulnerable in both economic and national security terms.

And just last year (February 1995), President Clinton found our domestic oil supply situation, with over 50 percent of our daily supplies being imported, a threat to national security. In 1994, IPAA and other American oil and natural gas producers filed a petition requiring the Clinton administration to investigate America's growing dependence on imported oil and its impact on national security. The study involved the departments of Commerce, Energy, Interior, Defense, Labor, State and Treasury, as well as the Office of Management and Budget, the Council of Economic Advisors, and the U.S. Trade Representative. The study, like the four that preceded it, concluded that "petroleum imports threaten to impair U.S. national security." President Clinton confirmed that finding. However, neither the Congress nor the Administration has offered new initiatives to lessen the nation's growing dependence on oil imports.

"Solutions" and Misguidance

The cornerstone of the president's 1994 energy investigation was maintaining the Strategic Petroleum Reserve, which he called the nation's "bulwark against a [petroleum import] supply disruption." But, alas, the government is now selling off parts of the oil stockpiles for deficit reduction or, if you believe what is being said, to reduce gasoline prices. I note with great disappointment that the president and the Senate Appropriations Committee has proposed selling even more oil from the Strategic Petroleum Reserve in fiscal year 1997. Now is the time to stop this madness and to think seriously about America's vulnerable energy situation.

In truth, America has two petroleum reserves. One is the 500 million-plus barrels of oil in government storage facilities in Texas and Louisiana. The other reserve is the 22.5 billion barrels of known and recoverable oil reservoirs (and ten times that number in potential resources) located in thirty-three states and on the Outer Continental Shelf. Both are of great strategic importance to America, to our economy and national security.

The past few months have been utterly fascinating. Adjusted for inflation, gasoline prices climbed from a fifty-year low all the way up to the price of the 1960s. In truth, gasoline price increases tracked very closely to the rise in crude oil prices worldwide. There were other, equally predictable and clear reasons why crude oil prices and gasoline prices rose as they did as the requested DOE study quietly reported.

What Happens When the Real Crisis Hits

If this kind of political ruckus gets kicked up by a temporary supply imbalance, Congress better get ready for political disaster when a real crisis hits. And a real crisis is -- again, in the words of the Secretary of Energy Hazel O'Leary -- "imminent." To prepare for that day, we need two things we do not now have -- an aggressive policy to preserve and to expand domestic oil and natural gas production and a long-term view about the role of the Strategic Petroleum Reserve.

America can't do anything easy or painless about worldwide oil price increases. At least, for now, we can get oil and gasoline. The real threat to our economy and national security comes when Americans cannot get enough oil, regardless of price, to fuel our industrial and transportation needs and, in some parts of the country, to heat our homes.

We now get more oil from foreign importers than we do from our own oil production. Most of the world's known oil reserves are controlled by governments that, in the past, have manipulated their oil supplies for nationalistic political goals. The world's most productive oil producing region -- the Persian Gulf -- is also one of the most politically volatile. Most oil exporting regions are producing very near their maximum capacity. OPEC alone is producing over 26 million barrels a day. There is little room for error, and that should be cause for greater concern.

The supply situation is compounded by the fact that demand for oil, both in the U.S. and worldwide, continues to grow and so does our vulnerability to an oil supply disruption. Our allies, especially those in Europe, have economies and militaries even more dependent on oil imports. They will be less capable of paying for our economic exports or, more importantly, less able or, perhaps, less willing to mobilize their military forces to assist the U.S. should oil exports from the Middle East be cut off for any reason. I hope you get the picture; America is the world's petroleum police.

The final piece of this puzzle is domestic oil production. For reasons both geological and political, America's ability to produce its own domestic oil and natural gas supplies continues to erode. Over the last century, America has produced its most accessible, low-cost oil reserves. A recent John S. Herold study has shown that the industries technological advances have lowered finding costs to compete with foreign production. However we are still be hampered by current government policies.

America's future domestic oil supplies, as the President's national security investigation pinpointed, "are likely to be in small onshore deposits, expensive offshore, and Arctic frontier areas." Some progress has been made in getting at these resources. Efforts to reduce costs on marginal wells on federal lands and to expand markets for heavy oil production, especially in California, are helpful. The agreement by Congress and the President to encourage development in the deepest and most costly offshore regions holds great promise. Still, on the whole U.S. laws and regulations make it difficult, costly, or just plain impossible to develop many small onshore deposits, many offshore regions, and the most promising prospects in Alaska.

The conventional wisdom claims that this policy will protect the environment. The conventional wisdom is wrong. What it will do is bring more foreign oil tankers our way, and that's an environmental risk many, many times greater than producing oil with America's strict environmental safeguards. It will also make our nation poorer and rob us of good-paying jobs.

Time is short. We have used up that time. Temporary gasoline price spikes should be the least of our worries. Americans need more domestic production yesterday to meet our needs. We need to do what we can now to get domestic production and refining capacity back on line. There are a number of pending issues that can be brought to closure in a relatively short time that will help now. We need to reduce the tax penalties and knock down the regulatory barriers that stand in the way of increasing domestic production. Our government must begin to work in partnership with this vital industry -- rules and policies must be changed so that today's smaller, leaner industry can produce what consumers demand. If tax reform accomplishes this goal, the nation will be well served.

U. S. Energy Policy; Focusing on Domestic Resources

With a vast remaining resource base, and technologies evolving continuously, it is not too late to revitalize the domestic oil and natural gas industry. This will mean hundreds of thousands of jobs across the economic spectrum which will contribute substantially to the long-term economic health and security of our nation. Revenues will increase for local, state and federal governments.

When we look at other countries -- from Norway to Canada to Venezuela -- their governments go to great lengths to encourage natural resource development. We are the only country in the world that restricts these strategic industries from developing the nation's resource base. So how can our government revitalize the nation's energy industry? The government must adopt four key policy goals: reform the tax code; reform environmental regulations and key resource legislation; develop a spirit of cooperation between all government levels (federal, state and local) and industry; and explain the importance of a strong energy policy to the public.

Current Tax Burden on the Domestic Oil and Gas Industry

According to a survey of our members conducted last year we -- the independent oil and gas producers -- already have a considerable tax burden in the U.S. We asked our members to send in actual information from their tax returns for the past three years. Preliminary results show that the effective tax rates paid by the oil and gas industry were 20 percent higher than those of all industries published in the Statistics of Income.

In the tax years 1992 through 1994, the survey found that our membership paid effective tax rates of 32 percent, 34 percent and 38 percent in the respective years. It is important to note that two-thirds of IPAA's membership has fewer than 20 employees and that most our those members file their returns on an individual basis.

It is important to add that excluded from these calculations are State Severance and Ad Valorem taxes which are taken directly from the producers' gross income from the sale of crude oil and natural gas. These rates vary from state to state, but are another significant tax on the producer. At one of the lowest production levels in recent history, the oil and gas industry paid the states $3.4 billion in 1994. This reduced amount is directly attributable to declining production and price levels since the mid 1980's.

The effective tax rates paid by companies which submitted corporate tax returns to IPAA showed that in 1992 their effective tax rates were 38 percent and 33 percent in both 1993 and 1994.

State Efforts to Lower Tax Burden and Spur Production

At the state level there is an appreciation of the need to lower the tax burden on the oil and gas industry and spur production at no cost to taxpayers. Let us look at the efforts by several states to increase domestic exploration and production by reducing the tax burden on these activities.

Two years ago Louisiana enacted a package of state tax incentives (exemptions from the state's severance tax) to maintain existing production from stripper wells and to encourage new drilling. Those incentives spurred a production climb from 2.6 MMBOE to more than 5.5 MMBOE from existing wells. The production from deep wells increased nearly four-fold and production from horizontal wells increased nearly three-fold. Royalties from existing wells rose more than ten-fold. For deep wells, royalties rose from $4 million to $5.4 million. For horizontal wells, royalties rose from just over $0.5 million to $1.1 million. The Louisiana State University Center for Energy Studies estimates that the increase in economic activity directly related to the incentives netted the state treasury, in just over a year of operation, some $4.9 million in increased revenues from sales taxes, payroll taxes, and royalty increases. Local governments received an additional $6.8 million.

The Texas program, first enacted in 1989 and substantially expanded in 1991, had similar results. The Texas Railroad Commission testified that the Texas severance tax incentive package added, by mid-1994, some 945 million barrels of oil reserves, some one and half times the oil in the Strategic Petroleum Reserve. It is estimated that the wellhead value of that added production would be $14 billion ($15 per barrel) and the total economic value to Texas would be an estimated $41 billion. Indeed, Texas officials estimated that increases in other tax revenues were nearly three times greater than the severance tax losses from the incentive package.

U.S. Tax Policy Vis-A-Vis International Competitors For Capital

Other countries who are also developing their resource base provide considerable encouragement to come and do business with them because they recognize it is in their national interest to be as energy sufficient as they can be. Also, government working as a partner rather than killing the golden goose with overregulation and taxation can provide government coffers with tremendous financial reward.

The United Kingdom arguably has one of the most developed and conducive fiscal environment relative to capital cost recovery for the oil and gas industry. This tax regime is paying dividends in increased oil exportation and production. In February 1996, oil production from the U.K. was 2.615 million barrels per day. This was approximately 40 percent of the U.S. production for the same period. A recent study by Petroconsultants, Ltd. indicated that in recent years the U.K. finished second only to Saudi Arabia in hydrocarbon discoveries worldwide.

The U K. currently imposes only one level of tax on new oil and gas developments, the Corporation Tax. The rate of tax is a relatively low 33 percent and is applied to net income from activities in the U.K. Certain small companies may pay an even lesser rate of 25%. Generally, immediate deductions, i.e. expensing, are given for all exploration and appraisal drilling and directly incurred seismic and similar work. Tangible and intangible development expenditures qualify for 25 percent declining balance recovery per year.

For existing developments, a two-tier system of industry transfers to government operates: Royalty is levied at the rate of 12.5 percent on the value of petroleum. The Petroleum Revenue Tax (PRT) is a separate tax applying strictly to the oil an gas industry. The current rate of PRT is 50 percent, albeit the life of field rate in present value terms is significantly less. In enacting PRT, the U.K. Government created an investment oriented tax system designed to encourage optimal production of its resources. The use of innovative concepts, such as supplemental expenditure allowance in addition to complete cost recovery, and exempting certain amounts of annual production from tax, ensure that U.K. oil and gas developments earn a reasonable return on capital invested before being burdened with PRT. A project must realize actual cash flow profit and a rate of return before it can be encumbered with PRT. This type of tax regime for existing fields, provides an attractive investment environment for the oil and gas industry.

Effect of Tax Policy on the U.K. Oil Industry

Unlike the U.S., the U.K. government has demonstrated a willingness to adjust taxation policy so as to retain the commercial attractiveness of the region. In an article in the December 1994 Oil and Gas

Journal, an analysis of fiscal terms of 43 tax regimes revealed that the U.K. tax on marginal fields is one of the lowest; ranking second only to Ireland, which is a relatively insignificant participant in world markets. A study performed by Petroconsultants, Ltd. indicated that the U.K. was the second most favorable regime for economic and large fields. By comparison, the same study ranked the U.S. 12th for large fields and 30th for marginal fields.

The U.K. oil industry proved to be very responsive to recent fiscal changes. The Petroleum Economist reported that major U.K. operators announced almost immediate accelerated development plans in response to the elimination of PRT. The abolition put the U.K. in the position of taxing oil ventures solely on the basis of normal company tax. The U.K. directed its tax policy toward ensuring maximum reserve recovery from the older fields and maintaining a good flow of new developments. Tim Eggar, the immediate past U.K. Minister for Energy, indicated in July 1993 that the government's objective continued to be to ensure the maximum economic development of the U.K.'s resources and to reduce the burden that government imposes on the oil industry. A special report dated August/September 1994 published by The Petroleum Economist indicated that the tax changes have allowed many operators to develop incremental reserves at older fields and that overall, the tax changes have been beneficial.

Comparison of U.S. vs. U.K. and Spanish Tax Systems

The U.K. tax system provides no specific oil and gas incentives, but more importantly, provides no disincentives. The U.K. does not impose an overall disincentive even remotely resembling the U.S. AMT. In the U.S. geological and geophysical costs (G&G) are capitalized until proven worthless or recovered over the depletable life of a property. In the U.K. G&G is 100 percent deductible in the year incurred. AMT worsens this comparison. Tangible expenditures, once placed in service, are recovered in the U.S. over an extended life. By contrast, the U.K. generally allows a 25 percent annual allowance.

The impact of the tax system can perhaps best be shown by comparative project analysis. The economics of an exploration and production project were analyzed under the U.S. tax system and under the U.K. tax system. The results indicate that the project, if done in the U.K. by a U.K. company, would have a net present value which is 30 percent higher than that of the project done in the U.S. by a U.S. company. This kind of economic difference is cause for concern. It is also notable that the Petroconsultants, Ltd. study ranked the U.K. second in overall net present value per barrel for marginal field. The U.S. ranked 46th.

Reform of the U.S. tax system as it applied to the oil industry is critical. The AMT should be repealed or substantially reformed, and capital cost recovery rules should be modified. Foreign tax systems have many positive characteristics which encourage exploration and production activity. The result of the U.K. fiscal changes demonstrate the dramatic effect tax policy has on business investment.

The worldwide basis of U.S. taxation as applied to the oil industry creates competitive disadvantages. As discussed, the U.S. foreign tax credit limitations tend to increase the risk of double taxation in multiple jurisdictions. U.S. tax policy that singles out oil companies for adverse tax treatment is inappropriate, potentially detrimental to the economy and adversely impacts the competitiveness of U.S. oil and gas companies in the world market.

The Spanish tax regime is even more favorable in encouraging capital formation for oil and gas exploration and production. The Spanish tax regime offers a 25% depletion allowance. Even more useful to promoting capital formation, under this investment-oriented regime, companies which plow back their profits into additional investment for research and exploration are rewarded. As long as they make such investments within five years of the profit they may defer taxation on that income until they spend, or otherwise distribute the profits, for activities not related to oil and gas exploration and production.

Reform the Tax Code Now

Taxes on the oil and gas industry have evolved and have become increasingly punitive over the last several years. In fact, a 1995 survey of independent oil and gas producers found that the effective tax rate for the industry is 20 percent greater than other industries (when state and local taxes are added in, the percentage jumps three points). Meanwhile, critics argue that the industry is a recipient of "corporate welfare," because it receives legitimate business deductions. But, indeed, these ordinary and necessary business deductions are the same type of deductions all other businesses "write off." They're just called a different name in the tax code, and hence, have caught the eye of the extreme environmental lobby. When the "corporate welfare" mantra is used to advocate changes in the tax code, lawmakers must realize that these extreme groups are really talking about raising taxes.

Speaking of the "corporate welfare" debate, I wish to raise the alarm about an action taken in the "other body," last week. IPAA is extremely concerned about the actions of the Senate Government Affairs Committee in approving S.1376. Senator McCain's bill would create a BRAC-like commission to draft a list of "corporate subsidies" including tax provision, for Congress to terminate with minimal review and almost no debate. We have not always prevailed before this committee or the Senate Finance Committee, however, we reject the notion contained in S. 1376 that our tax system should be revamped without your expertise and judgment.

Instead of altering the tax code to erode natural resource industries, our leaders should encourage capital investment in developing the nation's resource base, especially to encourage drilling and to preserve so-called "marginal" production which just earns enough money to operate. Therefore, to protect the future of our industry and the benefits it provides to the entire economy, we strongly support making modifications to the current system to make it more fair, efficient, and administerable, rather than creating an entire new system. We support the following proposals, which we believe are necessary to ensure a competitive U.S.-based oil and gas industry:

- **Reform of the Alternative Minimum Tax (AMT).** The AMT doesn't allow full deductions of intangible drilling costs. These ordinary and necessary business expenses need full recognition in the tax code.
- **Reform the percentage depletion allowance.** Increasing the percentage depletion allowance rate for all producers and royalty owners from 15 percent to its historical level of 27.5 percent would encourage the maintenance of substantial U.S. reserves and increase cash flow to finance domestic drilling. Further, repeal the net income limitation on percentage depletion. This limitation effectively prevents most low volume wells from qualifying for percentage depletion during periods of low oil prices. The cost of operating a marginal well frequently exceeds the revenues received from the well's production. Repeal of the limitation will target depletion from those domestic properties which most need improved cash flow.
- **A tax credit to preserve marginal production and to encourage new drilling.**
- **Expand the Enhanced Oil Recovery Credit.** The Treasury Department allows deductions to be taken on certain advanced technologies, allowing new technologies to be used more often. However, Treasury has not updated its rules to allow deduction of some expensive new technologies used in the production of oil and natural gas. If the rules were updated, new technology and natural resource recovery techniques would help to expand our existing natural resource base.
- **Allow geological and geophysical costs to be expensed.** The industry has made enormous strides in seismic technology. Beginning with the Department of Energy's Natural Gas and Oil Initiative, the administration has promised a review and recommendation regarding the expensing of this costly, high-tech imaging technology that can, in some instances, account for 70 percent of the cost of drilling a new well. For nearly three years now, we have waited for even a hint from the administration on what, if anything, it can or will do about this open question. This technology is expensive, and unless today's tax laws are updated, smaller oil and natural gas producers cannot gain access to these technological marvels. If allowed to expense the costs incurred, these technologies could be used more often, leading to improved "finding rates" of oil and gas reserves (up to a 50 to 85 percent improvement rate). Also, the use of this new technology significantly improves the odds of drilling a successful well initially (reducing the number of wells drilled), thus leaving less of a "footprint" on the environment.

Conclusion

Again, Mr. Chairman and Members of the Committee, as you proceed next year in reforming America's tax system, I urge you to remember that we need to end up with a system that makes the taxation of natural resources, and thus our ability to raise capital, more competitive with the rest of the world.

I appreciate your kind attention and welcome any questions you might have.

Mr. CHRISTENSEN. Thank you, Mr. Linn.

Next, Mr. Huard.

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

Mr. HUARD. Thank you, Mr. Chairman.

In view of the hour, I will introduce my statement for the record and summarize as fast as I can.

I think it should go without saying that tax burdens are of critical importance to manufacturing competitiveness. This is because in today's highly competitive global economy increased tax burdens, which are an increased cost of doing business frequently, cannot be passed forward in price increases. So, the ability of manufacturers to maintain their market share and to sell a competitively priced product is very closely related to the tax burden that is imposed upon them.

In the manufacturing sector, we have concluded that the current Tax Code is the single biggest obstacle to growth that we now face. There are several reasons for this. One is that the aggregate levels of taxation are simply excessive and the second is that compliance with the existing tax system, particularly the income tax system, is much too costly.

In the case of small firms, there have been any number of studies that demonstrate that the cost of compliance for small firms, say with revenues under $1 million, is a large multiple of the taxes raised. One study by the Tax Foundation suggested the multiple was seven.

Even in the case of larger firms, there are certain arcane areas of compliance, most notably the alternative minimum tax, as well as the entire cadre of foreign source income provisions of the Code, where the cost of compliance is so high as to make the value of the provisions very questionable.

We have, therefore, concluded that replacement of the entire system is really the way to go. That the current system is beyond repair or salvage or retrofitting to make it viable. In designing a replacement system, we've examined various proposals that are out there and were set forth in the hearing notice. We haven't taken a position for or against any of them.

We do believe the design of a replacement system should take various conceptual principles into account. The first is that there should not be any net tax increase on either individuals or business. Tax increases basically deter growth. They don't stimulate growth.

Simplicity should be a major factor to eliminate wasteful compliance costs. Closely related to that should be stability. Since the late seventies we have had a nasty habit of making major changes in the rules of the game every 12 to 24 months. This makes business planning very difficult and it makes for a very complex situation for many taxpayers who basically are doing things under a multiplicity of depreciation schedules and other rules, depending on when they put an asset in service, or when they bought a particular asset or business. So, stability is almost as important as simplicity.

We should have a system that is much more conducive to capital investment. The current system, particularly for those taxpayers that are caught up in the alternative minimum tax, is one of the worst depreciations systems in the industrialized world. Ideally, to improve it and to also achieve the goal of simplicity, we ought to be moving toward something that looks like first year expensing.

As a number of witnesses have already mentioned, compatibility with the systems of our trading partners, sometimes referred to as border adjustability, is important so that products manufactured in the United States, particularly exports, do not bear an unfair burden of taxation relative to products manufactured outside the United States.

In terms of replacing the existing system, the goal should be to eliminate multiple taxation and tear that particular defect of the current system out by the roots. That means properly integrating the individual and corporate income taxes, and it means not double-taxing savings. Multiple taxation of payroll by both the Social Security tax and the income tax is a problem for workers.

Finally, if you do address payroll taxes—and I realize the hearing notice said they weren't necessarily part of this—you should do it in the context of also looking at reform of the Social Security system which is going to self-destruct somewhere out there in the future when the baby boom generation starts to retire. If you don't do that, and that may be too big a mouthful to chew on, you should at least make Social Security taxes deductible against income taxes so that you are not double taxing workers.

Thank you. That concludes my testimony.

[The prepared statement follows:]

TESTIMONY ON THE IMPORTANCE OF TAX REFORM TO DOMESTIC MANUFACTURING

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

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JULY 31, 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 domestic manufacturing.

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 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.

Tax rates were lowered substantially under the Tax Reform Act of 1986, although for manufacturers, many of which are 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 both personal and corporate income have increased since the 1986 Act, yet any narrowing of the base has been nonexistent or at best negligible.

Furthermore, 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 at a top marginal rate of about 42%. This rate, which includes back-door increases through reductions in personal exemptions and itemized deductions, represents a staggering 50 percent increase since 1986! And, 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 S corporations. Approximately 4000 of the NAM's 10,000 small manufacturers are S corporations.

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.

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. The cost of compliance by all *Fortune 500* companies is an estimated $815 million. Collectively, all businesses will pay an estimated $105 billion in 1996 to comply with the federal income tax according to the Tax Foundation. The lost economic opportunities due to these excessive compliance costs is inexcusable and detrimental to optimal economic growth.

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

-- <u>Simplicity</u>. 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.

-- <u>Elimination of Multiple Taxation</u>. 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 the border adjustable systems 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.

-- No Net Tax Increase. There should be no net tax increase on either individuals or business. Tax increases deter economic growth.

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 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.

Mr. CHRISTENSEN. Thank you, Mr. Huard.
Mr. Lawson.

STATEMENT OF RICHARD L. LAWSON, PRESIDENT, NATIONAL MINING ASSOCIATION

Mr. LAWSON. Thank you, Mr. Chairman.

I also, for purposes of time of the Committee, will ask that my remarks be submitted for the record, and I will attempt to cut them short with some of the most important aspects of our concerns.

As you know, the National Mining Association involves all of the mining activities that occur in this country, and we have strong feelings about our tax system. I would like to begin by expressing the industry's commendation for this inquiry into the flaws and failures of the income tax system. And in my time this morning, I will discuss some fundamental concepts but we will submit a detailed statement for the record, which would include a compilation of the taxes and fees the industry pays and the specific features of the current Tax Code which are of great concern to the industry.

From my standpoint, speaking for the industry, the Nation requires a tax system that raises sufficient revenue to operate the government without habitual resort to deficit finance, that attempts to hide no taxes, that does not allow for taxes to be easily or casually raised, that encourages the kinds of investment and behavior that produce an expanding and internationally competitive economy and more jobs, and finally, that allows the delivery of industrial resources to the economy at the lowest possible cost, which also encourages the use of competitive domestic resources, especially to enhance energy security for the country.

Any possible replacement for the present system should provide incentives for mining companies to explore for, discover, and develop new reserves as present ones are used up, the continuation of the depletion allowance or a provision that serves the same purpose in the same way. And whether the present system is replaced or simply reformed, the application of the alternative minimum tax to capital intensive industries such as mining is harmful, not only to the Nation, but appears to be, to us, to be punitive, should be eliminated, and certainly should be revised in terms of our international competitiveness.

Mr. Chairman and Members of the Committee, the mining industry of the United States endorses the spirit and direction of this inquiry and although it won't be a tea party, we can establish a system that is designed for a purpose and it should be in the American tradition of taxation.

Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD L. LAWSON
PRESIDENT
NATIONAL MINING ASSOCIATION

TO THE
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

HEARING ON
THE IMPACT ON REPLACING
THE FEDERAL INCOME TAX
JULY 31, 1996

Mr. Chairman, members of the committee, I am Richard Lawson, the president of the National Mining Association.

NMA's members deliver to Americans the industrial resources and electric power that produce a competitive, modern economy and good jobs. America is one of the world's energy and resource rich countries. Each form of mining makes both individual and combined contributions to the continued growth, security, and competitiveness of the United States economy.

The U.S. is first or second in world production and reserve holdings of most important metallic and non-metallic minerals. Products of domestic mining are required for virtually all forms of economic activity. Ores become tools and capital goods, including computers and tractors. Non-metallic minerals go into industrial processes, chemicals and fertilizers. Many mining products and much equipment fabricated from mined materials are exported.

American coal perennially delivers almost three-fifths of the nation's electric power and comprises two-fifths of all domestically produced fossil fuel. Coal-fired electricity is a principal reason America's industrial power rates are 49 percent below our primary economic competition in Europe and 73 percent below our principal competitors in Asia.

The saying is, "If it can't be grown, it has to be mined." That certainly is true in America. In 1995 the U.S. economy required new metals and minerals at an annual rate of 40,000 pounds per person. Add to that the billion-plus tons of coal U.S. miners produce and you begin to see the contribution of the U.S. mining industry to America and Americans.

I want to begin by expressing the industry's commendation for this inquiry into the flaws and failures of the federal income tax system. A former Secretary of the Treasury once said, "The nation should have a tax system that looks like someone designed it on purpose." The mining industry feels that such purpose ought to be an America that is economically strong and capable of responding to all challenges, and for that reason our industry intends to be a full contributing participant in the policy process now underway.

There are two fundamental approaches to taxation. One is basically European and rooted in the attitudes of feudal times. It assumes that government should simply take what it needs and that people would be permitted to keep a share of the fruits of their labor and investment -- but only a share. I sometimes think of it as the King George of England system.

This philosophy gives to things left untaxed names such a tax expenditures and middle-class subsidy. In it, taxes have two purposes: To raise revenue and to coerce behavior for social and other policy purposes; and revenue is not always the first purpose of a tax provision.

The other approach is distinctly American and stems also from the time of King George, tea parties and America's ultimate tax reform: It is based on the conviction that the people grant to government a share of their earned wealth in exchange for the efficient and orderly conduct of national affairs.

In it, taxes also have two purposes: To raise revenue and to encourage behavior. Tax expenditures are taxes paid, not activities left untaxed. I urge the committee to re-emphasize the American approach. America requires a tax system that:

- Raises sufficient revenue to operate the government without habitual resort to deficit finance;
- Attempts to hide no taxes;
- Does not allow for taxes to be easily or casually raised;
- Encourages the kinds of investment and behavior that produce an expanding and internationally competitive economy, and more jobs;
- Allows delivery of industrial resources to the economy at the lowest possible cost; and,
- Encourages the use of competitive domestic resources -- especially to enhance energy security.

A major deficiency of the present tax system is the corporate alternative minimum tax, which, as the Committee is well aware, operates as a parallel tax system. The end result is a tax structure that penalizes investment and gives capital intensive industries the worst capital cost recovery system in the industrialized world. We applaud the Committee's efforts to repeal and reform the AMT in the 104th Congress.

The AMT hits nearly every mining company at nearly every stage of a mine's investment and life cycle--exploration, development and production. This makes many mining companies permanent AMT taxpayers and as a result they pay higher effective federal income tax rates than other businesses.

A review of information in the public domain indicates that the mining industry pays higher taxes than most industries. Some commodities, such as coal, already bear an extremely high tax burden. Information on total tax burden is useful to better understand the full impact and implications of fundamental tax reform on any given industry or segment thereof.

The coal industry provides a good example of the amount of non-income based taxes paid by an industry. Like other industries, coal producing companies pay federal and state income taxes, property, sales and use tax, and federal and state mandated payroll taxes. Coal companies also pay a variety of industry specific taxes and fees including state (and local) severance taxes, federal abandoned mine lands fees and federal Black Lung Excise tax. A significant amount of coal production occurs on lands subject to federal or Indian royalties. Also, many coal companies must pay a federally mandated retired miner health care tax.

Revenues provided by severance taxes are a significant source of funds for coal producing states. The total coal severance tax collected by all coal producing states in 1993 totaled $559 million. To illustrate the importance of these taxes, Wyoming, the nation's largest coal producing state, collected $100.4 million in coal severance tax in 1993 representing 15% of this states total tax receipts.

At the federal level, the coal industry paid $329 million in federal and Indian royalties in 1993. The nation's coal production subject to federal or Indian royalty accounted for 31% of total coal production in 1994. The coal industry paid $605 million in coal black lung excise tax in 1993 and abandoned mine lands fees of $238 million.

The impact of these non-income based taxes is significant. For example, a Wyoming coal company selling Powder River Basin coal for an average price of $3.33 per ton FOB mine will pay $1.23 per ton or 36.9% of selling price in non-income, non-payroll taxes and fees:

State (and county) severance	$ 33
Black Lung Excise Tax[1]	.15
Federal royalty	.40
Abandoned mine land fee	.35

	$1.23
	=====

Subtracting the $1.23 in non-income based taxes from a selling price of $3.33 leaves only $2.10 per ton to cover production costs, overhead, payroll and income taxes. As a result, profit margins are razor thin.

Any alternative tax system should take into account all excise taxes, fees and industry - specific taxes paid to government entities--federal, state and local, including Indian tribal entities

Historically, the federal income tax system has recognized the fundamental and essential role of this country's mining industry. Mining's importance has been long acknowledged through such provisions as the deduction for exploration and development expenditures and the percentage depletion allowance. These and other provisions affecting capital cost recovery have helped to foster an assured availability of raw materials for manufacturing and energy production while helping to generate needed cash flow for the industry.

One of the distinguishing characteristics of mining compared to other forms of commercial endeavor is the necessity to discover through high risk exploration and development activity, the primary asset of the business--its mineral deposits (reserves). The tax code must encourage the entrepreneurial risk taking activity inherent in these activities.

A mineral deposit is a wasting asset that requires investments in exploration, acquisition and development in order to yield a flow of commodities over its productive life. As is true of other assets, the value of a mineral deposit diminishes with its depletion. The present tax system recognizes these characteristics: (1) a mineral deposit is a unique wasting asset for which the percentage depletion allowance is necessary to provide meaningful capital recovery; and (2) the massive capital requirements, above average risks and long lead times from exploration to commercial production inherent in the mining industry.

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[1] Other coal operators pay considerably more Black Lung Excise Tax--up to $1.10 per ton.

Any modification to the present system, or a change to a new system, that results in an increase in the tax burden on mining companies is the same as an increase in production costs. Because minerals are commodities traded in the international marketplace at prices determined by world-wide supply and demand factors, mining companies cannot increase prices to recover higher costs. Ultimately, higher tax burdens will have a chilling effect on investment in both existing mines and proposed mining projects and damage the long-term viability of the mining industry. Any downsizing in the U.S. mining industry as a consequence of tax hikes means good, high-paying jobs will be exported and we will import mineral products to offset lost domestic production.

NMA is concerned that the flat and USA alternative tax systems, as presently drafted, could result in a major tax increase on the mining industry which will have adverse consequences not only to mining companies but their employees, suppliers and other entities with a stake in the success and viability of the domestic mining industry.

Any possible replacement for the present system should provide incentive for mining companies to explore, discover, and develop new reserves as present ones are used up -- the continuation of the depletion allowance or a provision that serves the same purpose. And whether the present system is replaced or simply reformed, the application of the alternative minimum tax to capital-intensive industries such as mining is harmful and punitive and should be eliminated.

Mr. Chairman, members of the committee, the mining industry endorses the spirit and direction of your inquiry. It won't be a tea party, but we can establish a system that is designed for a purpose; and it will be in the American tradition.

Mr. CHRISTENSEN. Thank you, Mr. Lawson.

Mr. Collins, do you have any questions?

Mr. COLLINS. Mr. Chairman, no, I won't ask any questions. It seems like we have quite an event going on across the street that we all have to attend about every 15 minutes. But we do appreciate each of you coming, and we are very concerned, as you are, with the tax structure in this country and how it affects jobs domestically as well as how it affects exports. I prefer to export goods rather than exporting jobs.

And I think our Tax Code has a tendency for us to export jobs more favorably than it should. We solicit your support in our efforts to change the Tax Code as we attempt a change in this Congress. And I am sure that the Chairman, within the next Congress, will continue to move forward with more changes, changes our critics say are in effect, giving corporate welfare to business. But in the long run, these incentives are for the welfare of those who work in this country.

Because I've always been a believer that no matter where you implement a tax, who you implement it on, what product you implement it on, working people of this country pay the bill, when they buy those products or buy those goods and services.

We appreciate your efforts, your interest, and your patience with the procedural vote tactics that are going on today.

Thank you very much.

Mr. CHRISTENSEN. As Mr. Collins stated, there is another vote on the floor. There are a number of procedural things that are happening. In light of that, I will probably have to pass at this time. I want to thank the Committee and thank the panel for their time and spending here, the whole morning. And your full statement will be entered into the record, and we appreciate the fact that you've given your time to come to testify this morning.

Thank you very much.

[Recess.]

Mr. ENGLISH [presiding]. We are going to reconvene this hearing and introduce a new panel. Each of the witnesses will have 5 minutes to testify and then we will have an opportunity for questions and answers.

Our panel on this round will consist of James F. McMahon, vice chairman of the taxation committee of the Edison Electric Institute, and general tax counsel of the Consolidated Edison Co. of New York, and he is accompanied, I believe, by Peter Merrill, a partner at Price Waterhouse.

We have with us Dawn Erlandson, executive director of Americans for a Sustainable Economy; Brent Blackwelder, president of Friends of the Earth; and Gary Rogliano, senior vice president for the Pittston Co. of Stanford, Connecticut, speaking on behalf of the Coal Industry Tax Committee.

Thank you all for coming and participating today.

We anticipate having a few more Members here before this panel is completed, to ask questions. I would like to start with Mr. McMahon, and then Mr. Merrill.

STATEMENT OF JAMES F. MCMAHON, VICE CHAIRMAN, TAXATION COMMITTEE, EDISON ELECTRIC INSTITUTE; AND GENERAL TAX COUNSEL, CONSOLIDATED EDISON CO. OF NEW YORK, INC.; ACCOMPANIED BY PETER MERRILL, PARTNER, PRICE WATERHOUSE LLP

Mr. MCMAHON. Thank you, Mr. Chairman. Good afternoon.

We welcome the opportunity to speak before the Committee with respect to tax reform. We support your efforts to develop an alternative tax system. Now we have reviewed the various tax proposals, and I will just break them down, in the interest of time, for short analysis.

The USA tax encourages capital investment by expensing our expenses. We, as you know, in public utilities, make large investments, and this particular expensing will be a great capital investment for us.

The national retail sales tax is similar to the sales taxes imposed in 45 States. It is also similar to the VAT tax. EEI has found significant merit to the VAT tax and has prepared written comments, which we gave to the Committee last June.

The flat tax also allows expensing and does have the advantage of capital investment. However, while it does enhance our competitive position, it is, as far as foreign taxes are concerned, not border adjustable.

As to the effect on electric utilities, I would just point out a few things.

In our compliance, one of our major problems in taxes is the distinction between expensing and capitalization. All three proposals eliminate that problem, which is an excellent idea.

We do have, however, transition problems regarding cost recovery issues and losses, and other transitional questions. We ask that the Committee examine other issues as they are important to the electric utility industry.

In the regulatory area, reductions or elimination of deferred tax liabilities could result in temporary but significant reductions in cash flow and limited investment opportunities for public utilities.

We also ask that the Committee take a careful review of the normalization provisions that are in the Tax Code, and be careful about abandoning them.

In the foreign tax area, we are now facing global competition and electric utilities are looking forward into foreign investments. The flat USA tax and the sales tax do not tax offshore activities, but the flat tax does tax exports, and is not border adjustable.

As the Committee is aware, there have been changes in the electric industry primarily because of the Energy Policy Act of 1993. It has brought forth retail competition and a new class of nonutility generators. We ask that consideration be given to a level playingfield, and a fairness in taxation, and that tax advantages enjoyed by municipal government-owned utilities be equated with public utility taxation.

In summation, we have five points I would like to make.

One, EEI and the public utility industry support any proposal to eliminate the income tax and replace it with a broad-based consumption tax.

However, we do not support the addition of a compensation tax on top of existing income taxes.

We favor the consumption tax, but we would want the public utility to collect the tax, but the tax would be placed on the end user.

We urge you to look at the transition issues raised by the recovery of bases and by losses.

We also ask that consideration be given to the normalization, and finally, we ask for fairness and a level playingfield, so that our long-term goal is to tax all electricity at the same rate, regardless of who produces it or who sells it.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES F. MCMAHON
VICE CHAIRMAN, TAXATION COMMITTEE
EDISON ELECTRIC INSTITUTE, AND GENERAL
TAX COUNSEL, CONSOLIDATED EDISON CO. OF NEW YORK, INC.,
ACCOMPANIED BY PETER MERRILL, PARTNER, PRICE WATERHOUSE LLP

Mr. Chairman and Members of the Committee:

I am James F. McMahon, General Tax Counsel of the Consolidated Edison Company of New York, Inc. I appreciate the opportunity to appear today representing the Edison Electric Institute (EEI). EEI is the association representing the nation's shareholder-owned electric utility companies. Its members serve 99 percent of all customers served by the shareholder-owned segment of the electric utility industry. EEI's members generate approximately 79 percent of all the electricity produced in the United States and serve 76 percent of the nation's customers. EEI and its member companies appreciate the opportunity to present our comments on this important issue, and look forward to working with the Committee in its search for an alternative tax system to replace the federal income tax.

A number of Members of Congress as well as others believe that the current federal income tax system should be repealed and replaced by a new tax that is designed to facilitate savings and investment, international competitiveness, and tax simplification. House Ways and Means Committee Chairman Bill Archer (R-TX), Senate Finance Committee Chairman William Roth R-DE) and Ways and Means ranking member Sam Gibbons (D-FL) have all expressed an interest in sweeping tax reform. EEI applauds these efforts.

Our current tax system is extremely complicated and burdened with a multitude of complex and tangled regulations, exemptions and loopholes. It punishes success and rewards consumption at the expense of savings and investments, and is extremely difficult and expensive to administer. The administration of the system can, at best, be described as inefficient and adversarial. EEI supports the Committee on Ways and Means' efforts to develop an alternative tax system that is fairer and encourages savings and economic activity. Our remarks will address the principal options most frequently discussed as alternatives to the current system. The proposals include a flat tax, a national sales tax, and an income tax with an unlimited savings deduction.

Three fundamental tax reform proposals introduced during the 104th Congress have received the greatest amount of attention: the Flat Tax introduced by House Majority Leader Dick Armey (R-TX) and Sen. Richard Shelby (R-AL), the "Unlimited Savings Allowance" (USA) Tax introduced by Senators Pete Domenici (R-NM) and Sam Nunn (D-GA), and the National Retail Sales Tax (NRST)

introduced by Reps. Dan Schaefer (R-CO) and Billy Tauzin (D-LA). Each of these proposals would repeal the current federal individual and corporate income taxes and introduce a new consumption-based tax system. We agree that a new tax should not be added on top of the current income tax system.

Adoption of any of these proposals would represent a radical change in U.S. tax policy. While over 100 countries have adopted national value-added taxes (VATs), none has repealed its corporate or individual income tax system. Change of this magnitude would raise numerous issues for the electric utility industry. The purpose of these comments is to identify the potential impact of fundamental tax reform on our industry.

CHANGES IN THE ELECTRIC UTILITY INDUSTRY

The electric utility industry has entered into an era of increasing competition. The Energy Policy Act of 1992 has stimulated wholesale competition by opening the nation's transmission system and creating a new class of non-utility generators at the wholesale level. With regard to retail sales to the ultimate customer, forty-seven states and the District of Columbia are addressing reforms to traditional retail electric service. Several states are conducting retail competition experiments.

At this time it is not known how future electricity markets will be constructed. But there will continue to be a regulated and an unregulated part of what is now the electric utility business, at least for the forseeable future.

We point this out because whether or not an electricity company is regulated has income tax implications. One of the major differences is that, in calculating the cost of service for providing electricity, regulators determine the income tax expense that is chargeable to the customer in rates. The treatment of deferred tax is another area of significant difference.

Thus, any restructuring of the tax system must take into consideration the changing nature of the electricity industry. Some parts of the business such as distribution will, in all likelihood, continue to be regulated. Other parts of the business, such as generation, may be partially or fully deregulated.

In order to ensure that all electricity suppliers compete under the same rules, the tax system should not give an unfair advantage to any market participant.

USA TAX

Introduced by Senators Pete Domenici (R-NM) and Sam Nunn (D-GA), the "Unlimited Savings Allowance" USA Tax (S. 722) imposes two consumption taxes: (1) a consumed income tax on individuals with progressive rates up to 40% and (2) a subtraction method value added tax on businesses at an 11% rate. Businesses generally would compute their USA Tax base by

deducting from gross receipts the cost of goods and services purchased from other businesses, including materials, energy, plant and equipment, advertising, accounting and legal fees, and other costs. The primary business expenses that would not be deductible under this system are employee compensation and benefits, interest payments and taxes (other than product taxes). Dividends, interest and capital gains income from sales of financial assets would not be included in the tax base of non-financial companies. Dividends and interest payments would not be allowed as deductions under the USA Tax for non-financial companies. Rent and royalty income would be includable in business receipts, while rent and royalty expenses would be deductible, as under the corporate income tax.

Capital purchases, including the entire cost of property, plant and equipment, would be fully deducted in the year of purchase. Gross proceeds from the sale of assets would be included in the USA Tax base. Depreciation, depletion and amortization rules would be eliminated. Transition rules would apply to the unrecovered basis of assets purchased before the effective date of the USA Tax. The proposal would retain the accrual method of accounting for purposes of determining the timing of recognition of taxable receipts and deductions of business purchases.

The USA Tax is a territorial tax with "border adjustments." Income from foreign branches and dividends from foreign subsidiaries would be excluded. Gross receipts from exports of goods or services from the United States would also be excluded from the tax base. Foreign source rents, royalties, commissions, service fees, etc., received by a U.S. business would be treated as export receipts and excluded from the tax base. Imports of goods and services would be treated as taxable receipts to the importer. The import tax could not be reduced by any deductions or credits.

The USA Tax accomplishes some important tax policy objectives. First, it encourages capital investment. Utilities make substantial investments in plant and equipment, and capital expenditures would be expensed rather than depreciated. Secondly, the USA Tax enhances the electric utilities' competitive position abroad. The electric utility industry has become significantly more involved in offshore projects which generate foreign source income, all of which would be exempt from the USA tax base. Although the USA Tax does not allow for deductions for wages and other forms of compensation, on balance, we believe the USA Tax provides an appropriate base of taxation. The immediate deductibility of capital expenditures promotes capital investment that is vital to productivity and economic growth and would lower the cost of capital. In addition, the exclusion of income generated offshore encourages additional activities by U.S. domiciled utilities operating in foreign countries. These foreign projects create jobs in the United States. They do not export jobs. These projects involve U.S. service personnel as well as U.S. based technology. The power plants abroad will be built and operated either by a U.S. company or by a foreign competitor. It is an inherent economic advantage for the United States that these plants be built, equipped and operated by U.S.

companies rather than our foreign competition. The USA Tax does little, however, to level the playing field for all electricity producers.

FLAT TAX

Although there are different versions of a Flat Tax, perhaps the one most frequently discussed is the one introduced by House Majority Leader Dick Armey (R-TX), H.R. 2060 and Senator Richard Shelby (R-AL), S. 488. Their proposal imposes a flat 17% tax on businesses and individuals. Robert Hall and Alvin Rabushka of the Hoover Institution suggested a 19% rate should be implemented. A January 1996 U.S. Department of the Treasury analysis estimated that a 20.8% rate would be required for the Flat Tax bill to be revenue neutral. Under the Flat Tax, a business generally would compute its tax base as it would under the USA Tax with some significant differences:

- In contrast to the USA Tax, wages and salaries and contributions to qualified pension plans would be deductible under the Flat Tax. Other fringe benefits such as health care would not be deductible as under the USA Tax.

- Unlike the USA Tax, the Flat Tax would not tax imports, nor exempt exports. Like the USA Tax, the Flat Tax would be calculated on a territorial basis; only domestic operations would be included in the determination of tax liability and income from foreign operations would be exempt. Foreign source royalty, rental, commission and service fee receipts would, unlike the USA Tax, be included in the tax base under the Flat Tax.

- In contrast to the USA Tax, Flat Tax legislation generally would require the use of the cash method of accounting.

BROAD BASED CONSUMPTION TAX

Representatives Dan Schaefer (R-CO) and Billy Tauzin (D-LA) have introduced legislation -- (H.R. 3039) the "National Retail Sales Act of 1996" -- that would repeal the corporate and individual income taxes, the estate and gift taxes, most federal excise taxes. It also imposes a new 15% national retail sales tax (NRST). The Schaefer/Tauzin NRST is generally similar to retail sales taxes (RSTs) now imposed by 45 states. The Schaefer/Tauzin NRST, however, would apply not only to goods but also to most services. The bill would encourage states to take over administration of the NRST by allowing administering states to keep 1% of the amount of NRST collected as an administration fee. The bill also would eliminate funding for the Internal Revenue Service after FY 2000.

Under the NRST, businesses would pay tax equal to 15% of the gross amount received for sales of goods and services. Sellers would be required to provide an invoice with respect to taxable sales stating the amount of tax and certain other information. Sales to other businesses for resale or for use in the production of taxable goods and services would be exempt as would exports. Taxpayers would be allowed an administrative credit equal to 0.5%

of tax collected as well as a credit equal to 50% of the cost of equipment purchased to comply with the invoice requirement.

Employers would be required to pay each employee a "family consumption refund" equal to 15% of the lesser of (1) the poverty level for the employee's family unit; or (2) the employee's annual compensation. The refund would be creditable against the employer's payroll tax.

The NRST is similar to a value added tax (VAT). A VAT taxes the difference between the value of a business' sales and its purchases from other businesses. A value added tax is a tax on businesses that is collected as goods move through different phases of production. VATs generally tax consumption rather than investment and are border adjustable.

Because a retail sales tax such as the NRST and a credit-invoice VAT (with the same rate) generally impose the same amount of tax on the same tax base (i.e., total final sales), economists generally believe that the taxes will have largely the same impact on savings, international trade and distribution of income. Thus, the differences between a retail sales tax and a credit invoice VAT are primarily matters of administration and compliance. EEI believes that a traditional VAT has substantial merit and provided this Committee with written comments on the subject on June 22, 1995. As in the case of the other approaches to fundamental tax reform addressed in our remarks, we believe that these measures have the potential to be significantly more efficient and administrable than the present corporate and individual income tax and that they would also better promote the important goals of capital formation, domestic job growth, and foreign competitiveness.

Ratemaking Under a Broad Based Consumption Tax

The interaction of a broad based consumption tax with state rate-making raises significant issues for the electric utility industry. The "revenue requirement" of an electric utility includes its tax liability and is in principle recovered through the rate-making process. State gross receipt taxes, state franchise taxes and income taxes are all expenses included in a utility's revenue requirements. Utilities cannot automatically adjust rates to reflect changes in such taxes since these changes require approval of regulatory authorities. A sales tax imposed on customers is not part of the revenue requirement. A sales tax is generally a liability of the consumer with utilities serving solely as collection agents for the government. Utility bills therefore automatically reflect a sales tax.

Treatment of a broad based consumption tax for rate-making purposes should ensure that the ultimate consumer of electricity bears the cost. However, the design of a national sales tax raises several issues. The design could be such that utilities are simply collection agents. This is how the House drafted the proposed BTU tax in its version of the Omnibus Budget Reconciliation Act of 1993. An invoice-method national sales tax would be a liability of the ultimate consumer and would be collected and remitted by the utility. It would not be part of

the utility's revenue requirements. Instead, the tax would be a separate calculation outside the rate-making process.

Alternatively, the design of a broad based consumption tax could designate the seller as the taxpayer. Such a design would create regulatory problems for the utility. For example, under a subtraction method VAT, such as the USA Business Tax, utilities would likely be required to obtain regulatory approval in order to include the amounts in rates.

COMPLIANCE AND TRANSITIONAL ISSUES

For many taxpayers, the prospect of relief from the compliance burden associated with the current federal income tax system is one of the most attractive features of fundamental tax reform. Proponents of the various tax reform proposals have focused on this taxpayer concern. The major fundamental tax reform proposals we have discussed are likely to provide some, perhaps significant, relief from the present compliance burden but the transition to a new system will create different compliance burdens, and each of the proposals contains at least some potential complexities. In addition, each of these restructuring proposals may make it more difficult to use financial accounting data as a starting point for the calculation of tax liability.

For the electric utility industry, a significant amount of tax complexity relates to the question of whether to deduct or to capitalize an expenditure. The Flat Tax, the USA Tax and a national sales tax would eliminate this major source of complexity since all expenditures would be expensed. Significant cost recovery issues relating to existing property and other transitional issues, however, would be inherent in the adoption of any new method of taxation.

Another significant source of complexity relates to the United States taxation of offshore business activity. The Flat Tax, the National Retail Sales Tax and the USA Tax are territorial systems and would not tax the offshore activity of U.S. corporations. A national sales tax and the USA Tax would be border adjustable and eliminate the extraordinary complexities involved with the taxation of U.S. entities abroad. The Flat Tax would be border adjustable and would tax royalties and other payments received for exports of services and intangibles. As a result, transfer pricing would remain a significant source of complexity in the administration of the Flat Tax. Moreover, the taxation of foreign-source royalty payments - with no deduction or credit for foreign withholding taxes on these royalties could result in an increased tax burden on the development and commercialization of technology by U.S. companies. It is critical that any new tax system maximize the competitive position of U.S. utilities operating abroad.

Depending on how a national sales tax is constructed, significant administrative burdens may result. For example, the NRST would impose significant compliance burdens with its "family consumption refunds." Coordination would be required where a family unit has more than one working member. This process would

raise significant compliance problems. Another example is that, under the NRST, sellers would need to maintain exemption certificates for each business customer for a period of three years and would bear the burden of ascertaining that these certificates are not fraudulent.

Another area of complexity involves interstate sales. Under the NRST, interstate sales would be taxable in the same manner as intrastate sales. However, the destination state would have tax jurisdiction over these sales. Consequently, utilities would need to ascertain the residence of all nonexempt customers and calculate tax separately for each customer based on the state of residence.

A publicly-traded company's incremental cost of compliance with the present tax law is significantly influenced by the degree to which information developed for other purposes (such as the financial statement) can be used for tax purposes. Generally, a company will not calculate all of the elements of taxable income separately, but rather will use the financial statement measure of income as a starting point and make the adjustments necessary to determine taxable income. A corporation is required to summarize these adjustments on Schedule M-1 of the corporate income tax return Form 1120. Obviously, extensive and complex adjustments to the financial statement that may be required to determine taxable income increase the cost of tax compliance. Unlike present law, neither the Flat Tax nor the USA Tax uses a single existing figure such as book income as the starting point of its calculation. While continued use of financial accounting information may be possible, it may no longer be able to serve as the starting point for the calculation of tax liability as it does under present law, necessitating the creation of a new, unique calculation of taxable income.

FINANCIAL ACCOUNTING AND TRANSITION ISSUES

If tax reform retains some definition of income as part of the tax base, continued financial accounting measurement of tax expense and liability will be required. This will result in both transitional and ongoing financial accounting implications.

The main transitional effects are the benefit due to a reduction in net deferred tax liabilities resulting from a tax rate reduction; and, absent transitional relief, the burden resulting from the loss of tax basis in existing assets. The positive and negative transitional effects may be recognized immediately or over time, through earnings or directly through the equity account. Whether an individual utility will experience a net positive or negative effect will depend upon the size of the reduction in tax rates, the utility's deferred tax account, the utility's adjusted tax basis in its depreciable assets, and the transition rules provided. Additionally, EEI member companies have accumulated over $1 billion of minimum tax credit carry-forwards under the current alternative minimum tax system. Consequently, the transition rules for utilizing these credits are of extreme importance to EEI.

Ongoing implications of tax reform that will affect the

determination of a utility's effective tax rate includes the change in the statutory tax rate and the numerous permanent and temporary differences between the USA and Flat Taxes and the present corporate income tax. Although the deferred tax liability account may be decreased by the transition to the new system as a result of the change in statutory rates, it is expected to be increased on an ongoing basis as a result of allowing the current deduction of capital expenditures.

REGULATORY ISSUES

Some regulatory issues are raised by fundamental tax reform. The regulatory treatment of the reduction or elimination of deferred tax liabilities is an issue of concern. Its incorporation into the rate-making process could result in a temporary (but potentially significant) reduction in the cash flow of the regulated utility. Such a change could be detrimental to the electric utility industry. A one-time refund would be unfair to a majority of customers.

The need to normalize future investment in depreciable property also must be addressed. Under the Flat Tax and the USA Tax, capital expenditures are deductible immediately. Failure to normalize the tax benefits of expensing plant and equipment would produce undesirable fluctuations in rates as well as compromising tax reform's intended incentive for investment.

Introduction of a consumption-based tax system like the NRST or the USA Business Tax may cause a one-time increase in the price level because employee compensation and benefits are not business deductions. By contrast, the Flat Tax, because it taxes wages at the household rather than the business level, is less likely to cause an increase in the price level. The potential inflationary effect of the USA Tax and the NRST are of particular concern to regulated industries, such as the electric utility industry. Regulated industries generally cannot rapidly adjust their prices to reflect the impact of inflation on costs. Consequently, a burst of inflation may depress income, reduce the value of shareholder equity, and make it more difficult for utilities to finance investment. To avoid this result, regulators would need to allow rates to increase commensurately with the overall price level in the economy.

EQUAL TAXATION FOR SIMILAR TRANSACTIONS

As compared to investor-owned utilities, cooperative and government-owned utilities generally are not subject to entity level taxation and, in many cases, have access to tax exempt financing. We believe that it is imperative that all of the fundamental tax reform proposals create a level playing field and subject all providers of electricity to the same level of taxation in the evolving, competitive electricity market. Of the principal types of fundamental tax reform proposals discussed above, the USA Tax would do the least to level the playing field. Government-owned electric utilities would retain their tax-exempt status because the provision of public utility services is considered an essential government function under the USA Tax. Cooperative utilities would be subject to the business tax;

however, cooperative electric companies would be allowed to treat patronage dividends as a refund of a portion of the amount paid by the patron for services. Under the USA Tax, income from tax exempt bonds would continue to be exempt from taxation although the value of the exemption would likely be reduced because of the deduction for net additions to savings. We believe that Congress should use fundamental tax reform to help establish a level playing field in the evolving, competitive electric industry.

Under the Flat Tax, government entities and organizations exempt from tax in present law would continue to be exempt from the Flat Tax on businesses. However, government entities and tax exempt organizations would be subject to a separate tax, at the Flat Tax rate, on "excludable" compensation. Unlike present law, government-owned and mutual and cooperative utilities would not be entirely free of tax at the entity level. The Flat Tax would treat taxable and tax exempt bonds identically, and thus at least one aspect of the playing field would be leveled.

The NRST would subject the sales of all electricity, regardless of the type of ownership, to the same level of taxation. Thus, from a federal tax perspective, investor-owned, government-owned and cooperative utilities would compete on a level playing field. This does not mean that the shareholder-owned electric utility necessarily favors the NRST over other fundamental tax reform proposals. Rather, we believe that all of the major proposals can be structured in a way which accomplishes, in the long-term, the all important goal of taxing all electricity at the same rate regardless of who produces and sells the electricity.

CONCLUSION

We applaud this Committee's efforts to take a long overdue look at the current federal income taxation system. Although we believe that a new system can be designed that accomplishes the national objectives of encouraging savings and investment and raising revenue in a far simpler and economically-productive manner, any such system will create significant transitional issues. With respect to the electric utility industry, fundamental tax reform also provides an opportunity to level the playing field and produce equal tax results for all participants in the evolving, competitive electricity market. In addition, tax reform should consider the impact of rate regulation.

We would be pleased to provide this Committee with more information about our industry's views on fundamental tax reform and its impact on the shareholder-owned electric utility industry as the process moves forward and as the specifics of various proposals become more clearly defined. We thank you for the opportunity to participate in this process.

Chairman ARCHER. Thank you, Mr. McMahon.

My apologies. I wish I could apologize to the previous panel, but this is a three-ring circus here on Capitol Hill right now, and one person has a lot of difficulty being in three different rings at the same time. Actually, it is four rings now, counting these hearings.

So I apologize for that. But we are delighted to have your testimony today, and our next witness is Peter Merrill. If you would identify yourself for the record, you may proceed.

Mr. MERRILL. I am accompanying Mr. McMahon today and do not have a separate testimony.

Chairman ARCHER. All right. So you will associate yourself with his remarks?

Mr. MERRILL. One hundred percent. [Laughter.]

Chairman ARCHER. Our next witness is Dawn Erlandson. If you will identify yourself for the record you may proceed.

STATEMENT OF DAWN ERLANDSON, EXECUTIVE DIRECTOR, AMERICANS FOR A SUSTAINABLE ECONOMY

Ms. ERLANDSON. Certainly. Good afternoon, Chairman Archer, and Representatives English and Ensign.

I am Dawn Erlandson, executive director of Americans for a Sustainable Economy.

We work on better integrating economic, social, and environmental goals, particularly in the area of tax policy.

I would like to thank you today for allowing us to testify.

We offer three basic principles, which any tax reform proposal should embody, beyond ease of compliance and enforceability.

The first principle is equity, meaning that any new tax system should, as a minimum, retain the progressivity of the current personal and corporate income tax system.

We believe this is particularly important, given the regressivity of the Federal payroll tax, and many of our State tax systems.

Second, the tax system should promote job creation and rising real incomes for ordinary families, as well as foster overall economic vitality.

Third, the tax system should encourage protection of the environment and wise use of natural resources.

As we examine the four tax options before the Committee, and their effects on industrial sectors, one potentially positive element stands out for us.

To the extent that all of these options eliminate preferential treatment of and subsidies for the extraction of natural resources, they would provide an important environmental benefit missing from the current tax system.

Nonetheless, the environmental advantages of eliminating this special treatment may be more than offset by the advantages to capital intensive industries, such as mining, that these new alternative systems would create.

The question of whether savings and investment will increase in response to lower tax rates is an open one.

The evidence from the United States economy in both the sixties and the eighties does not demonstrate that high effective tax rates on investment income inhibited investment or decreased national

savings, nor does it suggest that investment incentives increased total investment.

The switch, then, to consumption taxes shifts the burden from capital to labor, regardless of whether that shift creates additional investment.

If the shift encourages investment, there may be some growth advantages to offset negative distributional burdens, provided the investment in physical capital caused by the tax cut to capital is not offset by a reduction in investment in human capital from the labor tax increase.

As a result, these tax systems would favor capital-intensive investment over labor- and knowledge-intensive investment.

This will move the United States economy in the wrong direction, back toward earlier industrial age, based primarily on high levels of investment in physical capital, and inefficient use of energy and natural resources, rather than pushing forward into the information age, and beyond, in which investment in human capital is the key to economic success.

Instead, we must position the United States to compete in the global economy for high-growth, knowledge-intensive industries that are energy efficient and clean, while creating more energy-efficient and less polluting production in our traditional industry sectors.

If the tax changes discussed today, despite evidence to the contrary, do stimulate increased capital investment, then we may see more pollution and greater energy consumption due to increased growth.

It is true that new physical capital investment is usually more energy efficient and less polluting than the physical capital that it replaces. But in order to ensure the environmental benefits are realized, this burst of new investment needs to occur in an atmosphere of strong environmental standards.

Without a climate of strong environmental protection, and with declining or flat natural resource prices, the overall impact on the environment is apt to be negative.

Each of these four basic tax systems shifts taxes to those whose earnings are from labor and away from those whose earnings are from capital.

While this shift raises substantial equity questions, it also raises the issue of directing capital investments that move the country economically and environmentally in the wrong direction.

In our economy, only one-quarter of our capital stock is physical capital. The other three-quarters of our capital stock is human capital. Wages reflect a return to human capital investment in education and training.

Studies show that a skilled labor force has more influence in a manufacturer's investment decision to locate in one country or another than the tax rates on capital; therefore, a tax structure that encourages physical capital over human capital investments does not address the potential of three-quarters of our capital stock nor does it encourage expansion of high-growth, energy-efficient and clean industry sectors, or strengthening of our traditional industry sectors that are both reliant on highly skilled labor.

Simply put, these four tax proposals do not achieve the goal of a high-wage, clean, and energy-efficient economy that will take the United States into the next century.

We recommend that in addition to these proposed reforms, that the Committee examine an alternative, which is not part of the hearing today.

Such a proposal would lessen the tax burden on human capital rather than increasing it. Instead, it would increase the tax burden on consumption of natural capital which these proposals do not.

Under this reform, the United States would encourage what is abundant, human know-how and labor, and would discourage what is scarce, consumption of natural resources.

Such a reform would be better for equity, long-term economic vitality, and the environment.

Thank you for the opportunity to testify.

[The prepared statement follows:]

Ms. Dawn Erlandson
Executive Director
Americans for a Sustainable Economy

Testimony Before the
Ways and Means Committee
U.S. House of Representatives

Hearing on
Impact of Replacing the Federal Income Tax on
Manufacturing and Energy and Natural Resources

July 31, 1996

Good morning, Chairman Archer and Members of the Committee, my name is Dawn Erlandson. I am the Executive Director of Americans for a Sustainable Economy. Thank you for allowing us the opportunity to submit our views. We work to better integrate economic, social and environmental goals, particularly through tax policy.

We believe the Committee's interest in major tax reform is timely. We offer three basic principles which any tax reform proposal should embody, beyond ease of compliance and enforceability. The first principle is equity, meaning that any new tax system should as a minimum retain the progressivity of the current personal and corporate income tax system. This is particularly important given the regresivity of the federal payroll tax and most state tax systems. Secondly, the tax system should promote job creation and rising real incomes for ordinary families as well as foster overall economic vitality. And thirdly, the tax system should encourage protection of the environment and wise use of natural resources.

As we examine the tax options before the Committee, a flat tax, a national sales tax, a value-added tax, and an income tax with an unlimited savings component and their effects on industrial sectors, one potentially positive element stands out. To the extent that all of these options eliminate preferential treatment of and subsidies for the extraction of natural resources, they would provide an important environmental benefit missing from the current tax system. Natural resource extraction has consistently received special treatment not afforded to other industrial sectors. Nonetheless, the environmental advantages of eliminating this special treatment may be more than offset by the advantages to capital-intensive industries, such as mining, that these new alternative systems would create.

The question of whether savings and investment will increase in response to lower tax rates is an open one. The evidence from the US economy in both the 1960s and the 1980s does not demonstrate that high effective tax rates on investment income inhibited investment or decreased national savings, nor does it suggest that investment incentives increased total investment (though they may affect where investment dollars go). The switch to consumption taxes shifts the burden from capital to labor regardless of whether that shift creates additional investment. If the shift encourages investment, there may be some growth advantages to offset negative distributional burdens---provided the investment in physical capital caused by a tax cut to capital is not offset by the reduction in investment in human capital from the labor tax increase.

As a result, these tax systems would favor capital-intensive industries, such as mining and basic materials production, over labor- and knowledge-intensive manufacturing, such as

software and pharmaceuticals. This will move the U.S. economy in the wrong direction, back towards an earlier industrial age based primarily on high levels of investment in physical capital and inefficient use of energy and natural resources, rather than pushing forward into the information age and beyond, in which investment in human capital is the key to economic success. Instead we must position the US to compete in the global economy for high-growth, knowledge-intensive industries that are energy-efficient and clean., while creating more energy-efficient and less polluting production in traditional industry sectors.

If the tax changes discussed today, despite evidence to the contrary, do stimulate increased capital investment then we will have more pollution and greater energy consumption due to increased growth. It is true that new physical capital investment is usually more energy-efficient and less polluting than the physical capital it replaces. But in order to ensure that the environmental benefits are realized this burst of new investment needs to occur in an atmosphere of strong environmental standards. Without a strong climate of environmental protection and with declining or flat natural resource prices the overall impact on the environment is apt to be negative. And the recent emergence of incentives offered by some electric utilities to consumers for increased consumption of electricity.

Each of the four tax systems we are looking at today shifts taxes to those whose earnings are from labor and away from those whose earnings are from capital. While this shift raises substantial equity questions that should be addressed in another hearing, it also raises the issue of directing capital investments that move the country economically and environmentally in the wrong direction.

In our economy, only one quarter of our capital stock is physical capital. The other three quarters of our capital stock is human capital. Wages reflect a return to the human capital investment in education and training. Studies show that a skilled labor force has more influence in a manufacturer's investment decision to locate in one country or another than the tax rates on capital; therefore, a tax structure that encourages physical capital over human capital investments does not address the potential of three quarters of our capital stock nor does it encourage expansion of high-growth, energy-efficient and clean industry sectors or strengthening of our traditional industry sectors that are both increasingly reliant on highly skilled labor.

Simply put, these four tax proposals before the Committee today do not achieve the goal of a high-wage, clean, and energy-efficient economy that will take the United States into the next century. We recommend that in addition to these proposed reforms that the Committee examine an alternative tax proposal not part of the hearing today. Such a proposal would lessen the tax burden on human capital rather than increasing it. Instead, it would increase the tax burden on consumption of natural capital (e.g. fossil energy and minerals), which these proposals do not. Under this reform, the United States would encourage what is abundant, human know-how and labor, and would discourage what is scarce, consumption of natural resources. Such a reform would be better for equity, long-term economic vitality, and the environment.

Thank you, again, for the opportunity to share our views.

Chairman ARCHER. Thank you, Ms. Erlandson.

Our next witness is Brent Blackwelder, and if you would identify yourself for the record, you may proceed.

STATEMENT OF BRENT BLACKWELDER, PRESIDENT, FRIENDS OF THE EARTH

Mr. BLACKWELDER. Yes. I am Brent Blackwelder, president of Friends of the Earth, United States. We are part of Friends of the Earth International with member groups in 54 countries. Some of our affiliates are very interested in tax reform and Tax Code changes.

I have four basic points to make in summarizing my statement.

One is we think that there are three conditions under which any tax shift, or tax reform, ought to be judged. One is, Is it improving the quality of life and standard of living?

Second, Is it creating more and better jobs?

Third, Is it producing a clean environment for our children, and our children's children?

The present Tax Code—my second point—is not friendly toward these conditions. In particular, the Tax Code seems to reward short-term exploitation, and in a report which we did and submitted to the Committee last year called Dirty Little Secrets, we itemized 15 tax breaks, not for business as a whole, but for certain businesses, which cause extensive environmental damage, or create large amounts of pollution.

And we suggested these tax breaks ought to be eliminated so as to have a more level playingfield for innovation, and alternative approaches to the energy sources on which we would run our economy.

So we do need to make some changes in the Tax Code and we are supporting an option and an alternative.

So my third point is that instead of the proposals pending before us for this hearing, consumption tax, a value-added tax, a flat tax, which tend to treat consumption uniformly, we need a different approach to consumption, which I would call an ecological tax shift.

Not all forms of consumption are the same. Certain forms of consumption cause extensive pollution or problems for other people. They have unintended side consequences or they involve lots of externalities.

We have an opportunity with an ecological tax shift to put more of the burden on these and really send a price to consumers that reflects those burdens and costs, the pollution and health consequences.

If we did the ecological tax shift, we could substantially improve the functioning of our economy and our society and meet these three conditions I laid out; improve the quality of life, create more jobs, and create a cleaner environment.

So the final point is that this idea of an ecological tax shift is not an extreme or far-out proposal. Rather, it is one which we find support for in the President's Council on Sustainable Development report.

We find it also occurring in Europe, where Sweden already enacted, 5 years ago, an ecological tax shift, reducing income tax, but putting more tax burden on carbon and on sulfur dioxide. Other countries in Europe have embraced this, including the German Ministry of the Economy.

And so we see, now, the possibility, if the United States could take the leadership, for revising our Tax Code in a way that would meet these conditions, and is different in approach from the pending proposals, flat tax, consumption tax, and others.

So this is the kind of approach which we have outlined in our testimony, and we would urge the Committee to consider.

[The prepared statement and attachments follow:]

Statement of

Brent Blackwelder
President
Friends of the Earth

prepared by
Brian S. Dunkiel
Director of Tax Policy
Friends of the Earth

On Behalf of

Friends of the Earth

Before the

Committee on Ways and Means
United States House of Representatives

Hearing on
The Effects of Fundamental Restructure of the Tax Code on the Domestic Manufacturing Industry and on Energy and Natural Resources

July 31, 1996

Introduction

Mr. Chairman and Members of the Committee, Friends of the Earth is a global environmental advocacy organization with organizations in 54 countries. On behalf of Friends of the Earth, I thank you for the opportunity to testify before you today. Through hearings like this we hope that the critical link between tax policies and the environment will be acknowledged and respected. Friends of the Earth urges you and this Committee to recognize that tax policy has profound impacts on environmental quality.

To begin, my comments focus on the effects a consumption tax will have on environmental quality, because most discussions and proposals have focused on a shift from an income-based tax to a consumption-based tax in the form of a flat tax. A discussion on how ecological tax reform will better serve the public's interest will follow.

Friends of the Earth supports tax reform that ensures progress toward three compatible and critical goals:

i. **an increase in the standard of living for American families,**
ii. **more, better paying jobs,** and
iii. **cleaner air and water for our children and our children's children.**

For the sake of our environmental and economic well-being, we believe that any tax reform proposal must be measured against its ability to meet these three goals. Moving toward these three goals together will move us toward a truly Sustainable America.[1]

Unfortunately, the flat tax, which has garnered so much public attention, the national sales tax and the value added tax proposals would all fail when measured against this three-pronged

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[1]See the attached pages from Sustainable America: A New Consensus for Prosperity, Opportunity, and a Healthy Environment.

criteria. Friends of the Earth believes that these proposals will not ensure environmental sustainability, will not improve standards of living, and will not create better jobs.

Borrowing from Future Generations

Persuasive evidence exists that today's lifestyles are dependent upon borrowing from future generations. The threat encompasses more than the federal government's level of debt. For example, the United States ranks last among industrialized nations in the fraction of Gross Domestic Product (GDP) devoted to investment and savings. Economists say our saving rate is so low that it risks a strong economic future for our children. Similarly, our current behavior is contributing to a mounting environmental debt that will compromise the future. For example, the U.S. ranks first among industrial nations in emitting pollution that contributes to global warming. Scientists tell us that our present CO2 pollution rate threatens the fundamental health of the global environment.[2] *Present generations are unfairly borrowing from future generations' economic and environmental well being.*

How do these facts relate to tax reform? They are critical to tax reform because the single largest influence on the health of the environment is the federal government's budget and how the government collects revenue to fund the budget. All too often the Tax Code and government spending subsidize activities that harm the environment. In fact, the Tax Code is often in direct conflict with our environmental laws' laudable goals. In effect, we take one step toward cleaning up our nation's air and water by passing strong environmental laws, and then we take two steps back by subsidizing industries and behaviors that pollute. This is why Friends of the Earth focuses on tax policy and government appropriations.

Criteria to Evaluate A Tax Shift

Friends of the Earth suggests that any proposal to make fundamental changes to the Tax Code should be evaluated based on the goals listed above. Let me elaborate.

First, tax reform should **increase the standard of living for American families**. The standard of living of most Americans has stagnated during the past two decades. Traditionally, three general ways have been used to measure standard of living: earning power, purchasing power and individual worker productivity. The U.S. has lost its lead in the first and is losing its lead in the other two. Unfortunately, these measures give only a crude indication of how well each nation lives. There are severe problems with measuring a nation's well-being by productivity alone. When one considers exactly how each nation spends its Gross Domestic Product, the weakening of the U.S. position in the world becomes even more apparent. GDP contains contradictory goods and services. For example, it includes the production of cancer-causing pollutants as well as cancer-curing medicines. *The Tax Code should not treat all production equally. Production that increases the standard of living of American families should be favored over those that decrease it.*

Second, tax reform should **create more, better paying jobs**. Worker's wages have been falling. Median family income fell in every year from 1989 to 1993. Under the present Tax Code that treats all production uniformly, worker wages continue to fall despite the fact that GDP and corporate profits continue to rise.[3]

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[2]On average, 19.5 metric tons of CO2 are emitted per person in the United States each year. This compares with 7.3 metric tons for Europe and the 1.7 metric tons scientists predict necessary to hold global warming in check. With less that one-twentieth of the world's population, we manage to use more than one-third of its annual energy production.

[3]See the attached graphs from the U.S. Bureau of Labor Statistics that contrast the fall of production worker wages and the fall in manufacturing jobs with the rise in GDP. Note also the data from the Organization for Economic Cooperation and Development that graphs the increase in corporate profits in the corresponding time period.

Big government is a popular scapegoat for the erosion of income levels. Representative Armey asserts that people are working harder and getting less because government is taking a bigger bite out of their paycheck. But, in reality, it is pre-tax pay that has decreased. According to the Congressional Budget Office, the effective federal tax rate on the middle class is stable or declining. *We believe that the way to create more and better jobs requires looking beyond how much we tax to what we tax. Tax reform that stops subsidizing pollution and encourages work by decreasing the tax rate on labor and shifting the tax onto pollution would improve family wages.*

Finally, we must improve upon our environmental performance, and tax reform should give us **cleaner air and water for our children and our children's children**. The Tax Code should encourage economic development in ways that protect our shared natural wealth. Clearly, the economic growth we promote must not create irreparable environmental harm. *A shift in the Tax Code needs to halt the current and deep subsidy to sectors of the economy that degrade the environment. A new Tax Code should discourage dependence on fossil fuels and polluting industries.*

A fundamental and well-understood flaw of market-based economies is their failure to reflect the true costs of many products, services and activities. A large portion of "true cost" includes adverse impacts on the environment and on public health. Without higher prices to serve as "red flags," warning consumers of these hidden costs, environmental quality will continue to grow worse. *The Tax Code is perhaps the most efficient way to introduce red warning flags to guide buying decisions away from environmentally destructive and towards environmentally benign goods and services.*

Friends of the Earth believes that any plan to reform the Tax Code should be evaluated based on how well it meets these three important goals. Although our comments are not directed to any specific tax reform proposal, we believe it is clear that all the consumption-based tax plans that treat all consumption uniformly fail to meet these goals. We urge this Committee to adopt these criteria as their own and to thoroughly explore whether specific proposals would accomplish each of these goals.

When evaluating tax reform, we understand it is also necessary to keep in sight additional policy issues. These issues might include fairness, deficit reduction, budgetary requirements, simplicity and other policy reforms. We believe Tax Code reform that promotes the three goals cited above could be crafted to meet these needs as well.

An Evaluation of the Uniform Consumption-Based Tax Proposals

Friends of the Earth believes that the current proposals for a flat tax, a value-added tax and a national retail sales tax are all variations of a tax on consumption. Each effectively exempts investment or capital income from the tax base. To ensure that we are clear, the Chairman's consumption tax plan, Representative Army's flat tax proposal and Senator Domenici's U.S.A. tax are all versions of a consumption tax.[4] Therefore, our comments will focus on how a consumption tax, as defined broadly by these proposals, would impact the environment.

Would any of the consumption taxes proposed advance the three goals?

No. All of these proposals treat all forms of consumption uniformly; consumption patterns that pollute the air and water, deplete non-renewable resources and threaten public health are on par, in these proposals, with those that conserve resources, promote new, green technologies, reduce or recycle wastes and otherwise protect our natural heritage. With that environmental blind eye, none of these plans will help to create an environmentally sustainable economy or raise the standard of living of American families. In fact, they allow the present downward spiral to continue, effectively ensuring lower worker wages and environmental destruction. None of the

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Congressman Gephardt's tax reform proposal is not included in this list because it is calls for a flat income-based tax. However, like the consumption tax proposals, Representative Gephardt's would continue to subsidize environmental damage and the dirty industries of the past.

consumption tax proposals would make significant strides to increase the standard of living of American families. All fail to restructure the economy for the next century.

Because all investment is treated as though it has the same social value, investments into more efficient, cleaner technologies is not encouraged. Some might view a flat tax as benefitting the environment, if it eliminated all the tax breaks in the present Tax Code that reward investment into environmentally destructive activities.[5] On one level, that would, in fact, be an improvement. *However, a flat tax still misses important opportunities to improve Americans' quality of life, because it leaves unchanged the existing anti-sustainability bias in the Tax Code.*

A flat tax would also fail to encourage the type of investments needed to prepare society for the future. For example, under a flat tax, the purchase of an automobile and money spent on education would be treated equally. Both are consumption. Studies consistently show that quality of life is critically linked to education level, but no signal exists to remind the consumer that to invest in education maybe more desirable for the individual, the economy and society.

Some policy makers argue that increased saving and investment alone will relieve stagnant wages, and a consumption tax would encourage saving and investment. However, we find conflicting economic statistics on this point. For example, in the early 1980s historically low taxes on savings were accompanied by historically low savings rates. We believe that more is needed than increased savings rates to improve economic well-being.

Again, the consumption tax proposals before us today treat all forms of production uniformly whether or not they harm the environment. Therefore, under these proposals, unfair and unwise destruction to the environment will still be encouraged. Unfair subsidies for unsustainable fossil fuel usage, for polluting industries, and for activities that dirty our air and water will continue. This means that the oil wasted through leaks, spills and inefficiency that studies show is equivalent 1,000 Exxon Valdez oil spills per year will continue to be subsidized. *Unwise subsidies for the development of the dirty industries of the past would continue, and an opportunity to encourage the cleaner industries of the future will be missed.*

Without a visionary level of Tax Reform, industries will continue to invest in technologies that produce waste and pollution. The Tax Code will continue to be at odds with environmental laws, leaving command and control regulations as the only line of defense for the environment and public health. While a handful of market signals have been created to warn industry that certain polluting and depleting activities entail heavy societal costs, *our Tax Code, for the most part, continues to foster rather than stem the types of behavior that our environmental regulatory programs struggle to control. The consumption tax proposals before this Committee today do not correct that fundamental flaw in the existing system and therefore, fail to secure a cleaner and healthier environment for our children and our children's children.*

An Ecological Tax Shift Satisfies the Three Criteria

In contrast to the proposals before you, a sustainable and ecological tax shift would be simple, fair, efficient and environmentally sound. Ecological Tax Reform, a form of a consumption tax, would raise the revenue necessary to fund government operations while working to accomplish crucial societal goals. In a nutshell, ecological tax reform (ETR) shifts taxes off employment to stimulate job growth and onto pollution to correct market failure. ETR can tackle three problems at once while raising the same amount of revenue as under the present Tax Code. *ETR can create better jobs, encourage wiser use of our natural resources and foster economic efficiency. This means a higher standard of living for American families.*

A fundamental tenet of a system like ours is that product demand is frequently based on price. As a product's price increases, demand for that product generally decreases. Capitalizing on that rule, ETR taxes products that harm the health of society, so that the price for products

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The attached Friends of the Earth report entitled, Dirty Little Secrets, exposes fifteen tax breaks that subsidize wealthy corporations' environmentally destructive activities.

that are good for society are comparatively cheaper. In effect, ETR removes the subsidies prevalent in the current Tax Code that foster unwise consumer decisions by using prices as a red flag to warn consumers that a particular product is harmful.

Ecological tax reform would create more, better paying jobs because the Tax Code would stop subsidizing waste and start encouraging work. As mentioned earlier, these days we often hear complaints about the economy's performance. Workers' wages are stagnant. There are jobs, but they do not pay well. Often households with two workers are not doing as well as those in the past with only one wage earner. American workers are frustrated. One part of this problem is that the present Tax Code taxes labor, and by making labor more expensive, discourages what is beneficial to society, the availability of good paying jobs.

We believe that a tax shift should favor investment in human capital. By reducing the tax burden on labor, ETR would encourage more labor which, in turn, will create more better paying jobs. Reducing the tax burden is also important as we head into the next century and the era of an information based economy. The developing economy will be more service oriented and therefore human labor intensive. It is in our interest to adapt to and encourage this economic change.

The Tax Code is often used to encourage activities allegedly in the public's interest. For example, long ago the government chose to provide favorable tax treatment to investments associated with resource extraction. By giving corporations that undertake these activities a tax break, the government intended to encourage more mining or oil exploration. The subsidies, however, have long outlived their societal benefit, and we believe it is time for Congress to recognize that an economy well prepared for the next century will not be based on polluting industries of the past. Therefore, these activities of the past should no longer receive favorable tax treatment. *A 21st century tax shift should favor an investment in human capital, education and technical job training, not activities that use up or destroy limited natural resources.*

This Committee should be aware that many other nations appear to be embracing an ecological type of tax reform. In fact, it appears that acceptance of an ecological tax shift might reach beyond political affiliation. In the United Kingdom, for example, both the Labour Party and the Conservative Party have recognized the merit in shifting taxes off labor and onto waste. In addition, Switzerland, Denmark and Sweden are introducing pollution taxes as part of their overall tax restructuring.

For the United States to implement a flat consumption tax that is blind to environmental impacts risks our economic and environmental health and surely will be recorded as a policy folly of monumental proportions.

Conclusion

The primary flaw of the consumption tax proposals before you is that they continue the unwise economic policies of the past. These tax plans would continue to prop up the environmentally destructive industrial sectors that do not offer the jobs of the future. In the duration, the new business sectors that do offer the jobs of the future compete at a distinct disadvantage with the firmly established industries still receiving tax breaks. By failing to tax environmentally damaging activities at a higher rate than desirable ones, all of these tax shift plans miss an important and unique opportunity to create an environmentally sustainable economy or improve our standard of living.

An ecological tax shift, another form of a consumption tax, would encourage wiser savings and investment, foster an environmentally sustainable economy and raise the standard of living of American families.

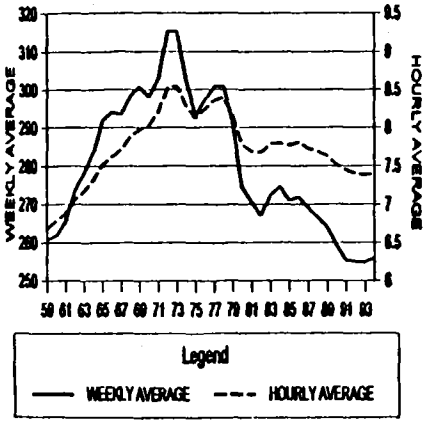
In closing, we urge this Committee to accept as your own the following criteria to evaluate any proposal for tax reform.

- **an increase in the standard of living for American families**
- **more, better paying jobs,** and
- **cleaner air and water for our children and our children's children.**

Again, thank for the opportunity to testify today. We look forward to working with you on these important issues.

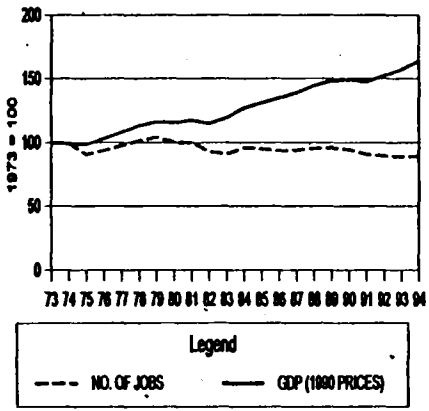
US: PRODUCTION WORKERS WAGES FALL

(IN 1982 US DOLLARS)



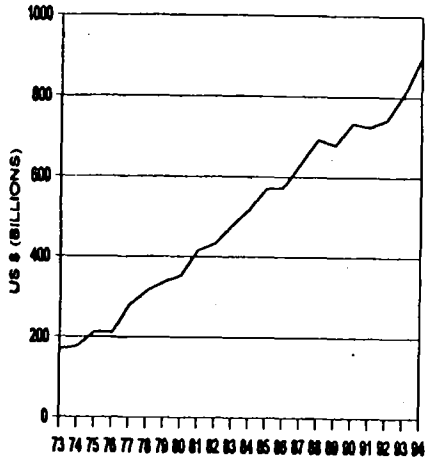
Source: *US Department of Labor, Bureau of Labor Statistics.*

US: EMPLOYMENT IN MANUFACTURING FALLS AS GDP RISES



Source: *US Bureau of Labor Statistics, and the International Monetary Fund.*

US: CORPORATE PROFITS RISE



Source: *Organization for Economic Cooperation and Development.*

Definition and Vision Statement

DEFINITION OF SUSTAINABLE DEVELOPMENT

". . . to meet the needs of the present without compromising the ability of future generations to meet their own needs."

— The World Commission on Environment and Development (The Brundtland Commission), *Our Common Future* (Oxford: Oxford University Press, 1987), p. 43

VISION STATEMENT

Our vision is of a life-sustaining Earth. We are committed to the achievement of a dignified, peaceful, and equitable existence. A sustainable United States will have a growing economy that provides equitable opportunities for satisfying livelihoods and a safe, healthy, high quality of life for current and future generations. Our nation will protect its environment, its natural resource base, and the functions and viability of natural systems on which all life depends.

— The President's Council on Sustainable Development

We Believe Statement

There are certain beliefs that we as Council members share that underlie all of our agreements. We believe:

1 To achieve our vision of sustainable development, some things must grow — jobs, productivity, wages, capital and savings, profits, information, knowledge, and education — and others — pollution, waste, and poverty — must not.

2 Change is inevitable and necessary for the sake of future generations and for ourselves. We can choose a course for change that will lead to the mutually reinforcing goals of economic growth, environmental protection, and social equity.

3 Steady progress in reducing disparities in education, opportunity, and environmental risk within society is essential to economic growth, environmental health, and social justice.

4 The United States made great progress in protecting the environment in the last 25 years, and must continue to make progress in the next 25 years. We can achieve that goal because market incentives and the power of consumers can lead to significant improvements in environmental performance at less cost.

5 Economic growth based on technological innovation, improved efficiency, and expanding global markets is essential for progress toward greater prosperity, equity, and environmental quality.

6 Environmental regulations have improved and must continue to improve the lives of all Americans. Basic standards of performance that are clear, fair, and consistently enforced remain necessary to protect that progress. The current regulatory system should be improved to deliver required results at lower costs. In addition, the system should provide enhanced flexibility in return for superior environmental performance.

7 Environmental progress will depend on individual, institutional, and corporate responsibility, commitment, and stewardship.

8 We need a new collaborative decision process that leads to better decisions; more rapid change; and more sensible use of human, natural, and financial resources in achieving our goals.

9 The nation must strengthen its communities and enhance their role in decisions about environment, equity, natural resources, and economic progress so that the individuals and institutions most immediately affected can join with others in the decision process.

10 Economic growth, environmental protection, and social equity are linked. We need to develop integrated policies to achieve these national goals.

11 The United States should have policies and programs that contribute to stabilizing global human population; this objective is critical if we hope to have the resources needed to ensure a high quality of life for future generations.

12 Even in the face of scientific uncertainty, society should take reasonable actions to avert risks where the potential harm to human health or the environment is thought to be serious or irreparable.

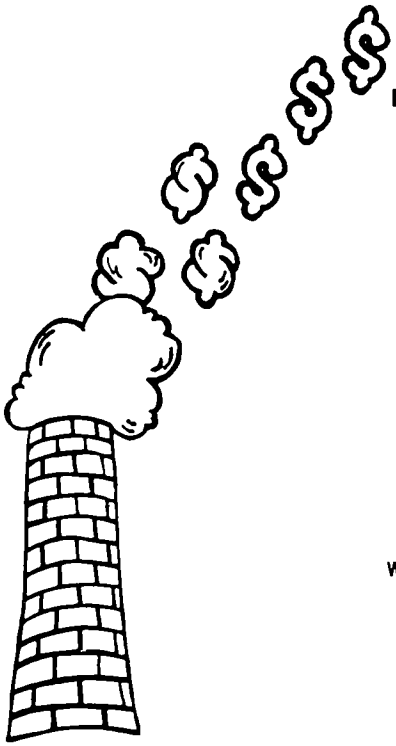
13 Steady advances in science and technology are essential to help improve economic efficiency, protect and restore natural systems, and modify consumption patterns.

14 A growing economy and healthy environment are essential to national and global security.

15 A knowledgeable public, the free flow of information, and opportunities for review and redress are critically important to open, equitable, and effective decisionmaking.

16 Citizens must have access to high-quality and lifelong formal and nonformal education that enables them to understand the interdependence of economic prosperity, environmental quality, and social equity — and prepares them to take actions that support all three.

Dirty Little Secrets



Polluters save while people pay: exposing 15 of the tax code's most unfair tax breaks

by Friends of the Earth

With support from Citizens for Tax Justice, Natural Resources Defense Council, Progressive Policy Institute, U.S. Public Interest Research Group, and The Wilderness Society

April 1995

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Agribusiness:		
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Pigs in a Poke: Dairy and Livestock Expensing	18	$700
Polluting Industries:		
Up in Smoke: Tax Exempt Bonds for Incinerators	19	$900
Cloaking Profits: Publicly-Traded Limited Partnerships	20	n/a
Spoils of Spills: Pollution Deduction	21	n/a
Sources	22	
TOTAL SAVINGS		**$22,200**

Overview

This report is dedicated to the millions of Americans who diligently pay their taxes and hope the government will spend them wisely. No one enjoys paying taxes. But Americans have a right to expect that taxes are spread equitably, that the same rules apply to everyone, and that everyone has to pay for the services tax dollars provide.

Close inspection, however, reveals that some taxpayers are paying less than their fair share. Through powerful lobbying, polluters have carved out special treatment in the tax code. What they do is not illegal, but it is unfair. It is also a disaster for the environment and human health.

In Washington, politicians are clamoring for a balanced budget and "an end to welfare as we know it." The face of welfare has been that of the poor, but Secretary of Labor Robert Reich has offered another face: that of rich corporations. He has challenged Washington to "ask Corporate America to get off welfare and play by the rules as well."

Friends of the Earth has accepted the challenge. In January, we published *The Green Scissors Report* with other environmental and taxpayer groups. The report called for the elimination of 34 federal programs that harm the environment and cost the taxpayers $33 billion. *Dirty Little Secrets* addresses the other side of government spending -- tax expenditures.

"Tax expenditures" are a form of government spending. They are special exclusions, deductions, credits and other tax breaks that result in lost government revenue. Many of these tax breaks serve worthwhile public purposes, but the breaks cited in this report undermine the public good. Not only is the government subsidizing environmental degradation, but average citizens must make up for the lost revenue by paying higher taxes or suffering under the burden of increased national debt. In effect, they function as a reverse Robin Hood, taking from average working people and giving to rich, polluting businesses.

Every year, these polluting tax subsidies cost taxpayers close to $4.5 billion each year. What could the government do with $4.5 billion a year? If these subsidies were eliminated, the resulting revenue would equal all federal income taxes paid by close to 13 million low-income taxpayers, about 1 in 9 taxpayers. The revenue gained from cutting these subsidies could also roughly offset all federal income taxes paid by the citizens of Kansas. Or Oklahoma. Or Iowa. Or New Mexico and West Virginia. Or Arkansas and Montana.

Too long the domain of corporate lobbyists and tax lawyers, tax policy must be made more equitable and reclaimed by the people.

Close Up Polluter Loopholes

This report calls for the elimination of tax subsidies that:

* **conflict directly with federal health and environmental policies.** It makes no sense to subsidize pollution that the federal government and the private sector spend billions of dollars a year to clean up.

* **subsidize practices that harm the environment and human health.** For example, the federal government currently taxes the production of most chemicals that destroy the stratospheric ozone layer like chloroflourocarbons (CFCs) and halons. However, two types of ozone-depleting chemicals are slipping through. Methyl bromide and HCFCs are not taxed despite international agreements and EPA action to eliminate them. These chemicals contribute to an increase in the sun's harmful rays that can cause skin cancer and threaten the health of sensitive ecosystems such as coral reefs.

* **favor declining, polluting industries over growing, clean industries.** These tax subsidies hurt competition. They lock-in dinosaur technologies, such as coal-fired electricity, and make it harder for new, cleaner, more efficient technologies such as solar or wind energy, to take hold and compete. Also, subsidizing the logging and extraction of virgin minerals makes recycling and pollution prevention less competitive.

* **distort market decisions about investments.** Tax subsidies undercut the normal market pressures for firms to become more efficient. They weaken America's overall economic prospects by placing every unsubsidized sector and firm at a disadvantage. Tax subsidies substitute political micromanagement for normal market forces that govern the allocation of capital. They encourage more rapid depletion of our scarce natural resources.

* **exacerbate the federal budget deficit.** These tax breaks drain the treasury of revenue year after year. They operate like entitlements, unchecked with no spending limits.

* **benefit the few at the expense of the many.** To pay for these tax loopholes, the rest of us, both individual and corporate taxpayers, have to pay higher taxes. Furthermore, the beneficiaries of these special tax favors are rarely low- and middle-income working people but usually wealthy investors.

The Tax Code Plays Favorites

The industries most responsible for polluting our environment and depleting our natural resources are the beneficiaries of special tax treatment. In stark contrast, tax benefits are rare for clean industries, or even for better practices within polluting industries. Studies have found that extractive and polluting industries such as coal mining, petroleum and natural gas, and hardrock mining industries have lower effective tax rates than other industries. The effective tax rate is the tax rate on actual profits.

Incredibly, this coddling of polluters in the tax structure exists alongside a comprehensive set of federal laws that seek to maintain clean air, water, and soil and preserve species of plants and animals. It appears that one hand of government does not know, or has chosen to ignore, what the other hand is doing.

This report is not comprehensive.[1] More research would almost certainly find additional

[1] For reasons of brevity and uncertainty, a number of issues are not addressed in this report. One major example is the case of ethanol. Great controversy surrounds the overall environmental impact of ethanol on the environment. In fact, Friends of the Earth is party to a lawsuit that would require the Treasury Department to issue an Environmental Impact Statement relating to the extension of ethanol tax breaks to ETBE, an ethanol derivative. In the meantime, this report does not target the generous tax subsidies for the production of ethanol. In addition, this report does not address several environmentally damaging tax breaks that broadly benefit many Americans: for example the treatment of employer-provided parking benefits as tax-free fringe benefits. These provisions need reform, but as part of a larger dialogue that assures equity and fairness. This report also does not address the failure of certain industries to fully pay for their use of government services. Examples include fees on the use of our

provisions that are unfair and hurt the environment. That said, simply eliminating these subsidies would be a major step toward greater tax equity and improved environmental protection.

The industries that benefit from special tax breaks for polluting activities are:

* **Chemicals** -- Polluters can write off almost all the costs of cleaning up hazardous substances, including lawyers fees. Companies that spill oil and dump toxic wastes receive this tax subsidy even when the actions are intentional or the result of gross negligence.

* **Mining** -- The industry enjoys outright tax subsidies for mining toxic substances such as lead, mercury, and asbestos. These subsidies can exceed the value of the owner's investment in the mine.

* **Oil & Gas** -- The oil and gas industry enjoys the best targeted tax treatment available to any industry. For example, investors can write off "passive" losses from oil and gas investments but not from investments in other industries.

* **Agribusiness** -- The tax code provides tax breaks to huge, chemical-intensive agriculture without helping small farmers nor promoting sustainable agricultural practices.

* **Timber** -- Special tax benefits for the industry drive up profits but do nothing to promote sustainable forestry. For example, special rules permit timber companies to deduct capital costs immediately while other businesses cannot deduct such costs.

Polluter Welfare: "Get out of the wagon and help pull"

At a time when there are no guarantees of government support for the poor, the young, or the infirm, one might ask whether there should be guarantees of government support for businesses, particularly those that degrade our natural environment and threaten our health.

While federal appropriations provide plenty of "pork" for polluters, at least these expenditures are subject to annual review. Typically, they cost millions of dollars. Polluter "pork" in the tax code, on the other hand, is not subject to annual review. Once a tax loophole is in law, it is more likely to become embedded in the tax code than repealed, thus costing hundreds of millions and even billions of dollars.

In the debate over welfare for the poor, some have made distinctions between the "deserving" and the "undeserving." If there are to be government handouts to business, it is clear that established businesses that pollute the environment do not belong in the category of "deserving."

It is time to end these extensive tax breaks that have produced a culture of dependency. Generations of businesses have grown up dependent upon the public dole rather than upon their own initiative. It is time these businesses took responsibility for their success. Senator Phil Gramm has said during the welfare reform debate that it's time to ask able-bodied men

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highways by heavy trucks and the use of the nation's inland waterway system by commercial barges. Finally, current tax regimes that could be made more environmentally effective are not included, such as Superfund taxes and the tax on gas guzzling automobiles.

and women who are riding in the welfare wagon to get out of the wagon and help the rest of us pull. We believe this sentiment applies to polluters, too.

Throwing Stones

Defenders of these tax breaks will make any number of arguments to defend their special favors. They will say:

This tax relief is needed to maintain the viability of "strategic industries" that are essential to American national security.

The oil industry justifies its tax breaks this way. Unfortunately, America is reliant on foreign sources of oil to meet roughly half of its current appetite for oil. Given the limited oil reserves in the United States and the pattern of increasing consumption, to believe that we will ever again be self-sufficient is to believe in fairy tales. If reducing American dependence on foreign oil is the true goal, it is more prudent to curb demand, through higher fuel efficiency and fewer miles traveled by car, than to increase supply.

Repealing these tax breaks will cost jobs.

Many of the industries receiving tax breaks are actually very poor job-producers. They are relatively capital-intensive and produce fewer jobs per dollar of investment than other unsubsidized industries. For example, oil and gas extraction produces 7.02 jobs per million dollars invested, coal mining produces 12.88 jobs, and other mining produces 13.51 jobs. By comparison, health services produce 23.15 jobs per million spent, construction produces 20.97 jobs, and transportation and communications produce 16.37 jobs.

Our business is uniquely risky, and so these tax breaks are needed to attract investment.

Investing in oil and gas exploration is risky; however, tax policy should not promote pollution over stewardship. In reality, the major effect of these special industry entitlements is to divert capital to politically well-connected businesses at the expense of their less politically influential competitors. For example, staff size of the American Petroleum Institute, the big oil trade association, is about 470 people while the staff size of the Solar Energy Industries Association is 30 persons.

There are tax breaks that help the environment, too.

Targeted tax breaks to assist clean, infant technologies to gain a foothold and grow bear some merit. They are transition assistance, not permanent subsidies. In addition, they may be necessary to meet the goals of national environmental legislation as well as international environmental commitments. Removing the subsidies for the polluting competition is important as well and lessens the need for "clean" tax subsidies. Clean technologies, unlike the dirty ones they replace, provide environmental and technology benefits that flow to the public and not the firms that receive the tax break. Studies show that previous tax breaks for renewable energy, for example, were necessary for the development of renewable energy technologies that now are quickly becoming competitive with coal-fired electrical generation.

Eliminating these tax breaks is tantamount to raising taxes.

Tax subsidy reforms are not tax increases. As Senator Bill Bradley noted, "spending is

spending whether it comes in the form of a government check, or in the form of a special exception from the tax rates that apply to everyone else. Tax spending does not, as some pretend, simply allow people to keep more of what they have earned. It gives them a special exception from the rules that oblige everyone to share in the responsibility of our [government]". Nothing is free, including a tax break. Someone has to pay for it.

The Challenge Ahead

In 1996, the federal government will spend approximately $450 billion through special tax breaks. In comparison, total collected revenues amount to about $1.3 trillion. This means that for every dollar the federal government collects, it gives back about 35 cents through loopholes and special tax breaks. This report does not suggest that all of these tax breaks should be revoked. We do believe, however, that in their zeal to cut the federal budget, the Administration and Congress -- especially members of the powerful House and Senate tax committees -- have not adequately examined the Internal Revenue Code.

Tax policy is a rarefied, obscure realm. Much of tax policy is very complicated, not to mention boring. Yet it is too potent to be ignored. Seemingly trivial provisions or phrases can mean billions of dollars in revenues. Over the years, tax bills have been a playground for powerful special interests. Over the last few decades, a $13 billion industry of tax lawyers and accountants has emerged to promote and exploit the loopholes and inequities of the tax code as well as enforce the law, according to the Tax Foundation.

With all these forces conspiring to protect polluters, cutting polluter subsidies out of the tax code will be a daunting challenge indeed. The hope lies with the American people. Only if citizens become savvy and speak out about how our tax system contributes to planetary degradation will we wrest control of the tax code from the lobbyists, tax lawyers, and dependent businesses.

We cannot release this report without putting it in context of what is happening on Capitol Hill. The House of Representatives completed its Contract with America by passing the "crown jewel," a massive tax cut. If enacted into law, the House Republican tax plan would undo many of the tax reforms passed in 1986. These reforms eliminated tax shelters while bringing down tax rates. The House Republican bill would bring back the days of massive tax shelters and no-tax corporations. The bill calls for large cuts in capital gains taxes, elimination of the corporate Alternative Minimum Tax, and accelerated write offs for investment in capital equipment. These changes, by and large, would particularly benefit resource and capital intensive industries such as oil and gas and timber.

Gold Diggers: Percentage Depletion Allowance

PROPOSAL: Eliminate the percentage depletion allowance for mining operations. This would save $2.8 billion over five years according to the Congressional Joint Committee on Taxation.

BACKGROUND: The percentage depletion allowance, first codified early in this century, is based on the idea that as minerals are extracted, the mine is worth less. The percentage depletion allowance permits mining companies to deduct a certain percentage from their gross income to reflect the mine's reduced value over time. However, instead of allowing deductions that reflect the actual loss of value, the percentage depletion allowance allows mining companies to deduct a fixed percentage of gross income. The percentages range from 22 percent allowance to a 5 percent allowance, depending on the mineral. For example, clay, sand and gravel receive 10 percent while uranium, sulphur, and lead get 22 percent. This fixed deduction often bears no resemblance to the actual lost value or to the amount of investment. In fact, the money that mining companies recoup through this tax subsidy generally exceeds the total investment in the property. In other words, the public provides more investment than the owner.

TAXPAYER ARGUMENT: The billions of dollars the percentage depletion allowance costs directly benefits the mining industry and burdens taxpayers and the environment. Average taxpayers must pay taxes on things such as college fellowships and telephone ownership to pay for tax breaks to bolster the profits of mining interests. Such a large subsidy also distorts the market for minerals and other extracted resources, providing financial incentives for mining and drilling regardless of the real economic value of the resource. The result is overinvestment and poor allocation of resources.

ENVIRONMENTAL ARGUMENT: The percentage depletion allowance makes a mockery of the notion of conservation. The subsidy encourages wanton mining regardless of the true economic value of the resource. The result is more tailings piles, scarred earth, toxic byproducts, and disturbed habitats.

Ironically, the more toxic the mineral, the greater the percentage depletion allowance subsidy is. Mercury, zinc, uranium, cadmium and asbestos are among the minerals that receive the highest percentage depletion allowance while less toxic substances have lower rates.

In many instances, this tax break creates absurd contradictions in government policy. For instance, federal public health and environmental agencies are struggling to come to grips with a vast children's health crisis caused by lead poisoning. Nearly nine percent of U.S. preschoolers, 1.7 million, have lead poisoning. Federal agencies spend nearly two hundred million taxpayer dollars each year to prevent lead poisoning, test young children, and research solutions. At the same time, the percentage depletion allowance subsidizes the mining of lead with a 22 percent depletion allowance.

Money for Mining: Expensing Exploration & Development

PROPOSAL: Eliminate expensing, or immediate write off, for mining exploration and development costs and special capital gains treatment for coal and iron ore. This proposal would save about $675 million over five years according to the Congressional Joint Committee on Taxation and Office of Management and Budget.

BACKGROUND: Section 617 of the Internal Revenue Code (IRC) allows certain costs associated with the exploration and development of mineral resources to be deducted in the year the costs are incurred, rather than over the productive life of the mine. Under normal tax rules that apply to other businesses, such "capital" costs are investments in property like buildings or mines that last more than one year and are written off over time as the property wears out, or is depleted in the case of a mine. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out. The result is that tax bills early in the life of the property, or mine, are lower and consequently save the mining company money.

Exploration and development costs include site location, determination of quality and amount of mineral resource, and construction of shafts and tunnels. Covered minerals include coal, uranium, and hard rock minerals such as lead, gold, copper, and asbestos. Congress enacted immediate write off of mine development costs in 1951 and exploration costs in 1966. In 1982, such expensing for corporations was limited to 85 percent of costs.

The other tax break for for mining companies is Section 631 of the IRC which treats the sale of coal and iron ore as a capital gain. Capital gains are profits reflecting increased values of stocks, bonds, investment real estate, and other "capital," or lasting assets. Under normal tax rules, the sale of coal and iron ore should be treated as ordinary income (e.g. wages, interest), not capital gains income. It is preferable to have one's income treated as capital gains rather than ordinary income because the tax rate on capital gains is lower than the tax rate on ordinary income for well-to-do taxpayers. This special capital gains treatment for coal was granted in 1951.

TAXPAYER ARGUMENT: When combined with other tax subsidies, effective tax rates in the mineral industry are reduced to rates below those of other industries. These tax breaks stimulate increased investment in mining at the expense of other business investments. At the same time, the taxpayer underwrites the risk of exploration rather than the mining company. It is patently unfair to burden average working Americans with higher taxes in order to cut tax bills for mining companies.

ENVIRONMENTAL ARGUMENT: A scarred landscape and polluted water attest to the environmental degradation caused by mining. Over the past 25 years, coal mining has disturbed almost 2 million acres of land, only half of which has been reclaimed to minimum environmental standards. The legacy of hardrock mining has littered 32 states with more than 557,650 abandoned sites. The exploitation of the land caused by mining activities has altered the topography of sites to the extent that they will never be able to be restored to their previous conditions and uses. Strip mining has resulted in landslides, which have scarred more than 3,000 miles of land. Mining related activities have introduced dangerous levels of lead, mercury, iron, and sediment to our water supplies. If there are to be tax breaks for materials, they should be for recycled materials, not extraction of scarce, raw materials.

Play Now, Pay Later: Reclamation Deduction

PROPOSAL: Require that mining companies establish a separate trust fund that is adequately funded and escrowed in order for mine reclamation and closing costs to be deducted immediately. Otherwise, repeal the special rules that allow costs for reclamation to be deducted before they have actually been paid. This provision costs the treasury $200 million over five years.

BACKGROUND: Section 486 of the Internal Revenue Code permits reclamation and closing costs to be deducted immediately when mining begins even though the eventual closing of the mine and reclamation of the mine site will not occur for some time. Without this special provision, general tax rules would require the companies to wait until the mine site is closed, restored, and the costs associated with these activities are paid before the companies can deduct these costs.

This provision was adopted as part of the Deficit Reduction Act of 1984. The stated intent of the provision was to encourage reclamation, but there is no requirement that actual payment into a reclamation and mine closing trust fund actually occur in order to get the tax break, nor even that the reclamation and closing actually occur. Reclamation of coal mining sites is required by the Surface Mining Control and Reclamation Act (SMCRA) of 1977, but is not well enforced. There is no similar reclamation requirement for hardrock mineral sites.

TAXPAYER ARGUMENT: The tax treatment of closing and reclamation costs is flawed for several reasons. The law does not require that a separate trust fund be set up or that funds actually be available when it is time to close and reclaim (clean up) the mine. This exposes funds for mine closing and reclamation to the risk of default as well as claims by creditors in the case of bankruptcy of the mining operator. Simply put, there is no guarantee that there will be money available for clean up or mine closing. In the end, taxpayers may well get stuck paying for closing and reclamation of the mines even though the mining company had already claimed a deduction for mine closing and reclamation.

ENVIRONMENTAL ARGUMENT: The tax code delegates to local authorities the power to control the nature of the reclamation or closing activity, but enforcement has been lax. Since 1977, there have been more than 6,000 coal mines closed but not reclaimed. There are more than 550,000 abandoned hardrock mines. A current deduction without a requirement for a separate trust fund raises the possibility of non-compliance and a deduction for activities that are never performed. Until proper standards exist regarding environmental impacts of mining, no tax subsidy should be available to the industry. According to the U.S. Bureau of Mines, 12,000 miles of rivers have been polluted by mining activities and waste. In California, wastes from one closed mine delivers an average daily dose of 4,800 pounds of iron, 1,466 pounds of zinc, 423 pounds of copper, and 10 pounds of cadmium into the Keswick Reservoir on the Sacramento River, which serves as the source of drinking water for Redding.

Pumping the Tax Code: Percentage Depletion Allowance

PROPOSAL: Eliminate the percentage depletion allowance for independent oil and gas companies. This will save about $2 billion over 5 years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Independent oil companies -- those oil companies that are not substantially involved in retailing or refining activities -- can use a special "percentage depletion" method to write off oil and gas investments. The percentage depletion allowance allows these oil and gas companies to deduct a flat 15 percent of their gross income, or sales revenue, to reflect the declining value of the wells as they are drained. This flat deduction bears little resemblance to the actual loss in value over time and the independent oil and gas companies often end up deducting more than the value of the investment.

Percentage depletion allowances were established by Congress early in this century. In recent years, Congress has gradually pared back the subsidy. Nonetheless, the percentage depletion allowance is still an enormous benefit which serves little purpose other than subsidizing production from certain oil and gas companies.

The 15 percent deduction actually gets bigger for some smaller "marginal production" oil companies. According to current tax law, if the price of oil drops below $20 per barrel, the company can increase its deduction -- one percent for every dollar less than $20 per barrel.

TAXPAYER ARGUMENT: The percentage depletion allowance amounts to a simple production subsidy for the oil and gas industry. The special subsidy benefits certain oil and gas producers to the disadvantage of competitors. The deduction can amount to 100 percent of an operation's net income. In other words, for some companies all profits may be due to government tax subsidies.

The percentage depletion allowance distorts the market by attracting investment that could be used more productively elsewhere in the economy. Because the percentage depletion applies only to independent producers, the subsidy encourages the draining of scarce domestic energy resources. In combination with other subsidies for the oil and gas industry, the percentage depletion allowance subsidy often exceeds 100 percent of the actual value of the energy produced.

The general effect of this subsidy is to promote oil production and energy waste rather than efficiency or conservation. Increased profits for polluters are not the best use of taxpayers' money, especially when the tax breaks encourage overproduction of scarce resources at the expense of clean alternatives.

Tax law has been very generous to the oil and gas industry. It has propped up the industry in the face of stiff competition from cheap, imported oil.

ENVIRONMENTAL ARGUMENT: Oil and gas tax policy has focused on production while doing little to increase energy efficiency throughout the oil and gas system or conservation of petroleum in the transportation sector. The percentage depletion allowance not only drains the treasury but also taxes the environment. It encourages producers to prematurely tap marginally economic oil and gas fields, resulting in the exhaustion of energy reserves and the destruction of environmentally sensitive areas such as estuaries, bays, and wetlands. In addition, the oil and gas industry enjoys special exemptions under our environmental laws including Superfund, the Clean Air and Clean Water Acts, the Safe Drinking Water Act, and the Emergency Planning and Community Right-To-Know Act.

Bad to the Last Drop: Enhanced Oil Recovery

PROPOSAL: Repeal the 15 percent credit for "enhanced oil recovery" and disallow expensing, or immediate write off, of so-called tertiary injectants until proper environmental regulations for the industry are adopted and the current waste and inefficiency in the oil and gas industry are dramatically curbed. These special tax breaks cost the treasury $500 million over 5 years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Section 43 of the Internal Revenue Code provides for a 15-percent income tax credit for the costs of recovering domestic oil by a qualified "enhanced-oil-recovery" method. Qualifying methods involve injecting fluids, gases, and other chemicals into the oil reservoir, and use heat to extract oil that is too viscous to be extracted by conventional techniques. Costs covered by the tax credit include the costs of equipment, labor, supplies, repairs, and injectants. The tax credit was adopted in 1990.

In addition, Section 193 allows for expensing, or immediate write off, of so-called tertiary injectants used in enhanced oil recovery. According to standard tax principles, tertiary injectant expenditures should be written off over the income-producing life of the oil and gas property. Such "capital" costs are investments in property like buildings or oil wells that last more than one year and should be written off over time as the property wears out, or is depleted in the case of an oil well. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out. The result is that tax bills early in the life of the property, or oil well, are lower and consequently save the oil company money. This provision became law in 1980.

These provisions were adopted in order to reduce the costs of producing oil from abandoned reservoirs and to increase the domestic supply of oil. The combined effects of the enhanced oil recovery credit and immediate deduction of tertiary injectants result in a net subsidy due to a negative tax rate.

TAXPAYER ARGUMENT: Oil production in the United States peaked in 1970 and has been declining about 4 percent every year since then. Having depleted our most accessible oil reserves, the U.S. is increasingly a high marginal-cost producer. Reliant on foreign sources for about half of our country's oil needs, it is unlikely that the U.S. can reverse the long-term slide in domestic production and growing dependence on imports, given current trends. Even if subsidies such as the enhanced oil recovery provision do manage to relieve short-term dependency by increasing domestic production, less oil will be available in the longer-term. All of this begs the question of why taxpayers should subsidize production at $30 per barrel when it costs only $18 to buy a barrel of oil on the global market. If and when the price of oil increases due to real or politically-induced scarcity, production from these wells will become economical without subsidy.

ENVIRONMENTAL ARGUMENT: In general, it is environmentally desirable to extract all the oil in a well to avoid waste and seepage. That said, much greater energy savings could be gained by eliminating current waste in the oil and gas industry. Today, the oil and gas industry tolerates a degree of energy waste and pollution that is hard to believe: an energy loss -- through spills, emissions, evaporative loss, venting and flaring, waste generation, inefficient processing, pipeline and storage tank leaks -- that is equivalent to 1,000 Exxon *Valdez* oil spills every year, according to Friends of the Earth's Crude Awakening.

Enhanced oil recovery methods themselves often are bad for the environment. They force oil and sometimes chemical injectants into surrounding surface and groundwater, which can lead to contamination of drinking water, soil, crops, and wetlands. Additionally, reliance on oil imports could be totally eliminated by energy efficiency improvements and aggressive conservation. This would negate the need for enhanced oil recovery in the near future.

Drilling for Dollars: Intangible Drilling Costs

PROPOSAL: Repeal the tax provisions permitting oil and gas producers to immediately deduct "intangible" drilling and development costs (IDCs). Instead, require IDCs to be deducted over time. This reform would raise approximately $2.5 billion over 5 years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Section 263 of the Internal Revenue Code permits integrated oil companies such as Exxon and Chevron to immediately deduct 70 percent of intangible drilling costs (IDCs). IDCs are the costs of wages, fuel, repairs, hauling, supplies, and site preparation. The other 30 percent must be deducted over five years. Under normal tax rules that apply to other businesses, such "capital" costs are investments in property like buildings or oil wells that last more than one year and should be written off over time as the property wears out, or oil is depleted. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out, or the oil is depleted. The result is that tax bills early in the life of the investment are lower and consequently save the oil and gas company money.

Smaller, independent oil and gas producers, who are not involved in retailing or refining activities, can immediately deduct all of their IDCs. In addition, independent producers enjoy special treatment of IDCs under the Alternative Minimum Tax (AMT). The AMT is an alternative tax system that was created to ensure that profitable businesses do not avoid taxation because of extensive write-offs. However, in the case of independent oil and gas producers, the AMT is less effective because write-offs are permitted.

IDCs typically account for 75-90 percent of the costs associated with developing an oil and gas well. When combined with other tax subsidies, the ability to deduct IDCs effectively reduces tax rates on oil and gas producers significantly below tax rates on other industries. Unlike the percentage depletion allowance, this tax break is largely claimed by corporate producers rather than smaller, independent producers.

IDCs were first determined to be immediately deductible in 1916. Since then, various courts have tried to rule that IDCs should be deducted over time, but Congress and precedent have overturned the rulings. Congress justified the special treatment of IDCs in order to stimulate exploratory drilling, which could increase domestic oil reserves and enhance energy security.

TAXPAYER ARGUMENT: According to the Congressional Joint Committee on Taxation, this special treatment of oil and gas expenses effectively lowers income taxes for oil and gas companies to zero, a huge benefit. This tax break erodes fairness in the tax system. While wealthy oil companies save, other taxpayers, including middle class Americans, pay the bill for the subsidy. In addition, this tax break, along with others that promote exploitation of domestic reserves, unnecessarily charges taxpayers in order to "pump up" oil industry profits.

ENVIRONMENTAL ARGUMENT: The oil and gas industry enjoys many special tax breaks, which creates perverse incentives for irresponsible treatment of scarce natural resources and environmentally sensitive areas such as wetlands, estuaries, and bays.

The intended purpose of special tax treatment for IDCs is to encourage domestic oil and gas production in order to curb foreign oil imports. The environmentally sound way to reduce our reliance on foreign oil imports would be to reduce our demand for oil rather than increase our supply. Incentives for increased automobile fuel efficiency and greater use of mass transit and ridesharing are two key steps to lessen our demand for oil.

Lucky Loser: Passive Loss

PROPOSAL: Eliminate the "passive loss" tax shelter for investors in oil and gas. This change would save $665 million over 5 years according to the Office of Management and Budget.

BACKGROUND: The 1986 Tax Reform Act greatly limited the ability of taxpayers to use losses, deductions, and credits from so-called "passive" business investments to offset other income such as salary or portfolio income (e.g. interest, royalties, dividends, annuities, and gains from the sale of investment property). Prior to these changes, taxpayers with substantial sources of income from salaries or portfolio income could eliminate or sharply reduce tax liability by investing in tax shelters. One of the most infamous results of tax sheltering involved commercial real estate. Investors built office buildings for tax purposes even though there was no economic demand for the buildings.

Today, investors have to "materially participate" in a trade or business in order to offset salary and portfolio income with passive losses. A taxpayer "materially participates" in an activity only if he or she is involved in the operations of the activity on a regular, continuous, and substantial basis.

These rules, however, do not apply to oil and gas investments. Passive losses are still allowed to be used to offset other income in the case of investors who have a "working interest" in oil and gas. "Working interest" is defined by the existence of an unlimited and unprotected financial risk proportionate to the oil and gas investment and is a weaker test than "material participation." Congress decided that the financial risk associated with oil and gas investments outweighed the need to clamp down on tax sheltering. At the time, this boon to the oil and gas industry was intended to alleviate the impact of worldwide competition and low prices.

TAXPAYER ARGUMENT: This tax loophole makes oil and gas investments more attractive than other investment opportunities, thus diverting investment capital from more productive activities and distorting sound economic decisions. Oil and gas investors can be less cautious in their investments because losses actually have tax advantages.

With plenty of cheaper oil available to consumers, it does not make sense to prop up expensive domestic production with costly subsidies and special treatment that benefit rich investors at the expense of average working Americans.

ENVIRONMENTAL ARGUMENT: This oil and gas tax shelter attracts investors that might otherwise invest in cleaner, growing industries. In addition, the tax break encourages the overproduction of oil and gas, which has many attendant damaging environmental consequences affecting air, land, water, and soil quality. Streams and rivers have been fouled and beaches coated with oil. Waterfowl and other wildlife have died from spills at sea, and millions of birds have been killed onshore after diving into unnetted waste pits and ponds. Oil products seep through the ground in hundreds of communities across the country, threatening drinking water supplies and depressing property values.

Oil and gas are polluting, non-renewable resources. Tax policy would do better to provide incentives to conserve oil and gas rather than stimulate additional production.

Syn Sins: Nonconventional Fuel Production Credit

PROPOSAL: Repeal the "nonconventional fuel" production credit, except for the capture of coalbed methane from active coal mining and landfills and for clean biomass technologies using agricultural waste and wood. This provision costs the treasury roughly $5.8 billion over 5 years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Section 29 of the Internal Revenue Code provides for a production tax credit of $5.75 per barrel of oil-equivalent for certain types of liquid and gaseous fuels produced from alternative energy sources. These fuels include oil produced from shale or tar sands, synthetic fuels produced from coal, and gas produced from geopressurized brine, Devonian shale, tight formations, biomass, and methane from coalbeds. The credit applies to facilities "placed in service" between 1979 and 1993 and may be claimed through 2002. The credit is available for gas produced from biomass and synthetic fuels produced from coal or lignite until 2007 if the facility is placed in service by 1996. Although set to expire, the "placed-in-service" rule has been extended three times since first enacted.

The credit was originally passed in 1980 as part of the Crude Oil Windfall Profit Tax Act. Its purpose was to provide incentives to increase development of alternative domestic energy resources due to concern over oil import dependence and national security that resulted from the 1979-80 Iran-Iraq war.

TAXPAYER ARGUMENT: In theory, the credit was supposed to lower the costs of producing nonconventional substitutes for imported petroleum. Instead, the credit has distorted fuel markets without displacing imports. With oil prices low and costs of nonconventional fuel production high, the credit has proven ineffective. Total production of nonconventional fuels has not increased since the credit was enacted, according to the Joint Committee on Taxation. So, in effect, the credit has been a windfall for a few producers and a waste of taxpayers' money.

The credit has, however, favored the development of one domestic fuel over another. Due to the generosity of the credit, which at times has equaled the price of natural gas, as well as declining production costs, coalbed methane production has boomed. This increased production has occurred at the expense of conventional natural gas production.

ENVIRONMENTAL ARGUMENT: A remnant of the $88 billion "synfuel" program under the Carter Administration, the Section 29 credit has had unintended environmental consequences. Unfortunately, coalbed methane developers in states such as Colorado, New Mexico, Wyoming, and Alabama have been overlaying a new grid of wells on top of older fields of abandoned oil and gas wells that have not been properly plugged. When new methane wells are drilled, the gas not only moves up the new wells but also can move into underground aquifers and escape through older oil and gas wells and even water wells. The result has been contaminated drinking water and irrigation systems, and even explosions. As a whole, the credit simply adds to the volume of tax-subsidized fossil fuels and the pollution that results from burning them.

This report recommends retaining the credit for certain narrow applications. One is for coal beds that are emitting methane into the atmosphere. When coal beds are opened for mining, methane escapes. Methane is a powerful greenhouse gas that contributes to climate change. A "Section 29" well can trap the methane so that it does not escape into the atmosphere. For this narrow purpose, the credit is useful environmentally and should be retained. A similar situation exists at landfills that emit methane as the rubbish decomposes.

Logging Loopholes: Special Tax Treatment of Timber

PROPOSAL: Require sustainable forest management plans to be adopted before timber companies and investors can receive special treatment. Alternatively, repeal the timber industry's ability to deduct its costs immediately. Instead, require the capitalization of multi-period timber growing costs. In addition, repeal special capital gains treatment for timber sales. These provisions cost the treasury about $2.6 billion over five years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Timberland owners and the forest products industry enjoy special tax benefits, including capital gains treatment of timber income and expensing, or immediate write off, of capital costs.

Timber income has been treated as capital gains since 1944 and thus has been taxed less than other kinds of income. Capital gains are profits reflecting increased values of stocks, bonds, investment real estate, and other "capital," or lasting assets. Under normal tax rules, the sale of timber should be treated as ordinary income (e.g. wages, interest), not capital gains income. This provision benefits richer individual taxpayers who prefer to have income treated as capital gains rather than ordinary income because the tax rate on capital gains is lower than the ordinary income tax rate for well-to-do taxpayers.

"Expensing" of costs to maintain a timber stand has been available since the early 1900s. These costs include silvicultural practices after seedling establishment, disease and pest control, fire protection, insurance, property taxes, and management. Under normal tax rules that apply to other businesses, such "capital" costs are investments in property like buildings or land that last more than one year and are be written off over time as the property wears out or timber is harvested. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out, or before the timber is harvested. The result is that tax bills early in the life of the investment are lower and consequently save the timber company money. In 1986, President Reagan proposed eliminating the bulk of these special benefits, but the Congress rejected the idea.

To receive either of these tax benefits does not require sustainable forestry practices, including replanting a diversity of native species after harvest or allowing natural reforestation. A more sustainable approach would tie receipt of these tax breaks to adoption of a sustainable forestry management plan. At minimum this plan should adhere to the standards of the National Forest Management Act (see 36 cfr 219.19), which calls for the viability of all native tree types and native wildlife and limits clearcutting. Ideally, selective cutting should be adopted.

TAXPAYER ARGUMENT: Unlike other businesses, timber producers are able to deduct costs before the product, in this case, timber, is sold. This gives timber producers an interest-free loan from the government and effectively reduces their tax rate on investments to zero. When combined with capital gains treatment, timber receives a negative tax rate or a net benefit. This lowers the tax burden on timber in general. It distorts the market by diverting investment into timbering that might have otherwise gone to other businesses. In addition, the bulk of these tax benefits flow to corporations and wealthy investors.

ENVIRONMENTAL ARGUMENT: Forests serve multiple purposes. They provide habitat for wildlife, medicines, recreational benefits for hikers, fishers, and hunters, as well as timber products. Unfortunately, the current tax breaks treat forests like farms rather than ecosystems, which must contain a diversity of plant and animal life to survive. In addition, these breaks make timber production more profitable for investors and forest products cheaper, which hurts recycling efforts. Better than tax incentives for timber production would be incentives that encouraged recycling, and environmentally friendly pulp and paper alternatives.

Loophole in the Sky: Tax Ozone-Killing Chemicals

PROPOSAL: Include methyl bromide and HCFCs in the list of taxed ozone-depleting chemicals. This is consistent with earlier efforts to tax new chemicals and is worth $1.6 billion over 5 years according to the Congressional Budget Office.

BACKGROUND: In 1989, Congress enacted a tax on ozone-depleting chemicals to provide an economic incentive to reduce production and use of these destructive substances. The tax complements international and domestic measures to reduce and phase out these chemicals.

Ozone-depleting chemicals include chloroflourocarbons (CFCs), methyl chlorform, carbon tetrachloride, halons, methyl bromide, and HCFCs (CFC substitutes). These chemicals are found in various consumer products and used in agricultural and industrial processes. Release of these chemicals into the atmosphere causes damage to the stratospheric ozone layer which shields the Earth and its inhabitants from the sun's damaging ultraviolet radiation.

In 1985, scientists confirmed the existence of a "hole" in the ozone layer over Antarctica. Since its discovery, the ozone hole has grown to cover an area of approximately nine million square miles, roughly the size of the North American Continent. This ecological crisis spurred more than 120 countries to negotiate and approve the Montreal Protocol on Substances that Deplete the Ozone Layer in 1987. While the Protocol called for the phase-out of many ozone-depleting chemicals, some chemicals such as HCFCs and methyl bromide were not included in the original agreement. In 1992, however, parties to the Protocol amended the original agreement to include HCFCs and methyl bromide. The Protocol requires industrialized countries to cap methyl bromide production at 1991 levels and to phase out all HCFC production by 2030. Due to the delay in listing methyl bromide and HCFCs under the Montreal Protocol, however, these chemicals were not included when Congress passed the tax on ozone-depleting chemicals. Since then, however, political pressure on Congress has kept methyl bromide and HCFCs off the tax list.

TAXPAYER ARGUMENT: No policy rationale exists for the inconsistency of taxing some ozone-depleting chemicals while leaving others untaxed. This disparate treatment is simply the result of timing and politics. Methyl bromide is the only Clean Air Act Class I ozone-depleting chemical that is not taxed. While HCFCs are listed as Class II chemicals, they are more potent than other chemicals that are already taxed (i.e. methyl chloroform).

Taxing these chemicals makes good economic sense. The existing tax has very successfully accelerated the phase-out of harmful chemicals while at the same time spurred development of ozone-safe alternatives. Too often our tax code punishes desirable behaviors and businesses while rewarding ecological destruction. The tax on ozone-depleting chemicals does the right thing, and it works.

ENVIRONMENTAL ARGUMENT: Methyl bromide and HCFCs are a direct threat to human health and ecosystem integrity. Their destructive impact on the stratospheric ozone layer has been conclusively established. Ozone layer destruction causes increased ultraviolet radiation which can lead to higher rates of skin cancer and eye diseases such as cataracts. Increased ultraviolet radiation also can suppress the immune system and weaken its response to a host of diseases. In addition, the radiation may decrease crop yields, stunt animal reproduction, and cause fast degradation of materials such as plastics, wood, and rubber.

Methyl bromide is extremely noxious and is acutely toxic. It can cause fatal damage to the central nervous system and severe damage to the lungs, kidneys, eyes and skin. Workers that handle methyl bromide run the greatest risk of toxic exposure and injury.

HCFCs serve as transition chemicals between the more damaging CFCs and safer alternatives. However, ozone-safe substitutes are available for nearly every use of HCFCs.

Cooking the Books: Cash Accounting

PROPOSAL: Disallow the use of "cash accounting" method for agricultural businesses with gross sales of more than $1 million. This proposal would save about $1.3 billion over five years according to the Congressional Joint Committee on Taxation.

BACKGROUND: The cash accounting method does not require a farmer to accurately match expenses to income when paying income taxes. The rules date back to the early part of this century when the IRS determined that many farmers were not sophisticated enough to use more complex bookkeeping procedures that are required for most businesses. Since 1919, however, farms have gotten much larger and most farms are run more like businesses. Today, large agricultural operations are able to take advantage of cash accounting under current law and they are able to significantly reduce their taxes by manipulating expenses, inventory, and income.

Cash accounting is one of a number special tax breaks and loopholes that once lured nonfarmer investors into agricultural tax shelters and speculation. This speculation drove up land prices and caused havoc in the farm economy. According to a 1982 U.S. Department of Agriculture report entitled The Effects of Tax Policy on American Agriculture, "the tax preference may overstimulate production and lead to lower product prices, or may cause the values of limited inputs, such as land, to be bid up." In general, these tax breaks, and the game-playing they invite make it difficult for smaller-scale farming to compete and survive.

In the tax reform of 1986 and subsequently, many of the worst tax shelters in agriculture were eliminated. However, some, like cash accounting, survived. Since cash accounting tends to benefit richer farmers it plays a role in the increased concentration of farmland ownership with high-income farmers and businesses.

TAXPAYER ARGUMENT: The ability to defer taxes and immediately deduct costs creates an enormous tax benefit for large farm operations and invites inappropriate mismatching of income and expenses. The fact that farmers with up to $25 million in gross sales can use cash accounting methods means that many large farm operations benefit from a provision intended primarily for smaller, family farms. Agriculture Department studies show that the cash accounting makes farming more profitable to farmers in higher tax brackets while making it harder for farmers with low incomes to compete. According to the 1982 USDA study, "in a tax-favored industry such as farming, success depends not only on entrepreneurial skill and luck; it also depends on the successful management of the tax system and assets and liabilities. The rules of the game demand not only agricultural expertise but also tax expertise and a number of other skills."

ENVIRONMENTAL ARGUMENT: Experts in agriculture policy argue that the mismatching of expenses and income actually subsidizes the purchase of agrichemicals such as fertilizers and pesticides. U.S. agriculture has become reliant on chemicals. Today, crop production systems in most areas of the country rely on at least one pesticide and often several to control weeds, insect pests, and plant disease. Added to the pesticides is a huge volume of synthetic fertilizers. In 1987, for example, U.S. farmers were applying some 10 million metric tons of nitrogen to the land, with the vast majority of it synthetic. Pesticides, which by their very nature are poisons, have been dispersed widely throughout our food supply and environment. The EPA estimates that every year farmworkers suffer more than 27,000 acute illnesses due to pesticide exposure. Pesticides and nitrates have become pervasive contaminants of water supplies, with EPA estimating that at least one of every ten public water wells in the country contains at least one pesticide. Millions of American children, whose diets are high in particular fruits and vegetables, receive -- by age 5 -- up to 35 percent of what is considered an entire lifetime's "safe" dose of cancer-causing pesticides.

Pigs in a Poke: Dairy and Livestock Expensing

PROPOSAL: Disallow immediate deduction for costs related to raising livestock and dairy. This would raise about $700 million over five years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Under current law livestock breeders and dairy producers enjoy special rules which provide favorable tax treatment for their business. When their livestock and cattle are sold, the profits are counted as capital gains income which is taxed at the rate of 28 percent even if the taxpayer is in a higher tax bracket. However, the costs of purchasing, breeding, and raising the livestock are not treated as capital investments, but rather as ordinary expenses. This is the best of both worlds for livestock and dairy producers. Costs are deducted immediately and income is taxed at a relatively low capital gains rate rather than as regular income. This inconsistency is highly favorable for dairy livestock producers and has helped to make cattle and other livestock operations profitable tax shelter ventures.

TAXPAYER ARGUMENT: Livestock producers get a special deal in their business. They can immediately deduct the costs associated with raising the diary and breeding livestock. Yet when they sell, the income is treated as a capital gain and taxed at a 28 percent rate for high-income taxpayers instead of the higher rate at which it should be taxed. Other businesses must treat the income from sales of product as regular income. Most other farmers must treat their sales income as regular income.

This tax break attracts farm investments into animal breeding that might otherwise be directed toward growing crops. It also serves to benefit livestock and dairy breeders at the expense of other taxpayers.

ENVIRONMENTAL ARGUMENT: This tax break subsidizes agricultural activities, which are becoming increasingly controversial in their impact on environmental quality and rural communities. In many rural communities, industrial hog farming and large dairy operations are meeting growing resistance due to significant waste problems (they are smelly and cause water pollution) and because they tend to crowd out smaller scale, diversified farms.

In addition, this tax break distorts farming and animal husbandry decisionmaking. The tax code requires that livestock be sold as breeding stock and not for slaughter in order to receive special tax treatment. Farming and husbandry decisions should be driven by the biology and resources, not tax policy.

Up in Smoke: Tax Exempt Bonds for Incinerators

PROPOSAL: Subject tax-exempt bonds sold to finance incinerators (solid waste facilities that produce electric energy) to the private-activity bond annual volume cap. This would raise about $900 million over five years according to the Office of Management and Budget.

BACKGROUND: Current law provides a tax exemption for interest income on state and local bonds used to finance construction of certain energy facilities. These bonds are classified as "private activity bonds," instead of government bonds, due to the fact that a substantial portion of their benefits is reaped by individuals or businesses rather than the general public. Most private-activity bonds, including hydroelectric facility bonds, are subject to certain limits set by each state. However, bonds issued for government-owned solid waste disposal facilities are not subject to these limits.

In general, the 1986 Tax Reform Act repealed the tax-exempt status of most bonds used to finance projects with substantial private involvement due to the fact that they served as tax shelters for wealthy investors and oftentimes subsidized projects with little overriding public benefit, such as golf courses. Tax-exempt bonds for incinerators and a few other private-activity bonds escaped reform.

TAXPAYER ARGUMENT: Tax-exempt bonds in general distort investment decisions. Because the interest from the bonds is tax free, wealthy investors buy them to shelter income rather than buying taxable corporate bonds or stocks. While tax-exempt bonds continue to help state and local government finance important public projects, construction of environmentally harmful projects for private profit do not merit such special tax treatment. Further, this kind of tax break violates the "polluter pays" principle. Those who create the solid waste should pay for its disposal rather than the taxpayer.

ENVIRONMENTAL ARGUMENT: Although called "renewable" energy facilities by the 1980 tax bill, incinerators as currently used are not environmentally friendly. They emit harmful levels of highly toxic substances into the air such as cadmium, lead, and dioxins. The EPA has not yet issued regulations regarding safe emission levels for incinerators. Providing tax benefits for construction of incinerators before incinerators have met environmental standards is ludicrous.

Cloaking Profits: Publicly-Traded Limited Partnerships

PROPOSAL: Eliminate the corporate tax exemption provided for the development of natural resources through publicly traded limited partnerships. There is no estimate available for how much this reform would save.

BACKGROUND: Certain "publicly traded limited partnerships" enjoy tax benefits not available to many other similar business entities. On the one hand, these partnerships enjoy the advantages of being treated like corporations in that investors can trade their interests in public markets and investors have limited financial liability. On the other hand, they do not pay corporate income tax, essentially skipping a level of taxation. In 1987, the Congress changed the law to treat publicly traded partnerships like corporations for tax purposes. However, major loopholes were left after the reform. Partnerships primarily involved in natural resource development were exempted. Thus, publicly traded partnerships involved in mining, geothermal energy, fertilizer, and timber enterprises can continue to avoid a corporate-level tax while retaining the advantages of being traded like a corporation.

TAXPAYER ARGUMENT: This exemption means that certain businesses can avoid paying taxes that other similarly situated businesses must pay. Such subsidies distort the market and tend to attract artificially high levels of investment in business activities eligible for the publicly traded limited partnership exemption. According to a 1994 investigative report of the House Natural Resources Committee, this tax loophole can radically reduce tax revenues from companies. For instance, one timber company was reportedly able to reduce its tax liability from about 59 percent to about 3 percent. In fact, some companies engaged in natural resource development have restructured as partnerships to avoid corporate-level tax.

This tax break is nothing but a massive giveaway of taxpayer dollars to rich investors and the polluting businesses they support.

ENVIRONMENTAL ARGUMENT: This tax loophole creates an unfair advantage for investment in the extraction and depletion of natural resources and provides yet one more encouragement for business enterprises to deplete the nation's natural resources. The subsidy makes natural resource development cheaper and devalues the natural resource. A better system would let the market determine the rate and manner of extraction of a finite supply of resources.

Spoils of Spills: Pollution Deduction

PROPOSAL: Disallow corporate income tax deductions for future costs associated with illegally released pollution. Cleanup of existing pollution or contamination should be exempted. No estimate is available for how much this proposal could save taxpayers.

BACKGROUND: Under current law, polluters who cause environmental harm can fully deduct all the costs related to illegally released pollution including cleanup costs, legal costs, court settlements, even the cost of the polluting substance itself. Even gross violations of law can qualify for normal business deductions. For instance, when Exxon's *Valdez* oil tanker spilled 11 million gallons of oil into Prince William Sound, nearly all the costs related to the disaster were deductible. This included all the costs of litigation, legal settlements, cleanup, studies, public relations, etc. Exxon settled a criminal case in court with the United States and the State of Alaska for about $1 billion. However, except for a paltry $25 million criminal fine, the entire settlement was tax deductible for Exxon. The value of this deduction is approximately one-third of the settlement, or $300 million.

This situation arises because under tax law, a business may deduct nearly all the expenses incurred as a matter of conducting business. The law allows deduction of "ordinary and necessary" business expenses and the IRS has been very liberal in its interpretation of this clause.

While the vast majority of business expenses are deductible, Congress has disallowed a deduction for some egregious or ethically complicated activities. For instance, illegal bribes, kickbacks, and fines are not deductible. Damage payments for anti-trust violations are not deductible. Lobbying expenses and political campaign contributions are not deductible. Paying CEOs more than $1 million is not deductible to corporations. But the costs associated with breaking environmental laws, including punitive damages, are deductible.

TAXPAYER ARGUMENT: Companies that deduct the costs of oil spills and chemical discharges avoid paying taxes and save money while damaging the earth. For many corporations, environmental disaster is just a cost of doing business. An average of about 16,000 oil spills every year stretches the definition of "accident." In reality, many polluters would rather take their chances with pollution, litigation, and cleanup than prevent the disasters in the first place. That's not a calculus the taxpayers should subsidize.

This perverse tax treatment of costs associated with illegally released pollution means that taxpayers finance a portion of these costs due to the polluter's tax write offs. In addition, taxpayers usually have to pay to help the polluter clean up, as they did in the case of the Exxon *Valdez* oil spill. Finally, the citizens who live near the pollution site bear enormous costs associated with loss of a natural resource, whether it is clean water or clean air.

ENVIRONMENTAL ARGUMENT: Eliminating the business deduction for illegally released pollution would reduce the incentive to cut corners or to knowingly risk dangerous accidents. Currently, the tax code allows costs such as cleanup for negligent oil spills, intentional dumping of toxic pollutants, and litigation on the illegal filling of wetlands to be immediately deducted. However, the costs to avoid these problems with investment in pollution prevention are not immediately deductible. For instance, an oil distributor whose pipeline bursts and spills oil into a river can immediately deduct the costs of repairing the pipeline and cleaning up the spill. However, if the company wanted to double-wall the pipeline or make other improvements to prevent leaks, those costs would likely have to be deducted over many years. In other words, deductions for failure are immediately deductible while the deductions for prevention must come over several years, which costs the taxpayer more money. Eliminating the deductibility of environmental harm due to gross negligence or illegal pollution would begin to turn the balance of incentives in the right direction.

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Chairman ARCHER. Thank you, Mr. Blackwelder.

And thank you also for summarizing your testimony. Your entire written statement will be inserted in the record, without objection.

Our last witness of this panel is Gary Rogliano. If you will identify yourself for the record, you may proceed.

STATEMENT OF GARY ROGLIANO, SENIOR VICE PRESIDENT, CONTROLLERSHIP AND TAXES, PITTSTON CO., STANFORD, CONNECTICUT; ON BEHALF OF COAL INDUSTRY TAX COMMITTEE

Mr. ROGLIANO. My name is Gary Rogliano. I am a senior vice president for the Pittson Co. I am appearing on behalf of the Coal Industry Tax Committee, an ad hoc group of companies whose primary product is coal. Its membership represents over one-fourth of the annual coal production in this country. We welcome the opportunity to testify on tax reform from the perspective of the coal industry and applaud the House Ways and Means Committee for analyzing impacts of tax reform on all sectors of the economy before making changes to the tax system.

I would like to give you a brief overview of the coal industry.

The U.S. coal industry is essential to a reliable and low-cost supply of electricity for America. Coal comprises one-third of the Nation's primary energy and is a source generating over 55 percent of our Nation's electricity.

Coal is used in all 50 States and provides the Nation with abundant, clean, and affordable energy. At present rates of recovery and use, U.S. coal reserves will last more than 250 years.

The industry directly employs over 100,000 workers and indirectly supports several hundred thousand more jobs in the United States.

Coal produced in the United States is also exported to over 40 countries, resulting in a positive contribution of over $3 billion annually to the United States balance of payments.

I will discuss three tax issues today. The first issue is that simplification of the Tax Code should take into consideration the total tax burden on specific industries.

The coal industry is among the most heavily taxed industries in the United States. Coal companies are burdened with a host of taxes specific to the industry.

They have more industry taxes than any other sector of the economy. In addition to Federal and State income taxes and payroll taxes, a typical coal operator also pays Federal black lung tax, Federal abandoned mine land fees, and for many companies, a federally mandated coal miner's retiree health care tax.

In addition, coal companies also pay Federal royalties on all coal mined on Federal land, State severance taxes, sales and use taxes, and substantial real and personal property taxes, which significantly support the communities in which these companies operate.

By any objective standard, the coal industry is carrying a heavy tax burden. In fact the effective tax rate on the collective earnings of the Coal Industry Tax Committee members, using all taxes paid in 1995, was 66 percent.

In other words, $2 of taxes are paid for every $1 of profits. Simplification of the Code should take into consideration the total tax

burden on specific industries. In the case of coal, it should consider all taxes paid.

Second, the alternative minimum tax should be reformed. While the AMT was originally enacted as a parallel system, it has actually become a permanent tax system for many coal companies, resulting in a higher effective tax rate.

Finally, international competitiveness should be a consideration of tax reform. While the United States has the most productive coal miners in the world, the cost of the industry-specific taxes paid by the U.S. coal industry, and the high cost of compliance with U.S. regulations, generally cause the costs of coal to many markets to exceed those of our major foreign competitors. This cost disadvantage applies not only to exports, but also enables some countries to import coal into this country, which is ironic, because we have the largest reserve base of coal in the world.

In summary, the Coal Industry Tax Committee would ask the House Ways and Means Committee to consider the following points as you contemplate tax reform.

The Committee supports reform of the Tax Code if it results in simplification with greater tax equity.

Industry specific taxes should be considered in tax reform.

The AMT should be simplified, and international competitiveness should be one of the considerations during tax reform.

I thank you for allowing me to testify on behalf of the Coal Industry Tax Committee.

[The prepared statement and attachment follow:]

STATEMENT OF GARY ROGLIANO
SENIOR VICE PRESIDENT
CONTROLLERSHIP AND TAXES, PITTSTON CO.
ON BEHALF OF COAL INDUSTRY TAX COMMITTEE

Introduction

Mister Chairman and Members of the Committee, my name is Gary Rogliano. I am Senior Vice President, Controllership and Taxes for the Pittston Company. I am appearing on behalf of the Coal Industry Tax Committee, an ad hoc group of companies whose primary product is coal. Member companies in the group include Peabody Holding Company, Inc., Zeigler Coal Holding Company, The Pittston Company, Drummond Coal Company, Ashland Coal, Inc., and AMVEST Corp. The Committee has been in existence since 1984 and focuses exclusively on tax issues impacting the coal industry. Its membership represents over one-fourth of the coal production in the United States.

The Coal Industry Tax Committee welcomes the opportunity to testify on the impact of tax reform on the coal industry. The Committee applauds the House Ways and Means Committee for analyzing the impacts of tax reform on all sectors of the economy before making changes to the tax system.

Extensive changes in the structure of the U.S. corporate and individual income tax systems are currently being explored by this Committee. Some changes in the tax code could substantially alter the tax liabilities of many industries and businesses. For businesses facing increases, the higher taxes will translate into increased costs, which in turn will result in higher product prices or lower profit levels. Thus, tax reform may affect the competitiveness of one business or industry as compared to another. Some businesses will find it more difficult to compete in product markets and for capital needed to expand and become more efficient. I would like to speak today specifically about the impact of tax reform on the coal industry.

The Coal Industry

The U.S. coal industry is essential to a reliable and low cost supply of electricity for America. Coal comprises one-third of the nation's primary energy and is the source generating over 55 percent of our nation's electricity. Coal is produced in 26 states but is used in all 50 states and provides the nation with abundant, clean and affordable energy. Chart I depicts coal usage in the states represented on the House Ways and Means Committee.

There are an estimated 285 billion tons of recoverable coal reserves in the United States encompassing 38 states. At present rates of recovery and use, U.S. coal reserves will last more than 250 years.

Mechanization, robotics, lasers and computers are common components of modern coal mine operations. The end result of this mechanization is safer and more productive mines.

The U.S. coal industry directly employs over 100,000 workers and indirectly supports several hundred thousand more jobs in the U.S. Coal miners are among the highest paid and best trained workers in the United States.

Coal produced in the United States is also exported to over 40 countries, resulting in a positive contribution of over $3 billion annually to the U.S. balance of payments.

The Coal Industry is One of the Most Heavily Taxed Industries in the U.S.

The coal industry is among the most heavily taxed industries in the United States. According to Bureau of Mines data, coal is also heavily burdened with a multitude of comprehensive and expensive federal and state taxes as well as health, safety, and environmental regulatory costs far more than our principal international competition.

The coal industry is also burdened with a host of taxes specific to the industry and has more industry specific taxes than any other sector of the economy. In addition to federal and state income taxes and payroll taxes, a typical coal operator must also pay federal black lung tax, federal abandoned mine land fees, and for many companies a federally mandated coal miner's retiree health care tax. In addition to all of these various taxes, the industry also pays federal royalties of up to 12 1/2 percent on all coal mined on federal land. Added to all these taxes, the industry also pays state severance taxes, sales and use taxes, and substantial property and personal property taxes. By any objective standard, the coal industry is already carrying a very heavy tax burden. In fact, the effective tax rate on the collective earnings of the member companies, using all taxes paid in 1995, was 188 percent. In other words, committee members collectively paid almost twice as much in taxes as they earned in profits.

By way of illustration, Chart II shows the collective tax burden of the Coal Industry Tax Committee as a percentage of the total cost of a ton of coal. As outlined in the chart, taxes and royalties represent 21 percent of the cost of a ton of coal, compared to salaries and benefits of our employees of 27 percent. Taxes represent an unusually high percentage of the costs of the coal industry.

Simplification of the tax code should take into consideration the total tax burden on industries; in the case of coal, it should consider all taxes paid, especially those federally imposed taxes such as black lung and abandoned mine land fees.

Discussion of the Alternative Minimum Tax

Although the intent of the alternative minimum tax (AMT) was to ensure that all companies reporting profits pay some tax, the AMT actually does much more than that. The AMT adds to the complexity of the tax code by creating a parallel tax system that requires a totally different set of tax calculations in addition to those required for regular corporate income tax.

The alternative minimum tax imposes a severe penalty on productivity investments in capital intensive industries. The AMT has actually become the permanent tax system for many coal companies, resulting in a higher effective tax rate than many other industries pay under regular corporate income tax.

Coal mining is a very capital intensive industry. Companies must make substantial capital investments for new mine development, technology and efficiency improvement, and for environmental, health and safety compliance. The bias against capital intensive industries built into the AMT system makes it very difficult for coal companies to make the needed investments.

The added tax burden of the AMT increases the cost of capital and reduces the cash flow needed for operations. Ironically, companies are more likely to be AMT taxpayers when they are making large capital expenditures or when they have low taxable income, in other words, when the need for cash is greatest.

The AMT inhibits the growth of capital intensive industries, resulting in sluggish or even negative job growth. Any simplification of the tax code should certainly include substantial reform or repeal of the alternative minimum tax.

Several studies have confirmed the negative impact of the AMT.

1. Joel L. Prakken, Chris P. Varvares and Laurence H. Meyer's (PVM's) study entitled "Investment, Economic Growth and the Corporate Alternative Minimum Tax" for the American Council for Capital Formation Center for Policy Research argues that the AMT has the potential to reduce investment spending because AMT-filers pay a higher average tax rate and consequently generate less internal cash flow than they would under the regular tax. This, in turn, may curb investment by firms with impeded access to capital markets.

   PVM's results show that firms permanently on the AMT face capital costs significantly higher than firms that pay the regular corporate income tax. PVM's econometric simulations show that if all firms were to face the AMT indefinitely, the result would be to reduce the level of output by approximately $60 billion annually relative to the case in which all firms paid the regular income tax.

2. Research by Arthur Andersen and Co. confirms that U.S. firms paying the AMT recover their investment costs for new equipment much more slowly than do companies in major competitor nations.

International Competitiveness

Congress has long recognized that capital investments in natural resources are different from investments in other assets such as buildings and equipment. Unlike buildings and equipment, natural resource deposits contain a finite amount of economically recoverable minerals. As the minerals are extracted, the available reserve is depleted. Any changes to the current tax system as a result of tax reform should continue to recognize the finite characteristics of natural resources. Many foreign coal producers enjoy favorable tax treatment compared to U.S. producers even under the current system. Any changes that would further penalize U.S.

companies would likely have a detrimental impact on U.S. industry. While the U.S. has the most productive coal miners in the world, the cost of the industry specific taxes paid by the U.S. coal industry and the high cost of compliance with U.S. regulations generally cause U.S. costs of coal to many markets to exceed those of our major foreign competitors such as China, Colombia, Australia and South Africa. This cost disadvantage applies not only to exports from the U.S. but also enables some countries to import coal into this country, which is ironic because we have the largest reserve base of coal in the world.

Summary

In summary, the Coal Industry Tax Committee would ask the House Ways and Means Committee to consider the following points as you contemplate tax reform.

1. The Committee supports reform of the tax code if it results in simplification with greater tax equity.

2. The coal industry's tax burden is higher than most industries because of the specific taxes imposed on it. These specific taxes should be considered in the tax reform process.

3. The alternative minimum tax should be eliminated as part of tax simplification because it has a negative impact on the economy and inhibits growth.

4. The finite characteristics of natural resources should be considered during tax reform to ensure the U.S. remains competitive in the world market.

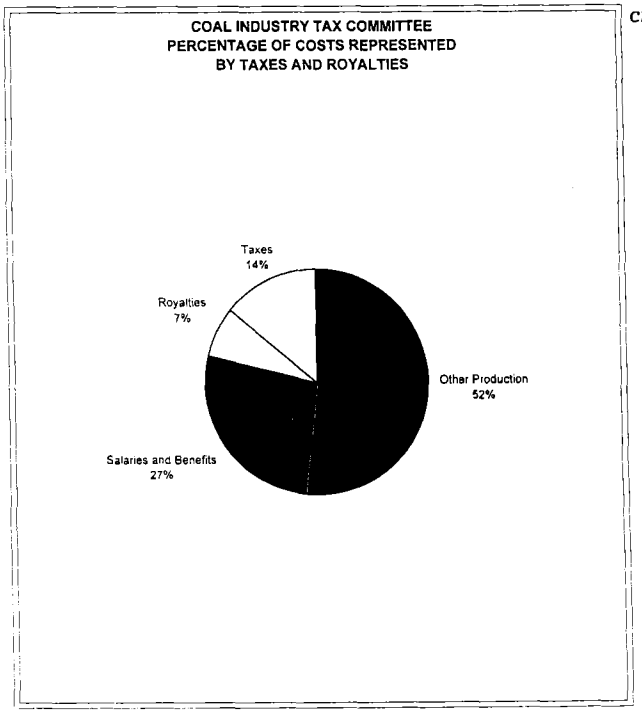
Mr. Chairman, I thank you for allowing me to testify on behalf of the Coal Industry Tax Committee.

COAL USE IN SELECTED STATES

	Coal Consumption (million tons) (1994)	Percent of Electricity Produced by Coal (1995)
Texas	93.8	47
Indiana	60.0	98
Ohio	56.7	88
Pennsylvania	54.1	57
Illinois	39.1	43
Kentucky	38.1	95
Michigan	35.7	71
Georgia	29.3	65
Missouri	27.7	82
Florida	26.1	42
Tennessee	25.4	71
Wisconsin	21.7	71
Iowa	19.3	85
Minnesota	18.7	63
Louisiana	14.1	29
Virginia	12.8	46
New York	11.5	20
Maryland	10.5	61
Nebraska	9.3	64
Nevada	8.0	70
Washington	6.3	6
Massachusetts	3.9	39
California	2.5	**
New Jersey	2.0	19

**Majority of coal-fired electricity is generated in neighboring states.

CHART II



Mr. McCRERY [presiding]. Thank you very much.

First of all, I want to apologize for everybody running in and out today. There is a lot of action on the floor we did not anticipate. We are trying to get the welfare reform bill up for a vote this afternoon, and some on the floor are hesitant to get that bill before us, so they are using some delaying tactics, and causing us to run back and forth to vote on silly things like whether it is permissible to use an exhibit on the floor, and things like that.

So I want to apologize for Members having to be out so much.

Before I ask Mr. Ramstad if he would like to ask some questions, let me just ask all of you, generally, whether, in your opinion, whatever tax code we develop, or even if we could tinker with the current Tax Code, should our tax system be neutral on production of natural resources, energy resources, the production of energy?

Or should we favor, in our Tax Code, development of our resources, and production of energy in this country? Anybody have a thought on that?

Mr. ROGLIANO. Speaking on behalf of the Coal Industry Tax Committee, what we would prefer is that all industry taxes be taken into consideration. Whether it favors production of natural resources, that would be fine, but already the coal industry is burdened with excess taxes. We are looking for something that would be fair and put the coal industry in the same taxation burden as other industrial segments of the economy.

Mr. BLACKWELDER. On behalf of Friends of the Earth, I would reply that the current Tax Code is overly generous to those industries that cause the greatest amount of pollution and the most rapid depletion of natural resources, and we are looking for at least a more level playingfield, but we think you ought to actually do more. That there are ways of running the economy much more energy efficiently. Thus, products become more competitive.

The problem now is the price of any product does not tell the full truth from society's standpoint, or an ecological standpoint.

The price of oil does not reflect all of the extraordinary costs we go to to protect it in the Persian Gulf, and we are importing, as we heard earlier, over one-half of our crude oil.

The cost of utilizing fossil fuels, to the extent we have, does not reflect the tremendous health damage, loss of life, hospitalization costs, all the medical costs you are confronted with trying to pay for.

If we ran an economy on a more energy-efficient basis, and a solar basis, which we could do over 20 years, then it seems to us we would meet the conditions we laid out in our testimony.

We would improve our standard of living. We would create more jobs, better jobs, and we would have a cleaner environment for our children and grandchildren.

So the answer is we should not treat natural resources as we have been doing in the past. Our tax system should encourage appropriate and efficient use, recycling and that sort of action, and it has got to really reorient itself.

Mr. McCRERY. Anybody else have an opinion on whether the tax system should encourage development of our natural resources?

Mr. McMAHON. Well, I hear we get a lot of tax incentives and tax breaks, but my company pays over $2 billion a year in taxes.

I fail to see all the incentives that are being mentioned here. I would think, as I said in my testimony, I would prefer a level playingfield, a neutrality as far as different industries are concerned, so that everybody is being—competition on a level playingfield.

Mr. MCCRERY. What do you mean by everybody? You mean everybody within the energy——

Mr. MCMAHON. Well, within the particular industry, and compare industries to industries.

Mr. MCCRERY. OK. I would just point out, Mr. Blackwelder, that it is hard to have it both ways. You say we do not take into account the cost of protecting oil resources, for example, in the Persian Gulf area. Well, if we produced more here, domestically, we would not need to depend so much on those resources. So maybe we could reduce the cost, then, if we would spend more of our resources here, developing known reserves here in this country. For example, in Alaska, and other places.

But that is a different Committee, so I will leave that alone.

Well, I think Mr. Ramstad has left.

Just generally, before I let you go, the primary alternatives, I think we can say, to the current tax system are switching from an income tax to a consumption tax, or going to some kind of single rate income tax.

Do you have any, just general thoughts, as to how each of those would affect your industries in comparison to the current Tax Code?

Mr. ROGLIANO. If I could, a lot depends on what taxes will be taken into consideration if a consumption flat tax were to be imposed.

As I mentioned earlier, the coal industry pays Federal black lung taxes and abandoned mine land fees, coal miner's retiree health care tax, and a number of other industry specific taxes. If a consumption or flat tax is imposed, over and above these other taxes, without at least providing for a credit of these taxes, it could cause serious harm to the coal industry. The question is whether these taxes will be taken into consideration or not.

Mr. MCMAHON. I would say, sir, as a capital-intensive industry, in the public utilities the movement from the present tax system to a consumption-based tax system would be more beneficial for the overall economy. So we would support that.

Mr. MCCRERY. So you think the current tax system is overly burdensome on capital-intensive industries?

Mr. MCMAHON. Extremely so.

Mr. MCCRERY. Mr. Merrill, do you agree with that?

Mr. MERRILL. Yes, I do. Our current income tax system, as you know, double taxes corporate income, both at the corporate level and when it is received by the shareholder as a dividend, or capital gain. So there is a double taxation on capital.

Mr. MCCRERY. And Ms. Erlandson, do you have any thoughts on——

Ms. ERLANDSON. With regard to a flat tax versus a consumption tax, disregarding equity effects, we would prefer a consumption tax, if it incorporates all of the externalities that are now not cur-

rently incorporated in our pricing system, and a tax mechanism can do that.

If that were the case, it is possible that we could support something like that, although we are concerned about competitiveness and border adjustability issues.

Mr. McCRERY. OK.

Mr. BLACKWELDER. The one thought Friends of the Earth would offer on these is we should look at the problems with the current Tax Code and its bias against labor and employment, and the burden it puts on people, as we want to hire more people.

If you reward capital-intensive industries, you are exacerbating a problem now, where we are finding more and more Americans having to hold down two jobs just to bring in the same kind of family income that our fathers brought in 25 or 30 years ago, when we were raised.

The figures from the U.S. Government on average production worker wages show they have dipped to the level they were at in the late fifties, and shifts to some of the proposals we have before us, the consumption tax, flat tax, have a labor penalty associated with them.

That is why we think you have to distinguish among the types of consumption because certain types of consumption will create more jobs, more employment, and others will, if you favor capital intensity, actually lead to, we think, growing unemployment.

Mr. McCRERY. Do you think if we had more industry in the United States, we would have more unemployment?

Mr. BLACKWELDER. I would say if you based the economy more on high-efficiency renewables and solar, you will have many more jobs per BTU expended than you do under the present energy system, and you would greatly improve the overall health of the economy and the population.

Mr. McCRERY. OK. Well, thank you very much. We appreciate your testimony before the Committee today and look forward to continuing to hear your ideas and thoughts as we go through this process.

Thank you. The hearing is adjourned.

[Whereupon, at 1:12 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT ON THE
IMPACT OF FUNDAMENTAL TAX REFORM ON DOMESTIC MANUFACTURING

BY THE
AMT COALITION FOR ECONOMIC GROWTH

SUBMITTED TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
FOR THE HEARING RECORD OF JULY 31, 1996

The *AMT Coalition for Economic Growth* is a broad-based coalition formed to advocate repeal or substantive reform of the Alternative Minimum Tax (AMT). The coalition consists of small, medium, and large companies and associations representing a wide range of manufacturing-related industries including: airlines, automotive, chemicals, energy, mining, paper, steel, transportation, and utilities.

Mr. Chairman, the members of the AMT coalition commend you and this committee for having a hearing on the impact of fundamental tax reform on domestic manufacturing. The best evidence for fundamental tax reform is underscored by the mere existence of the AMT. The AMT is overly complex as a parallel tax system, fueling unnecessary administrative burdens and excessive compliance costs. Supporting this assertion of complexity is a **Tax Foundation** study citing the AMT as the second most complex area of the tax code. Companies are required by law to calculate annually their tax liability under both the Alternative Minimum Tax (AMT) and the regular corporate income tax systems. The AMT is an anti-competitive, anti-investment, Anti-Manufacturing Tax.

In considering tax overhaul, Congress should ensure that the burden of taxation is as broad-based as possible, so that it does not fall disproportionately on U.S. manufacturing, the nation's key source of high-wage, high-skilled jobs. Our existing business tax code is an impediment to U.S. economic growth and competitiveness. There are some areas of the tax code that simply cannot wait for overall reform. The committee recognized this need during 1995 by passing legislation (H.R. 2491) that was ultimately vetoed by President Clinton. This legislation would have made substantial progress toward eliminating the penalty imposed on investment under the AMT.

In fact, a recent DRI/McGraw-Hill study showed that AMT reforms, similar to those passed last year, could result in as much as a 1.6 percent increase in GDP. Without these kinds of changes to the AMT, the economy will continue its less than optimal performance, and more specifically, tens of thousands of high-paying jobs will not be created. Therefore, we hope the committee will act as soon as possible to make these limited reforms a reality.

While we are hopeful for the future, we cannot ignore the fact that another economic downturn will come, and when it does, the AMT will make it longer and deeper than would otherwise be necessary. The AMT's negative reinforcing effect on the economy was clearly evident during the recession of 1991 by further constraining cash flow at a time when companies could least afford it. AMT repeal, or at least substantive reform, is one of the most important actions Congress can take to improve the current tax code bias against productivity-improving investments.

AMT: The Anti-Manufacturing Tax

The AMT originally was intended to ensure that all profitable U.S. corporations pay at least some tax. Mr. Chairman, that goal has been turned on its head. Enactment of the AMT in the 1986 Tax Reform Act (TRA) has had the unintended effect of placing many capital-intensive companies in a near-permanent AMT status with taxes being payable even in years when economic losses were incurred. One company, for example, reported losses to shareholders of more than $1.3 billion over five years (1990-1994), yet paid more than $200 million in AMT. As a result, the AMT is having a serious, adverse impact on U.S. capital-cost recovery and a highly distorted effect on U.S. investment flows.

The AMT continues to be a critical problem for U.S. manufacturers -- namely, the grossly inadequate capital-cost recovery system in the United States, especially as it affects AMT payers. The AMT's discriminatory depreciation methods and excessively slow recovery periods have had especially harmful effects on U.S. manufacturers. That's because the AMT is most damaging to (1) companies that must invest heavily and continuously in new equipment, (2) companies in cyclical industries, and (3) companies whose profitability is subject to dramatic swings because their prices are set by the global market. These criteria define much of the U.S. manufacturing sector.

The primary problem continues to be the AMT's extreme bias against capital investment. This anti-competitive tax treats accelerated depreciation as an adjustment (an increase in income) that must be added back into the AMT calculation, even when profits are low or non-existent. Insofar as many manufacturing companies have no choice but to invest heavily and continuously -- in good times and bad -- it is this "add-back" that increases taxable income and, thus, forces many capital-intensive companies into long-term, if not permanent, AMT status.

Since passage of the Tax Reform Act of 1986 and its harmful AMT provisions, many companies with significant reported losses (for both financial and regular tax purposes) have been forced to pay AMT and defer any tax benefits associated with losses until regular taxes exceed the AMT, which may be never. Adding insult to injury, companies have remained stuck in the AMT and have been unable to use their accumulated minimum tax credits (AMT credits) that accrue in the years when the AMT exceeds regular tax liability.

AMT credits can be used only to the extent that a taxpayer's regular tax liability exceeds its AMT liability. The intent of the AMT credit was to ensure that over time no company would pay more tax than if it were in a regular tax position. Many capital-intensive companies are expected to remain in the AMT indefinitely and, thus, will generate AMT credits that would not be usable. Therefore, the AMT, in effect, has become for these companies a permanent tax increase relative to what they would have paid as regular taxpayers. Many other companies are unable to use credits against regular tax within a meaningful time frame. For these companies, this prepayment of tax and limited use of AMT credits result in an interest-free loan to the government.

In addition to the negative treatment of depreciation, companies also find they pay a significant penalty due to the AMT's limitations on the use of business credits such as research and development, alternative fuels, target jobs credits, net operating losses and foreign tax credits. Many of the broad policy objectives instituted through the tax code and reflected in these credits do not work as intended. The effect of these limitations, again, is to put the AMT firm at a competitive disadvantage. In the case of foreign tax credits, it is indefensible to double-tax foreign-earned income by arbitrarily limiting the use of foreign tax credits to 90 percent.

The AMT is anti-competitive because it places capital-intensive, cyclical companies at a severe disadvantage, particularly against their foreign competitors, who pay no income tax when they have no profits and whose depreciation is not subject to an AMT. The fact that the AMT is the worst capital-cost recovery system among industrialized nations gives further credence to the anti-competitive effect of the AMT.

The AMT is imposing a tremendous administrative burden because it requires numerous depreciation and inventory calculations. It is inherently inequitable because it is applying vastly different tax treatment to similar investments made by similar taxpayers. It is acting as a competitive drag on U.S. manufacturing. It is penalizing, in particular, those companies that invest the most in relation to their profits. And by denying the use of pre-paid regular tax -- *i.e.*, AMT credits -- at all, or within a meaningful time frame, the value of these credits is rendered worthless.

Absent fundamental reform, many manufacturing companies are likely to remain stuck in the AMT for the remainder of this century and beyond. The reason is twofold. First, although many companies have seen profits in the short term, they have not been high enough to offset all of the losses and AMT credits generated during the last recession. Second, companies continue to face substantial new investment requirements to meet both global competitive pressures and new environmental rules (stemming from legislation and agency-initiated efforts).

Fundamental Tax Reform and Transition Rules

The Coalition fully supports repeal of the AMT, and as such, urges that repeal be included in any fundamental tax reform proposal seriously advanced by Congress. Should such reform occur, Congress is not without precedent in providing transition rules when the tax code has been significantly changed to ensure fair and equitable treatment for taxpayers who committed substantial business resources based on current tax law. Current, unused, accumulated AMT credits exceed $23 billion. Given that the AMT credit is a pre-paid tax payment generated largely as a result of the punitive depreciation system under the AMT, the Coalition urges that existing AMT credits be either refunded or permitted to reduce future tax liabilities under a new tax system.

Absent Tax Overhaul, AMT Reform Recommended

The AMT Coalition favors complete repeal of the AMT. We believe the United States should have a single, reasonably understandable tax system that applies equally to all corporate taxpayers. The current dual tax system of the AMT is unequivocally poor tax policy. If complete repeal cannot be accomplished, however, then there are several reforms short of repeal that would help minimize the anti-competitive impact of the AMT.

With respect to AMT reform, the coalition recommends you consider the following principles: Capital-cost recovery provisions should promote, not impair, manufacturing investment and competitiveness; recovery lives and method under the AMT should be conformed to the regular tax; AMT credits and other business credits should be made available to companies that find themselves in the AMT; and, foreign tax credits should not be limited.

Given these principles, we urge enactment into law of the following proposals that were previously passed by Congress as part of the vetoed 1995 Balanced Budget Agreement, H.R. 2491:

- **Eliminate the depreciation adjustment for new investment under the AMT.** Today, a company's depreciation system (method and length of asset lives) is determined less by the type of asset and more by the profitability of the company. Some profitable firms recover their cost of investment through tax depreciation more than twice as fast as less profitable firms subject to the AMT. For example, steel assets are depreciated over a 7-year period under the regular tax but over a 15-year period using a slower depreciation method under the AMT. Treating regular tax-accelerated depreciation as an adjustment under the AMT violates the most basic tax policy principle that investment in similar assets should be taxed in the same manner. It makes no economic sense to continue to penalize capital investment in this way.

- **Change the way the AMT credit operates to make it usable for industries that are near-permanent AMT payers.** The AMT was never intended to tax capital investment at a higher rate than the regular tax on a permanent basis. But this is exactly what happens when AMT payers are denied use of the credit. Since many AMT payers will not have enough regular taxable income to use their AMT credits fully in a meaningful time frame, a mechanism should be established to allow partial use of credits against AMT liability. This would monetize these credits and, thus, decrease the cost of capital. It would also stimulate economic growth by liberating funds for additional capital investment.

The coalition also recommends additional AMT reforms. Specifically, remove the unfair limitations on the use of business credits, NOLs and foreign tax credits that apply only to AMT payers. Since the AMT is essentially America's second business-tax system, with its own rules and limitations, many of the broad policy objectives instituted through the tax code do not work as Congress intended. This is true for many business credits, including R&D, target jobs, alternative fuels (Sec. 29), etc.. Arbitrary limitations on the use of NOL deductions and foreign tax credits are equally unfair.

Conclusion

The *AMT Coalition for Economic Growth* urges your serious attention to the significant anti-growth, anti-investment problems posed by the AMT in designing a new, improved, simpler, tax system that promotes capital investments in productivity-improving assets. Absent imminent fundamental tax reform that includes repeal of the AMT, the coalition recommends substantive changes now to the AMT. Thank you for your interest in rectifying one of the most egregious examples of complexity and unfairness in the tax code: the AMT.

TESTIMONY OF THE HONORABLE W. S. STUCKEY, JR. FOREST LANDOWNERS ASSOCIATION AND FOREST LANDOWNERS TAX COUNCIL ON THE IMPACT OF REPLACING THE FEDERAL INCOME TAX ON MANUFACTURING AND ENERGY AND NATURAL RESOURCES

WAYS AND MEANS COMMITTEE UNITED STATES HOUSE OF REPRESENTATIVES

JULY 31, 1996

On behalf of the Forest Landowners Association, and as Chairman for the Governmental Affairs Committee, I am privileged to submit, for the record, our thoughts about the importance of replacing the federal income tax with a flatter, fairer tax and the effect it will have on individual landowners who manage this country's vital natural resources.

Forest Landowners represents approximately 6,000 members whose combined holdings total over 47 million acres of privately held non-industrial forestland, primarily in 17 southern states. Nationwide there are over ten million independent forestland owners in the U.S. managing over 300 million acres of trees. This private, non-industrial segment of the forestry community compromises over 60 percent of the timberland available to supply our nations lumber and paper needs.

The forest ownership patterns among the private landowner community in the Southern United States can be summarized by looking at just one region of the area that includes seven states -- Alabama, Arkansas, Louisiana, Mississippi, Oklahoma, Tennessee, and Texas. There are 99 million acres of total forest area in that seven state region. Two thirds, or 66 million acres, are owned by private, non-industrial landowners. Public forests make up just 10 million acres, or 10 percent of the forested area. Private, non-industrial landowners hold over six times the forest land the government controls in these seven states.

There are over 1.5 million individual landowners in this seven state region alone. Fifty percent of these individuals own less than 500 acres. Twenty percent own less than 100 acres. The average tract size is 80 acres. By ownership type, 28 million acres are under sole proprietorship, 19 million acres are owned by husband and wife. In total, 52 million acres of the private forest are in individual ownership.

While some non-industrial timber growers own tracts of forested land in hundreds, or even thousands, of acres, most are small landowners with ten, twenty, or fifty acres of trees. These are not wealthy Americans seeking a tax break. Rather, most forest landowners are hard working, middle-class taxpayers. They are farmers, retirees, and school teachers, who love their land and work diligently to manage and make productive the natural resource asset they are privileged to own.

Today, the independent forestland owner is being asked to supply more wood fiber and is being pushed to manage more intensely his acreage because of both market conditions and government policy. When government policy discourages the planting of trees through excessive taxation and increased regulation, fewer trees will be grown which is not only bad for the economy, but bad for the environment.

Increasingly strict environmental regulations place limits on the timber acreage that is available for harvest from public lands. At the same time, since the capital gains increase in 1986, the reforestation rates on small non-industrial tracts of land have declined in many parts of the country. The disparity between acres harvested and acres planted continues to grow. Environmental groups, private forestland owners, and the forest products industry all

agree it is crucial our U.S. tax policy be changed to provide greater incentives for reforestation efforts. As a direct result of higher capital gains taxes, some forestland owners, particularly in the South, are selling their forestland and investing in something that will provide them with a more certain return. Others are not investing in forest management practices or in reforestation activities, as they once were. Timber land will regenerate significantly faster producing better quality wood if it is managed and reforested properly.

The Capital Gains tax provisions in the 1996 Balanced Budget Act would have provided a much needed tax relief. However, an alternative to incorporating these provisions in a budget plan to provide this country with two very beneficial results – more trees and a better environment, would be to replace the Federal income tax. Simply put, allowing tree farmers to keep more of what they produce means they will have more to reinvest in tree production while ensuring proper management of existing forest land. Ultimately, lower taxes on trees means more wood for homes at lower cost to the home buyer.

The Forest Landowners Association is working to see that a more balanced tax treatment of timber restored. I want to commend the Congress of its passage of the Balanced Budget Act, vetoed by the President last December, that contained provisions to exclude 50% of capital gains from taxation. The legislation would have made the effective top rate on capital gains 19.8% for capital assets, including timber, held for a year or longer. The corporate capital gains rate would also have dropped from 35% to 28%, and assets would have been indexed prospectively. It is our ardent hope that Congress will continue to move forward with this important legislation.

Included in his veto of the Balanced Budget Act, President Clinton eliminated an opportunity to bring about estate tax relief for "family-owned business interests". That legislation would have excluded the first million of value from a decedent's estate, and also excludes 50% of the value between $1.0 and $2.5 million. That legislation would have required surviving members of the family to keep the business for 10 years to avoid additional estate taxes. Even the 7-year balanced budget which did include a provision to provide a modest amount of estate tax relief including family farms and closely-held businesses is a modest amount that does not begin to adequately address the problems.

We are grateful for the support of a majority of Congress for the goals of the Balanced Budget Amendment. The Federal Income Tax System, with a flatter, fairer tax, will benefit all citizens of our nation, including forest landowners. In particular, I am hopeful that the provisions of capital gains and estate taxation will continue to be considered by the Ways and Means Committee this election year and during upcoming debates. This change in the treatment of taxes is needed to ensure that small land owners are not penalized for exercising proper management of their lands. It will also benefit citizens who own land that has been passed down from generation to generation from having to sell part of their farm just to pay off death taxes.

I appreciate the opportunity to submit the Forest Landowner Association's views for the record. We applaud your efforts to provide tax relief and reform to our nation. We are encouraged that legislation has emerged to provide the necessary incentives to allow non-industrial forest landowners to invest more money in reforestation, management, and maintenance of forestlands so they can continue to provide this country with an abundant, affordable supply of timber. We eagerly await the passage of these tax provisions.

Comments on the Impact of Fundamental Tax Reform on Domestic Manufacturing

August 14, 1996

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 July 18, 1996. They are submitted for inclusion in the printed record of the hearing held on July 31, 1996 on the impact of fundamental tax reform on domestic manufacturing and on energy and natural resources; our comments focus only on domestic manufacturing. The Tax Reform Study Group previously submitted comments for the written record of the May 1996 hearing on the impact of tax reform on state and local governments, and the July 1996 hearing on the impact on international competitiveness.[1] The Tax Reform Study Group is also working on a more comprehensive comment letter to submit to the tax writing committees at a later date; such letter will expand upon the topics covered in this submission.

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 their 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 has sponsored several seminars on tax reform and 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 draftspersons of these comments was William C. Barrett, Director: Tax, Export & Customs, Applied Materials, Inc., Annette Nellen, Professor, San Jose State University, and Donald J. Scott, Director: Tax Compliance, Oracle Corporation; substantive contributions and review were provided by Jean Alexander, 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; David W. Mitchell, Hoge, Fenton, Jones & Appel Inc.; and Dr. John E. Thomson, Adjunct Fellow, Tax Foundation.

[1] These comments can also be found at http://www.svi.org/jointventure/tax/tax_fed.html, and 96 STN 142-36 (July 23, 1996) or State Tax Notes, Vol. 11, No. 4, July 22, 1996, pg. 253.

Introduction

These comments focus on selected issues relevant to manufacturers that have not received much attention in the tax reform debate relative to other issues. These topics include:

- The importance of R&D incentives to manufacturing and service companies;
- Accounting methods; and
- Impact on financial statements and stock prices.

Importance of R&D Incentives to Manufacturing and Service Companies

Various government and private studies have indicated that government incentives for research are justified in that society's rate of return on research exceeds that of the company incurring the research costs and risks. Thus, the company conducting the research and incurring the costs will not be able to completely reap the rewards of its research because some of the benefit will spill over to others.[2] For example, although research leading to an innovative new drug can be protected by a patent to help a company obtain the economic benefits of its research, the fruits of the research will be enjoyed by others upon the patent's expiration. Because a company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research.[3]

Research incentives also benefit society. Both government and private studies have shown that the credit for increasing research activities (IRC §41) has had an impact on the amount of research conducted. A 1989 General Accounting Office (GAO) report, "The Research Tax Credit Has Stimulated Some Additional Research Spending," stated that the research credit "raised corporate spending on R&E above the level that otherwise would have been achieved."[4] This study, based on a sample of 800 corporations and economic models, concluded that the credit "stimulated between $1 billion and $2.5 billion of additional spending for the 5 years 1981 through 1985." Such an increase represented an increase of 15 cents to 36 cents for every dollar of foregone tax revenue due to the credit.[5]

A 1994 private study concluded that the GAO study underestimated the benefits of the research tax credit. This study estimated that the credit stimulated additional

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[2] "Businesses may not find it profitable to invest in some research activities because of the difficulty in capturing the full benefits from the research. Costly technological advances made by one firm are often cheaply copied by its competitors. A research tax credit can help promote investment in research, so that research activities undertaken approach the optimal level for the overall economy. Therefore, the Committee believes that, in order to encourage research activities, it is appropriate to reinstate the research tax credit and to modify certain rules for computing the credit." From: Small Business Job Protection Act of 1996 (H.R. 3448), Senate Finance Committee Report on H.R. 3448, S. Rpt. 104-___, June 1996, Explanation of Present Law.

[3] "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," a staff study prepared for the Joint Economic Committee of the U.S. Congress, S. Rpt. 99-73, August 23, 1985, pg. 4 ("'spillover benefits' ... put R&D into the class of goods such as public health and sanitation, education, clean air and water, and defense that fall into the sphere of governmental responsibility.") Also see Congressional Research Service Issue Brief "The Research and Experimentation Tax Credit," by D. Brumbaugh, November 17, 1993 ("because the level of investment a firm undertakes depends on the return it alone can earn from the investment, without public support firms are willing to undertake less research than is warranted by its return to society.") Also see study and testimony of Barents Group LLC of KPMG Peat Marwick LLP; 95 TNT 65-20 (4/4/95); ("Social rates of return to R&D investments are typically about twice as high on average as private rates of return.")

[4] GAO, "The Research Tax Credit Has Stimulated Some Additional Research Spending," GAO/GGD-89-114, Sept. 1989, pg. 22.

[5] 1989 GAO report, *supra*, pg. 22.

spending in the short run of about $2 billion per year (in 1982 dollars) with foregone tax revenues of about $1 billion per year.[6]

The economy also benefits from research activity. It has been estimated that at least half of the economic growth in the U.S. stems from advances in technology.[7]

Manufacturers are the primary user of the research tax credit. In 1993, 75.2% of the aggregate amount of research tax credit claimed was claimed by manufacturing companies; 12% was claimed by service companies.[8]

Impact of a consumption tax on R&D. Two important R&D rules under our income tax system are IRC §41, *Credit for increasing research activities*, a tax incentive, and IRC §174, *Research and experimental expenditures*, a positive accounting rule. These R&D rules are particularly important to computer software development and hardware manufacturing companies. A significant element of both the deduction and credit for research expenditures relates to employee labor. Under a consumption tax, expenditures related to employee labor, including wages, fringe benefits and payroll taxes do not reduce the taxable base. Thus, a consumption tax will eliminate a significant deduction attributable to R&D activity.

The treatment of R&D under our income tax system versus a consumption tax can be compared as follows:

R&D Expenditure:	Income Tax	Consumption Tax
Employee labor	Currently deductible under IRC §174.	Not deductible.[9]
Outside labor (such as independent contractors).	Currently deductible under IRC §174.	Deductible business purchase.
Equipment	Not currently deductible, depreciation may be treated as a current deduction under IRC §174(a) & (c).	Deductible business purchase.

There appears to be some belief among tax reform proponents that the loss of R&D incentives (research tax credit and wage deduction) is more than offset by the benefit attributed to the current deduction of equipment. While this may be true for some capital intensive manufacturers, not all manufacturing R&D processes require significant equipment purchases. The software industry, for example, is highly labor intensive in both the development and manufacturing stages and the loss of the research tax credit and the wage deduction is not offset by a deduction for capital equipment. Tax reform proponents who seek to improve economic growth for the U.S. must consider how the tax burden is distributed among both labor intensive and capital intensive industries.

We suggest that more attention be paid to the potential impact of moving completely from an income tax with R&D incentives to a consumption tax with no R&D incentives (no research tax credit). Because R&D activity is a growth engine for the U.S. economy, further study must be made as to whether R&D activity will

6 "R&D Tax Policy During the 1980s: Success or Failure," by Bronwyn H. Hall, National Bureau of Economic Research, Reprint No. 1872, April 1994, pg. 29.

7 See July 18, 1996 testimony of The High-Technology Tax Restructuring Group before the House Ways & Means Committee, fn. 3. The statement is based on a 1995 report by the Office of Technology Assessment, "The Effectiveness of Research and Experimentation Tax Credits."

8 Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax*, (JCS-3-96), April 23, 1996, pg. 95.

9 However, the Armey flat tax (H.R. 2060, 104th Cong. 1st Sess.) would allow a deduction for cash wages and certain retirement plan contributions; the USA tax (S. 722, 104th Cong., 1st Sess.) would allow a credit for payroll taxes.

decrease under a consumption tax, and if so, reformers must then consider the impact to one of the key goals for tax reform - economic growth. This further study must consider:

- the impact of changed R&D tax incentives, along with other changes, such as reduced tax rates and the move to a territorial tax system, on a company's cost of doing business;[10]
- the impact of R&D incentives provided by other countries;
- the possible changed behavior of companies in response to reduced tax benefits for R&D activity;[11]
- the varying impact of reduced R&D tax benefits among different industries;[12] and
- the possible impact to economic growth from reduced R&D tax benefits.

Accounting Methods

Current proposals: Only two of the current reform proposals include provisions on accounting methods: the USA tax proposal (S. 722, 104th Cong., 1st Sess.) and the National Retail Sales Tax proposal (H.R. 3039, 104th Cong., 2d Sess.). Under the USA tax proposal, a business would generally be required to use the accrual method of accounting; the all events test and economic performance requirement of present law would continue to apply. Generally, if a business was allowed to use the cash method of accounting under present law, it could continue to do so under the USA tax. The USA tax proposal directs the IRS to provide regulations (consistent with present IRC §447 and IRC §448) under which a new business might be able to adopt the cash method of accounting. The USA tax proposal also provides that certain changes or expansions of a business may result in it no longer qualifying for use of the cash method, under regulations to be provided by the IRS. Under the USA proposal, the present rules on changes in method of accounting and bad debt expense, would remain.[13]

Under the National Retail Sales Tax proposal, the cash method is the general rule. However, a vendor could elect to adopt the accrual method to determine when tax is due on its sales. For taxable property and services sold under the installment method, tax is due when payment for the property and services is actually received. With respect to property and services returned to the vendor, the vendor would be entitled to a credit (refund) when actual payment for the returned property and services is made by the vendor.[14] Apparently, a similar rule would apply to bad debts of a vendor using the accrual method (but a specific rule is needed to this effect).

The Armey flat tax (H.R. 2060, 104th Cong., 1st Sess.) does not mention accounting methods, but it implies, as does the Hall-Rabushka model upon which the Armey flat tax is based, that a cash method of accounting would be used. The subtraction VAT proposal of Congressman Gibbons also does not discuss accounting methods.

Considerations in Developing Accounting Method Rules: We suggest that the following principles be considered in developing accounting method rules for any tax reform proposal:

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[10] See July 18, 1996 testimony of The High-Technology Tax Restructuring Group, *supra*, for an example of how a consumption tax could increase the cost of U.S.-based R&D activities.

[11] Changed behavior may include changes in a company's mix of domestic and foreign R&D spending, and increased use of outside contractors for R&D activity, relative to employee labor.

[12] The level of R&D spending among manufacturing industries varies. For example, in the automotive industry, R&D expenditures as a percentage of sales revenue is about 4%, while it is about 10% for the semiconductor industry and approximately 14% for the software industry. As reported by the Semiconductor Industry Association (SIA), based on a *Business Week* report; SIA Annual Databook, 1995, pg. 41.

[13] The accounting method provisions of the USA tax proposal are at S. 722, *supra*, §§220 to 226.

[14] H.R. 3039, 104th Cong., 2d Sess., §22(e).

- One of the desired simplification provisions of many businesses is for increased book-tax conformity.[15] However, conformity is not possible if the income tax system is replaced with a consumption tax, because books will still report income (not consumption). However, wherever possible, the goal of increased book-tax conformity should be followed.
- Under a consumption tax, where a business is allowed to immediately write-off purchases of business assets, including land and inventory, timing rules will not be as important as under our current income tax system. For example, uniform capitalization rules and depreciation rules will be eliminated. Thus, the emphasis of current law on "clear reflection of income" from the perspective of the IRS (IRC §446(b) and Treas. Reg. §1.446-1(a)(2)) should no longer be the focal point of proper reporting of income and expenditures. Instead, emphasis should be placed on the methods used for book purposes (IRC §446(a) and Treas. Reg. §1.446-1(a)(1)), in order to achieve greater book-tax conformity.
- The cash method of accounting should be considered an acceptable method of accounting for businesses with average annual gross receipts of $5 million or less.[16]

Example: ABC Corporation is a publicly-traded company that prepares its financial statements according to generally accepted accounting principles (GAAP). For its year ended December 31, 1998, ABC's income statement reports:

Net sales		$2,600x
Cost of sales		
Beginning inventory	$500x	
Direct materials	$600x	
Direct labor	$700x	
Indirect costs	$300x	
Ending inventory	- $400x	$1,700x
R&D		$300x
Selling, general and administrative		$320x
Operating income		$280x
Interest, net		$120x
Income from operations before income taxes		$400x

Because ABC's financial statements are based on income, but its tax return is based on a consumption tax system, many book-tax differences will exist. However, for purposes of simplification, ABC should be allowed to start with the above numbers in determining its tax base under any of the consumption tax proposals. For example, under a subtraction method VAT, ABC would make the following adjustments:

a) Eliminate labor, fringe benefits, taxes, interest and beginning and ending inventory included in its expenditures;
b) Eliminate net interest income.
c) Eliminate depreciation and amortization amounts;
d) Remove gain or loss amounts from the sale of fixed assets;
e) Include a deduction equal to the book amount of equipment, building and land acquired and placed in service during the year (rules are required to

[15] See 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, pg. 77.

[16] As under IRC §448. Arguably, under a system where inventory is deducted when acquired, rather than when sold, a small business with inventory should not be precluded from using the cash method of accounting for tax purposes (this is not allowed under current law per Treas. Reg. §1.446-1(c)(2)(i) which requires a taxpayer with inventory to use the accrual method for purchases and sales). Rules can be provided to prevent possible abuses, such as large year-end inventory purchases made solely for tax purposes where the inventory is returned in the next year; see Revenue Ruling 79-188, 1979-1 C.B. 191.

ensure that there is no interest expense element included in this deduction); and

f) Increase its tax base for the book sales price of equipment, building and land sold during the year.

The above adjustments should *not* be expanded to require ABC to apply the all events test and economic performance requirement to determine when it incurred expenditures and had basis in assets purchased. Similarly, ABC should not be required to apply the existing income recognition rules of IRC §451 and the regulations; instead, it should be allowed to use its book revenue amounts.

Impact on Financial Statements

Regardless of how U.S. tax reform evolves, the need to accrue state and foreign income tax liabilities in financial statements will continue under GAAP accounting although the geographic mix of income tax liability could change dramatically.[17] For many companies, foreign income tax liabilities will likely increase in proportion to the corporate U.S. (state) tax liability. Income tax accounting with respect to foreign operations will become much more important to the global income tax provision and accordingly increases the administrative burden to U.S.-based tax departments in managing the income tax accounting work.

Discussion of transition issues in the tax reform debate so far have focused on the tax and economic reasons of either providing transitional rules or not providing such rules. However, another important aspect of transitioning from an income tax to a consumption tax is the impact on financial reporting. The impact of moving from an income tax to a consumption tax can have a significant impact on a company's income statement and balance sheet, and potentially on its business decisions and stock price. Financial reporting (GAAP) aspects of major federal tax reform include:

- the impact on a company's net deferred tax assets or net deferred tax liabilities in existence at the transition date;
- how the change from one set of rules to another should be reported on financial statements for the year of change; and
- what the incidence of the new tax is and whether or not it should be reflected on a company's income statement as the income tax currently is. For example, would the financial accounting rule for federal taxes be the same under the Armey flat tax, USA tax and national retail sales tax proposals?

A company's mix of deferred tax assets[18] and deferred tax liabilities[19] and whether the company is in a net deferred tax asset or net deferred tax liability position can vary from year to year for a variety of reasons. The type of transitional rules provided can have a significant impact to companies, particularly those with net deferred tax assets. Tax reformers should consider the impact of limited transitional relief on both the tax and financial reporting positions of companies. Transition rules should take into account ways to prevent undue burdens for companies with significant tax attributes at the transition date.

GAAP (FAS #109) requires tax law changes to be reflected in financial statements in the year enacted. Assuming that FAS #109 would continue to apply to a consumption tax, the value of net deferred tax assets and net deferred tax liabilities would decrease. Again, this would affect companies differently depending on their prior tax attributes. Whether or not transition rules exist to allow a tax benefit for loss and credit carryovers and undepreciated asset basis at the transition date will

[17] Financial Accounting Statement (FAS) #109, Accounting for Income Taxes.

[18] Deferred tax assets tend to represent non-deductible current expenses that will be deducted in the future and may represent such items as inventory reserves, deferred revenue, loss carryovers, and foreign tax credits.

[19] Deferred tax liabilities may exist for such items as book-tax depreciation differences.

have an impact on corporate financial statements, stock prices, and transitional planning.

There are many unknowns with respect to the impact of tax reform on financial statements. For example, will the current income tax reporting rule under GAAP (FAS #109) apply to consumption taxes, or will a new rule be required? Also, what is the proper reporting of the particular consumption tax on the financial statement? For example, a national retail sales tax collected by a taxpayer should not be reported on the income statement. However, it is not clear whether the same would be true for a subtraction method VAT, although theoretically, the economic incidence of a subtraction method VAT is the same as for a sales tax (tax imposed on the final consumer). Additional uncertainties stem from these accounting unknowns which may have significant impacts on the economic impact of fundamental tax reform. For example, how will the stock market react to changes in balance sheets (likely improvements for companies with deferred tax liabilities, but likely reductions to earnings for companies with deferred tax assets) and effective tax rates?

Example: In the first year of the flat tax, Young Corporation (YC) has $600 million in domestic revenue and flat tax deductions of $330 million. Thus, YC's pre-tax income is $270 million and its flat tax liability is $54 million (20% tax rate). YC has $70 million in prepaid tax assets on its books, attributable to inventory reserves, loss carryovers and research tax credit carryovers. Assuming no transitional rules exist to allow YC to ever obtain benefit of the prior inventory purchases or carryovers, the prepaid tax asset must be removed from YC's financial statements. YC's income tax provision for the first year of the flat tax would be:

Flat tax	$54M
FAS #109 adjustment	$70M
Total	$124M
U.S. pre-tax income	$270M
U.S. effective tax rate	46%

Without the FAS #109 adjustment, YC's effective tax rate would have been 20%. This example is a simplified one involving only three book-tax differences; a typical manufacturer would have significantly more book-tax differences to analyze. The impact of tax reform will raise many difficult accounting issues for companies due to the significant nature of the contemplated changes - analyzing the specifics of reserves, moving from a worldwide system to a territorial one, lack of transitional rules, and uncertainty as to the incidence of the tax burden.

Congress must consider the need for financial statement guidance that must follow reform of the federal tax system. The impact of tax reform on financial statements (and stock prices) must be included in the tax reform debate with respect to the technical and economic points, as well as providing a sufficient time frame for the accounting issues to be resolved.

Conclusion

Major federal tax reform presents significant accounting, economic, social and political issues. Our comments above only identified and discussed three of these significant issues. To summarize, manufacturing companies are particularly sensitive to changes to the current treatment of R&D expenditures. Consideration of a consumption tax must take into account possible reduction in U.S. R&D spending and whether economic growth may be impacted adversely. Also, accounting method rules for any consumption tax proposal must consider how to best reach the simplification goal of tax reform, and realize that income tax standards for what is a proper method of accounting might not automatically apply to a consumption tax. The financial reporting (GAAP) issues indicate the need to consider the very broad brush tax reform sweeps over businesses beyond just their tax obligations to the government. In addition, financial reporting issues indicate the need to have a broad spectrum of parties involved to some degree in the tax reform process, including the Financial Accounting Standards Board (FASB).

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U.S. HOUSE OF REPRESENTATIVES

WRITTEN COMMENTS

ON

NEW REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET

JANUARY 8, 1997

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ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
April 15, 1996
No. FC-15

CONTACT: (202) 225-1721

Archer Announces Request for Written Comments on New Revenue Provisions in President's Fiscal Year 1997 Budget

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee is requesting written public comments from all parties interested in certain revenue provisions in President Clinton's Fiscal Year 1997 budget.

BACKGROUND:

On March 19, 1996, President Clinton submitted his fiscal year 1997 budget to the Congress. The proposed budget contains several revenue provisions. While many of these revenue provisions were included in the Balanced Budget Act of 1995, a number were not. The Committee is requesting comment only on those provisions that were not included in the Balanced Budget Act of 1995.

DETAILS FOR SUBMISSIONS OF WRITTEN COMMENTS:

Persons submitting written comments should submit six (6) copies, with their address and date of request 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.

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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Comments

of
The Ad Hoc Coalition
on Intermarket Coordination

Submitted to

The Committee on Ways and Means
U.S. House of Representatives

May 15, 1996

These comments are submitted by the Ad Hoc Coalition on Intermarket Coordination, a coalition of the nation's leading options exchanges and their clearing firm, in response to Chairman Archer's request for comments on certain revenue provisions in the President's 1997 Budget. The participants in the Coalition are the American Stock Exchange, the Chicago Board Options Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, and The Options Clearing Corporation. The four exchanges account for approximately 99 percent of all transactions in exchange-traded options on individual equity securities.

OVERVIEW

The President's 1997 Budget includes two proposals of concern to the Coalition. One of these proposals is commonly referred to as the "short-against-the-box" proposal. The proposal is often described as being targeted against the short-against-the box transaction and, specifically, the ability of taxpayers under present law to defer recognition of gain until the transaction is completed. The legislative proposal included in the President's 1997 Budget, however, goes far beyond what is needed to stop such transactions and would fundamentally change long-standing tax principles by requiring recognition of gain (but not loss) on stocks, bonds and other financial instruments when taxpayers engage in various risk-reduction (i.e., hedging) strategies, including strategies involving the use of exchange-traded options. The vague language of the proposal also raises significant line-drawing questions, particularly with respect to options transactions.

If Congress decides to eliminate the tax benefits of the short-against-the-box transaction, a decision that the members of the Coalition believe should be made only after the relevant issues have been vetted in the normal legislative process, any legislation implementing that decision should be limited to that transaction. If other specific transactions are determined to be close substitutes for a short-against-the-box transaction, the legislation could also clearly identify those transactions and apply to them.

Exchange-traded options, which are created pursuant to established rules of the exchanges, have uniform and straight-forward terms intended to make them suitable for a broad range of risk-shifting and other investment-oriented transactions. Such options are used primarily to hedge short-term risks or to generate investment income and gains. To the best of the knowledge of the members of the Coalition, exchange-traded options are not used as substitutes for the short-against-the-box transaction. Moreover, hedges consisting of exchange-traded options are not economically equivalent to a short-against-the-box transaction. Accordingly, the Coalition opposes the Administration's Proposal to the extent it would apply to hedges consisting of exchange-traded options.

The second proposal addressed by these comments is the proposal to deny the dividends received deduction ("DRD") to a corporation that has hedged its risk of loss with respect to dividend-paying stock around the time of the dividend. The stated

reason for this proposal is simply that the DRD should not be allowed when the owner of the stock does not bear the risk of loss inherent in the ownership of stock at the time a dividend is paid. The proposal does not appear to be aimed at any type of abusive transaction. Rather, it reflects a novel view of the function of the DRD that is at odds with the long-standing policy against imposing multiple layers of corporate-level taxes on the same income. The Coalition believes that current law adequately prevents "dividend stripping" and other tax-motivated transactions relating to the DRD and that it is inappropriate to impose multiple layers of corporate-level taxes on the same income simply because the owner of stock has hedged its risk around the time that a dividend is paid.

BACKGROUND

The options exchanges play an important role in the nation's economy. One of their most important functions is to permit individuals and firms that do not want to bear certain risks to transfer those risks to others who are more willing to bear them. In the words of the Securities and Exchange Commission, exchange-traded options:

> "provide a means for shifting the risk of unfavorable short-term stock price movements from owners of stock who have, but do not wish to bear these risks, to others who are willing to assume such risks in anticipation of possible rewards from favorable price movements."

SEC, Report of the Special Study of the Options Markets, House Committee on Interstate and Foreign Commerce (Committee Print 96-IFC3) 96th Cong. 1st Sess. 1 (1979).

The existence of options markets also tends to enhance the liquidity of the underlying markets. The options markets afford an efficient and cost-effective means of adjusting an investment's risk/return characteristics and provide market participants with the ability to create more diverse risk/return alternatives. These features tend to make participation in the underlying markets more attractive to a greater number of participants, thus increasing the liquidity in those markets.

The utility of the options markets is evidenced by the substantial volume of transactions on the options exchanges. In 1995, for example, 174.4 million options contracts on individual equities were traded on the options exchanges. The average daily volume for the year was 695,000 contracts, with each contract representing 100 shares of stock. The total option premiums for the year amounted to $50.8 billion.

DISCUSSION

I. The Short-Against-The-Box Proposal

The Administration's proposal would require gain recognition on an "appreciated financial position" held by a taxpayer whenever the taxpayer (i) enters into a transaction with respect to "substantially identical property" that "substantially eliminates the risk of loss and opportunity for gain" on such position "for some period" or (ii) enters into any other transaction that is marketed as being "economically equivalent" to such a transaction. These transactions are referred to as "constructive sales." Under the Administration's proposal, purchasing a put option or writing a call option on substantially identical property constitutes a constructive sale if the option is "substantially certain" to be exercised.[1/]

[1/] See section 9512 of the President's 1997 Budget Bill.

The broad language of the Administration's proposal goes much further than changing the tax treatment of the short-against-the-box transaction. It would appear to reach many risk-reduction transactions that are not tax-motivated and are clearly not "abusive". This broad scope is plainly inconsistent with the fact that the Administration's proposal would trigger only gains and not losses.

The vagueness of the language used in the Administration's proposal raises significant line-drawing questions for hedging transactions that significantly reduce, but do not eliminate, risk of loss and opportunity for gain. The line-drawing questions are perhaps most significant for transactions involving the use of options, particularly exchange-traded options (also known as "listed" options). The uncertainty created by the proposed language will cause investors and traders to refrain from non-tax-motivated investment and hedging transactions because of the tax risk, leading to costly and undesirable market distortions and inefficiencies. Creating this type of uncertainty in the markets is clearly inappropriate in the absence of some Congressional finding that the options markets are being used by taxpayers to engage in transactions that are determined to be abusive.

The comments that follow discuss more specifically these and other concerns raised by the Administration's proposal and set forth recommendations for limiting the scope of the proposed legislation.

A. **Options Transactions Are Fundamentally Different from the Short-Against-the-Box Transaction** -- Options transactions are fundamentally different from the short-against-the-box transaction. First, exchange-traded options are generally used to hedge short-term risks or to generate investment income and gains. Since they are of limited duration, these options cannot be used to eliminate risk of loss and/or opportunity for gain for an indefinite period (or until death), as is the case with the short-against-the-box transaction. Thus, even though a taxpayer may reduce his risk during the term of the option, entering into the option transaction affords no protection from risks for the period beyond the term of the option.

Although a taxpayer could conceivably enter into a series of options transactions, one after the other as each option expires or is closed out, doing so would not be an efficient means of obtaining tax deferral. This is true for the following reasons:

- If the value of the hedged stock declines and the value of the option increases, the gain that was in the stock will essentially shift over to the option, and the gain on the option will be recognized at or before the time the option expires. Thus, the taxpayer cannot have any assurance of deferring gain recognition through a series of option transactions.

- Alternatively, if the value of the stock increases, and the value of the option declines, the taxpayer will have to invest a greater amount of capital to replace the option.

- Each time the taxpayer enters into a new options transaction, he would create a new straddle under Code section 1092. Gains on any such options would be taxed when the options are closed out or expire, while losses on such options would be deferred under the straddle rules.[2/]

[2/] Since the straddle rules defer losses to the extent of unrecognized gains in offsetting positions without regard to when the gains accrue economically, a loss on the option due to the decline in its time value will not be allowed even where the

(continued...)

Thus, over time the taxpayer would be "whipsawed" with respect to gains and losses on the options.[3] In addition, under Code section 263(g) the taxpayer would have to capitalize any interest and carrying charges allocable to the positions in the straddle.

- Each time the taxpayer enters into a new options transaction, he would incur additional transaction costs.

Second, unlike a short-against-the-box transaction, which completely eliminates upside and downside risk, exchange-traded options transactions can never completely eliminate such risk. For example, writing a deep-in-the-money call may reduce downside risk (as well as upside potential), but the taxpayer still bears the risk that the stock may drop below the strike price of the option. Even in the recent bull market, one can point to numerous examples of steep declines in the values of individual stocks over relatively short periods of time. Unlike a short-against-the-box transaction, a deep-in-the-money call does not protect an investor against such risks. Similarly, a taxpayer who purchases a deep-in-the-money put with respect to stock that he holds still has an opportunity for gain if the stock price rises above the strike price of the put.

In addition, a taxpayer who hedges a stock with exchange-traded options continues to receive any dividend on the stock and has no obligation to make any comparable payments to another party. Thus, the taxpayer continues to receive the economic return attributable to the dividend, and he bears the risk that the dividend may decrease (as well as the potential benefit from an increase in the dividend).[4]

Third, options transactions that may be covered by the proposal are entered into for non-tax reasons. The options transaction that comes closest to a short-against-the-box transaction is known as a "forward conversion," which consists of (i) long stock and (ii) a long put and a short call with the same strike price and the same expiration date. A forward conversion comes very close to eliminating downside risk and upside potential during the life of the options. Nonetheless, the principal use of forward conversions is in a non-tax-motivated arbitrage strategy that locks in small profits based on price discrepancies in the stock and options markets.[5] These arbitrage transactions would take place even if there were no tax system.

Similarly, a taxpayer who wants to hedge his stock (whether appreciated, depreciated or flat) may purchase a put to protect against perceived short-term risk. In order to finance the cost of the put, the taxpayer may write a call and use the premium

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[2](...continued)
value of the stock, which had appreciated before the options transaction was entered into, remains unchanged during the life of the option.

[3] The applicability of the straddle rules to options is apparently one of the reasons that they are not viewed as an efficient means of deferring gains. See Kleinbard and Nigenhuis, Short Sales and Short Sale Principles in Contemporary Applications, 53d N.Y.U. Institute of Taxation § 17.01(1) n.3. (1995) ("Options transactions seem to be less attractive to investors" as a tax deferral strategy than short-against-the-box and equity swap transactions in part because of the straddle rules).

[4] See J. Hull, Options, Futures and Other Derivative Securities, pp. 140-141 (2d ed. 1993).

[5] Because of transaction costs, these arbitrage profits can be captured only by large traders, stock specialists and market makers.

received for the call to pay for the put. For example, if a stock is trading at $42, a taxpayer might purchase a put at $40 for $2 and write a call at $45 for $2. The $2 premium received for the call would pay for the cost of the put. This transaction, which is known as a collar, is engaged in simply to hedge short-term risk at little or no cost and would be utilized even if there were no tax system. Nonetheless, it may be covered by the Administration's Proposal because the taxpayer may be viewed as retaining only limited downside risk and upside potential.

Fourth, exchange-traded options are particularly unsuited as substitutes for a short-against-the-box transaction. These options are standardized contracts, and the exchanges specify the strike price of an option and the date of expiration in accordance with their rules. An option is traded on an exchange only if the exchange authorizes trading in that option. Thus, listed options cannot be customized to suit an individual taxpayer's situation.

Under the rules that govern the listing of options, the exchanges do not create deep-in-the-money options. Rather, listed options are created at strike prices that are very close to the current price of the stock.[6] For example, if a stock is trading at $48, the exchanges would create options at strike prices of $45 and $50. Although options can become deep-in-the-money over time as a result of price movements in the stock, the extent to which a listed option can become deep-in-the-money is limited by the life of the option and the volatility of the stock. For example, for a stock trading at $48 in June, the exchanges would create new options with strike prices of $45 and $50 expiring in February of the following year. If the stock goes up to $100 by the following January, these $45 and $50 March options will still be listed for trading on the exchange. However, a stock whose value increased by such a great amount in such a short period of time is a very volatile stock, and thus its market value could change so rapidly that deep-in-the-money options may provide relatively little protection.

In addition, exchange-traded stock options are American-style options, which means they can be exercised at any time prior to expiration. Thus, for example, an investor who writes an in-the-money call option is at risk that the option will be exercised against him at any time. A taxpayer seeking deferral of gain would prefer the certainty of a European-style option, which can be exercised only at expiration.

Fifth, the vast majority (roughly 90%) of exchange-traded equity options are closed out or expire unexercised. Taxpayers who use options as hedges generally continue to hold their stock after they close out the option or the option expires. Entering into the hedge is not simply a prelude to disposing of the stock. These hedges are thus distinguishable from the types of options transactions apparently envisioned by the Administration's proposal, which consist of selling a call or buying a put that is substantially certain to be exercised. That language seems to reflect the view that such options should be treated as constructive sales because they are in effect a forward sale, i.e., the taxpayer has entered into a transaction that will result in the sale of an asset at a certain price but is able to defer the recognition of the gain for tax purposes. This analysis does not apply to hedges where the taxpayer continues to hold the asset after the option expires or is closed out.

Finally, unlike the short-against-the-box transaction, which is a well-defined transaction, the types of options transactions that are potentially subject to the Administration's Proposal are highly uncertain (i.e., the transactions are not well-defined). The Administration's Proposal would apply to certain options if they are "substantially certain" to be exercised or if the options "substantially eliminate" risk of

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[6] See, e.g., CBOE Rule 5.5, Interpretations and Policies .02. See generally Hull, supra, pp. 139-140.

loss and opportunity for gain "for some period." None of these terms has any precise meaning.

Applying such vague standards to options transactions will create unacceptable uncertainty in the markets.[7] Vague standards will cause taxpayers to refrain from engaging in non-tax-motivated transactions because of a fear that they may unknowingly trigger gain recognition in an appreciated stock position, which will lead to costly and undesirable market distortions and inefficiencies.

Recommendation: In light of these differences between options and the short-against-the-box transaction, the members of the Coalition believe that the legislation should not apply to hedges using listed options. Accordingly, hedges consisting of listed options should be excluded from the definition of a constructive sale.

B. Options as Appreciated Financial Positions. -- The Administration's proposal defines an appreciated financial position as including not only direct interests in stock, but also positions with respect to stock, including an option on the stock. If a taxpayer purchases a call option on a stock and the call increases in value, the call would be an appreciated financial position. If a taxpayer then enters into a transaction that substantially eliminates the risk of loss and opportunity for (additional) gain on the call, the gain on the call would be recognized.

As explained above, a listed option has a limited life that is set by the exchange pursuant to its rules. In order for an option to appreciate to any significant extent, some time must pass after it is initially entered into, and thus appreciated options positions will have an even shorter remaining life until expiration. Since any gain on the option will generally be recognized by the time the option is scheduled to expire, it seems unnecessary to treat such options as appreciated financial positions.

The taxpayer will recognize any gain on the option when he closes out the option or the option expires unexercised.[8] The taxpayer cannot avoid recognizing that gain by entering into a new options transaction. There is also no way that the term of an exchange-traded option can be extended.

It is also possible that the option will be exercised. Situations in which the option might be exercised fall into two categories, neither of which would be efficient from a tax-deferral perspective. First, if the appreciated option is a long put or a short call, the exercise of the option would force the taxpayer to sell stock and any gain on the option would generally be taxed as part of such sale. Second, if the taxpayer's option position consists of a long call or a short put, the taxpayer could either exercise the call or be assigned on the put, with the result that he would have to purchase the underlying stock. While in these situations any gain on the option would effectively be rolled into the stock, a taxpayer would not pursue this strategy to obtain deferral of gain in the option because (i) as compared with the relatively small cost of

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[7] The importance of certainty to the markets is illustrated by the existence of the "qualified covered call rules" in section 1092(c)(4), which provide mechanical tests for determining whether writing a covered call creates a straddle. Similarly, Congress clarified the rules for "securities lending transactions" in section 1058 so that taxpayers could have certainty as to whether a transaction would be treated as a sale. Congress provided this clarification because it recognized that securities lending transactions contribute to the liquidity of the securities market. See S. Rep. No. 95-762, 95th Cong. 2d Sess. 5 (1978), reprinted in 1978 U.S.C.C.A.N. 1286, 1290.

[8] As noted above, roughly 90% of exchange-traded options are closed out or expire unexercised.

the option, he would need to make a significant capital investment to acquire the stock, (ii) he would incur transaction costs on the purchase of the stock as well as on a subsequent sale of stock, and (iii) he would take on the risks of owning the stock.

Treating exchange-traded options as appreciated financial positions also creates some peculiar and undesirable results. For example, taxpayers holding stock frequently write calls, particularly qualified covered calls,[9] with respect to stock that they hold. Writing covered calls is viewed by many as a conservative investment strategy that entails giving up the opportunity to benefit from an increase in the value of the stock during the life of the option in return for a more predictable return. If a taxpayer writes a qualified covered call and the underlying stock declines in value, the taxpayer will have a gain in the short call position.[10] If the taxpayer then purchases additional shares of the stock, he may be entering into a constructive sale of the short call since, depending on the facts, the newly acquired long stock could be viewed as substantially eliminating the risk of loss and opportunity for gain on the short call. This inappropriate treatment could apparently apply even though the taxpayer's motivation was simply to acquire more of the stock (e.g., under a "dollar cost averaging" investment strategy).

In addition, treating listed options as within the scope of appreciated financial positions will create an additional realm of complexity in determining whether one or more options transactions "substantially eliminate" risk of loss and opportunity for gain on other options positions. The combinations of positions that are possible are much greater than when the appreciated financial position is a direct interest in stock, as is the case in the short-against-the-box transaction. In addition, there is a serious risk that the IRS would match up a taxpayer's positions in ways other than the taxpayer intended.

Recommendation: For all of the foregoing reasons, the options exchanges believe that listed options, as well as other short-term options, should be excluded from the definition of an appreciated financial position. Given the short-term nature of these instruments, excluding them from the scope of appreciated financial positions should not have any material effect on the revenue expected to be raised by the proposal

II. Holding Period Requirement for the DRD

Under current law, a corporation is not eligible for the DRD with respect to stock that is held for 45 days or less.[11] For this purpose, any day that is more than 45 days after the date on which the stock goes ex-dividend is not taken into account. In addition, the corporation's holding period is reduced for periods in which the corporation has reduced its risk of owning the stock through entering into various transactions. See Code § 246(c). Once the corporation has satisfied this holding period requirement, the corporation is eligible for the DRD with respect to dividends on the stock without regard to whether the corporation has reduced its risk of loss with respect to the stock around the time of any particular dividend.

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[9] A qualified covered call is an exchange-traded call option that satisfies certain mechanical tests under section 1092. Qualified covered calls are not subject to the straddle rules.

[10] Even if the stock price stays flat, the passage of time will give rise to gain in the short call position.

[11] The holding period requirement is 91 days in the case of certain preferred stock.

The holding-period requirement of current law is designed to prevent "dividend-stripping" transactions in which a corporation would purchase stock shortly before the ex-dividend date and sell the stock shortly after that date. In the absence of the holding-period requirement, the corporation would receive dividend income eligible for the DRD and generate an off-setting short-term capital loss on the sale of the stock, which (all else being equal) would decline in value by roughly the amount of the dividend. This capital loss could be used to reduce unrelated capital gain. By requiring the corporations to hold the stock for more than 45 days, and by excluding for this purpose any days on which the taxpayer has reduced its risk, this rule requires a corporation to bear market risk associated with owning the stock for a sufficiently long period to make dividend stripping unattractive.

Current law also includes various other rules designed to prevent "tax arbitrage transactions" relating to the DRD. For example, no DRD is allowed with respect to a dividend if the corporation has an obligation to make related payments with respect to positions in substantially similar or related property. See Code § 246(c)(1)(B). Thus, a taxpayer that sells short against the box can not claim the DRD for any dividends it receives during the period of the short sale because it has an obligation to make "in lieu of dividend payments" to the stock lender. Another rule requires basis adjustments in stock when a corporation receives certain extraordinary dividends with respect to that stock unless the corporation has held the stock for a period of two years.[12] See Code § 1059. Yet another restriction is found in section 246A, which denies the DRD for debt-financed portfolio stock in order to prevent taxpayers from both claiming the DRD and deducting interest expense with respect to debt that finances the holding of the dividend-paying stock.

The Administration's proposal would take the current rules that are designed to prevent dividend-stripping and apply them with respect to each dividend. Thus, in order to be eligible for the DRD with respect to a dividend, the corporation would be required to hold the stock -- unhedged -- for at least 46 days around the time of the ex-dividend date. The stated reason for this proposal is simply that it is inappropriate for a taxpayer to receive the DRD if it is not at risk around the time of the dividend.

This policy change is difficult to justify. It would deny the DRD to a long-term holder of stock simply because it hedged its risks at a time proximate to a dividend payment. Other than as part of a package to reduce the benefits of the DRD, along with the Administration's proposal to reduce the DRD on portfolio stock from 70% to 50%, we see no rationale for the proposal. The effect of the proposal is to exacerbate the triple-tax problem that the DRD is intended to minimize. While the issue of whether to continue the longstanding policies that underlie the DRD is certainly a matter for Congress to decide, we do not believe that the fact that a corporation happens to hedge its risks over a dividend date is a reasonable basis for determining that the earnings distributed by the dividend should be subject to multiple layers of full corporate tax.

The fact that a taxpayer has reduced its risk of loss with respect to a stock does not mean that it is not the tax owner of the stock. Thus, in the absence of some abuse of the tax system or some inappropriate tax arbitrage, the fact that the taxpayer has reduced its risk is not a sufficient reason for denying it the benefits of ownership. This principle is evidenced by the treatment of holders of municipal bonds. The fact that a taxpayer that holds a municipal bond has hedged its risk with respect to the bond,

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[12] An amendment included in the Balanced Budget Act of 1995 and in the President's 1997 Budget would require immediate gain recognition with respect to stock in the case of certain extraordinary dividends.

say by purchasing a put on the bond, does not mean the interest that it receives on the bond is no longer tax-exempt. Similarly, there are a number of types of preferred stock, such as auction-rate preferred and mandatorily redeemable preferred, that include substantial risk-reduction features. Holders of such stock are entitled to the DRD under current law and would continue to be eligible for the DRD even under this proposal.

CONCLUSION

For the reasons set forth above, the members of the Coalition believe that any legislation designed to eliminate the tax benefits associated with the short-against-the-box transaction should not apply to hedges with exchange-traded options. Such options should also be excluded from the definition of an "appreciated financial position." Finally, the proposal to apply the current-law DRD holding period requirement to each dividend should not be adopted.

Airports Council International - North America
American Association of Port Authorities
American Planning Association
American Public Gas Association
American Public Power Association
Association of Local Housing Finance Agencies
American Metropolitan Sewerage Agencies
Council of Development Finance Agencies
Council of Infrastructure Financing Authorities
Education Finance Council
Equipment Leasing Association
Government Finance Officers Association
Municipal Treasurers' Association
National Association of Counties
National Association of Higher Educational Facilities Authorities
National Association of Housing & Redevelopment Officials
National Association of Independent Insurers
National Association of State Treasurers
National Association of State Universities and Land Grant Colleges
National Council of Health Facilities Finance Authorities
National Council of State Housing Agencies
National League of Cities
National Realty Committee
National School Boards Association
Public Securities Association
United States Conference of Mayors

May 15, 1996

Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Attn: Phillip Moseley, Chief of Staff

Dear Ways and Means Committee Members:

Re: Comments on Revenue Provisions Contained in President Clinton's Fiscal Year 1997 Budget Request: Extension of Pro Rata Disallowance of Tax-Exempt Interest Expense to All Corporations

The 25 organizations listed above are writing in opposition to the Administration's FY 1997 budget provision that adversely affects the demand for tax-exempt municipal bonds by extending to all corporations the deduction disallowance of interest expense for entities that hold tax-exempt interest securities. These organizations represent elected and appointed state and local government officials as well as underwriters, leasing companies, and financial services corporations that assist governments in their financings by purchasing their securities.

The Administration's proposal would have a significant negative effect on the financing costs of public entities at a time when the federal government is calling upon states and localities to undertake new responsibilities. The Administration's proposal is billed as a corporate welfare provision that purports to target corporate tax loopholes. However, if enacted, it would adversely affect corporate demand for tax-exempt debt and state and local government financing costs. This would lead to state and local government tax increases, or, more likely, a decrease in services to balance budgets.

Corporations would not be willing to purchase tax-exempt securities at the same interest rate if they lost the current law interest deduction. This valuable source of funding for state and local governments would be severely diminished. As a result, the cost of infrastructure facilities financed by municipal tax-exempt bonds and the cost of school buses, police cars, 911 phone systems, and other necessary governmental equipment acquired through a tax-exempt municipal leasing program would increase. With respect to municipal tax-exempt leases, if governments have to pay lessors the equivalent of a taxable interest rate, current rates that the governments pay could increase by as much as 50 to 60 percent.

Current Law

Under current law, the general rule is that no income tax deduction is allowed for interest on debt used directly or indirectly to acquire or hold tax-exempt securities. However, there are special rules that apply to various types of corporations. Nonfinancial corporations and certain other taxpayers are permitted to apply a tracing rule to determine if their interest expenses are permitted deductions. If a corporation can demonstrate that it did not finance its purchases of tax-exempt bonds through borrowing, no portion of its interest expense deduction is disallowed. Furthermore, the Internal Revenue Service (IRS) established in Revenue Procedure 72-18 two other "bright line" tests to assist taxpayers in complying with the law.

The first of these is the two percent *de minimis* rule. The rule provides that so long as the investor's holdings of municipal securities constitute less than two percent of it total assets, the IRS generally will not inquire whether any of the borrowings of the investor were incurred for the purpose of purchasing or carrying tax-exempt securities. The second test is a vendor financing exception, which allows a corporation to take nonnegotiable obligations in payment for goods or services rendered to a state or local government. A tax-exempt lease payment is an example of such a payment and a portion of that payment is tax-exempt income to the lessor.

The Clinton Administration's Proposal

Under the Clinton Administration proposal, all corporations would be treated the same as financial corporations are treated under current law. For example, all corporations would not be allowed an interest-expense deduction for the portion of their interest expense equal to the portion of their total assets that is comprised of tax-exempt securities. Additionally, this disallowance provision would apply to all related parties and would treat all members of a consolidated group as a single entity.

The Administration has proposed an exception to the affiliated companies section of its proposal for property and casualty firms, which in the aggregate hold approximately 13 percent of outstanding municipal bonds, but buy up to 50 percent of new issues. Because they generally do not borrow or incur substantial interest expenses, property and casualty firms are not affected by current-law restrictions on corporate municipal bond investors. Almost all of these firms, however, are part of a larger, consolidated corporate group that has debt outstanding and would have been caught by the new affiliated companies provision. The Administration's proposed exception for property and casualty firms is a step in the right direction and would restore demand for municipal bonds by this key group of bond buyers. However, it fails to address the concerns of other affected municipal bond purchasers.

The Administration proposed the extension of the pro rata disallowance provision to remove distinctions in the tax code that are related to the type of business activity a corporation conducts, and to apply similar tax rules to all corporations. The architects of the plan say that

this approach recognizes that money is fungible and that borrowing for one purpose frees the taxpayer's remaining assets for other purposes. Although many of these rules have been in existence for almost 80 years, the administration claims that the current law permits the affected corporations to reduce their tax liabilities inappropriately through federal tax benefits of interest-expense deductions and tax-exempt interest income.

In previous attempts to amend the section of the tax code that sets forth these rules (Section 265), the charge has been made that corporations have deliberately engaged in arbitrage practices by borrowing in the short-term market and investing in tax-exempt obligations. Treasury officials also now claim that the new proposals are intended to "help" banks by equalizing the tax treatment of financing subsidiaries of large corporations with that of banks. Under current law, banks are permitted to take an interest deduction only for certain so-called "bank-qualified" bonds.

Impact on State and Local Governments

Corporate investors affected by the proposal, in its current form, hold about 6.8 percent of the approximately $1.3 trillion of outstanding municipal bonds. These corporations buy and hold a substantial amount of newly issued securities in the short-term market and in municipal leases. With the elimination of this corporate investor demand, the market would become more dependent on individuals and would become captive to individual investor sentiment and the flow of new monies into mutual funds. Interest rates would be more volatile and would be higher than now. The higher interest rates would be passed on to the government that is borrowing in the municipal market or entering into a municipal tax-exempt lease. Ironically, the proposed change would result in a greater revenue loss for the federal government because investors who are not affected by Section 265, that is, they are not borrowing funds and taking an interest deduction, would receive greater tax-exempt interest income, due to the loss in investor demand and the resulting higher rates.

Different types of corporations participate in the municipal market in different ways. Therefore, the administration's proposal could affect different types of municipal financing, as described below.

- *Short-term Borrowing*. Many corporations currently invest in short-term tax-exempt securities for cash management purposes. The 2 percent *de minimis* rule assures corporate investors that if they stay within the 2 percent limitation, they will not have to produce evidence of the relationship between their borrowing and their tax-exempt income. Corporate investment provides a great deal of liquidity in the market for short-term notes, and the administration's proposal would drastically curtail or eliminate corporate participation in this market.

  One example is the traveler's check and money order companies that invest their reserves in short- and medium-term tax-exempt securities. Most states have laws that strictly control traveler's check and money order businesses, requiring them to maintain substantial reserve funds and to invest those fund in very creditworthy securities such as Treasuries, municipals, or high-rated corporate securities. These companies are not using municipals as a tax dodge, but rather are buying tax-exempt bonds because state regulators view them as a safe investment. Thus, the Administration's proposal would curtail the level of demand these companies would have for municipals.

- *Tax-exempt Leasing*. States and localities routinely lease assets and equipment, such as school buses, police cars, phone systems, and computers. Equipment lessors estimate that their cost of financing for state and local governments would increase between 210 and 450 basis points because of the administration proposal. Although

the administration's proposal would not apply to "certain nonsalable tax-exempt bonds acquired by a corporation in the ordinary course of business," this intended relief for state and local governments is illusory. The vast majority of equipment manufacturers who sell to state and local governments prefer not to hold municipal leases because they do not want to tie up their capital. These companies generally sell their financing contracts to third-party investors to generate the capital they need to continue to operate their businesses. Even where a manufacturer owns a captive finance company, the manufacturer would lose the vendor lease exemption when the lease was sold from the manufacturing company to the finance subsidiary.

An example of the impact on leasing costs has been provided by the Equipment Leasing Association. If a government enters a five-year lease for a $1 million 911 phone system and pays a 5.5 percent interest rate, the total amount repaid is $1,109,841. If the interest rate increases to a taxable equivalent of 9.0 percent, however, the total amount repaid increases 6.3 percent or by $69,482.

- *State and Local Housing Finance*. Federally sponsored corporations such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) are active in the markets for state and local housing bonds. These corporations also would be affected by the tax law change, and there would be a powerful incentive for these corporations to withdraw their support from the state and local housing bond market even though these corporations are required under federal law to engage in activities relating to mortgages on housing for low- and moderate-income families.

Repeal of Deduction Disallowance Is At Odds With New State/Local Responsibilities

The attack on tax-exempt financing by the Clinton Administration, whether intended or not, is at odds with the President's historical position on tax-exempt financing. In the late 1980s, he served as a member of the Anthony Commission on Public Finance and expressed his support for tax-exempt bonds in a 1988 *New York Times* op-ed piece entitled, "America is Buckling and Leaking." He noted the impact of similar tax code changes when he wrote:

> "Tax revision has had a further destructive impact on local finance. The alternative minimum tax has reduced the number of purchasers of tax-exempt bonds while driving up the bonds' cost in capital-poor states like Arkansas. In effect, the government is shifting responsibility for meeting more public needs down to the state and local level while restricting the tools we need to respond."

At the very time Congress is calling upon state and local governments to undertake new responsibilities, the U.S. government should not increase the borrowing and leasing costs these entities will incur in carrying out those obligations. Many Members of the House Ways and Means Committee have already expressed opposition to the extension of the pro rata disallowance of tax-exempt interest expense to all corporations. We are grateful for this support for our position. State and local governments and the private-sector firms that support their ability to finance public projects and services are hopeful that this opposition will continue, and encourage Congress to reject this highly objectionable budget proposal.

For more information, please contact the Government Finance Officers Association at 202/429-2750 or the Public Securities Association at 202/434-8400.

American Association of Classified School Employees
American Federation of State, County and Municipal Employees
American Federation of Teachers
American Public Power Association
Fraternal Order of Police
Government Finance Officers Association
International Association of Firefighters
International Chiefs of Police
International City-County Management Association
International Personnel Management Association
National Association of Counties
National Association of Government Deferred Compensation Administrators
National Association of Police Organizations
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Treasurers
National Conference of State Legislatures
National Education Association
National League of Cities
National Public Employee Labor Relations Board
National School Board Association
Service Employees International Union
United States Conference of Mayors

May 13, 1996

The Honorable Bill Archer, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515-6348

Dear Chairman Archer,

The above organizations respectfully request that this letter be submitted for the record in response to Chairman Archer's requests for comments on the FY '97 federal budget.

We urge you to pass, this year, as part of a budget reconciliation bill, a tax bill, or as a separate measure, a provision to protect $40 billion dollars of public employee retirement savings currently invested in Section 457 deferred compensation plans throughout the country. These plans are the primary vehicle used by government employees to set aside their own money for future retirement needs. The savings set aside under the rules of the plan are tax deferred until money is actually received at retirement.

Section 457 of the Internal Revenue Code requires deferred compensation plans to follow a number of rules. Most rules exist to ensure that money saved is in fact used for

retirement. One rule, however, defeats both that goal and the broader national purpose of encouraging saving for retirement.

Section 457 (b)(6) requires the governmental employer to own assets of the deferred compensation plan--without recognition of the employee's interest in those assets. The IRC also requires that plan assets must be subject to the claims of the employer's creditors. During times of fiscal stress this requirement creates the possibility of seizure or manipulation of this money. Recent fiscal problems faced by local governments in Southern California and other jurisdictions emphasize that this is real.

Both Congress and the President have actively supported provisions requiring that all Section 457 assets be held in trust, or a similar mechanism, for the exclusive benefit of participants and their beneficiaries. This would repeal the current law requirement that amounts deferred under Section 457 deferred compensation plans are subject to the claims of the employer's creditors. This trust or similar insulating device would protect these funds to be used for retirement against raids and insolvency of the employer. No other change in the structure or operation of these plans is intended.

Congress, with the Committee on Ways and Means taking the lead, included such a requirement in the Balanced Budget Act of 1995. The President has included it in his FY '97 budget proposal and in his Retirement and Savings Plan, soon to be introduced in Congress. Therefore, placing public employees' retirement assets at risk is entirely unnecessary. With agreement on this issue on all sides, it is urgent that such legislation be passed this year, as there was recently another public entity bankruptcy.

Additionally, we urge you to support the other pension simplification provisions included in the 1995 Balanced Budget Act and in the President's proposals, as well. They include enhancements to Section 457 plans long supported by this coalition;

indexation of the $7500 maximum contribution; disbursement of small fund balances; and, a one-time change in the effective date of withdrawal of 457 deferred compensation funds, as well as changes to Section 415(a).

Since Congress enacted Section 457 in 1978 over $40 billion has been contributed by millions of public employees, including police, teachers, park rangers, firefighters, and construction crews. Nearly all plans exist without a penny of taxpayer support. Therefore, we urge you to work with Congress and the Administration to pass legislation this year that all sides can support to protect both these Section 457 assets and the fruits of self denial and savings by the men and women who serve all Americans. We thank you, in advance, for your consideration of this most important matter.

STATEMENT OF AMERICAN BANKERS ASSOCIATION
ON

Revenue Provisions contained in President Clinton's Fiscal Year 1997 Budget Proposal
Committee on Ways and Means
U.S. House of Representatives

Increased Information Reporting Penalties

The ABA strongly opposes the Administration's proposal to increase penalties for failure to file information returns. Changes to the penalty structure solely for revenue raising purposes and without any underlying evidence to support a compliance problem is totally unwarranted and bad tax policy. The banking industry prepares and files a significant number of information returns annually in good faith for the sole benefit of the IRS. The current penalty structure provides more than enough incentive to file information returns properly, and the ABA strongly opposes the imposition of additional and unnecessary penalties for the sole purpose of raising revenue. This does not constitute "corporate welfare", or a "corporate loophole". The only way one could conclude that this proposal reduces "corporate welfare" or closes "corporate loopholes" would be to assume that corporations are noncompliant. There is no evidence suggesting noncompliance by corporations. The ABA, along with several other trade associations, objected to this measure when it was included in the Administration's December 7, 1995 budget proposal.

Limit Dividends Received Deduction

The ABA strongly opposes the Administration's most recent budget proposal to reduce the dividends-received deduction from 70% to 50% for corporations owning less than 20% of the stock of a U.S. corporation. The ABA, along with other trade associations and financial services companies, previously opposed this measure when it was included in the Administration's December 7, 1995 budget proposal. The Administration has not, however, provided any adequate justification for the reduction of this legitimate deduction. The dividends-received deduction currently prevents multiple level taxation of earnings from one corporation to another and does not constitute "corporate welfare", nor should it be considered a "corporate loophole". Such a limitation would create an unnecessary, unfair, and egregious multiple level corporate tax.

Modify Net Operating Loss Carry-back and Carry-forward Rules

The ABA opposes the Administration proposal to limit carry-backs of net operating losses (NOLs) to one year and extend carry-forwards to twenty years. Current law permits the use of NOLs to offset taxable income for three preceding taxable years and the succeeding fifteen taxable years to correct income distortions resulting from losses reported at the end of the taxable year. The proposed NOL carry-back limitation would further distort and prevent the reporting of accurate income for previous years. The Treasury Department explanation for the proposed limitation on NOL carry-backs cites increased complexity and administrative burden associated with carry-backs. Those reasons are inconsistent with sound tax policy and are not an adequate justification for a significant limitation on the NOL carry-back period. This proposal also may have non-revenue implications. Further studies are necessary in order to determine how such a proposal would impact regulatory capital. This provision should not be considered a "loophole" nor does it constitute "corporate welfare".

Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments

The ABA opposes the provision in President Clinton's Fiscal Year 1997 budget requiring prepayment assumptions for interest accruals that would cause credit card issuers to pay tax on grace period interest before having a fixed right to the income. The proposal would require issuers to include currently in taxable income an estimate of the amount of grace period interest that will accrue in the future. This estimate would be based on the

credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period.

The Treasury Department claims that prepayment assumptions currently applicable to REMIC interests should be extended to credit card receivables in order to "equalize" the treatment of these two types of instruments. This goal is misplaced, however, because prepayment assumptions are used under present law only for the limited purpose of accruing discounts and premiums on REMIC interests, but are not used for accruing stated interest. Instead, stated interest on debt instruments (including credit card receivables) is accrued under the historic "all events test" whereby taxpayers pay federal income tax on taxable income determined by reducing fixed and determinable income by fixed and determinable expenses. A consistent application of the fixed and determinable standard to both income and expense preserves the integrity and fairness of the system even though some income or expense items may be taken into account at different times for financial statement purposes. Accrual method taxpayers are not entitled to deduct estimates of future expenses (such as bad debts) which, based on experience, are highly likely to be incurred. Predictions of uncertain future events have long been rejected as a basis for tax accounting on both the income and the expense side. In fact, since 1984 the accrual of expenses has been deferred beyond the time that they are fixed and determinable. A further one-sided departure from the historic "all events test" will significantly distort taxable income solely for the sake of a one-time revenue raiser.

This provision should not be considered a "loophole" nor does it constitute "corporate welfare." The ABA believes that this proposal can only be viewed as a tax increase and an arbitrary departure from well established tax policy.

Basis of Substantially Identical Securities Determined on an Average Basis

The ABA opposes the Administration proposal that would require taxpayers to determine their basis in substantially identical securities using the average of all of their holdings in the securities. The ABA also opposes the proposed requirement that taxpayers use the first-in, first-out (FIFO) method for purposes of determining whether gain or loss on the sale of a security is long-term or short-term.

The proposed elimination of the separate identification of stock or securities sold and the mandated use of the FIFO method for calculating the holding period unnecessarily creates additional and complex recordkeeping burdens. Taxpayers would be required to maintain two sets of records for each investment: one for average cost (which must be adjusted at the time of each purchase) and another for acquisition dates (which must be adjusted at the time of each purchase or sale). This additional burden is further complicated for taxpayers who maintain computerized records. The programming itself would be substantial in order to establish, maintain and adjust two sets of records at the time of each transaction. We oppose the significant imposition of costs and compliance burdens associated with this proposal to change the timing aspects of reporting gain or loss from the sale of stock or securities.

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May 15, 1996

Mr. Philip D. Mosely
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Mosely:

This letter contains a summary of the position of my client, the American Car Rental Association ("ACRA"), concerning the President's FY 1997 Budget Proposals. The President's proposal to extend permanently the luxury tax on automobiles is of great concern to ACRA. ACRA opposes extension of the tax.

ACRA is a national trade association representing most of the nation's major car rental companies, including Budget Rent A Car Corporation, Dollar Systems, Inc., Avis, Inc., National Car Rental System, Inc., Thrifty Rent A Car System, Inc., Enterprise Rent A Car, Inc., and Alamo Rent A Car, Inc. ACRA's members also include hundreds of small independent businesses which are franchisees/licensees or independent car rental companies.

ACRA opposes the permanent extension of the tax because the tax imposes an inequitable burden on the cost of rental car company inventories. The car rental industry purchases millions of new cars each year. The additional costs of the luxury tax on those cars to which the tax applies cannot always be passed on to the consumer and will result in car rental companies' purchasing fewer vehicles that are subject to the tax.

Moreover, the luxury tax on cars is not a tax on luxury for the car rental industry. Larger cars that are subject to the tax are frequently rented by small groups of business travelers or

families on vacation, who need additional space provided by the larger vehicle. These types of consumers were not intended to be targeted by the luxury tax.

Finally, many car rental companies must pay this tax two or three times a year. Car rental companies cycle their fleets two or three times a year to assure their customers of low mileage vehicles. Such frequent payment of the luxury tax is a significant burden on cash flow, increasing the capital requirements for car rental companies even further.

The luxury tax on cars purchased by car rental companies has always been unfair. ACRA not only opposes the permanent extension of the tax, but urges Congress to pass legislation that would repeal the tax entirely.

ACRA appreciates the opportunity to comment on the President's 1997 Budget Proposals. ACRA looks forward to working with the Committee on Ways and Means on this and other tax measures during the coming months.

Sincerely,

J. KEITH AUSBROOK
Counsel to the
American Car Rental Association

JOINT STATEMENT OF THE AMERICAN COUNCIL FOR CAPITAL FORMATION, ET AL.

WRITTEN TESTIMONY SUBMITTED TO THE
WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

REGARDING A PROPOSAL INCLUDED IN PRESIDENT CLINTON'S
FISCAL 1997 BUDGET

TO REDUCE THE DIVIDENDS-RECEIVED DEDUCTION

MAY 15, 1996

The undersigned trade associations and companies appreciate the opportunity to respond to the Chairman's request for testimony to the House Ways and Means Committee on the new tax provisions of President Clinton's fiscal 1997 budget plan. Specifically, we are testifying in opposition to the Administration's proposal to reduce the dividends-received deduction from 70 percent to 50 percent.

As the list of signers to this testimony demonstrates, a broad range of trade associations and companies are concerned that the proposal relating to the dividends-received deduction takes a detrimental approach towards the critical tax and economic policy issues involved in the proper treatment of intercorporate dividends.

This is particularly the case given Congress' interest in examining tax proposals, including proposals representing fundamental tax reform, that promote savings and investment and the competitiveness of U.S. business. The Coalition believes very strongly that the President's proposal is inconsistent with these goals, and is inconsistent with the long-standing objective of the dividends-received deduction itself, which clearly has been to reduce the incidence of the multiple taxation of corporate income.

CURRENT LAW AND THE PRESIDENT'S PROPOSAL

Under current law, a corporate holder of an instrument that has been issued by a U.S. corporation and classified as equity for tax purposes is entitled to a deduction for dividends received on that instrument. In general, the deduction is 70 percent of dividends received if the recipient owns less than 20 percent of the stock of the payor, or 80 percent if the recipient owns 20 percent or more of the stock. If recipient and payor are members of the same affiliated group, the deduction is 100 percent.

The Administration has proposed reducing the 70-percent deduction to 50 percent. The proposal would be effective for dividends paid or accrued more than 30 days after the date of enactment.

The Administration's terse rationale is that the current 70-percent deduction "is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation."

HISTORY OF THE DIVIDENDS-RECEIVED DEDUCTION

The dividends-received deduction has existed in the federal tax law since 1909 -- when corporate income first became taxable. At the time, the dividends-received deduction was enacted to provide the full deductibility of intercorporate dividends. This 100 percent deduction ensured that income earned by a corporation was not taxed more than once at the corporate level.

The dividends-received deduction was reduced for the first time in 1935, to 90 percent, and then again in 1936 to 85 percent. During this period, the corporate income tax included a surtax applicable to income above a certain level, called the "surtax exemption amount." At the time, it was feared that a corporation would attempt to take advantage of multiple surtax exemptions by splitting its income among several subsidiaries, with subsidiary dividends being paid tax-free back to the parent, which received a 100-percent dividends-received deduction. The dividends-received deduction was reduced, therefore, to 85 percent in order to discourage "income splitting." The result, for the first time, was a second dose of corporate tax imposed on certain earnings (intercorporate dividends) before they had left the corporate sector.

The 100 percent dividends-received deduction was restored in 1964 for dividends paid within affiliated groups that elected to use only one surtax exemption. In 1975, the use of a single surtax exemption for an affiliated group became mandatory, so the rationale for reducing the dividends-received deduction was eliminated. Nevertheless, Congress at the time failed to restore the full dividends-received deduction for all corporations. As part of the Tax Reform Act of 1986, Congress reduced the dividends-received deduction from 85 percent to 80 percent, a move apparently intended to leave unchanged the effective tax rate on dividends as the corporate income tax rate was reduced.

Finally, in the Omnibus Budget Reconciliation Act of 1987, the deduction was reduced to 70 percent for dividends received from the stock of corporations in which the receiving corporation owns less than a 20 percent interest. The official rationale for reducing the deduction was that an 80-percent deduction was viewed as "too generous," although it was not explained how triple taxation could be "generous" in any degree. Of course, the paramount objective of the 1987 Act was to reduce forecasted budget deficits.

RATIONALE AND SUPPORT FOR CURRENT LAW

The history of the dividends-received deduction suggests that policy makers have consistently sought to use the deduction as a device to mitigate multiple layers of corporate tax. Without the dividends-received deduction, income would be taxed first when it is earned by a corporation, again when the remaining income is paid as a dividend to another corporate shareholder and, finally, a third time when the remaining income of the receiving corporation is paid as a dividend to an individual shareholder.

Without the deduction, the federal income tax on $100 of earnings could be nearly $75 after three levels of tax are applied.

The purpose of the dividends-received deduction is to mitigate the middle level of taxation, and a further reduction in the dividends-received deduction would exacerbate the triple taxation of intercorporate dividends. Reducing the dividends-reduced deduction runs counter to 85 years of corporate tax policy; moreover, taxing such income so heavily is both inequitable and distorts the economic decision-making process. These ill effects are present regardless of whether one corporation is an "alter ego" of another.

One such distortion would be to increase the cost of capital. Companies would tend to mitigate this result by raising capital through borrowing. Because interest is deductible, corporate earnings paid to investors in the form of interest, rather than dividends, would avoid the layers of tax imposed by the reduction or elimination of the dividends-received deduction. Yet policy makers have for some time questioned whether the tax law should encourage the use of debt over equity financing.

Moreover, there are sound, business reasons for one corporation to hold the stock in another, including regulatory requirements that apply to financial institutions and public utilities. It is thus inherently unfair and anti-competitive to penalize these and other companies that rely on equity rather than debt financing.

Moreover, a reduction in the dividends-received deduction would encourage corporations to raise equity capital by retaining earnings, rather than through new stock issuances. However, it can be argued that economic efficiencies are enhanced when earnings are distributed to shareholders.

Finally, while the corporation is an important form of business entity, the formation of which should be driven by business and economic concerns and not by tax considerations, the multiple taxation of corporate dividends can perversely encourage taxpayers to conduct business in non-corporate forms that are taxed only once on their earnings.

PERSONAL HOLDING COMPANIES

For personal holding companies, the incidence of three levels of tax on corporate dividends is very real. Personal holding companies face a 39.6-percent penalty tax if they do not pass on to their shareholders annually all dividends earned in a year on portfolio stock; personal holding companies really do not have an option to retain earnings and thus avoid multiple levels of tax. Therefore, all dividends earned by a personal holding company are subject to at least two federal income taxes -- a corporate income tax at the payor level and an individual shareholder tax when the amount is distributed by the personal holding company. A reduction in the dividends-received deduction to 50 percent increases the third level of tax -- from an effective tax rate of 12 percent to 20 percent at the personal holding company level and an overall tax on such earnings of nearly 69 percent.

MOVEMENT IN THE WRONG DIRECTION

There is good reason why well-meaning tax reform efforts have advocated reducing rather than increasing the multiple taxation of corporate income. In fact, tax policy and legal experts have advocated the "integration" of the income tax system for more than a generation.

It is ironic, therefore, that the proposal to reduce the dividends-received deduction comes at a time when Congressional leaders have committed themselves to tax reform proposals that correctly include only a single level of corporate income tax. While there are considerable differences over how a restructuring of the income tax system should be pursued, there appears to be a growing consensus in support of reducing the multiple taxation of corporate income.

Such proposals are founded in the fundamental goal that business investment, organization, and financial decisions be driven by economic and not tax considerations, and that, from a policy perspective, corporate net income should be taxed just like other income -- once and only once.

The Treasury Department, in 1984, recommended that triple taxation of corporate income be eliminated, and double taxation be halved, as part of its blueprint for an ideal tax system. Note that Treasury's recommendation was not limited to corporate "alter egos," since that concept is irrelevant to the fact, theory, or analysis of multiple taxation. A subsequent Treasury Department report, released in 1992,[1] documents the substantial economic benefits of integration and the economic distortions caused by the current multi-tiered system of taxing corporate income. The report concluded that any of three proposed integration prototypes would increase the capital stock in the corporate sector by $125 billion to $500 billion and would decrease the debt-to-asset ratio in the corporate sector from 1 to 7 percentage points.

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[1]Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems, January 1992.

Finally, most U.S. trading partners have adopted a single level of corporate taxation as a goal and provide some relief from double taxation of corporate income through corporate integration rules. To consider proposals that accentuate the problem of multiple taxation, rather than ameliorating this problem, will harm the international competitive position of U.S.-based corporations.

CONCLUSION

We urge the Committee not to consider the President's proposal to reduce the dividends-received deduction. Instead, changes to the deduction should be considered as part of the Committee's current comprehensive review of the income tax system. It is hoped that, as part of such a review, the Committee will agree that a more appropriate approach would be to reduce or eliminate the multiple taxation of corporation income, rather than further accentuate the inefficiencies and inequities of the current system.

This testimony is being submitted by the following trade associations and companies:

Trade Associations
The American Council for Capital Formation
American Insurance Association
Edison Electric Institute
Family Holding Company Group
Financial Executives Institute
Securities Industry Association
U.S. Chamber of Commerce

Companies
Baltimore Gas & Electric Company
Bear Stearns & Co., Inc.
The Chase Manhattan Corporation
Cinergy Corp.
Citicorp
Colonial Pipeline Company
Entergy
Household International
Houston Industries Incorporated
International Paper
J.P. Morgan & Co., Inc.
Kansas City Power & Light Company
Lehman Brothers Inc.
Merrill Lynch & Co., Inc.
Minnesota Power
Montana Power Company
Morgan Stanley & Co., Inc.
Nuveen Duff & Phelps Investment Advisors
Pitney Bowes Inc.
Prudential Securities

Statement for the Record

Mr. Sheldon Elliot Steinbach
Vice President and General Counsel
American Council on Education

HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
May 1, 1996

Mr. Chairman and Members of the Committee:

On behalf of the higher education associations listed below, we are pleased to file the following comments on the potential impact on America's charitable and educational organizations of replacing the federal income tax with an alternative tax system. This is an extremely serious issue about which the higher education community is deeply concerned.

I. Introduction

From the earliest colonial days, America's charities -- including its colleges and universities -- have helped define our national character and improve the quality of our individual lives. Such organizations are a uniquely American invention, one that grows out of our belief in the ability of private individuals to come together and work for the greater social good. No other country relies as heavily on the nonprofit sector to provide essential services such as education, health care, and disaster relief -- to name only a few of the myriad public purposes served by America's charitable institutions. And, in no other country is active participation and support by private individuals as important to the vitality of the nonprofit sector. Voluntary private giving accounts for 19% of the total support for our nonprofit sector. By contrast, in other developed countries where government provides virtually all public goods, there simply is no comparable tradition and practice of private giving. Not only is the nonprofit sector in these countries far smaller than in the U.S., it is also the case that private giving accounts for a dramatically smaller percentage of the nonprofit sector's total support.[1] At a time when government at all levels is reducing its support for public programs -- and, thus, shifting a greater share of the burden of offering these programs onto nonprofits -- it is critical that Congress maintain strong tax incentives for private giving.

The success of the American model in marshalling private generosity to foster public programs is nowhere more clearly evident than in our colleges and universities. Our system of higher education is the envy of the world. Every year hundreds of thousands of foreign students attend American educational institutions, both public and independent, to benefit from the highest quality instruction and research opportunities that are available here. America's colleges and universities are a key resource for ensuring long-term economic growth and international competitiveness. These institutions train the skilled and flexible workers business needs, nurture the scientific research that has made American industry a leader in new technology, and

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[1] In Germany and Italy, private giving accounts for just 4 percent of the support the nonprofit sector receives. In France and the U.K., private giving provides only 7 and 12 percent of total support respectively. Japan's nonprofit sector receives only 1 percent of its support from private contributions. Moreover, as noted above, it is important to bear in mind that in all of these countries, the nonprofit sector is far smaller than in the U.S. Chronicle of Philanthropy, at 1 (June 28, 1994) (reporting data from Johns Hopkins University Comparative Nonprofit Sector Project).

foster the spirit of innovation that is essential to a vital economy. Equally important, higher education broadens the base of individuals who benefit from the economic prosperity it helps create. Throughout the twentieth century, higher educational institutions have been the stepping stone for countless Americans to richer and more productive lives.

In recognition of the substantial public benefits colleges and universities provide, they have long enjoyed favorable tax status. The unique tax treatment of colleges and universities is deeply rooted in our common law tradition and has played a critical role in fostering the development of higher education. The three principal federal tax benefits bestowed on nonprofit educational organizations are (1) exemption from federal income tax, (2) eligibility to receive deductible contributions, and (3) access to tax-exempt financing.[2] Each of these benefits is vitally important to the financial health of our system of higher education.

Moreover, the importance of these supportive tax policies greatly transcends their direct financial value. This favorable tax treatment serves as a strong and visible affirmation by Congress that American colleges and universities, by virtue of the good they do and the high fiduciary standards they maintain, deserve broad public support.

II. Tax-exempt status for charitable and educational activities

Exemption from tax is the central element in the current system's treatment of charitable and educational organizations. The distinction between taxable and non-taxable organizations pervades the tax system and, more importantly, reinforces the fundamental distinction between enterprises organized for private gain and those created for public purposes. This distinction has been part of the Anglo-American system of taxation for centuries and is virtually axiomatic today. Moreover, the underlying policy rationale remains as compelling as ever: the public derives tremendous benefit from encouraging the commitment of private resources to nonprofit, nongovernmental efforts to advance the public good.

Tax-exempt status is widely understood to bring not only benefits but to impose burdens as well. The grant of tax exemption draws charitable organizations into a framework of legal rules and IRS oversight aimed at encouraging organizations to maintain a single-minded focus on their public service mission. Obviously, the public would lose the benefit of this accountability mechanism if charitable tax exemption were eliminated from federal tax law.

All of the various categories of tax reform proposals under consideration -- flat taxes, taxes on consumed income, and business transaction taxes (both the VAT and sales tax) -- can, and should, be designed to incorporate exemption for charitable and educational organizations.[3]

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[2] Technically, state supported colleges and universities receive these tax preferences by virtue of being governmental entities rather than because they are educational organizations in their own right. For the purpose of this statement, however, the distinction between public and independent institutions is not relevant.

[3] The mechanics of tax exemption are significantly more complicated in some systems than in others. For example, under a VAT, because tax is collected at each point of sale in the chain of production, exempt organizations would not only need to be exempted from the requirement that they collect VAT when they sell goods or services, but would also have to be given credits for the VAT they pay to suppliers when they make purchases.

III. The charitable deduction

The current income tax system incorporates important tax incentives for charitable giving. Individual taxpayers who itemize their deductions are permitted, within broad limits, to deduct charitable contributions. Similar income tax deductions are provided for corporations and estates. Gifts of appreciated property receive favorable treatment, with donors generally permitted to deduct the full value of the appreciated asset on their tax returns.

In contrast, several of the tax restructuring proposals currently on the table, at least in their pure forms, would eliminate these incentives for charitable giving. For example, the most widely discussed flat tax proposals would entirely eliminate the charitable deduction in the interest of broadening the tax base to achieve the lowest possible tax rate.[4] Similarly, a shift to either a national sales tax or a VAT would necessarily eliminate the deduction since under both systems, tax is imposed on individual transactions rather than on an individual's aggregate annual consumption expenditures.

It is important to stress at the outset that excluding charitable contributions from taxable income -- or from taxable consumption -- has a strong conceptual justification entirely independent of any stimulative effect on charitable giving. Resources that an individual voluntarily turns over to a charity to advance public purposes are not available to the donor to finance either present or future consumption. In this sense, charitable contributions are qualitatively different from any other consumption or investment use of personal assets. Because these assets are neither consumed nor saved for future private consumption -- but, instead, are invested for public purposes -- they are appropriately excluded from the tax base under either an income or consumption tax.

In considering the appropriate tax treatment of charitable contributions, it is also vital that Congress consider the importance of charitable giving to the ability of America's charities to meet their public service missions. For example, in 1994, voluntary contributions to higher education reached $12.35 billion.[5] This amount represents a substantial and essential element in the overall financing of higher education. While voluntary giving plays a somewhat larger role in financing independent colleges and universities, publicly supported institutions have long realized that they too must raise funds from private sources in order to provide quality instruction to their students and to support research. Indeed, many public colleges have established section 501(c)(3) foundations exclusively for fundraising purposes.

Of course, a host of factors other than the charitable deduction motivate individuals to give to colleges and universities. For some donors, the decision to give may grow out of a conscious recognition that an institution played a critical role in setting the course of his or her life; others give because they believe that support for education is an investment in the future; still others may give simply because they have fond memories of their college years. Whatever the reason for giving in individual cases, however, it is clear that,

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[4] Even if Congress enacted a flat tax that retained a deduction for charitable giving, the value the deduction for charities would be greatly reduced since its stimulus effect is a function of marginal tax rates which would significantly lower under a flat tax.

[5] Council for Aid to Education, Voluntary Support for Education 1994.

particularly for larger givers, the charitable deduction plays a key role in increasing the amount given.

The current deduction lowers the after tax price of giving for a top bracket taxpayer by roughly 40%. Taxpayers in lower brackets benefit from a smaller, though still substantial, reduction in the price of their charitable gifts. Accordingly, eliminating the deduction would substantially increase the real, after-tax cost of charitable giving for taxpayers who itemize their deductions.

Economists agree that such an increase in the price of giving would, if not offset by other factors, result in a decrease in giving. Historical experience suggests that the magnitude of this "price effect" is substantial. During the 1980s, when marginal tax rates dropped sharply, there was a correspondingly sharp drop in charitable giving. For example, IRS data show that between 1980 and 1991, average charitable giving for taxpayers with taxable income in excess of $1 million dropped from $207,000 to $100,000. More broadly, over the same period, total giving by itemizers declined substantially both as a percentage of their income and as a percentage of total giving.

Some proponents of structural tax reform suggest that the negative price effect of eliminating the charitable deduction would be largely, or even entirely, off-set by a countervailing "income effect." Empirical studies of charitable giving reveal that -- other things being equal -- donors increase the amount they give when they have more income. Noting this fact, some tax reform proponents argue that structural tax reform will trigger economic growth and increase incomes a point where the income effect will prevent the level of charitable giving from dropping despite losing the deduction. In this regard, we note that while it is certainly to be hoped that tax restructuring could both be revenue neutral and stimulate increased economic growth, achieving these goals is highly uncertain. As an organization representing nonprofit institutions that depend on private gifts to provide quality education, ACE recommends that Congress make appropriately conservative assumptions about increased economic growth when assessing the implications of tax restructuring proposals for charitable giving.

In a recent analysis of various proposals for tax restructuring, Professor Charles Clotfelter -- a noted expert on the impact of federal tax policy on charitable giving -- in collaboration with Professor Richard Schmalbeck, analyzed the possible impact of these countervailing price and income effects on charitable giving.[6] Reflecting the fact that neither the price nor the income effect can be estimated with precision, Clotfelter and Schmalbeck considered a range of possible price and income effects. The results are as follows:

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[6] Clotfelter and Schmalbeck, The Impact of Fundamental Tax Reform on Nonprofit Organizations, paper presented at the Brookings Institution conference, The Economic Effects of Fundamental Tax Reform (February 15-16, 1996) (April 6, 1996 version) (unpublished).

Category of gift	low price effect high income effect[7]	high price effect low income effect
Individual gifts	10% decline	22% decline
Corporate gifts	15% decline	45% decline
Bequests	24% decline	44% decline

Significantly, even using the most optimistic estimates of the price and income effects, the Clotfelter & Schmalbeck results indicate that individual giving will decline by 10 percent, corporate giving by 15 percent, and bequests by 25 percent. Using less optimistic estimates, the model projects declines of approximately twice these amounts.

Serious as these results would be for the charitable sector as a whole, they understate the adverse impact eliminating the charitable deduction would have on higher education. A disproportionately large share of gifts to colleges and universities are made by taxpayers in higher brackets who receive the largest incentives to give under the current system. Accordingly, colleges and universities would be disproportionately hard hit by eliminating the deduction.

Congress also needs to understand the direct impact that a reduction in giving to higher education would have on students struggling to pay for their educations. America's colleges and universities share a commitment to subsidizing the costs of education for those who cannot afford to pay regular tuition. In large part because of that commitment, higher educational institutions, both public and independent, are able to serve students of widely varying economic means. Colleges and universities are under considerable financial stress, however, as costs continue to rise and direct support from government continues to decline. In this context, it is obvious that any drop in private giving would translate into fewer funds for scholarship aid and reduced access to higher education for America's young people.

A major impetus for the tax restructuring proposals this Committee is considering is a recognition that America needs to encourage increased savings and investment. At the same time, many in Congress are calling for increasing private initiatives to address important public needs. Given these two goals, it would be ironic indeed if tax restructuring were to eliminate or erode current tax incentives for charitable giving -- the one aspect of current tax law that most directly addresses both of these critical objectives. Thus, in considering these proposals, Congress must carefully consider the impact each would have on charitable giving. Should Congress decide to adopt a tax system that eliminates or significantly reduces the effectiveness of the charitable deduction, then it is critical that the new system incorporate comparable incentives for charitable giving.

IV. Tax-exempt financing

The third important tax benefit granted to colleges and universities under the current tax rules is access to tax-exempt financing. By allowing purchasers of bonds issued on behalf of nonprofit educational organizations to exclude the interest they receive from their taxable income, the current tax system enables

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[7] In place of the "income effect," simulations of anticipated changes in bequests used contrasting assumptions about the effect changes in the size of the net disposable estate -- i.e. gross estate minus estate and gift tax credits -- would have on willingness to give at death.

colleges and universities to borrow at rates between 1.5 and 2.0 percentage points lower than taxable rate. This rate differential has a significant impact on colleges and universities' borrowing costs. For example a university that issued a thirty year tax-exempt bond for $10 million would pay $4.9 million more in interest than if the bond were taxable.

Tax-exempt bonds are a crucial means of financing major capital expenditures for a wide range of large nonprofit organizations -- all of which are barred by state and federal law from raising funds by issuing stock. Such financing is particularly important for higher education because of the large and costly physical plant required for both education and research activities. A recent study estimates the capital construction needs of American colleges and universities for new construction and essential maintenance of existing facilities at $60 billion. Because of a lack of capital funding, many institutions face a major deferred maintenance problem.[8] Moreover, this already serious situation is exacerbated by continuing reductions in direct support for higher education from the federal government.

We strongly urge Congress to consider the impact tax restructuring would have on the ability of higher education to finance critical capital improvements. Most flat tax proposals explicitly exempt interest income from tax, and thus would eliminate the preferred status of college and university bonds, forcing them to pay the same interest rate as regular corporate bonds.[9] A VAT or a sales tax would also erase the distinction between taxable and tax-exempt bonds.

If Congress chooses to enact either a flat tax or a business transaction tax, serious thought needs to be given to how higher education -- as well as other charities and state and local governments -- will be given access to affordable credit. As noted above, colleges and universities currently face continuing increases in the cost of providing education together with substantial reductions in government support. Hence, any increase in borrowing costs occasioned by the loss of tax-exempt financing will result in reduced scholarship aid, higher tuition, or diminished services.

Before leaving the subject of tax-exempt bonds, it is also important to note that if Congress ultimately decides to retain the existing income tax system, it should consider important improvements in the existing tax-exempt bond rules. In particular, ACE recommends that Congress remove the arbitrary distinction between governmental bonds and bonds issued on behalf of charitable and educational organizations. This distinction was introduced into the tax code as part of the Tax Reform Act of 1986 and has greatly -- and unnecessarily -- restricted access to tax-exempt financing by colleges and universities.

Most important, we urge Congress to repeal the $150 million dollar limit on bonds that may be issued on behalf of a

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[8] For scientific research facilities, the National Science Foundation has reported that for every $1 spent to maintain research facilities an additional $3.50 was deferred, and for every $1 spent for new science facilities $4.25 was deferred.

[9] Some proponents of tax restructuring argue that shifting to a consumption based tax will increase savings and cause interest rates to drop, so that charities and local governments will not see a rise in their borrowing costs. However, we believe the impact of tax restructuring on general interest rates is far too uncertain to support the conclusion that elimination of tax exemption financing will not have a major adverse impact on colleges and universities' ability to finance essential physical plans.

particular section 501(c)(3) organization. This limit was added to the tax code largely as means of limiting arbitrage by organizations that issued tax-exempt bonds and then invested the proceeds in taxable instruments paying a higher rate. Other tax-exempt bond rules subsequently added to the Code -- including arbitrage rebate requirements, bond maturity limits, hedge bond rules and advance refunding restrictions -- effectively address the arbitrage problem much more directly and efficiently. Hence, the $150 million dollar cap is no longer needed to control arbitrage.

The cap is causing higher educational institutions to incur increased financing costs and has greatly complicated the tax-exempt bond system for all organizations. There are already many colleges and universities that have reached the cap and are now forced to issue more costly taxable bonds to pay for badly needed capital improvements. Further, as Treasury stated in earlier testimony to this Committee, "the technical rules associated with the $150 million cap have proven complex and difficult to administer. Repeal of the cap would simplify the tax-exempt bond rules applicable to tax-exempt universities, charities, hospitals and other 501(c)(3) organizations."[10]

Given that the goal the cap was enacted to serve -- eliminating arbitrage -- has been fulfilled by other, more direct, tax law provisions, the hardship and complexity it has created serve no purpose. Hence, this arbitrary constraint on affordable borrowing by charitable and educational organizations should be repealed.

V. Other issues raised by tax restructuring

The developing debate on the impact of tax restructuring on charitable and educational organizations has focused primarily on how aspects of the current system that directly benefit such organizations could be retained or replicated. However, reform proposals should also be carefully reviewed to determine if they would inappropriately impose new burdens on charitable and educational organizations.

For example, ACE is concerned about the treatment of non-cash compensation paid by tax-exempt organizations under a consumption based flat tax of the sort proposed in H.R. 2060. Such a system would impose a flat tax on individuals and businesses but allow taxable employers to deduct cash compensation paid to employees. In contrast to the current system, employers would not, however, be allowed a deduction for non-cash compensation -- such as employer-provided health care benefits. In an apparent attempt to maintain parallel treatment between non-cash compensation paid by taxable and tax-exempt employers, H.R. 2060 would impose a special tax on tax-exempt organizations equal to the value of any such benefits paid by tax-exempt organizations times the corporate tax rate.

This aspect of H.R. 2060 would significantly increase the tax burden on tax-exempt organizations and would be particularly burdensome for labor-intensive charitable activities like higher education. Requiring charitable organizations to pay such a tax would also be inconsistent with the basic principle -- which is generally reflected in H.R. 2060 -- that income earned by charities should be exempt from taxation.

While not nearly as central as the core issues of exemption, deductibility of contributions, and tax-exempt financing, such

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[10] Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Select Revenue Measures or the House Committee on Ways and Means, June 22, 1993.

second-order issues also can have a serious adverse impact on higher education. ACE will bring such issues to the Committee's attention as they emerge, and strongly urges the Committee to give them careful consideration.

V. Conclusion

America's colleges and universities face major new challenges as they confront substantial reductions in direct federal support. While the level of funding these institutions receive from governmental sources continues to decline, the need for books, classroom facilities, laboratories, and scholarships only increases. In light of the fundamental role higher education plays in our society and in our individual lives, this is precisely the wrong time to reduce the traditional tax support afforded to colleges and universities. As Congress evaluates replacing the existing income tax, it must consider that the flat tax, the VAT, and a national sales tax would eliminate tax incentives for charitable giving and tax exempt financing. Enacting any of these proposals without incorporating some specific measures to replace these tax supports would certainly have a grave impact on higher education.

The following associations join in this statement

American Council on Education
American Association of Community Colleges
American Association of State Colleges and Universities
Association of American Universities
Association of Community College Trustees
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Council of Graduate Schools
Council of Independent Colleges
Hispanic Association of Colleges and Universities
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Student Financial Aid Administrators
National Association of State Universities and Land-Grant Colleges

American Financial Services Association

May 10, 1996

The Honorable William Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

Pursuant to your request for written comments on new revenue provisions in the President's Fiscal Year 1997 Budget, the American Financial Services Association (AFSA) wishes to express its strong opposition to the provision titled, "Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments", which in reality seems to cover only credit card receivables. The provision is an inappropriate departure from tax accrual standards and there is no basis for extending the prepayment assumptions currently applicable (for only limited purposes) to REMIC interests to credit card receivables in order to "equalize" the two types of significantly different instruments. AFSA is concerned both with the specific impact of the proposal on the credit card industry as well as the precedent it sets for further departures from long-standing tax law accrual standards. This is not an issue of "corporate welfare" or of closing a "loophole", but of whether or not for impacted tax payers in an arbitrary fashion purely to raise tax revenue.

Thank you for requesting comments and for considering our views on this important matter.

Sincerely,

Jeffrey A. Tassey
Senior Vice President
Government & Legal Affairs

Attachment

919 Eighteenth Street, N.W., Washington, D.C. 20006 Telephone: (202) 296-5544 *Fax: (202) 223-0321*

Comments of the American Financial Services Association on the New Revenue Provision in the President's Fiscal Year 1997 Budget that would "Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments"

I. Summary of AFSA'S Position

The American Financial Services Association (AFSA) strongly opposes the new revenue proposal titled, "Require Reasonable Payment Assumptions for Interest Accruals on Certain Debt Instruments", which in reality seems to be directed toward unbilled, estimated interest on credit card receivables. The provision is an inappropriate departure from tax accrual standards and there is no basis for extending the prepayment assumptions currently applicable (for only limited purposes) to REMIC interests to credit card receivables in order to "equalize" the two types of significantly different instruments. AFSA is concerned both with the specific impact of the proposal on the credit card industry as well as the precedent it sets for further departures from long-standing tax law accrual standards. This is not an issue of "corporate welfare" or of closing a "loophole", but of whether or not the "all events" test can be selectively dispensed for impacted taxpayers in an arbitrary fashion purely to raise tax revenues. A more thorough discussion of the issue is found below followed by a description of AFSA's membership as required by the request for comments.

II. Background

Under present law, holders of credit card receivables recognize credit card interest income for tax purposes under the historic "all events test". Accordingly, any interest income that is both fixed and determinable is accrued currently. Any interest income, however, the right to which is contingent upon events outside the taxpayers control, is not includable in taxable income until all events occur which eliminate the contingency. This rule applies to interest related to a "grace period" provided to a credit card customer.

Under a typical grace period arrangement (please see the attached chart), a credit card customer can avoid any finance charge on year-end purchases by paying the outstanding balance on or before the payment due date (i.e., through a 25-day grace period). The customer will owe interest related to the period from the billing date through the end of the year only if the customer fails to pay the outstanding balance before the end of the grace period. As the credit card issuer's right to this "grace period interest" is not fixed until the end of the grace period, the issuer is not required to currently accrue any grace period interest which becomes fixed during the subsequent year.

III. The Administration's Revenue Proposal

Simply stated, the provision in President Clinton's Fiscal Year 1997 budget requiring prepayment assumptions for interest accruals would cause credit card issuers to pay tax on grace period interest before having a fixed right to the income. The proposal would require issuers to include currently in taxable income an estimate of the amount of grace period interest that will accrue in the future. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period. If, in the attached example, the taxpayer assumed, based on experience, that 50 percent of all nominal grace period interest becomes fixed, the taxpayer would, under the budget proposal, have to accrue for 1995 50 percent of the estimated grace period interest on the $1,000 balance outstanding at December 31, 1995, or $3.50.

IV. Why the Revenue Proposal's Departure from Tax Accrual Standards is Inappropriate and Why REMICS are not Comparable Instruments

The Treasury Department claims that prepayment assumptions currently applicable to REMIC interests should be extended to credit card receivables in order to "equalize" the treatment of these two types of instruments. This goal is misplaced, however, because prepayment assumptions are used under present law only for the limited purpose of accruing discount and premium on REMIC interests, but are not used for accruing stated interest. Instead, stated interest on debt instruments (including credit card receivables) is accrued under the historic "all events test" whereby taxpayers pay federal income tax on taxable income determined by reducing fixed and determinable income by fixed and determinable expenses. A consistent application of the fixed and determinable standard to both income and expense preserves the integrity and fairness of the system even though some income or expense items may be taken into account at different times for financial statement purposes. Accrual method taxpayers are not entitled to deduct estimates of future expenses (such as bad debts) which, based on experience, are highly likely to be incurred. Predictions of uncertain future events have long been rejected as a basis for tax accounting on both the income and the expense side. In fact, since 1984 the accrual of expenses has been deferred beyond the time that they are fixed and determinable. A further one-sided departure from the historic "all events test" will significantly distort taxable income solely for the sake of a onetime revenue raiser.

V. Conclusion

Under no circumstances can present law be viewed as a "loophole" or as providing "corporate welfare." On the contrary, adopting the proposal in question can only be viewed as a tax increase on a selected group of taxpayers. AFSA believes that the proposal is not only an undesirable departure from well established tax policy, but is also inequitable and one-sided.

Attachment

AFSA believes that the logic expressed by the Joint Committee on Taxation in its explanation (see below) of the repeal of the deduction for bad debt reserves in the 1986 Act holds equally to grace period interest. The conclusion of the explanation states that if a deduction is allowed prior to the taxable year in which the bad debt loss actually occurs, the tax liability of the taxpayer is understated. Conversely, if grace period interest must be recognized before the right to receive such income by a credit card issuer is actually fixed, its tax liability will be overstated.

Further, the proposal suffers from the same defects that the staff of the Joint Committee on Taxation relied on as the basis for the repeal of the deduction for bad debt reserves in the 1986 Act:

F. Reserve for Bad Debts (Sec. 805 of the Act and sec. 166 of the Code)[91]

Prior Law

Prior law permitted taxpayers to take a deduction for losses on business debts using either the specific charge-off method or the reserve method. The specific charge-off method allows a deduction at the time and in the amount that any individual debt is wholly or partially worthless. The reserve method allows the current deduction of the amount that is necessary to bring the balance in the bad debt reserve account as of the beginning of the year, adjusted for actual bad debt losses and recoveries, to the balance allowable under an approved method as of the end of the year. The deduction taken under the reserve method is required to be reasonable in amount, determined in light of the facts existing at the close of the taxable year.

Worthless debts are charged off, resulting in a deduction under the specific charge-off method, or an adjustment to the reserve account under the reserve method, in the year in which they become worthless. In the case of a partially worthless debt, the amount allowed to be charged off for Federal income tax purposes cannot exceed the amount charged-off on the taxpayer's books. No such requirement is applicable to wholly worthless debts.

Prior law required an actual debt be owed to the taxpayer in order to support the creation of a reserve for bad debts. An exception to this rule was provided for dealers who guarantee, endorse or provide indemnity agreements on debt owed to others if the potential obligation of the dealer arises from its sale of real or tangible personal property.

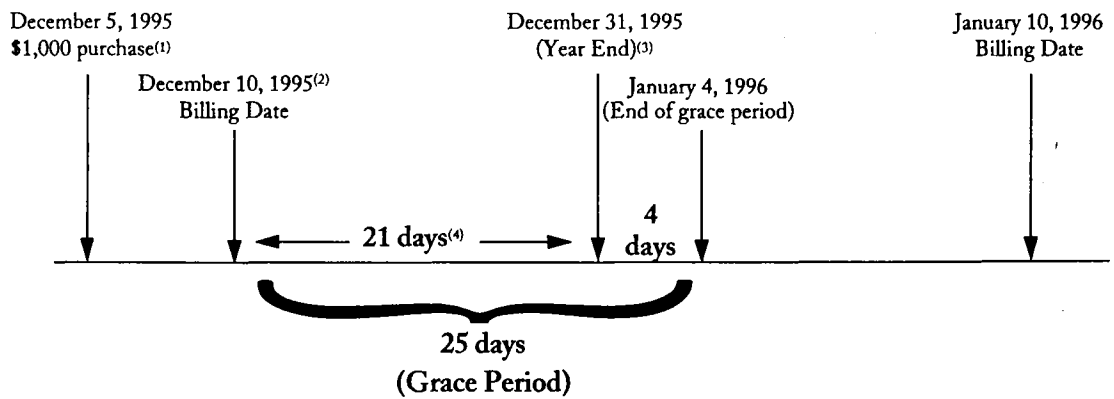
Reasons for Change

The Congress believed that the use of the reserve method for defining losses from bad debts resulted in the deductions being allowed for tax purposes for losses that statistically occur in the future. Thus, the Congress believe that the use of the reserve method for determining losses from bad debts allowed a deduction to be taken to the time that the loss actually occurred. This treatment under prior law was not consistent with the treatment of other deductions under the all events test. If a deduction is allowed prior to the taxable year in which the loss actually occurs, the value of the deduction to the taxpayer is overstated and the overall tax liability of the taxpayer understated. (emphasis added)

The administration's current revenue proposal applies to credit card issuers' receivables for which the above provision of the 1986 Act repealed the deduction for bad debt reserves. While the repeal of the bad debt deduction in 1986 relied on the "all events" test to prevent issuers of credit card receivables from using statistical data for purposes of accruing bad debt deductions, for income purposes the Administration is now willing -- for income purposes only -- to rely on statistics to require income inclusions with respect to the same credit card receivables.

[91] For legislative background of the provision see H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 906, H. Rep. 99-426, pp. 638-641; H.R. 3838 as reported by the Senate Committee on Finance on May 29, 1986, sec. 303; S. Rep. 99-313, pp. 153-158 and H. Rep. 99-841 Vol. II (September 18, 1986) pp. 314-316 (Conference Report).

Grace Period Interest Example



Assumptions/Notes

(1) Cardmember makes purchase on 12/5 on credit card which provides for 12% interest rate and 25 day grace period.

(2) Cardmember's monthly billing date is 10th.

(3) Card issuer is a calendar year taxpayer.

(4) Grace period interest on a 12% credit card = $1,000 x 12% = $120/12 (months) = $10 x 21/30 = $7.00.

The American Financial Services Association

The American Financial Services Association (AFSA) is the trade association for a wide variety of non-traditional, market-funded providers of financial services to consumers and small businesses.

AFSA's members fit into four basic categories:

- Diversified Financial Services Companies — These are companies that offer a broad range of financial services and products to consumers nationwide. Many of these members are affiliated with banks or savings and loans.

- Automotive Finance Companies — These companies are frequently referred to as "captive finance companies," they provide financing for customers that purchase the manufacturer's products. In addition, many of the companies or their parents have branched out into a range of other financial services, such as credit cards or mortgage lending.

- Consumer Finance Companies — The core business of this membership segment includes: unsecured personal loans, home equity loans, and sales financing (for retailers' credit customers). This segment includes companies of all sizes.

- Credit Card Issuers — This membership segment offers bank cards, charge cards, credit cards or private label cards. AFSA members include many of the largest credit card issuers in the U.S.

AFSA members are important sources of credit to the American consumer, providing between 10 and 15 percent of all consumer credit. AFSA members are highly innovative and compete at all levels in the financial services markets. Our members have charged AFSA with promoting a free and open financial services market that rewards the highest level of competitiveness.

COMMENTS OF THE
AMERICAN PETROLEUM INSTITUTE
ON NEW REVENUE PROVISIONS
IN THE PRESIDENT'S FISCAL 1997 BUDGET
SUBMITTED FOR THE
PRINTED RECORD OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

The American Petroleum Institute (API) represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing. API members are among the leaders in the global oil and gas business. API appreciates the opportunity to comment on the proposed changes in the '97 Budget of: I. The taxation of foreign oil and gas income; II. The foreign tax credit carryover rules; and III. Certain excise taxes affecting the industry (hereafter separately or collectively referred to as the Proposal).

I. MODIFICATION OF THE TAX RULES APPLICABLE TO THE FOREIGN TAX CREDIT AND "FOREIGN OIL AND GAS INCOME"

(Secs. 9565 and 9566 of "Title IX--Revenue" of the President's FY 1997 Budget, Submitted 3/19/96)

BACKGROUND

President Clinton's latest budget proposal includes some significant changes to the foreign tax credit ("FTC") rules impacting companies with foreign oil and gas extraction income ("FOGEI") as defined by Code Section 907(c)(1), and foreign oil related income ("FORI") as defined by Code Section 907(c)(2). Specifically, the proposal includes the following provisions:

- Effective for taxable years beginning after the bill's enactment, so-called "deferral" would be repealed for all "foreign oil and gas income" ("FOGI"). FOGI would be treated, instead, as Subpart F income as defined under Code Section 952 (i.e., not eligible for deferral), and trapped in a new separate FOGI basket under Code Section 904(d). FOGI would be defined to include both FOGEI and FORI.

- In situations where taxpayers are subject to a foreign tax and also receive an economic benefit from the foreign country, taxpayers would only be able to claim a credit for such taxes under Code Section 901 if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers, and then only up to the level of taxation that would be imposed under the generally applicable income tax.

- Despite these changes, U.S. treaty obligations that allow a credit for taxes paid or accrued on FOGI would continue to take precedence over this legislation (e.g., the so-called "per country" limitation situations).

Following is a detailed discussion of these changes and their expected effect on the taxation of FOGI.

DISCUSSION

INTRODUCTION AND TRADE ARGUMENTS

The proposed changes to the FTC rules for FOGI and the repeal of so-called "deferral" (i.e., current taxation of foreign subsidiary income before distribution) conflict with the Clinton Administration's announced trade policy. The Administration has demonstrated an intention to subscribe to the integration of worldwide trade, with a continuing removal of trade barriers and promotion of international investment (e.g., the GATT and NAFTA agreements). Moreover, because of their political and strategic importance, foreign investments by U.S. oil companies have been welcomed by the U.S. government. For example, recent participation by U.S. oil companies in the development of the Tengiz oil field in Kazakhstan has been praised as fostering the political independence of that newly formed nation, as well as securing new sources of oil for Western nations, which are still too heavily dependent on Middle Eastern imports. (*See* the April 28, 1996 Washington Post, at p. A-20).

Curiously, given this background, the Administration's proposals will further tilt "the playing field" against the U.S. petroleum industry's foreign exploration and production efforts, and will increase, or make prohibitive, the U.S. tax burden on foreign petroleum industry operations. They will not only stymie new investment in foreign exploration and production projects, but also change the economics of past investments. As illustrated in the example below, the proposed changes in the FTC rules would likely reduce the return on project investments by approximately one-third.

This proposed additional tax burden, like other barriers to foreign investments by U.S. firms, is based on several flawed premises. For example, there is the perception that foreign investment by U.S. business is responsible for reduced investment and employment in the U.S. These investments are perceived to be made primarily in low wage countries at the expense of U.S. labor; with such foreign investments also including a shift of Research & Development ("R&D") spending abroad. However, studies like the 1995 review by the Economic Strategy Institute (Multinational Corporations and the U.S. Economy [1995]) show these claims to be unfounded. Over a 20-year period, capital outflows from the U.S. averaged less than 1% of U.S. nonresidential fixed investment, which is hardly sufficient to account for any serious deterioration in U.S. economic growth. Instead, affiliate earnings and foreign loans, not U.S. equity, have financed the bulk of direct foreign investment.

Contrary to another perception, the principal reason for foreign investment is seldom cheap labor. Rather, the more common reasons are a search for new markets, quicker and easier response to local market requirements, elimination of tariff and transportation costs, faster generation of local good will, and other deep rooted host country policies. In this regard, the bulk of U.S. foreign investment is in Europe, where labor is expensive, rather than in Asia and Latin America, where wages are low. According to a recent study, almost two-thirds of employment by foreign subsidiaries of U.S. companies was in Canada, Japan, and Europe, all higher wage areas (Sullivan, From Lake Geneva to the Ganges: U.S. Multinational Employment Abroad, 71 Tax Notes 539 [4/22/96]). Although some R&D functions have been moved abroad, they make up only 15 % of domestic R&D, and are primarily in areas aimed at tailoring products to local demands. Moreover, two recent studies of the OECD countries conclude that foreign investment is beneficial to employment and incomes in both the home and host countries. (The OECD Countries, Paris [1994]; Trade and Investment: Transplants, Paris [1994]).

In the case of natural resource extraction and production, the reason for foreign investment is obvious. If U.S. oil and gas concerns wish to stay in business, they must look to replace their diminishing reserves overseas, since the opportunity to do so in the U.S. has been restricted by both federal and state government policy. If U.S. companies can not legitimately compete, foreign resources will instead be produced by foreign competitors, only then without any benefit to the U.S. economy, and without U.S. concerns or American workers deriving any direct or indirect income from the foreign production activity.

The FTC principle, along with so-called "deferral" of taxation of foreign subsidiary earnings until repatriation (see discussion below), make up the foundation of U.S. taxation of foreign source income. These proposals would destroy these basic rules of foreign income taxation on a selective basis for foreign oil and gas income only, in direct conflict with the U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

FOREIGN TAX CREDIT CHANGES

THE FTC IS INTENDED TO PREVENT DOUBLE TAXATION

Since the beginning of Federal income taxation, the U.S. has taxed the worldwide income of U.S. citizens and residents, including U.S. corporations. To avoid double taxation, the FTC was introduced in 1918. Although the U.S. cedes primary taxing jurisdiction for foreign income to the source country, the FTC operates by preventing the same income from being taxed twice. The FTC is designed to allow a dollar for dollar offset against U.S. income taxes for taxes paid to foreign taxing jurisdictions.

Under this regime, foreign income of foreign subsidiaries is not immediately subject to U.S. taxation. Instead, the underlying earnings become subject to U.S. tax only when the U.S. shareholder receives a dividend (other than certain "passive" or "Subpart F" income). Any foreign taxes paid by the subsidiary on such earnings is deemed to have been paid by any

U.S. shareholders owning at least 10 % of the subsidiary, and can be claimed as FTCs against the U.S. tax on the foreign dividend income (the so-called "indirect foreign tax credit").

BASIC RULES OF THE FTC

The FTC is intended to offset only U.S. tax on foreign source income. Thus, an overall limitation on currently usable FTCs is computed by taking the ratio of foreign source income to worldwide taxable income, and multiplying this by the tentative U.S. tax on worldwide income. The excess of FTCs can be carried back 2 years and carried forward 5 years, to be claimed as credits in those years within the same respective overall limitations.

The overall limitation is computed separately for various "separate limitation categories." Under present law, FOGI falls into the general limitation category, i.e., for purposes of computing the overall limitation, FOGI is treated like any other foreign active business income. Separate special limitations still apply, however, for income: (1) whose foreign source can be manipulated; (2) which typically bears little or no foreign tax; or (3) which often bears a rate of foreign tax that is abnormally high or in excess of rates of other types of income. In these cases, a separate limitation is designed to prevent the use of foreign taxes imposed on one category to reduce U.S. tax on other categories of income.

FTC LIMITATIONS FOR OIL AND GAS INCOME

In response to the development of high tax rate regimes by "OPEC", taxes on FOGI have become the subject of special limitations. For example, each year the amount of taxes on FOGEI may not exceed 35 % (i.e., the U.S. corporate tax rate) of such income. Any excess may be carried over like excess FTCs under the overall limitation. FOGEI is income derived from the extraction of oil and gas, or from the sale or exchange of assets used in such efforts. In addition, the IRS has regulatory authority to determine that a foreign tax on FORI is not "creditable" to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI or FOGEI. FORI is foreign source income from (1) processing oil and gas into primary products, (2) transporting oil and gas or their primary products, (3) distributing or selling such, or (4) disposing of assets used in the foregoing activities. Otherwise, the overall limitation (with its special categories discussed above) applies to FOGEI and FORI. Thus, as active business income, FOGEI and FORI would fall into the general limitation category.

THE DUAL CAPACITY TAXPAYER SAFE HARBOR RULE

As distinguished from the rule in the U.S. and some Canadian provinces, mineral rights in other countries vest in the foreign sovereign, which then grant exploitation rights in various forms. This can be done either directly or through a state owned enterprise (e.g., a license or a production sharing contract). Because of this apparent direct or indirect economic identity of taxing sovereign and grantor of mineral exploitation rights, the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "specific economic benefits" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign have resulted in such taxpayers being referred to as "dual capacity taxpayers."

To help resolve controversies surrounding the nature of tax payments by dual capacity taxpayers, the Treasury Department developed the "dual capacity taxpayer rules" of the FTC regulations. Under the facts and circumstances method of these regulations, the taxpayer must establish the amount of the intended tax payment that otherwise qualifies as an income tax payment but is not paid in return for a specific economic benefit. Any remainder is a deductible rather than creditable payment (and in the case of oil and gas producers, are considered royalties). The regulations also include a safe harbor election (*see* Treas. Reg. § 1.901-2A(e)(1)), whereby a formula is used to determine the tax portion of the payment to the foreign sovereign, which is basically the amount that the dual capacity taxpayer would pay under the foreign country's general income tax. Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (i.e., the U.S. tax rate is considered the country's generally applicable income tax rate).

THE PROPOSAL LIMITS FTCs OF DUAL CAPACITY TAXPAYERS TO THE HOST COUNTRY'S GENERALLY APPLICABLE INCOME TAX

If a host country that had an income tax on FOGI (i.e., FOGEI or FORI), but no generally applicable income tax, were to ignore the effect that its tax regime has on the new FTC position of U.S. companies, the proposal will result in disallowing any FTCs on FOGI. This would result in inequitable and destructive double taxation of dual capacity taxpayers, contrary to the global trade policy advocated by the U.S.

The inequity becomes even more obvious if one considers the situation where a dual capacity taxpayer and a taxpayer which is not a dual capacity taxpayer are subject to an income tax in country without a generally applicable income tax. Under the proposal, only the dual capacity taxpayer would receive no foreign tax credit, while the other taxpayer would be entitled to the full tax credit for the very same tax.

The additional U.S. tax on foreign investment in the petroleum industry would not only eliminate many new projects; but may also change the economics of past investments. In some cases, this will not only reduce the rate of return, but also preclude a return of the investment itself, leaving the U.S. business with an unexpected "legislated" loss. In addition, because of the uncertainties of the provision, it will also introduce more complexity and potential for litigation into the already muddled world of the FTC.

The proposal's concerns with the tax versus royalty distinction were resolved by Congress twenty years ago with the special tax credit limitation on FOGEI, which was then reinforced by the fragmentation of foreign source income from the 1986 Act into a host of categories or baskets. The earlier solution of the tax versus royalty dilemma recognized that (1) if payments to a foreign sovereign meet the criteria of an income tax, they cannot be denied complete creditability against U.S income tax on the underlying income; and (2) creditability of the perceived excessive tax payment is better controlled by reference to the U.S. tax burden, instead of being dependent on the foreign sovereign's fiscal choices, such as enacting an income tax on all income that applies to all persons, according to U.S. criteria.

THE PROPOSAL LIMITS FTCs TO THE AMOUNT WHICH WOULD BE PAID UNDER THE GENERALLY APPLICABLE INCOME TAX

By elevating the regulatory safe harbor to the exclusive statutory rule, the proposal eliminates a dual capacity taxpayer's right to show, based on facts and circumstances, which portion of its payment to the foreign government was not made in exchange for the conferral of specific economic benefits and, therefore, qualifies as a creditable tax. Moreover, by eliminating the "fall back" to the U.S. tax rate in the safe harbor computation where the host country has no generally applicable income tax, the proposal denies the creditability of true income taxes paid by dual capacity taxpayers under a "schedular" type of business income tax regime (i.e., regimes which tax only certain categories of income, according to particular "schedules"), merely because the foreign sovereign's fiscal policy has chosen not to include all types of business income.

For emerging economies of lesser developed countries, as for post-industrial nations, it is not realistic to always demand the existence of a generally applicable income tax. Even if the political willingness exists to have a generally applicable income tax, such may not be possible because the ability to design and administer a generally applicable income tax depends on the structure of the host country's economy. The available "tax handles" are defined by the country's economic maturity, business structure and accounting sophistication. The most difficult problems arise in the field of business taxation. One has to remember that a business profits tax presupposes that business accounting has been developed to measure profits adequately. Oftentimes, the absence of reliable accounting books will only allow a primitive presumptive measure of profits. Under such circumstances the effective administration of a general income tax is impossible. All this is exacerbated by phenomena which are typical for less developed economies: a high degree of self-employment, the small size of establishments, and low taxpayer compliance and enforcement. In such situations, the income tax will have to be limited to mature businesses, along with the oil and gas extraction business.

THE PROPOSAL INCREASES THE RISK OF DOUBLE TAXATION

Adoption of the Administration's proposals would further tilt the playing field against overseas oil and gas operations by U.S. business, and increase the risk of double taxation of FOGI. This will severely hinder U.S. oil companies in their competition with foreign owned oil and gas concerns in the global oil and gas exploration, production, refining, and marketing arena, where the home countries of their foreign competition do not tax FOGI. This occurs where these countries either exempt foreign source income or have a liberal foreign tax credit regime which truly prevents double taxation.

To illustrate, assume foreign country X offers licenses for oil and gas exploitation and also has an 85 % tax on oil and gas extraction income. In competitive bidding, the license will be granted to the bidder which assumes exploration and development obligations most favorable to country X. Unless a U.S. company is assured that it will not be taxed again on its after-tax profit from country X, it very likely will not be able to compete with another foreign oil company for such a license because of the different after tax returns.

EXAMPLE

	U.S. OWNED OIL COMPANIES		FOREIGN COMPETITORS
Host Country Taxation			
Taxable profit	100		100
Host Country Tax	-85		-85
After Host Country Tax	15		15
Home Country Taxation	US Present Law	US Proposed	Foreign Competitor's Home Country Tax
Taxable Profit	100	100	Not Applicable because foreign income not taxed
Foreign Tax deduction	No, because credit claimed	-85	
Taxable Income	100	15	
Tentative Tax (e.g., U.S. tax at 35%)	35	5.25	
FTC limited to US tax on foreign source income	-35	N/A	
Home Country Tax payable	0	5.25	
Profit after Tax payments			
Profit before taxes	100	100	100
Tax to Host Country	-85	-85	-85
Tax to Home Country	0	-5.25	0
After Tax Profit	**15**	**9.75**	**15**

Because of the 35 % additional U.S. tax, the U.S. company's after tax return will be more than one-third less than its foreign competitor's. Stated differently, if the foreign competitor is able to match the U.S. company's proficiency and effectiveness, the foreigner's return will be more than 50 % greater then the U.S. company's return. This would surely harm the U.S. company in any competitive bidding. Only the continuing existence of the FTC, despite its many existing limitations, assures that there will be no further tilting of the playing field against U.S. companies' efforts in the global petroleum business.

SEPARATE LIMITATION CATEGORY FOR FOGI

To install a separate FTC limitation category for FOGI would single out the active business income of oil companies and separate it from the general business income "basket." However, there appears to be no legitimate reason to carve out FOGI from the general limitation category or basket. The source of FOGI is difficult to manipulate: FOGEI is derived from the country where the natural resource is in the ground while FORI is derived from the country where the processing or marketing occurs. Moreover, any FORI that is subject to manipulation is very likely taxed currently, before distribution, under the anti-avoidance rules for undistributed earnings of foreign subsidiaries.

REPEAL OF SO-CALLED DEFERRAL

BACKGROUND

As stated above, the U.S. exercises worldwide taxing jurisdiction over U.S. persons, including U.S. corporations. However, foreign corporations are not creatures of U.S. law and are thus not subject to US income tax (at least not immediately). The earnings of CFCs are taxed currently only by the host country. They are taxed to the U.S. shareholder only if and when distributed as a dividend.

Thus, taxing the U.S. shareholder on all or part of the foreign corporation's earnings, before dividends are distributed, is the exception rather than the rule. In the corporate context, the norm is that although U.S. corporations are taxed on their worldwide income, there is no taxation before realization. Accordingly, there is no taxation of the earnings of foreign subsidiaries before they are received in the form of a dividend, or before disposing of the subsidiary's stock. This is symmetrical with individual shareholders not being taxed on earnings from companies in which they own shares until dividends are declared and paid.

However, if the US shareholder is suspected of using a foreign subsidiary for "tax deferral", then, as in other cases of perceived tax avoidance, the Code provides for current taxation of such suspect earnings, imputing a constructive distribution. These rules are found in "Subpart F", and the income to the U.S. shareholder from these deemed distributions is conveniently referred to as "Subpart F income." Such abuse is generally seen only with respect to passive income or income which can be easily manipulated to sources with no or low foreign taxes. These abuse rules, referred to as "anti-deferral" rules, are portrayed as denying the "privilege of deferral." However, they operate more in the nature of penalty provisions, rather than by conferring or denying a privilege. Other countries have a few tax avoidance rules for current taxation of undistributed earnings of foreign subsidiaries (e.g., *see* Joint Committee on Taxation, Comparison of the Tax Systems of the United States, The United Kingdom, Germany, and Japan [JCS-13-92]). By contrast, the Subpart F rules have grown into an elaborate, obfuscated network of provisions that extend beyond the repeatedly declared focus of current taxation of undistributed foreign earnings, i.e., low taxed income or portable income.

THE PROPOSAL STATES NO REASON FOR SINGLING OUT FOGI FOR SUBPART F TREATMENT

As stated above, Subpart F treatment is generally limited to passive income that is easily manipulated as to source or income, or that is earned in low or no income jurisdictions. The Administration's proposal does not indicate the perceived suspect nature of FOGI. It is clear that none of the typical rationales for Subpart F treatment applies to FOGI For example, FOGI is not passive income but, rather, very active income from the exploration, production, refining, and marketing of petroleum and its primary products; FOGI's source is not easily manipulated since it is determined by nature; and, FOGI is not earned in a low or no income tax jurisdiction.

Undistributed earnings of foreign subsidiaries should only be taxed to the U.S. shareholder where foreign earnings can be manipulated as to source or taxing jurisdiction, with a concomitant potential of U.S. tax avoidance. It is the potential for tax avoidance that calls for an exception from the fundamental principle. As active business income, FOGI is derived where and when the natural resource is extracted, without any tax manipulation intention.

Moreover, current taxation of foreign subsidiaries' FOGI will exacerbate the differences between the host country and U.S. tax laws. This may result in an additional U.S. tax burden, curtailing or crippling the competitiveness of U.S. oil companies. As a general rule, the host

country tax burden on a project is greater than the U.S. tax burden. Thus, in an ideal world, even current taxation of a CFC's earnings would not result in an additional U.S. tax burden. However, differences in the host country and U.S. tax laws, such as the timing of cost recovery, and the many restrictions in the U.S. tax credit mechanism, will frequently result in additional U.S. tax even though the cash flow is reinvested in the host country or region. Under present law, the U.S. shareholder can, as part of its dividend policy, mitigate this potential for double taxation to some extent. However, the proposal would eliminate this tool and tax the U.S. shareholder on the earnings of the foreign subsidiary, without regard to a distribution, and without regard to the timing of the foreign tax incidence or the actual cash flow.

THE PROPOSALS ARE BAD TAX POLICY

Reduction of U.S. participation in foreign oil and gas development will adversely affect U.S. employment, and any additional tax burden may hinder the U.S. company in its competition with foreign concerns. Although the host country resource will be developed, it will be done by foreign competition, with the adverse ripple effect of U.S. jobs losses and the loss of continuing evolution of U.S. technology. By contrast, foreign oil and gas development by U.S. companies assures utilization of U.S. supplies of hardware and technology, The loss of any major foreign project to a U.S. company will mean less employment in the U.S. by suppliers, and by the U.S. parent, in addition to fewer U.S. expatriates at foreign locations.

Foreign operations are not placed into foreign subsidiaries merely for tax reasons. Although current taxation of undistributed subsidiary earnings is oftentimes justified by the claim that the taxpayer's choice of operating in the host country through a U.S. company versus a foreign company should not affect the U.S. tax burden, such analysis is flawed. Choice of a foreign corporation as the vessel for doing business in the host country generally is for business reasons, e.g., the utilization of a host country company may be required for natural resources extraction.

II. MODIFICATION OF THE FOREIGN TAX CREDIT CARRYOVER RULES

(Sec. 9564 of "Title IX-Revenue")

For FTCs in excess of the overall limitation, the proposal would reduce carryback periods from two to one year and extend the carryforward from five to seven years. This is based on the perception that carrybacks were associated with increased complexity and administrative burdens, as compared to carryforwards.

This proposal increases the risk of losing utilization of excess credits effectively due to the reduction of the carryback period; this disadvantage is not offset by the extension of the carryforward period. As a substitute for the proposal, the FTC carryover rules should be aligned with the rules applicable to other tax attributes like Net Operating Losses (NOL) and Business Tax Credits (i.e., 3 years carryback and 15 years carryforward, in total 18 years carryover).

Liberal carryover periods are of even greater importance for FTCs because of variances in foreign and domestic tax rules which result in timing differences of the foreign and domestic tax incidence, with a mismatch of foreign and U.S. tax under the FTC rules. Finally the fragmentation of the foreign income streams in the 1986 Act into nine or more baskets makes a liberalization in an alignment with the carryover rules for other tax attributes even more imperative.

III. EXCISE TAXES

API also wishes to comment on the following excise tax provisions contained in the President's fy 1997 budget:

Extension of the excise taxes deposited in the Hazardous Substance Superfund Trust Fund.

NO REAUTHORIZATION WITHOUT REFORM

The President proposes reinstating the Superfund excise taxes from date of enactment through October 1, 2006, and the Corporate Enrivonmental Tax for taxable years beginning after December 31, 1995 and before January 1, 2007. API opposes reauthorization of the Superfund taxes without substantial reform of the current tax system and the underlying Superfund program.

When the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) was enacted in 1980, Congress envisioned a program that would cost $1.6 billion and be complete within five years. Sixteen years later, however, billions have been spent, but few sites on the National Priorities List have been cleaned up. Absent major changes in the current law, it appears the program will be without end. Serious program reform efforts are underway in the Congress, and reauthorization of the taxes prior to completion of that work will only diminish the likelihood that real reform will be accomplished.

Furthermore, the tax regime enacted to fund the CERCLA program needs to be revised to make it more equitable. Under the present system, the petroleum industry, which is estimated to be responsible for roughly 10 percent of Superfund cleanup liability, pays over 50% of the Superfund taxes. There is clearly no connection between the petroleum industry's large tax burden and its relatively small contribution to the problem. Superfund sites are a broad societal problem, and taxes raised to remediate these sites should be broadly based rather than focused on a specific industry.

TECHNICAL AMENDMENTS

When the Committee considers reform of the Superfund taxes, if the excise taxes are retained, API wishes to propose several technical changes. With regard to the Petroleum Tax, we propose the following:

1. **Change the point of taxation on imported crude oil** from point of importation to receipt at a refinery. This would make it consistent with the point of taxation for domestic crude oil.

2. **Modify IRC Section 4611(b) to eliminate the provision that imposes the petroleum tax on crude oil exported from the United States**. The courts have interpreted the export clause (Article 1, Section 9, Clause 5 of the United States Constitution) to prohibit the federal government from imposing any tax or duty upon exports. However, as long as the language exists in the statute, the Internal Revenue Service is compelled to issue an assessment for failure to pay the tax on an export, thus forcing a taxpayer to incur expensive litigation to avoid paying an invalid tax.

3. **Modify the definition of "petroleum product"** for purposes of the Section 4611 Petroleum Tax to ensure that none of the listed petrochemicals under the Section 4661 Chemical Tax are subject to double taxation. API would be pleased to work with the staff of the Committee to develop an appropriate definition.

4. A controversy has developed with regard to the **taxation of natural gasoline under the Petroleum Tax**. The IRS has taken the position that the term "United States refinery" includes "any facility in the United States in which natural gasoline is produced by fractionation or similar operation." Thus, under that interpretation natural gasoline produced at a gas processing plant by fractionation or similar operation is subject to the tax at the plant. Taxpayers have challenged that interpretation, arguing that Congress never intended a gas processing plant to be defined as a refinery. In a recent decision (Enron Gas Processing Company v. United States of America) the court for the Southern District of Texas found in favor of the taxpayer. The IRS is considering whether to appeal that decision.

If the Congress decides to clarify the tax treatment of natural gasoline by amending the statute, the API urges that whatever position is adopted should be prospective only. To make any change retroactive would create a nightmare of tax liabilities and refunds for both taxpayers and the Service.

5. **Allow a refund or credit of the Section 4611 Petroleum Tax paid with respect to crude oil or petroleum products used to manufacture or produce exported motor fuel** under rules similar to those applied to chemicals under Section 4662(e). This would complement the exemption for exported derivative chamicals that has been in the law since

1987 and would be consistent with the Congressional policy underlying that exemption of making United States producers more competitive in world markets.

With regard to the Section 4661 Chemicals Tax, the API proposes two technical amendments:

1. **Clarify the application of the Chemicals Tax in those situations where a taxable chemical makes up only a part of a hydrocarbon stream** by adding the following new subparagraph (c) to Section 4661:

> 4661(c). The tonnage of a taxable chemical sold or used is computed on a contained weight basis.

While the statute appears clear on its face that the tax applies only to the contained weight of a taxable chemical, and regulations proposed October 23, 1983 (subsequently withdrawn for unrelated reasons) mirrored this clear intent, the IRS has now taken the position on audit that the tax is imposed on the full hydrocarbon stream including any non-taxable chemicals contained therein. "The IRS has also issued a Technical Advice Memorandum holding that a mixed olefin stream consisting of approximately 75% propylene (a taxable chemical) and 25% propane (a non-taxable chemical) is taxable as though it were 100% propylene." To put these issues to rest and avoid unnecessary litigation, the API urges the adoption of the language indicated above.

2. **Clarify determination of tax paid on chemicals to produce exported taxable substances.** Chemicals taxed under Section 4661 are often used as raw material in the manufacture or production of a substance. Provided such substance has been determined to be a "taxable substance" under Section 4672(a), a credit or refund is allowable for the taxes paid on chemicals that have been used in the production or manufacture of the substance when the substance has been exported. Because manufacturing processes vary from producer to producer, and because these "taxable substances" are freely exchanged and sold between producers and then commingled in common storage, an issue has arisen with regard to determination of the amount of taxable chemical(s) eligible for the refund in any particular exported substance.

As a solution to this credit/refund problem, the IRS should utilize the same rate of tax as prescribed for the substance at the time it is added to the list of "taxable substances." API proposes that the following language be added to Section 4662(e):

> "Determination of tax paid on chemicals used to produce exported taxable substances. -- The amount of credit allowed or refund paid on taxable substances shall be computed by utilizing the rate of tax that was prescribed for such substance by the Secretary utilizing the predominant method of production.

Reauthorization of Oil Spill Liability Trust Fund Tax

The Administration proposes reinstating the Oil Spill Tax which expired December 31, 1994, and raising the Fund cap from $1 billion to $2.5 billion. This is despite the fact that the Administration's fy 1997 Budget indicates that there was over $1 billion in the Fund at the end of fy 1995 and that they project there will be $997 million in the Fund at the end of fy 1996 without any taxes being collected. Since its establishment in 1989, annual cash outlays from the Fund have never exceeded $170 million. Clearly, no new tax revenues are needed, and there is absolutely no reason to increase the cap. API opposes the Administration's proposal.

Kerosene Taxed as Diesel Fuel

Over the years, API has worked diligently with Congress and the Department of Treasury to reduce the evasion of motor fuels excise taxes by tax cheats. The 1993 Tax Act's change in the point of collection of the diesel tax and the requirement that diesel fuel be "taxed or dyed" constituted a substantial step forward in this effort. The Administration's proposal to define kerosene as diesel fuel, thereby subjecting it to the diesel tax or dye requirements would be an important additional step in reducing evasion of the federal excise tax on diesel fuel. API supports this proposal.

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May 9, 1996

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

This letter is in response to your invitation to comment on tax proposals contained in the President's FY 1997 budget proposal. In particular, I wish to state the opposition of the Association of Local Housing Finance Agencies to the President's call for repeal of the 2% de minimis safe harbor with respect to corporate purchases of tax-exempt bonds. The budget pejoratively refers to the safe harbor as a form of "corporate welfare."

As you know, in 1972 the Internal Revenue Service established a "safe harbor" under which corporations may purchase and hold tax-exempt bonds in an amount not exceeding two percent of their assets without having to demonstrate to the Service that borrowed funds were not used (and therefore no interest expense deduction was taken) to purchase the bonds.

The de minimis rule has facilitated corporate involvement in the municipal bond market allowing corporations to play an important role by purchasing short and long-term securities, variable rate debt, and tax-exempt leases. Elimination of this safe harbor would have a serious negative impact to the ability of local governments to finance affordable housing, infrastructure, and other capital facilities and equipment, as it would dampen corporate demand, lead to an inefficient market and drive up borrowing costs.

With respect to affordable housing, Fannie Mae and Freddie Mac, often in partnership with other corporate investors, are major purchasers of state and local housing finance agency-issued Mortgage Revenue Bonds as well as variable rate multifamily bonds. When Fannie Mae purchases an entire MRB issue, a savings of approximately 2% of the face value of the bonds is realized by the issuer due to the absence of underwriting costs. This savings is passed along to first-time homebuyers in various forms such as downpayment assistance or reduced mortgage interest rates. Since 1987 when Fannie Mae began purchasing MRBs, it has purchased a total of $7.1 billion from state and local housing finance agencies. As a result of this investment, an estimated 120,000 low-and moderate-income families have achieved the dream of homeownership.

Mr. Chairman, we applaud your statement earlier this year expressing your strong opposition to the repeal of the 2% de minimis rule. We urge you to continue that opposition and help insure defeat of the Administration's proposal.

Sincerely,

John C. Murphy
Executive Director

Vinson & Elkins
ATTORNEYS AT LAW

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May 15, 1996

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

Re: Revenue Provisions in the President's Fiscal Year 1997 Budget -- Dividends Received Deduction and Net Operating Loss Carryback

Dear Mr. Moseley:

In connection with Chairman Archer's request for public comments on the revenue provisions in President Clinton's fiscal year 1997 budget, we submit the following comments on behalf of a group of commercial banks that includes Bank of America, Bank of Boston, Chase Manhattan Bank, Citibank, First National Bank of Chicago, First Interstate Bank, Fleet Financial Corporation, Norwest Corporation, and Mellon Bank.

We urge the Committee to reject two of the tax proposals contained in the President's 1997 Budget: (1) The proposed reduction in the deduction for dividends received by a corporation, and (2) the proposed shortening of the period for the carryback of net operating losses to one year.

The corporate dividends received deduction and the net operating loss carryback are not "loopholes" or "subsidies" in any sense of those terms. Instead, their purpose is to prevent over taxation of income. The dividends received deduction is designed to prevent multiple-taxation of corporate earnings. The net operating loss carryback is designed to prevent the taxation of income artificially created by annual accounting, when income fluctuates from year to year.

These proposals, moreover, result in over taxation of business income and are therefore inimical to capital formation and economic growth.

Dividend Received Deduction

Corporations generally are eligible under current law for a deduction for dividends received. The purpose of this deduction is to prevent multiple taxation of corporate earnings as they are passed from one corporation to another. Ordinarily, corporate earnings are taxed twice, when earned and again when distributed to individual stockholders. Earnings are subject to a yet another level of tax, however, when distributed first to an intermediate corporate stockholder.

Section 243 of the Internal Revenue Code allows a corporation a deduction of 70% of dividends received if it owns less than 20% of the stock of the payor. The remaining 30% is subject to another level of corporate tax. This additional taxation of corporate earnings is compounded if earnings pass through additional corporations.

The Administration proposes to reduce the deduction to 50%.

Reducing further the dividend received deduction, as proposed by the President, would correspondingly increase the amount of corporate earnings subject to multiple taxation. In describing the reasons for its proposal, the Administration says only that the current 70% deduction is "too generous." This can be true only if multiple taxation of corporate earnings is

viewed as appropriate. The Administration does not establish a basis for such a view.

Indeed, it is ironic that such a proposal should be made at a time when many of our major trading partners are moving toward integration of the corporate and individual income tax, reducing even the two layers of tax historically leveled on corporate earnings. The result of the Administration's proposal will be, without apparent justification, to reduce the return to capital and thus to increase the cost of capital for U.S. corporations, especially vis-a-vis their international competition.

Net Operating Loss Carryback

The Administration's proposed modification in the net operating loss carryback is similarly without justification.

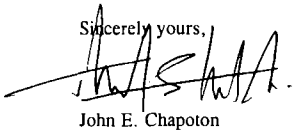
Under current law, corporations are permitted to use net operating losses in a taxable year to offset income in the three preceding years. The purpose of this carryback is to permit the taxpayer to offset income and losses over a period of years, and so eliminate the disparity in tax liability between businesses with stable income and expense from year to year and businesses that experience fluctuations in income or expense. In this manner, businesses with the same income over time pay the same tax.

The Administration proposes to shorten the carryback period from three years to one. This will significantly reduce the ability of a business to offset expenses against income. The President's proposal to extend the future period for which current losses may be used to offset income does not compensate for the loss of the carryback. Losses recovered 20 years in the future have little worth, and are very unlikely, in any event, to bear any connection to the ordinary type of income fluctuations it was the purpose of the carryover rules to address.

For banks, the proposed limitation on the carryback period presents a special problem. Bank regulatory agencies in general will recognize for purposes of accounting for bank capital the value of a net operating loss -- or any other deferred tax asset -- only with respect to income anticipated in the next year. Therefore, any carryover of more than one year is meaningless for purposes of determining regulatory capital. The carryback, on the other hand, is recognized no matter the period. Therefore, the effect of the President's proposal is to shorten the effective regulatory carryover/carryback period for banks from four years to two. During difficult economic periods for banks, the result will be to reduce bank capital.

We submit that the Administration's proposals on the dividend received deduction and net operating loss carryback are ill-considered. The Committee ought to reject them

Sincerely yours,



John E. Chapoton
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Counsel for *Bank of America, Bank of Boston, Chase Manhattan Bank, Citibank, First Interstate Bank, First National Bank of Chicago, Fleet Financial Services, and Mellon Bank*

BEAR STEARNS

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May 14, 1996

Mr. Philip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

In response to Chairman Archer's request, Bear Stearns & Co. Inc. is submitting a statement concerning two new tax provisions in President Clinton's Fiscal Year 1997 Budget. These provisions are: section 9512 of the Revenue Reconciliation Bill of 1996 (the "Bill"), which imposes constructive sale treatment on certain appreciated financial instruments; and section 9526 of the Bill, which modifies the holding period rules for the dividends received deduction (the "DRD").

The following is a summary of our comments. These provisions would penalize legitimate hedging transactions and adversely affect the financial markets. The scope of the constructive sale legislation is so broad that it covers many bona fide hedging transactions and would inhibit a broad range of other non-tax motivated transactions. We believe that narrowly drafted legislation can target potential abuses without adversely affecting legitimate hedging transactions and the financial markets. We also believe that the proposed DRD changes would penalize legitimate hedging transactions by imposing triple level taxation on distributions of corporate earnings. Current law is entirely adequate to ensure that the DRD is available only for economic investments.

Please do not hesistate to call if you have any questions. Our designated representatives are:

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Very truly yours,

BEAR STEARNS & CO. INC.

By:

Eli Wachtel
Senior Managing Director

Enclosure

STATEMENT OF BEAR STEARNS & CO. INC. CONCERNING PROPOSED CONSTRUCTIVE SALE AND DRD HOLDING PERIOD PROVISIONS

Summary

Two new tax provisions in President Clinton's Fiscal Year 1997 Budget would **penalize legitimate hedging transactions and adversely affect the financial markets**. These provisions are: section 9512 of the Revenue Reconciliation Bill of 1996 (the "Bill"), which imposes constructive sale treatment on certain appreciated financial instruments; and section 9526 of the Bill, which modifies the holding period rules for the dividends received deduction (the "DRD"). The scope of the constructive sale legislation is so broad that it covers many bona fide hedging transactions and would inhibit a broad range of other non-tax motivated transactions. We believe that narrowly drafted legislation can target potential abuses without adversely affecting legitimate hedging transactions and the financial markets. We also believe that the proposed DRD changes would penalize legitimate hedging transactions by imposing **triple level taxation on distributions of corporate earnings.** Current law is entirely adequate to ensure that the DRD is available only for economic investments.

Constructive Sale Provision

The Bill would treat a taxpayer as having made a constructive sale of an appreciated stock, debt instrument or partnership interest when the taxpayer "substantially eliminate(s)" both risk of loss and opportunity for gain "for some period". The basic problem with the proposed legislation is that it does not distinguish between legitimate hedging transactions and tax-motivated transactions. As a starting point, it must be stressed that management and reduction of risk for both businesses and investors should be encouraged and not penalized. Legislation which triggers tax on an appreciated financial position as a result of a non-tax motivated hedging transaction is simply bad tax policy.

The Bill does not provide a definition or guidance as to what triggers a constructive sale either in terms of: (1) what constitutes "substantial" elimination of risk of loss and opportunity for gain, or (2) what is the relevant "period" for such elimination. The provision appears to trigger a tax even if an investor hedges for only one day and thereafter retains all potential risk of loss and opportunity for profit.

Another major problem with the statutory framework is the difficulty in measuring potential risk of loss or opportunity for profit. In its report dated March 1, 1996, The New York State Bar Association suggested using option pricing or delta analysis as possible objective mechanisms for this purpose. However, as the NYSBA Report notes, different assumptions as to volatility, for example, will produce different results. More importantly, a statute that can be applied only by reference to sophisticated financial modeling not available to ordinary taxpayers or their advisors is patently unworkable.

Because of the sweeping scope of the proposed legislation, taxpayers who enter into a broad range of hedging transactions with respect to appreciated financial positions will be unable to determine whether such hedges trigger tax. These taxpayers will be reluctant to enter into legitimate, non-tax motivated hedging transactions because of the fear of triggering a current tax.

The chilling effect of the proposed legislation will have a negative impact on the stock and option markets. Many investors hedge a particular stock or all or a portion of a portfolio because of an economic event with respect to a specific company or general market conditions. The proposed legislation will likely cause many of these investors to choose to maintain their risk exposure rather than risk payment of a tax. The decrease in investor participation in the financial markets (especially the stock and options markets) will result in wider spreads and greater volatility in option and stock pricing. Ultimately, this will lead to less liquidity in the markets.

The following example illustrates the actual or potential application of the proposed legislation to legitimate, non-tax motivated hedging transactions. An employee may receive a significant portion of his compensation in the form of employee stock options, and the value of such options could comprise a meaningful component of the employee's net worth. If the employee is concerned about a potential general market decline or a specific event affecting his company or industry, the employee should be able to hedge a portion of his position without the fear of triggering a current tax.

The Treasury Department Explanation and JCT Description of the proposed legislation both refer to short sales as locking in gains on an appreciated stock. However, in most situations the potential for significant tax deferral from a short-against-the-box transaction is limited. The economic cost of a short-against-the box transaction generally will exceed the benefit of tax deferral **if the taxpayer maintains the short-against-the-box transaction for more than one year.** Therefore, there generally is no economic basis for long-term, short-against-the-box transactions, unless the investor intends to obtain a step-up in basis at death. See Appendix A for an illustration of this cost/benefit analysis.

The proposed legislation represents a dramatic change to current law. We urge Congress to carefully consider the impact this change would have on hedging practices and the financial markets. We believe that narrower legislation can address potential abuses that may exist under current law without impacting legitimate hedging transactions or adversely affecting the financial markets.

DRD Holding Period

Section 9526 of the Bill modifies the DRD holding period rules and would deny the DRD to a corporate shareholder that diminishes risk of loss within 45 days of the stock's ex-dividend date. The proposed change to the DRD holding period rules should not be enacted because it would have several major negative effects: (1) impose increased triple taxation of corporate earnings while many of the United States' major trading partners have moved to a system of single taxation of corporate earnings; (2) reduce participation in the options markets, resulting in increased volatility; and (3) increase the cost of capital for preferred stock issuers, especially in industries such as utilities in which preferred stock comprises a significant component of the capital structure. Finally, the proposed legislation is unnecessary because current law is adequate to ensure that the benefit of the DRD is available only for economic investments (as opposed to tax-motivated investments) in which the investor bears risk of loss for a meaningful period.

The United States has maintained its historical system of taxation whereby a corporation pays income tax on its corporate earnings and shareholders pay an additional tax upon distribution of earnings in the form of dividends. To minimize triple taxation of corporate earnings, U.S. corporations are allowed a 70-80% DRD for dividends received from other U.S. corporations.

The U.S. system of taxing corporate earnings should be compared to the tax systems of many of the United States' major trading partners such as Canada, England, France, Germany, Australia and New Zealand. These jurisdictions have an integrated system of taxation whereby corporate earnings are essentially subject to a single level of taxation. See January 1992 Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems Taxing Business Income Once.

By further limiting the availability of the DRD, the proposed legislation would increase the imposition of triple taxation on corporate earnings. Such triple taxation would result from a corporate tax being paid by the distributing corporation, a corporate tax paid by the recipient corporation, and a shareholder level tax. The proposed change to the DRD would result in a 74% tax on corporate level earnings before factoring in the additional cost of state and local taxes.

Example 1: A U.S. corporation ("Corporation A") earns $10000 and pays a U.S. federal income tax of $3500 on such earnings (35% tax rate). Corporation A distributes all of its earnings on a current basis and accordingly will distribute $65 to its 1% U.S. corporate shareholder ("Corporation B"). Corporation B has held the Corporation A stock for three years and plans to continue to hold the Corporation A stock for the indefinite future. However, Corporation B is concerned about the impact of a particular event on Corporation A and accordingly has purchased the right to put the Corporation A stock for 95% of its current fair market value in six months. Under the proposed change, Corporation B would not be eligible for the DRD and would pay a tax of $22.75 on such dividend (35% tax rate). Corporation B is owned by 10 individuals who are subject to tax at the highest U.S. marginal federal income tax rate of 39.6%. Such individual shareholders would collectively receive $42.25 in dividends and pay a collective tax of $16.83. Accordingly, such individual shareholders would collectively receive after-tax cash of $25.42, an effective tax rate of 74.5% on corporate earnings.[1]

The proposed legislation would also have a negative impact on the options markets. Market conditions often cause corporate investors to use various hedging techniques, especially through the use of options, to hedge a particular stock or all or a portion of a portfolio of stocks. These hedging transactions include cost-less collars (i.e., the purchase of an out-of-the-money put and the sale of an out-of-the-money call), the purchase of put options, and the sale of an "in-the-money" call that is more than one strike price in the money (i.e., non-qualified covered calls). The following examples are illustrative market-driven hedging transactions:

Example 2: Corporate investor purchases shares of Corporation X stock of July 13, 1995 for $50. On November 1, 1995, the stock price has dropped to $43/share and the investor believes that the stock prices will rebound to $50 but does not want to take the risk of significant further decline. To limit its future loss while retaining the upside, the investor purchases a June 1997 $40 put for 3 7/8 and sell as June 1997 $50 call for 3 7/8 (i.e. the investor has the right to put the X stock at $40 and has sold the right to call the X stock at $50). Under current law, this cost-less collar would allow the investor to continue to receive the DRD. However, under the proposed change to the holding period rules, the investor would not be entitled to the DRD. The proposed legislation would discourage this investor from entering into legitimate market-driven hedging strategies by penalizing the investor through a disallowance of all or a portion of the DRD.

Example 3: A corporate investor purchases shares of Corporation Y stock for $42 on March 15, 1996. For the purposes of obtaining an enhanced return, the investor immediately sells a June 1996 $40 call on the Y stock for 4 1/8 (a qualified covered call) to make an expected gross profit of 2 1/8 because the investor believes there is a limited risk below $40. On June 19, 1996, two days prior to the expiration of the June contract, when the stock price of the Y stock is $46, the corporate investor continues to believe that the Y stock price has limited risk below $40. Therefore, the investor "rolls" its June call position into a December call position by buying back the June 1996 call at $6 and selling December 1996 call for 8 1/4 for a net credit of 2 1/4. Under current law, all dividends received would be entitled to the DRD. Under the proposed change to the DRD holding period rules, the corporate investor would not be entitled to the DRD with respect to dividends received during the period it is hedged with the December call, subjecting dividends received by a corporate investor to three levels of taxation. Consequently, the proposed legislation would discourage corporate investors from engaging in enhanced return strategies.

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[1] Most states follow the federal income tax rules in imposing a state corporate income tax on corporations. For individual shareholders that own stock in corporations that operate in states with a high marginal tax rate, the result of this change to the DRD rules are magnified. For instance, assuming that the corporation and the corporate shareholder under the facts of the example above operate in a high state taxing jurisdiction and pay an effective federal and state tax rate of 40%, the corporate shareholder would only receive a $60 dividend and would pay $24 of tax on such dividend. The corporate shareholder would then distribute the $36 to its individual shareholders who, after paying a tax of 39.6% would be left with only $21.74. The corporate earnings would have been subject to an effective income tax rate of 78%.

Example 4 Similar to Example 3, a corporate investor buys Z stock at $53 with a 3.5% dividend yield in January 1994. For purposes of obtaining an enhanced return, the investor sells a January 1996 $50 call on the Z stock (having an implied volatility of 22) for 8 1/2 because the investor believes there is limited price risk below $50. Prior to expiration, the Z stock is trading at $56. The investor continues to believe there is limited price risk below $50 and rolls its existing call position by buying back the January 1996 call at $8 and selling the January 1998 $50 call (which also has an implied volatility of 22) for 11 3/4, for a net credit of 3 3/4. Because of recent increased volatility in the stock market, the implied volatility of the January $50 call has increased from 22 to 30, although the Z stock is still trading in the $56 range. On a marked-to-market basis, with the price of the stock virtually unchanged, the January $50 1998 call has increased from 11 3/4 to 14 7/8. The taxpayer purchased the Z stock and wrote the calls with the expectation of receiving the DRD and an enhanced return from premium. The proposed change to the holding period rules would dramatically impact the expected return. More importantly, unwinding the position at this time would result in a projected loss of 3 1/8 per share. This example demonstrates that, if Congress were to enact the proposed change to the DRD holding period rules, it would be inequitable not to grandfather existing positions.

Corporate investors will be discouraged from entering into hedging transactions through the use of options such as those described above because of the possibility of losing the DRD. This decrease in corporate investor participation in the options markets would result in wider spreads and greater volatility in options pricing. Ultimately, this will lead to less liquidity in the options markets, including the stock market whose trading volume is greatly influenced by the trading volume of the option markets.

This change to the DRD holding period rules would also increase the cost of capital for many corporate issuers of stock, especially issuers of preferred stock. The proposed holding period changes will create uncertainty as to the availability of the DRD for many preferred stock investors. Preferred stock issuers likely will have to increase the dividend yield to compensate for this uncertainty. The increased cost of capital will have particular impact on certain industries, such as utilities, in which preferred stock comprises a significant component of the capital structure.

The current 46-day and 91-day holding period requirements and other related provisions ensure that the benefit of the DRD is available only for economic investments (as opposed to tax-motivated) in which the investor bears risk of loss for a meaningful period. First, no DRD is allowed with respect to any dividend on any share of stock which is held by the taxpayer for 45 days (90 days in the case of preferred stock) or less. In determining whether the taxpayer has held the stock for more than 45 days, the taxpayer's holding period is reduced for periods where the taxpayer's risk of loss is diminished. The regulations interpreting when the taxpayer has diminished its risk of loss are extremely broad and in essence treat the taxpayer as having diminished its risk of loss when the taxpayer enters into a broad range of hedging transactions (other than qualified covered calls). Thus, under current law, a corporate taxpayer must incur significant economic risk of loss during the 45 day holding period to be comfortable that it is entitled to the DRD.

Second, no DRD is allowed to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. This rule is applicable to all dividend payments received by the corporate taxpayer and will prevent the taxpayer from obtaining a DRD even if the taxpayer has satisfied the holding period rules described above.

Third, no DRD is allowed to the extent that the taxpayer finances the purchase of its stock investment with indebtedness. This rule denies the DRD to a taxpayer that has satisfied with holding period rules and related payment rules described above.

The proposed modification to the DRD holding period rules will place corporate investors in the position of having to choose between entering into a bona fide hedge to reduce risk or losing the DRD. Congress should not pass legislation which either discourages hedging or increases triple taxation of corporate earnings.

Appendix A

Assumptions

1. Individual taxpayer with a combined marginal tax rate of 30% on long-term capital gains
2. 6% cost of money
3. Cost basis of $50
4. Annual cost of 100 basis points for top professionals customers; 150 basis points for typical large client
5. The benefit of the tax deferral is computed assuming: (a) a one-year deferral[2] and (b) a five-month deferral (to take account of estimated tax liability)[3]
6. The breakpoint represents the number of days that must pass before the cost of the short-against-the-box exceeds the benefit of the tax deferral

Illustrations

A. 25% Appreciation ($62.50 Fair Market Value)

	Top Professional Customer		**Typical Large Client**	
Deferral Benefit:				
one-year	.225		225	
5-month		.094		.094
Annual Cost	.625		.938	
Breakpoint	**132 days**	**55 days**	**88 days**	**37 days**

B. 50% Appreciation ($75 Fair Market Value)

Deferral Benefit:				
one-year	45		.45	
5-month		.188		188
Annual Cost	75		1.125	
Breakpoint	**219 days**	**92 days**	**146 days**	**61 days**

C. 100% Appreciation ($100 Fair Market Value)

Deferral Benefit:				
one-year	.90		90	
5-month		375		375
Annual Cost	1.00		1.50	
Breakpoint	**329 days**	**137 days**	**219 days**	**92 days**

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[2] Assumes no estimated tax liability

[3] Assumes no estimated tax liability in the year of the short sale, but estimated tax payments are made in the year of sale

COMMENTS OF
THE CHICAGO BOARD OF TRADE AND
THE CHICAGO MERCANTILE EXCHANGE
SUBMITTED TO
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
MAY 15, 1996

The Chicago Board of Trade ("CBOT") and the Chicago Mercantile Exchange ("CME") are submitting this statement in response to Chairman Archer's request on April 15, 1996 for comments by the public on tax provisions contained in the President's 1997 Budget proposals. Our comments are directed to the proposal to impose a constructive sale on certain "appreciated financial positions" – a proposal apparently designed in reaction to a "short-against-the-box" transaction in the stock market.

The CBOT and CME are the two largest markets in the world for transactions in futures contracts and options on futures contracts. The principal purpose of these contracts is to provide a means for the hedging of business and investment risks. The functioning of our markets can be impaired if tax rules threaten to penalize legitimate risk management activities.

The constructive sale proposal causes some concerns for our markets, even though the current tax planning strategies seemingly targeted by the proposal cannot be implemented on U.S. futures exchanges. The proposed statutory language does not appear to apply to transactions on the CME and CBOT, so long as the language is reasonably interpreted in light of the apparent purpose for the provision and its relationship to existing tax rules. However, the proposed language is so ambiguous, and the expressed purpose so ill-defined, that the proposal could have some negative effects on our markets if it is adopted in its current form.

We urge that, if it is believed desirable to address the tax results for the short-against-the-box transaction, the provision be drafted narrowly to ensure that U.S. exchange-traded futures and options on futures not be adversely affected.

Description of Proposal

Under the proposal, there is deemed to be a constructive sale of an "appreciated financial position" if the taxpayer (or a related person) enters into a position with respect to "the same or substantially identical property" that for some period "substantially eliminate[s] both risk of loss and opportunity for gain" on the appreciated financial position. For this purpose, an "appreciated financial position" is "any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold." A constructive sale is not deemed to occur under the proposal if the appreciated financial position is subject to the existing constructive sale treatment under the mark-to-market rules of sections 475 or 1256.

A "position" is defined to mean "an interest, including a futures or forward contract, short sale, or option." A U.S. exchange-traded futures contract (or an option on a futures contract) would generally not itself be subject to constructive sale treatment under the proposal because it would generally be marked-to-market already under existing section 1256. However, at least in theory, U.S. exchange-traded futures (or options on futures) could trigger a constructive sale of appreciated stock or an appreciated debt instrument under the proposal if the taxpayer holding such appreciated property entered into a futures contract (or an option on a futures contract) under circumstances where (i) the futures or options contract is with respect to property that is considered to be the same or substantially identical to the appreciated stock or debt obligation, and (ii) the futures or options position is considered to have the effect of substantially eliminating, for some period, both risk of loss and opportunity for gain on the appreciated stock or debt obligation.

Impact of Proposal on Futures and Options on Futures

The CBOT and CME, like other U.S. futures exchanges, offer standardized futures contracts with respect to underlying property or indices. In the case of a conventional futures contract, one contracting party (the "long" party) agrees to buy and the other contracting party (the "short" party) agrees to sell a specified quantity of underlying property at a specified price on a specified delivery date in the future. Other futures contracts, particularly with respect to indices of property prices or other market information, call for final settlement in cash to reflect price fluctuations, as opposed to actual delivery of property. The exchanges also offer trading in options with respect to futures contracts. In the case of either futures or options on futures, most contracting parties close out their positions prior to the delivery or final settlement date by engaging in an offsetting transaction on the exchange (e.g., a party with a long futures position enters into a short position having the same underlying property, quantity and delivery month).

The most actively traded contracts on the CME and CBOT are futures that relate to financial instruments. For example, the CME has cash-settled futures (and options on futures) with respect to various broad-based stock indices (e.g., the S & P 500 stock index). Both the CBOT and CME have futures (and options on futures) with respect to debt obligations, some of which call for actual delivery of a debt obligation (e.g., the CBOT's contract for Treasury bonds) and some of which call for cash settlement (e.g., the CME's Eurodollar contract). Accordingly, taxpayers using these financial futures contracts in connection with underlying stock holdings or holdings of debt obligations might potentially be affected by the constructive sale proposal.

Any such cloud of doubt should be removed. Irrespective of whether it is considered desirable to alter the current law treatment of a short-against-the-box transaction, a constructive current sale should not be imposed on a taxpayer who uses financial futures transactions to hedge the risk associated with holdings of stock or debt obligations.

A contract to sell in the futures market and a current sale in the so-called "cash" market cannot be regarded as being interchangeable versions of the same substantive transaction.

- Unlike a sale in the current (or "cash") market, a futures transaction involves no current transfer of property and no current payment for a transfer of property. Any purchase, sale and payment of sale proceeds occurs in the future. In contrast, a short-against-the-box involves a current transfer of property (borrowed by the short seller) to a purchaser, who pays currently a purchase price for the transferred shares (with the sale proceeds generally being held by the stock lender to secure the short seller's obligation to "repay" the borrowed property).

- Because futures transactions involve sales (or cash settlements) in the future, the sales price in a futures transaction is rarely the same as the sales price in the cash market. The futures price may be higher or lower than the cash price, depending upon such factors as the period of time to delivery (or final cash settlement), costs associated with holding the underlying property, and the amount of current earnings realized by a holder of the underlying property. In any event, these price differences reflect a real economic difference between a futures transaction and a transaction in the cash market, including a short-against-the-box transaction.

- Because a futures contract involves no current sale or purchase, the holder of a short futures position who also holds stock or a debt obligation has the right to any dividends or interest on the underlying securities. In contrast, a short seller-against-the-box effectively foregoes earnings on the securities he continues to own by obligating himself to make dividend or interest substitute payments to the securities lender.

- Persons who enter into short futures contracts (i.e., contracts to sell) in lieu of selling in the cash market generally do so to serve non-tax risk management objectives related to the distinct economic characteristics of futures transactions, not to postpone a gain that would be realized in a sale on the cash market.

It would be especially inappropriate to impose constructive sale treatment in the case of hedges on U.S. futures exchanges because all transactions on those exchanges involve standardized contracts traded in public markets.

- Persons who enter into countervailing positions on a futures exchange and another public marketplace (including a public cash market) perform an important economic function of minimizing inter-market pricing distortions and enhancing the future price discovery function of the futures market. As noted above, there is generally a difference between a futures price and a cash market price. Arbitrageurs place appropriate trades in the respective markets to benefit when the price spreads are too wide or too narrow, and this profit-seeking activity also benefits the marketplace by tending to bring the respective price relationships back into proper alignment.

- Because U.S. exchange-traded contracts are standardized, a financial futures contract is rarely a perfect offsetting match for a position in the underlying property. The resulting "basis risk" means that hedges using U.S. exchange-traded financial futures (or options on futures) rarely, if ever, "substantially eliminate" risk of loss and opportunity for gain.

- Most futures contracts call for delivery (or final settlement) in the relatively near future and, in any event, rarely more than two years distant. This short-term feature, coupled with the mark-to-market and straddle rules discussed below, makes U.S. exchange-traded futures (and options on futures) less susceptible than some off-exchange contracts to long-term deferral of tax on "locked-in" gain.

- Because of the liquidity of contracts traded on U.S. futures exchanges, futures positions can be readily disposed of. As a consequence, a hedge may be held for only a short period of time before being closed out through an offsetting exchange transaction. Unlike a typical short-against-the-box transaction where the taxpayer actually makes a sale (with borrowed shares) subject to an obligation subsequently to repay the borrowed shares, most holders of a short futures position never actually engage in a sale of the underlying property through the futures markets.

Most U.S. exchange-traded futures (and options on futures) are already marked to market under section 1256 and are also subject to the straddle rules of sections 1092 and 263(g).

- A taxpayer motivated solely by a desire to postpone recognition of gain on appreciated securities finds the futures markets an unaccommodating mechanism for doing so. Assume that a taxpayer with appreciated debt securities enters into short interest rate futures, and add the unlikely assumption that the appreciated securities and the short futures are so perfectly matched that risk of loss and opportunity for gain are "substantially eliminated." Under these circumstances, any subsequent market movement in the cash securities is offset by an opposite market movement in the short futures position, so that the preexisting gain might be regarded as being locked-in. But the locked-in gain is not effectively shielded from tax. If the appreciated securities subsequently lose value, the offsetting futures gain, and thus effectively a portion of the overall locked-in gain, will generally be taxed currently under the mark-to-market rules of section 1256. On the other hand, if the appreciated securities subsequently gain additional value, the resulting mark-to-market loss on the offsetting futures position cannot generally be recognized currently on account of the loss suspension rules for straddles under section 1092.

- Under section 263(g), interest and other costs of carrying a security must be capitalized, rather than deducted currently, if the security is hedged in a manner that substantially diminishes risk of loss.

- There is no need to create an additional constructive sale rule to prevent any taxpayer manipulations using futures contracts. A new constructive sale rule would only add complexity and create uncertainty for legitimate market-driven transactions.

Conclusion

We are concerned with the notion that a contract for future sale and delivery of property should be treated for tax purposes as a constructive current sale of the underlying property. Such a proposal is particularly disturbing if it has potential application to futures contracts traded on U.S. exchanges, which serve important non-tax risk management functions. A proposal inspired by purported tax manipulations through short-against-the-box transactions in the cash market for stock, should not cast any doubt on the continuation of current law tax treatment for futures transactions.

At a minimum, if the basic proposal is adopted, the legislation should make the following changes or clarifications:

- It should be made clear that stock index positions are not covered by the proposal. The regulations under section 246(c)(4)(C) and section 1092(d)(3)(B)(i)(II) provide detailed rules specifying the instances in which a taxpayer's stock portfolio sufficiently mimics a stock index so that a short position with respect to the index is regarded as being "substantially similar or related property" with respect to the stock portfolio. Under these Code provisions and regulations, the consequence of such a "substantially similar or related property" finding is application of straddle rules and, for corporate taxpayers, limitations on the dividends reduced deduction. The implication of these provisions is that a position with respect to a stock index is never considered to be a position with respect to property that is "substantially identical" to stocks in a portfolio. Cf. sections 246(c)(4)(A) and (C); sections 1092(d)(3)(B)(i)(I) and (II). If the short-against-the-box proposal is adopted, this implication should be confirmed to avoid undesirable disruption of stock portfolio hedging activities.

- If it is considered desirable to apply the proposal to debt obligations, notwithstanding the absence of evidence of tax deferral abuses with respect to such securities, the constructive sale treatment should not be applied with respect to debt obligations hedged through U.S. exchange-traded futures (or options on futures). Because of the standardization of exchange-traded contracts, it is very unlikely that such contracts should ever be regarded as "substantially eliminating" risk of loss and opportunity for gain with respect to debt obligations held by the taxpayer. Even if such a "substantial elimination" test could be met in a particular instance, the combination of the mark-to-market rules of section 1256 and the straddle rules of sections 1092 and 263(g) should be more than sufficient to prevent tax manipulations.

STATEMENT OF COALITION OF ALTERNATIVE RISK FUNDING MECHANISMS (CARFM)
SUBMITTED BY JON HARKAVY, PRESIDENT

This testimony is submitted on behalf of the Coalition of Alternative Risk Funding Mechanisms (CARFM) in opposition to the Administration's recent proposal regarding captive insurance (the "Captive Proposal") contained in Title IX, Section 9562 of the March 19, 1996 Budget Bill, which we believe will disrupt a significant marketplace depended upon by commercial insurance consumers to deal with their risk management and policyholder needs.

CARFM is an organization composed of six associations representing policyholder owned (captive) insurance companies, including the Captive Insurance Company Association (CICA), the Colorado Association of Captive Entities (CACE), the Hawaii Captive Insurance Council (HCIC), the Illinois Captive and Alternative Risk Funding Insurance Association (ICARFIA), the National Risk Retention Association (NRRA), and the Vermont Captive Insurance Association (VCIA). CARFM and its member associations represent insurance consumers who have sought to reduce their insurance costs and to address cyclical insurance availability/affordability problems by forming member/policyholder owned insurance companies.

The motivation to form the type of captive insurance companies that are recognized as insurers under decided case law is generally business-driven, not tax-driven. Captives provide business options in the face of lack of adequate insurance capacity or the commercial market's inability to respond to particular needs of an industry. Often, these are new industries most important to economic development. Unavailability of coverage, consolidation of premium funds, centralized claims management, and access to worldwide reinsurance markets for excess coverage are generally recognized as reasons for forming a captive insurance company. Given this business reality, what tax policy could justify treating, for example, a mutual insurance company with 10 equal insureds as something other than an insurance arrangement for tax purposes?

By way of background, the alternative insurance market which CARFM members represent has been estimated to include over 25% of the global reinsurance market, or about $87 billion dollars annually.[1] We provide this statistic to demonstrate the magnitude of the disruption that can be caused by the Treasury's "sledgehammer" approach to dealing with an issue which, by its own revenue estimate, is small in nature.

Under the Captive Proposal, a captive would be treated as an insurance company only if less than 50% of the captive's net written premium is attributable to the insurance or reinsurance of risks of "related persons." For purposes of the provision, a related person would be any 10% shareholder of the captive and any person which "controls" (i.e., owns more than 50%, by vote or value) or is "controlled" by the captive or is under "control" of the same person or persons that "control" the captive. If the 50% test is not satisfied, then the captive would not be treated as an insurance company. Premiums paid by related persons would essentially be treated as deposits, with no immediate deduction allowed by the insured and no immediate income accrued by the captive. Premiums paid by unrelated parties to the captive, however, would constitute income to the captive, but loss or unearned premium reserves would not be allowed. Moreover, the Internal Revenue Service would be allowed to consider certain unrelated parties to be related for purposes of the Captive Proposal.

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1 Rosenbaum, D. Hugh, Editor, Captive Insurance Company Reports, Tillinghast, a Towers Perrin Company, June 1993, pg. 1.

I. THE CAPTIVE PROPOSAL REJECTS WIDELY ACCEPTED JUDICIAL PRECEDENTS WHICH DEFINE "INSURANCE" FOR TAX PURPOSES

a) 50% Threshold for Unrelated Risks.

The Tax Court, the U.S. Court of Federal Claims and several circuit courts have addressed the effect of unrelated risks on the treatment of related party transactions as insurance for tax purposes.[2] The courts concluded that the insurance of risks of unrelated parties enhanced the risk shifting and risk distribution necessary to constitute insurance for tax purposes. Based upon expert insurance and actuarial evidence, the Tax Court and the Ninth Circuit Court of Appeals found in one case that the insurance of 30% unrelated risks was sufficient for insurance treatment.[3]

The 30% unrelated premium threshold was not arbitrarily selected by the courts. It relies upon the judgment of insurance experts that "insurance" in substance exists with such a level of unrelated premium and establishes a clear, easily applied standard for the IRS and for taxpayers.

The Captive Proposal, in contrast, is wholly arbitrary. It is not based upon any expert judgment or evidence about the nature of insurance.

b) 10% Large Shareholder Definition.

The Captive Proposal would treat as non-deductible premiums paid by 10 percent or more shareholders if insufficient business exists from smaller shareholders or others. This standard is totally arbitrary and would have a devastating effect on many group-owned captives, i.e., captives owned by groups of wholly unrelated parties. It is also directly contrary to all commonly understood definitions of insurance used by the courts or by experts in the insurance industry. For example, consider a captive owned equally by ten (10) unrelated taxpayers which pay equal premiums to the captive. The Captive Proposal would appear to treat all of the premiums received by the captive as non-deductible premiums.[4] This makes no sense at all, since from an economic perspective each unrelated insured has 90% third party business.

The 10% large shareholder rule would be detrimental especially to small businesses which often form group captives in order to pool risks that could only be insured at higher costs in the traditional market. For example, many small farm mutual and reciprocal insurance companies exist, in which small rural groups pool their resources and insure one another. To take another common example, small groups of hospitals commonly form group captives in order to pool their exposures that would be uninsurable in the commercial market. Such long-standing institutions would effectively be destroyed by the Captive Proposal. We do not understand the rationale for denying a premium deduction and insurance company status in such cases, where all would agree that from an economic standpoint risk shifting and risk distribution, the hallmarks of insurance, exist.

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[2] See, e.g., AMERCO & Subsidiaries v. Com., 96 T.C. 18 (1991), aff'd., 92-2 USTC Section 50,571 (9th Cir. 11/5/92); Sears Roebuck & Co. v. Com., 96 T.C. 61 (1991), aff'd. in para. and rev'd. in para. 92-2 USTC Para. 50,426 (7th Cir. 8/18/92); Ocean Drilling & Expl. Co. v. U.S., 24 Cl. Ct. 714 (1991), aff'd. per cur., 93-1 USTC Para. 50,160 (Fed. Cir.).

[3] The Harper Group v. Com., 96 T.C. 45 (1991), aff'd., 92-2 USTC Para. 50,572 (9th Cir. 11/5/92).

[4] The unreasonableness of the proposal is demonstrated by the fact that by arranging the ownership of the captive, one might attain insurance treatment for tax purposes: e.g., one shareholder/insured owns 49% of the stock and is responsible for 49% of the premiums, with the other nine shareholders/insureds all below 10%. Apparently, the premiums of all shareholder/insureds would qualify for insurance treatment in this example.

In sum, the "large shareholder" rule has the effect of denying insurance treatment for tax purposes where there is a true pooling of risks -- i.e., where true risk shifting and risk distribution exist in an economic sense. It is our understanding that not even the IRS questions insurance treatment in these circumstances.

II. THE CAPTIVE PROPOSAL WOULD ELIMINATE IMPORTANT MARKETS FOR THIRD PARTY BUSINESS

a) Treatment of Insurance from Small Shareholders and Non-Shareholders.

Because the Captive Proposal keys off the definition of insurance company for tax purposes, a captive that has significant unrelated business could nonetheless not be considered to be an insurance company for tax purposes Although the insured in such case would not be denied a premium deduction, the effect on the captive would be devastating. Even though the captive is assuming risks of third parties, because it is not considered to be an insurance company, it would not be entitled to take reserve deductions and, as a result, would be taxed on the gross amount of premium income. By contrast, a commercial insurance company would only be taxed on the net profit on the contract after reserves for losses to be paid in the future are taken into account. This disparate treatment would effectively prohibit captive insurance companies from insuring any unrelated parties, unless such premium would immediately constitute more than 50% of the company's net premium. Non-insurance company treatment with respect to the unrelated business would therefore eliminate most captives from the commercial insurance market, a market in which captives have had an ever increasing share over the years, and would have an anti-competitive effect.

b) Overreaching Definition of Large Shareholder.

Especially disturbing in the Captive Proposal is the regulatory authority given to the Treasury to promulgate regulations that would treat as "large shareholders" parties that have contractual relationships with the large shareholders and who purchase insurance from the captive. The Treasury Explanation indicates clearly that this legislative authority should extend to the type of arrangements that courts and the IRS have traditionally considered to be valid third party business for purposes of qualifying the captive as a valid insurance company.

For example, the courts have approved as valid third party business insurance purchased by customers of the captive's owner. There is no reason to consider this third party business to be that of the owner, particularly since the result apparently would be that the customer would not be able to deduct the premiums paid to the captive.

Many significant insurers insure primarily the risks of persons with whom the owner has contractual relations. For example, a number of well-known manufacturers and finance companies have "captives" that insure risks of their independent dealers or their finance customers, with premiums and reserves in the hundreds of millions of dollars or more. These risks are clearly third party business with respect to the owner of the captive.

Under the Captive Proposal, however, the Treasury would have authority to consider these premiums to be related to the captive's owner, denying the premium payor a deduction and eliminating the ability of the insurance company to take reserves. Suffice it to say, these captives (which are significant insurers) would soon be out of business, if no deduction were permitted them for reserves.

Even if regulations ultimately exempt such transactions, it is likely that such regulations will take a number of years to be promulgated In the meantime, taxpayers will have to operate under the specter of regulations that could destroy valid businesses.

III. THE CAPTIVE PROPOSAL WOULD REQUIRE AN UNNECESSARY EXCISE TAX PENALTY

Particularly objectionable is what is essentially a no-fault penalty contained with regard to the application of the Section 4371 excise tax. Under the Captive Proposal, the application of the excise tax hinges upon the mere taking of a deduction on the tax return for the premium, even if the premium deduction is ultimately not allowed. Under current law, no excise tax would apply if ultimately there is no premium deduction because the arrangement does not constitute insurance.[5] This is a logical extension of the requirement that the excise tax apply to policies of "insurance."

By contrast, the Captive Proposal would apply the excise tax even to situations where no deduction is ultimately allowed, but a deduction is taken on the return. Given that there will likely be many uncertainties in the interpretation of the statute and the regulations, this provision is merely a means of enacting a penalty on taxpayers without calling it one. Taxpayers should not be penalized for taking legitimate, good faith or reasonable interpretations of a statute or regulations.

IV. THE CAPTIVE PROPOSAL WOULD IMPOSE BURDENSOME RECORD KEEPING REQUIREMENTS

The Captive Proposal authorizes Treasury to promulgate regulations requiring shareholders of captives or related persons to maintain appropriate records and denies a premium deduction to persons who do not satisfy these record keeping requirements. This aspect of the Captive proposal apparently derives from a perceived inability of the Internal Revenue Service to obtain information concerning captive insurance companies. We believe that the Internal Revenue Service is significantly overstating the problem. In our experience, the Internal Revenue Service has not had problems receiving information from offshore captive insurance companies with respect to their income. Moreover, to the extent there are problems with receiving such information, the Internal Revenue Code contains summons provisions that effectively penalize a shareholder or insured who fails to provide the requested information. We do not disagree that the Internal Revenue Service should have the ability to require taxpayers to justify their deductions. However, we are concerned that the Treasury will use this power as an opportunity to require all shareholders, no matter how small, to provide full financial and ownership information with regard to the captive insurance company. Many times this will be impractical. If such record keeping is required, it should be limited to large shareholders of the captive and related parties.

V. THE CAPTIVE TAX PROPOSAL WILL GENERATE SIGNIFICANT UNFUNDED TAX LIABILITIES THAT MAY THREATEN CAPTIVE INSURER SOLVENCY

a) Application of the General Provisions of the Code to Insurers Not Meeting the 50% Test.

Under the Captive proposal, if the 50% test is not satisfied, the captive is no longer considered an insurance company. As a result, any premiums paid by unrelated parties to the captive would not be entitled to insurance accounting treatment. In the absence of such treatment, the premiums would constitute current income and the captive would not be able to take unearned premium reserves and loss reserves to reflect the very real liabilities to which it is subject. Thus the Captive Proposal would create huge unfunded tax liabilities for a number of single owned captives, group captives and pools, which would realistically render a number of them insolvent, thereby jeopardizing policyholders, claimants, and potentially a number of state insolvency funds.

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[5] See Rev. Rul. 78-277, 1978-2 C.B. 268.

Only a small portion of the premium which an insurance company collects is taxed as current income, for the simple reason that the most significant portion of the premium is set aside in loss reserves to pay claims, and other significant percentages of the premium dollar are needed to cover operating expenses. Indeed, the major concern of insurance regulation is protecting policyholders and claimants by making sure an insurance company has adequate loss reserves to pay claims. The Captive Proposal undermines these solvency concerns by treating all premium dollars paid by less than 10% shareholders to an insurer not meeting the proposed outside business test as current income. Consider the inequity if the Treasury decided to tax any business on gross earnings rather than on net profit. Then put this proposal in the context of an insurance company where the significant shortfall in operating revenue may very well mean that claimants and policyholders will not be indemnified for their losses.

VI. THE CAPTIVE PROPOSAL UNDERMINES THE FEDERAL LIABILITY RISK RETENTION ACT

In 1981, Congress enacted the Product Liability Risk Retention Act to encourage the formation of risk retention groups and purchasing groups to provide product liability insurance. In response to the crisis in the availability and affordability of commercial liability insurance, Congress passed the Risk Retention Amendments of 1986, which expanded on the earlier Act by permitting these groups to provide not only product liability insurance but all types of liability insurance. The stated purpose of these provisions was to allow a group of businesses to join together to set up their own insurance company to issue policies only to themselves. From a formation perspective, very few risk retention groups (RRG's) are fortunate enough during the start-up phase to have a large number of policyholders with equal access to the capital needed to form the insurance company. Generally, RRG's start forming with a comparatively small number of policyholders having concentrated ownership in the facility which is diffused after more policyholders join the group in the years following start-up. Faced with the draconian treatment afforded by the Captive Proposal, many nascent RRG's will not be able to be formed. Other RRG's in their infancy stage which do not meet the Treasury's 50% test will be faced with significant unfunded tax liabilities and real solvency concerns.

VII. THE CAPTIVE PROPOSAL OFFERS NO SIGNIFICANT REVENUE ENHANCEMENT

Indeed, the Joint Committee on Taxation estimates a $23 million revenue loss over ten years as a result of implementation of the Captive Proposal. The Administration's projections show an increase in revenue over 7 years of only $100 million. The Administration's projections under the prior proposal, which was not materially different from the current proposal, showed even less revenue, with a net increase in revenues for the first seven years of $62 million, and a net decrease in revenues for years 8 to 10 of $18 million. The miniscule revenue gain does not justify the disruption to the industry and the insureds who rely on the captive insurance market, nor does it justify several pages of complicated statutory language which contemplates the issuance of more pages of complicated regulations.

In conclusion, the Captive Proposal is completely without merit. It replaces existing standards of insurance principles and a body of judicial decisions justifiably relied upon by taxpayers with completely arbitrary standards that will impose upon both the Treasury and taxpayers horrendous regulatory compliance difficulties and will subject certain captives and small insurers to unfunded, unforeseen tax liabilities which could threaten their very solvency. In doing so, the Treasury will be disrupting a significant alternative insurance marketplace depended upon by commercial insurance consumers to meet risk management needs not addressed by the cyclical traditional insurance industry. Indeed, the Captive Proposal would undercut the very self-help mechanism established by the federal Liability Risk Retention Act Amendments of 1986 which Congress had enacted for commercial insurance consumers. Furthermore, the Captive Proposal embodies unsound tax policy, as it would penalize those taxpayers seeking to reduce their insurance costs by utilizing more efficient means to obtain improved coverage at a lower premium. The Treasury cannot credibly argue that these legitimate economic interest should be sacrificed on the altar of revenue enhancement, for according to unbiased Joint Committee on Taxation estimates, the Captive Proposal is a revenue loser. We urge the Committee to reject the Captive Proposal as an unworkable, economically dysfunctional solution to issues which the courts and lawmakers have adequately addressed in a manner relied upon by taxpayers.

STATEMENT OF THE COALITION ON CREDIT CARD INTEREST IN RESPONSE TO THE HOUSE COMMITTEE ON WAYS AND MEANS REQUEST FOR COMMENTS ON NEW REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET

This statement is respectfully submitted on behalf of the Coalition on Credit Card Interest in response to the Committee's request for comments on revenue provisions that were included in President Clinton's fiscal year 1997 budget but not in the Balanced Budget Act of 1995. The Coalition appreciates the Committee's interest in public comments on the Administration's new revenue proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular -- the proposal to require a prepayment assumption in computing the accrual of grace period interest on credit card receivables outstanding at the end of a taxable year. The proposal is detrimental to credit card businesses located throughout the United States, including the credit card operations of commercial banking and thrift institutions, non-bank financial institutions and retailers.

BACKGROUND

Credit card issuers frequently provide an interest-free "grace period" before customers are liable for any interest charges on purchases. In a typical arrangement, interest is not charged on a customer's credit card balance (other than the portion of the balance reflecting the principal amount of cash advances) during the grace period. The grace period typically begins on the date a customer's purchase is posted to his or her account and ends a specified number of days after close of the monthly billing cycle during which the purchase is posted.

For example, assume a customer purchases goods on November 15 using a credit card with a billing cycle ending the 12th of each month and a 25-day grace period. The purchase would likely be posted to the customer's account on November 15 or 16 and would be included on the customer's bill dated December 12. Under this arrangement, the customer would not incur a finance charge on the November 15 purchase if the December 12 balance, which includes the November 15 purchase, is paid on or before January 6. If, on the other hand, the customer fails to pay the balance by January 6, interest will generally be computed based on the average outstanding balance which was increased on the date the purchase was posted to the customer's account.

Under present law, a credit card issuer is not required to include grace period interest in taxable income until the grace period has expired. As the Committee knows, a provision in President Clinton's fiscal year 1997 budget would require a "reasonable payment assumption" for interest accruals on certain debt instruments.[1] These debt instruments would include pools of credit card receivables. The proposal would require credit card issuers to use an assumption about payment patterns to accrue interest income when the receivables are outstanding over the end of a taxable year. Simply stated, the proposal would require credit card issuers to accrue an estimate of the total amount of interest income expected to be earned at the end of the grace period. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period.

The Administration is proposing that this provision be effective for taxable years beginning after the date of enactment.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

As discussed below, the Coalition believes that the Administration's proposal is an inappropriate departure from historic tax accrual standards. Additionally, the Coalition believes that this proposal is not a "loophole" closer as the accrual method of accounting can hardly be viewed as a tax "loophole" or contributing to "corporate welfare." On the contrary,

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[1] See, Department of the Treasury, General Explanation of the Administration's Revenue Proposals, March 1996, at pages 76-77.

adopting the proposal in question can only be viewed as a tax increase on credit card issuers and an arbitrary departure from well-established tax policy. The Coalition strongly urges the Committee not to adopt the Administration's proposal in any form at any time.

1. The Proposal is an inappropriate departure from Tax Accrual Standards

Accrual method taxpayers are generally governed by the "all events test" which dates back to the 1926 Supreme Court case of United States v. Anderson.[2] In deciding the appropriate time for an accrual method taxpayer to accrue a deduction for a munitions tax liability, the Court stated: "in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it."[3] The all events test subsequently became the consistent standard for accruing both income and expenses. The Treasury Regulations provide:

> Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.[4]

The importance of accruing income and expense items based on a consistent standard cannot be overstated. In order to prevent a distortion of taxable income, the use of estimates should not be required for accruing income if estimates are not permitted in accruing expenses. As you are aware, estimates are not permitted in accruing expenses. For example, taxpayers are not permitted to accrue an estimate of the liability for self-insured medical costs even though the amount of the liability to be incurred can be accurately predicted by the taxpayer.[5] In addition, all other types of reserves, including bad debt reserves, are not permitted as a deduction against taxable income.

As stated above, the right to receive credit card interest does not become fixed, and therefore is not includible in taxable income, until the end of the grace period. While the extent to which a credit card customer will pay the outstanding balance before the end of the grace period could be estimated, predictions of uncertain future events have long been rejected as a basis for tax accounting on both the income and the expense side. A return to the use of estimates solely on the income side represents a one-sided departure from long established accrual principals and will significantly distort taxable income solely for the sake of a one time revenue raiser.

2. **The Administration Erroneously Equates Stated Interest on Credit Card Receivables with Original Issue Discount on REMIC Regular Interests and Qualified Mortgages.**

The Treasury Department's General Explanation of the Administration's Revenue Proposals suggests that the rationale for this proposed change is to treat interest on credit card receivables in a manner similar to the current law treatment of real estate mortgage conduit (REMIC) regular interests and REMIC qualified mortgages. Treasury's explanation, however, fails to state that the prepayment catch-up method applied under current law to REMIC regular interests and REMIC qualified mortgages is used solely to amortize fixed amounts of original issue discount, market discount or bond premium. Thus, under current law, the prepayment catch up method merely effects the timing of the recognition of a fixed amount of income.

The prepayment catch-up method is not applied to the accrual of qualified stated interest. As a result, qualified stated interests on both REMIC regular interests and REMIC qualified mortgages is accrued under the all-events test of Internal Revenue Code section 451. Moreover, the prepayment catch up method is not applied under present law to accrue any amount of income that is not fixed.

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[2] 269 US 422 (1926).
[3] 269 US at 441 (1926),
[4] Treas. Reg. §1.446-1(c)(1)(ii). See also Treas. Reg. §§1.451-1(a) and 1.461-1(a)(2)(i).
[5] United States v. General Dynamics Corp., 481 US 239 (1987).

Therefore, the fact that the prepayment catch up method applies under current law to REMIC regular interests and REMIC qualified mortgages does not provide any justification as a matter of tax policy for applying prepayment assumptions to the accrual of grace period interest on credit card receivables. As stated above, grace period interest is not fixed until the end of the grace period. In addition, once it becomes fixed, it is qualified stated interest rather than an amount of discount or premium. Unlike with REMICs, applying prepayment assumptions to grace period interest effectively results in a tax on income that has not been, and may never be, earned.

RECOMMENDATIONS

For the reasons set forth above, the Coalition strongly urges the Committee not to include the Administration's proposal to require the use of estimates for interest accruals on credit cards providing for a grace period, this year or in the future. The Coalition recognizes the need for modernization in the financial products area but believes this provision inappropriately attempts to treat contingent interest in the same manner as a fixed amount of original issue discount. Effectively, this proposal represents a tax increase on credit card issuers, not the closing of a corporate loophole.

The Coalition appreciates the Committee's interest in its views on this significant issue.

TESTIMONY OF

COOPERS & LYBRAND L.L.P.
AND
THE SECTION 1374 COALITION

REGARDING ADMINISTRATION'S PROPOSAL TO REPEAL IRC SECTION 1374

BEFORE

THE HOUSE WAYS AND MEANS COMMITTEE

MAY 15, 1996

[written testimony submitted for the record]

Mr. Chairman and members of the Committee:

Coopers & Lybrand and the Section 1374 Coalition are pleased to have the opportunity to comment on the Administration's proposal to impose a liquidation tax on C Corporations converting to S Corporation status. The proposal was included in President Clinton's Fiscal Year 1997 budget submission to Congress on March 19, 1996. We commend Chairman Archer and the Committee for its leadership in examining this issue, and we appreciate the opportunity to comment on behalf of the Firm and certain clients.

Coopers & Lybrand and the Section 1374 Coalition strongly oppose the proposal included in the President's FY 1997 budget submission. It is our belief that the proposed liquidation tax would constitute a significant change in corporate tax law, contradicts sound tax policy and would inappropriately deter, if not eliminate, future C corporation conversions to S corporation status. This proposal represents a drastic change to current law and has not been the subject of Congressional hearings. Additionally, the primary purpose behind Treasury's proposal, which is not coupled with other S corporation reform and simplification proposals, is to raise revenue in a manner we find short-sighted and inappropriate as a tax increase measure.

We would also point out that this proposal is a departure from the Administration's prior position as stated by Treasury Assistant Secretary for Tax Policy Leslie Samuels who testified that significant changes to Subchapter S should only be made "pursuant to a comprehensive, deliberate process, rather than on a piecemeal basis."[1] Coopers & Lybrand and the Coalition support S corporation simplification provisions included in the *S Corporation Reform Act of 1995*, introduced in the House and Senate (H.R. 2039 and S. 758). We also support the S

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[1] Testimony of Assistant Secretary Samuels on Miscellaneous Revenue Issues, before the House Ways and Means Subcommittee on Select Revenue Measures, Serial 103-63, Part 1, pg. 311, June 22, 1993).

corporation provisions included in H.R. 2491, the vetoed *Balanced Budget Act of 1995*, but are disappointed that several meritorious changes were dropped without adequate debate from the final version of H.R. 2491.

BACKGROUND

S corporations have been a long-standing, recognized tax entity. In 1958, Congress enacted Subchapter S of the Internal Revenue Code to permit owners of businesses which had incorporated an entity for business and legal purposes to elect to be treated for tax purposes in a manner similar to a partnership. By nature S Corporations are hybrid entities including some features similar to flow-through entities while others follow the corporate model.

Congress modified the S corporation rules in 1982, focusing on simplification and removing traps for the unwary. This tax act reaffirmed S corporations as an acceptable form of tax entity and recognized a long-accepted policy to integrate the corporate and individual tax systems for closely-held businesses. During Congressional deliberations of the 1982 act, a liquidation tax similar to the Administration's proposal was considered and rejected. Instead, Congress implemented a tax on excess passive income for S corporations that were previously C corporations, allaying concerns that personal holding companies could avoid their penalty tax by electing S status. A liquidation tax was not perceived necessary to curtail C-to-S conversions. In fact, a significant purpose of the 1982 act was to encourage more conversions.

Section 1374 was enacted as part of the Tax Reform Act of 1986, and was adopted primarily to prevent a C corporation from avoiding the repeal of the *General Utilities* doctrine (also enacted as part of TRA '86) by converting to S corporation status prior to a sale of its business. Hence, Section 1374 provides for a corporate-level tax on any built-in gain when assets owned as a C corporation are sold by an S corporation at anytime during the 10 years after conversion. During deliberations of the TRA'86, a liquidation tax again was considered and rejected. A determination was made then that a 10-year period provided an adequate period for collection of any tax on C corporation gains. Since enactment, it is our understanding that Section 1374 has been effective in achieving its purpose and should not be replaced with a burdensome and ultimately unfair liquidation tax.

In 1990, the House Ways and Means Committee looked again at a liquidation tax as a means of simplifying subchapter S.[2] This so-called simplification proposal was rejected and did not advance through the legislative process.

We believe it is important to note that on at least three previous occasions, Congress considered and rejected a liquidation tax comparable to the one proposed by the Administration. Unfortunately, the proposal has once again been resurrected and is now before the 104th Congress. We strongly urge you to reject this proposal because of its detrimental effect on choice of entity for small businesses.

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[2] Written Proposals on Tax Simplification, WMCP 101-27, pg. 24, May 25, 1990 (reprint of letter to Chairman Dan Rostenkowski from Ronald A Pearlman, Chief of Staff).

PRESIDENT'S PROPOSAL

The proposal from the *President's Fiscal Year 1997 Budget* submission to Congress on March 19, 1996, would repeal IRC Section 1374, thus imposing a liquidation tax on C Corporations with a value of $5 million or more that convert to S Corporation status. Currently, Section 1374 imposes a tax on built-in gains in assets held by the C corporation at the time of conversion if and when built-in gain property is disposed of during the ten-year period following the conversion. Under the proposal, a C-to-S corporation conversion would be treated as a liquidation of the C corporation followed by a contribution of the assets to an S corporation by the recipient shareholders, thus triggering an immediate recognition of gain by both the corporation and its shareholders upon the conversion to S corporation status.

The Treasury proposal would apply to Subchapter S elections that are first effective after January 1, 1997. This effective date reflects transition relief announced by Treasury earlier this year.[3] However, this transition relief in no way alleviates the burden of the liquidation tax for those existing corporations, as yet unidentified, that might want to make an S election in the future.

Although a liquidation tax has been debated on several occasions since Subchapter S was first incorporated into the Internal Revenue Code, the most recent effort to impose a tax on C-to-S conversions was proposed in a letter from Treasury Assistant Secretary for Tax Policy Leslie Samuels to Congressional leaders last July.[4] In the letter, Assistant Secretary Samuels suggested a conversion tax as a possible S corporation reform measure, stating "we should consider whether it is advisable to conform the tax treatment of the conversion of existing C corporations to S corporations with the treatment of their conversion to a partnership."

The liquidation tax proposal resurfaced again late last year as a revenue raiser offered by Treasury to offset the revenue loss associated with the *President's Seven-Year Balanced Budget Proposal*, released December 7, 1995.[5] As balanced budget talks continued between Congressional Republicans and the Administration, the proposed tax was also included in the *President's Balanced Budget Plan* submitted to Congress on January 6, 1996.[6] The latest proposal to repeal Section 1374 was included in the President's FY 1997 budget submission in March, 1996.

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[3] Treasury Announces Additional Transitional Relief, Department of the Treasury, press release, February 22, 1996.

[4] Letter from Treasury Assistant Secretary for Tax Policy Leslie Samuels to Congressional Leaders, July 25, 1995

[5] Description of the Tax and Health Insurance Reform Provisions in the President's Seven-Year Balanced Budget Proposal Released on December 7, 1995, JCX-58-95, pg. 71, December 15, 1995.

[6] Description of Tax Provisions Included in a Plan to Achieve a Balanced Budget Submitted to the Congress by the President on January 6, 1996, JCX-1-96, pg. 35, January 24, 1996.

ADVERSELY AFFECTS C CORPORATIONS AND EXISTING S CORPORATIONS

A Liquidation Tax Would Not Result In Parity: According to the Treasury Department's *General Explanations of the Administration's Revenue Proposals,* the rationale behind this provision is to treat the conversion of a C corporation to an S corporation the same as a C corporation conversion to a partnership. The proponents of this argument have indicated that imposing a liquidation tax would result in parity between S corporations and partnerships or limited liability companies (LLCs). S corporations, however, do not enjoy many of the benefits available to LLCs, and even if this proposal were enacted, the S corporation still would not be on the same level playing field as LLCs.

S corporations are formed to be a simplistic organization, taxed as a flow through entity. Owners of S corporations, in exchange for the such tax treatment, accept significant restrictions to which other tax entities are not subject. Unlike LLCs, S corporations currently have a limited number shareholders (35), none of whom can be either partnerships, other corporations or non-resident aliens. Additionally, tax-exempt organizations and certain trusts are not eligible to be S corporation shareholders and S corporations may not issue preferred stock or own more than 80 percent of another corporation's stock. Even if the S corporation reform and simplification provisions included in the vetoed *Balanced Budget Act of 1995* and other legislation currently pending before Congress (H.R. 2039, S. 758) were enacted, S corporations would still not be on equal footing with LLCs or partnerships.

Presently, there are few C corporations converting to partnership status. A liquidation tax will do little to achieve "parity" between entities, but instead will only aggravate the competitive disadvantage of businesses in C corporation form when compared to flow-through entities.

C Corporations Will Be At A Permanent Competitive Disadvantage: The Administration's liquidation tax will leave many small businesses at a competitive disadvantage with partnerships and those that have already converted to Subchapter S status. Under a liquidation tax, C corporations will be allowed to convert to S status only if they have their cash resources drained to pay the liquidation tax without first having disposed of assets. The other alternative is to continue their C status and pay the double layer of federal income tax which is what invariably all will do.

Future Subchapter S Elections Will Effectively Be Repealed: Subchapter S is a long-standing filling status permitted by current federal tax law. The tax proposed by the Administration will make almost all future elections prohibitively expensive. It runs counter to the very positive bi-partisan Congressional Subchapter S reform effort that has been co-sponsored by 22 Members of the House Ways and Means Committee and 7 Members of the Senate Finance Committee. Reforming Subchapter S is exactly what should be done and makes far greater sense than imposing a draconian liquidation tax on C-to-S conversions.

General Explanations of the Administration's Revenue Proposals, Department of the Treasury, pg. 84, March 1996.

Imposes Tax Before Assets Are Disposed: At the heart of our tax system is an established concept fundamental to assessing tax. This "wherewithal-to-pay" concept holds that income taxes should not be imposed until a transaction occurs in which the taxpayer recognizes income and has the ability to pay. Income from services or the sale of an asset result in the taxpayer holding monetary value, having the wherewithal to pay a tax on the income recognized. It is not in the best interest of U.S. commerce to impose a huge tax on the fictional liquidation proposed by the Administration on a C-to-S conversion before any assets have been disposed.

A built-in gains tax on appreciation in business assets is already imposed under current law, but only when assets are sold. The Administration's proposal would tax gains on a companies assets while still using them in an active trade or business. To pay this tax would greatly diminish business resources at a time when companies may not have the ability to pay. Thus, the proposal penalizes C corporations electing S status by requiring the recognition of gain which has not yet been realized.

Limits Ability Of Current S Corporation Growth Through Acquisition: This liquidation tax would impact all current S corporations. An S corporation that desired to grow through a corporate merger transaction with a C corporation would be subject to tax as if the acquired C corporation were liquidated. Such transactions would have prohibitive results, and current S corporations would not have the flexibility that they are now afforded. Additionally, they would be on unequal footing with C corporation counterparts in restructuring and reorganizing transactions. This effect runs counter to the many provisions in the Code that encourage growth and provide tax deferred methods to achieve it.

Undermines Integration Of Federal Income Tax System: The proposal greatly diminishes the ability to mitigate the double tax burden on C corporations' cost of capital. C corporations are burdened with two levels of federal income taxes (once at the corporate level and then again at the shareholder level). S corporations, like partnerships, pay a single level of tax at the ownership level. A tax on the appreciation in business assets at the time of the company's conversion to S corporation status would run directly counter to the effort to integrate the corporate and individual tax systems. Since taxpayers currently doing business as C corporations will effectively be denied the ability to operate under the simplicity of Subchapter S, the proposal only perpetuates the existing two-tier corporate tax system. Thus, it has the perverse effect of locking closely-held C corporations into the double-tax regime.

Corporate integration is a goal that has historically been supported by the Treasury Department. A comprehensive study released by Treasury at the conclusion of President's Ford's Administration in 1977 outlined several methods to achieve corporate integration.[8] In the Treasury report to President Reagan in 1984, Treasury asserted that "the double taxation of dividends increases the cost of capital to corporations and reduces the return to individual investors."[9]

[8] Blueprints for Basic Tax Reform, Department of the Treasury, 1977.

[9] Tax Reform for Fairness, Simplicity and Economic Growth, Volume I, Department of the Treasury, pg. 118, November 1984.

In 1992, the Treasury Department released the report *Integration of the Individual and Corporate Tax Systems*, which noted that "the current two-tier system of corporate taxation discourages the use of a corporate form even when incorporation would provide non-tax benefits such as limited liability for the owners."[10] The report further stated that "*the potential economic gains from integration are substantial.*"[11] (emphasis added).

$5 Million Threshold Complexity: The $5 million fair market value threshold for determining the applicability of the tax is not only too low a threshold to distinguish between large S corporations and small ones, but would result in a cliff. For example, if a C corporation is valued at $5,100,000, an election would result in a tax as if the company had liquidated. This would put unrealistic pressure on the difficult task of valuing the stock of a closely-held corporation. Additionally, even after obtaining an appraisal, the company could not be confident that the Internal Revenue Service would not challenge the appraisal later. Therefore, the proposal will needlessly increase controversies between taxpayers and the IRS over the value of small closely-held businesses.

S corporations of identical sizes but with different ratios of debt to equity will be treated differently. An S corporation with $10 million in assets and $6 million in debt will be able to make an S election. However, an S corporation with $10 million in assets and no debt will not be able to make an S election without a liquidation tax.

Technically Flawed: We concur with other commentators that the Administration's proposal is technically flawed for several reasons. It lacks clarity of scope, requiring taxpayers to speculate on the meaning of several aspects. Its proposed effective date has already put otherwise eligible corporations at a disadvantage to their industry competitors. It is inconsistent with subchapter S provisions allowing S corporations to be treated as regular corporations for many purposes of the Code. Additionally it's a trap for the unwary taxpayer. However, we do not recommend attempts to correct the proposal's technical deficiencies. The liquidation tax must be rejected outright.

CONCLUSION

Coopers & Lybrand and the Section 1374 Coalition urge the Committee to reject the Administration's proposal. Imposing a liquidation tax on C corporations converting to S corporation status is not only counterproductive and burdensome, but will effectively eliminate future Subchapter S.

As supporters of the S corporation reform legislation introduced during the 104th Congress, we find this proposal to be shortsighted, detrimental to business activities, and only serving to perpetuate a two-tier tax system that distorts the cost of capital. Rather than advance our tax policy towards an integrated tax system, it moves in the opposite direction. Additionally, it represents a drastic change to current law and has not been the subject of Congressional review or hearings.

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[10] Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once, report of the Department of the Treasury, pg. 1, January 1992.

[11] Ibid.

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EDISON ELECTRIC INSTITUTE

DAVID K. OWENS
Senior Vice President
Finance, Regulation, and
Power Supply Policy

May 15, 1996

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Sir:

RE: Corporate Tax Reform Provision in the President's Fiscal Year 1997 Budget Proposal

This letter is submitted in response to the request by the Committee on Ways and Means for public comments on certain revenue provisions in President's Clinton's Fiscal Year 1997 budget.

Edison Electric Institute (EEI) is the association of the United States investor-owned electric utilities and industry affiliates worldwide. Its U.S. members serve 99 percent of all customers served by the investor-owned segment of the industry. They generate approximately 79 percent of all the electricity generated by electric utilities in the country and service 76 percent of all utility customers in the nation.

EEI appreciates the opportunity to comment on two of the corporate tax reform provisions in the President's Fiscal Year 1997 Budget proposal. We are submitting an original and six copies of our comments for your consideration.

Dividends-Received Deduction

The President's plan would raise $2.9 billion over seven years by reducing to 50 percent the dividends-received deduction for corporations owning less than 20 percent of the stock of a U.S. corporation. The rationale behind this is that Treasury believes that the 70 percent dividends-received deduction is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a

sufficient ownership interest in that corporation. The proposal would be effective for dividends paid after January 31, 1996.

We strongly believe that the impact of this provision in the President's proposal is fundamentally anti-investment and anti-business, and will diminish capital formation, economic growth, and job creation. Under the regime of corporate taxation, the current 70 percent dividends-received deduction attempts to mitigate the middle level of taxation. Corporate income is taxed once as it is earned by a corporation, a portion of that same income is then taxed a second time when it is distributed to a corporate shareholder as a dividend; it is then taxed a third time when the recipient corporation distributes its earnings to its individual shareholders. Thus, excluding the effects of state income taxes this income is effectively taxed at a rate up to 68 percent! This is significant considering the electric utility industry pays in excess of $16 billion of dividends comprising approximately 80 percent of its net after tax savings. The revenue generated by the proposed reduction in dividends-received deduction would therefore be accomplished at the expense of exacerbating the current problem of multiple taxation of corporate income by reducing the intercorporate dividends-received deduction.

Studies by the U.S. Department of Treasury, the American Law Institute, the American Institute of Certified Public Accounts and economists from the academic have demonstrated that the multiple tax on corporate earnings results in a number of serious economic distortions that have a negative influence on the national economy. An additional tax on corporate dividends will negatively affect capital accumulation and savings, increase debt financing, reduce equity financing and by increasing the incremental cost of capital will reduce investment. Therefore, we believe that reducing the dividends-received deduction is counterproductive. As economic growth and jobs suffer, the federal revenues will decrease rather than increase.

In general, we are aware of no policy justification (other than the Administration's view that the current deduction is too high) for increasing multiple level corporate taxation and we therefore strongly oppose a reduction of the dividends-received deduction.

Elimination of the De Minimis Rule for Corporate Investments in Tax Exempt Bonds

The President's plan would also raise $0.5 billion over seven years by repealing the 2% de minimis rule for corporate investments in tax exempt bonds. This provision would create a significant, adverse impact on electric utilities' non-qualified decommissioning trust funds, which invest in tax exempt bonds to meet future obligations to decommission

nuclear plants and significantly increase the cost of borrowing for state and local governments.

In order to continue to operate nuclear plants, utilities are required to provide financial assurance of the ability to fund future decommissioning costs. Most utilities are providing this financial assurance by funding decommissioning trusts. Generally, utilities are utilizing both qualified and non-qualified decommissioning trusts because full funding for qualified trusts is prohibited if the nuclear plant was in service prior to 1984. Therefore, most utilities utilize non-qualified decommissioning trusts to fund a portion of the future decommissioning obligation. The non-qualified decommissioning trusts are not obtained by borrowing, but are generally amounts specifically approved by the public service commissions to be deposited in the decommissioning trusts. Thus, the repeal of the de minimis rule would unfairly and inappropriately presume for tax purposes that approximately 40% - 50% of the cost of the tax exempt investments are funded by the debt of the utility. In addition, it would effectively reduce the earnings of these trusts, which would require the utilities' customers to pay additional amounts for future decommissioning costs.

EEI strongly agrees with the March 6, 1996 letter sent to Secretary Rubin by 35 senators explaining the adverse impact that this proposal will have on state and local governments. Rather than reiterate these concerns, EEI agrees that this proposal will adversely impact the state and local governments as many corporations, including non-qualified nuclear decommissioning trust funds of electric utilities would no longer invest in these bonds.

If you have any questions, please contact Walter W. Foyt, Chairman of the Taxation Committee of the Edison Electric Institute at 713/207-3020.

Sincerely,

David K. Owens

David K. Owens

DKO:jei

STATEMENT OF KEITH E. ENGEL
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

I. Introduction

I am submitting this statement in opposition to section 9522 contained in President Clinton's Fiscal Year 1997 Budget Bill (the "Budget Bill"). Section 9522 creates gain recognition for certain distributions under section 355 of the Internal Revenue Code.

My interest in section 9522 of the Budget Bill is purely academic. I am currently a tax professor at Washington & Lee. My familiarity with section 355 stems from prior practice, having worked for the Office of Assistant Chief Counsel (Corporate) of the Internal Revenue Service and for the tax team at a major D.C. law firm. I was extensively involved in various section 355 issues while serving in both capacities.

For the reasons discussed below, I believe the statutory language of section 9522 of the Budget Bill does not comport with its purported policy and, therefore, Congress should substantially revise this provision's statutory language. As a result of this inconsistency, section 9522 appears to create corporate level tax for certain section 355 distributions which involve no tax avoidance concerns, and it appears to disregard certain section 355 distributions which present these tax avoidance concerns.

II. General Utilities Repeal and Section 355

As a general rule, the Internal Revenue Code imposes two levels of tax on corporate earnings generated from the sale or disposition of corporate assets. The Code imposes the first level of tax on a corporation when it sells assets, and the Code imposes a second level of tax on the corporation's shareholders when the corporation distributes net gain proceeds.

Prior to 1986, the Code contained numerous exceptions to this dual level of tax, commonly known as the General Utilities rule. See generally General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). As commonly used, the General Utilities rule refers to any exception from corporate level tax when a corporation disposes of appreciated assets. In 1986, Congress repealed the General Utilities rule, attempting to ensure the dual level of tax on corporate earnings was fully preserved . The centerpiece of General Utilities repeal was the consistent imposition of corporate level tax when a corporation distributes appreciated assets to its shareholders via a liquidating or non-liquidating distribution.

One exception to General Utilities repeal is section 355. In a section 355 distribution, a parent corporation ("Distributing") can distribute the stock of a controlled subsidiary ("Controlled) without tax at both the corporate and shareholder levels. Congress preserved tax-free treatment for section 355 distributions despite overall General Utilities repeal because a section 355 distribution "merely effects a readjustment of the shareholder's continuing interest in the corporation in modified form." Staff of J. Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 337 (May 4, 1987).

In 1990, Congress enacted section 355(d) of the Internal Revenue Code, which imposes a corporate level tax on certain section 355 distributions. The purpose of section 355(d) is to prevent taxpayers from using section 355 as a mechanism to dispose of controlled subsidiaries "in transactions that resemble sales, or to obtain a fair market value stepped-up basis for any future dispositions." H.R. Rep. No. 101-37, 101st Cong., 2d Sess. 70-71 (Oct. 15, 1990).

For example, assume Distributing owns all of Controlled, and Distributing plans to sell Controlled to Acquiring for cash. If Distributing simply sells Controlled for cash, Distributing would recognize gain on the Controlled stock. On the other hand, prior to 1990, Distributing could arguably use section 355 as a mechanism to sell Controlled without tax. Pursuant to this plan, Acquiring would use its cash to acquire newly issued Distributing stock from

Distributing, with the Distributing stock acquired being equal in value to Controlled. After waiting some period of time (usually two years) to avoid continuity of interest concerns, Distributing would distribute the Controlled stock to Acquiring in a split off exchange for all of Acquiring's recently purchased Distributing stock. Upon completion, Distributing effectively receives cash in a tax-free exchange for all of the Controlled stock by virtue of section 355. Thus, through the use of this overall section 355 mechanism, Distributing achieved the same economic effect of a straight sale but avoided the corporate level tax. See Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd per curiam, 886 F.2d 1318 (7th Cir. 1989) (involving a pre-1986 version of a section 302/311 distribution using a similar method to accomplish a tax-free disposition).

Section 355(d) ends the above tax scheme by creating corporate level gain if a shareholder owns a 50 percent or greater interest in either the distributing or controlled corporations after a section 355 distribution by virtue of a purchase within the 5-year period before the distribution. Thus, section 355(d) applies to the above example, requiring Distributing to recognize gain on the Controlled stock because Acquiring holds its post-split off interest in Controlled by virtue of Acquiring's purchase of Distributing stock only two years before the section 355 distribution.

III. General Description of the Proposal

Section 9522 of the Budget Bill extends section 355(d) corporate gain recognition to certain section 355 distributions that do not satisfy the following shareholder-control requirement. Under this shareholder-control requirement, the direct and indirect pre-distribution shareholders of the distributing corporation must, as a group, control both the distributing and controlled corporations after the distribution. These shareholders satisfy this control requirement only if they possess at least 50 percent of the combined voting power and total stock value in both the distributing and controlled corporations. In addition, these shareholders must maintain this control for a four year period beginning two years before the section 355 distribution. Section 9522 contains an exception to this control rule, which allows control to shift to new shareholders if these new shareholders acquire stock in an unrelated transaction.

Section 9522 of the Budget Bill primarily creates corporate level gain for two forms of transactions: (1) a section 355 distribution followed by a section 1032 issuance (a "spin off /issuance transaction") in which the issuance shifts control to outsiders, and (2) a section 355 distribution followed by an acquisitive reorganization (a "spin off/merger transaction") in which the acquisitive reorganization shifts control to outsiders. For example, assume Distributing owns all of Controlled, each of which are worth 50x as stand alone entities. In a spin off/issuance transaction, Distributing distributes Controlled, and Controlled issues its stock (worth 51x) to new shareholders pursuant to a prearranged plan. In this circumstance, section 9522 requires Distributing to recognize gain on its Controlled stock because the new shareholders acquire 51 percent control of Controlled. A similar result follows in a spin off/merger transaction if Controlled merges into Acquiring with the Acquiring shareholders owning 51 percent of Acquiring upon completion of the transaction. Lastly, section 9522 creates corporate level gain if Distributing issues its stock or merges after the section 355 distribution and the issuance or merger shifts 51 percent control to new shareholders.

IV. Purported Policy of the Proposal

The legislative history associated with the Budget Bill fails to describe the rationale behind section 9522. However, it is my understanding that the driving forces behind the proposal are certain spin off/merger and spin off/issuance transactions that resemble Distributing sales of Controlled stock.[1] This policy concern is consistent with the policy of

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[1] It is my understanding that section 9522 of the Budget Bill may also be partly motivated by device and continuity concerns. This submission does not address

section 355(d).

In the standard spin off/issuance transaction that resembles a sale, the spin off/issuance is combined with a transfer of cash from Controlled to Distributing. For example, assume Distributing owns all of Controlled. Controlled borrows cash from a bank, distributes the cash to Distributing, and Distributing distributes Controlled. Pursuant to a prearranged plan, Controlled subsequently issues stock to new shareholders in exchange for cash equal to the amount borrowed with Controlled using these proceeds to retire the bank loan. The net result is a spin off/issuance transaction that effectively amounts to a sale. Distributing has effectively disposed of its Controlled stock in exchange for received cash from the new shareholders.

The standard spin off/merger transaction of concern is similar to the spin off/issuance transaction just described. In this instance, Controlled borrows cash from a bank, distributes the cash to Distributing, and Distributing distributes Controlled. Pursuant to a prearranged plan but separated by an independent shareholder vote (see Rev. Rul. 75-406, 1975-2 C.B. 125.), Controlled subsequently merges into Acquiring with Acquiring using its resources to retire the bank loan. The net result is essentially the same as above. Distributing has effectively disposed of its Controlled stock in exchange for cash from Acquiring.

V. Policy/Statutory Mismatch

The chief policy behind section 9522 of the Budget Bill has merit, being consistent with the disguised sale concern that led to the 1990 enactment of section 355(d). However, the statutory language of section 9522 does not comport with its intent. The statutory language wrongfully focuses on shareholder control of the distributing and controlled corporation stock rather than on asset movements between the distributing and controlled corporations, the proposal's real concern.

Because section 9522 of the Budget Bill focuses on shareholder control rather than corporate level assets transfers, the proposal incorrectly creates a corporate level tax for certain transactions that do not resemble sales. For example, assume Distributing owns all of Controlled (worth 50x). Distributing distributes Controlled, and Controlled issues its stock to new shareholders in exchange for 51x cash. The transaction does not involve any asset movements between Distributing and Controlled. Under section 9522, Distributing has corporate level gain on the Controlled stock even though the transaction does not resemble a sale. Distributing has disposed of its Controlled stock, but has received nothing in return. Section 9522 similarly creates corporate level gain for spin off/mergers where the shareholders of Acquiring acquire 51 percent control of Controlled even if Distributing receives nothing in return (any stock of Acquiring instead being ultimately held by the Distributing and Acquiring shareholders).

In addition, the improper shareholder focus of section 9522 of the Budget Bill fails to create gain for certain spin off/issuance and spin off/merger transactions which resembles sales. For example, assume Distributing owns all of Controlled (worth 50x). Controlled borrows 20x cash from a bank, distributes the 20x cash to Distributing, and Distributing distributes Controlled. Pursuant to a prearranged plan, Controlled subsequently issues stock to new shareholders in exchange for 20x cash with Controlled using these proceeds to retire the bank loan. The net result is a spin off/issuance transaction that effectively amounts to a partial sale. Distributing has effectively sold 20x of its Controlled stock in exchange for the 20x cash received from the new shareholders. Yet, section 9522 does not apply because the

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these concerns, but the device and continuity requirements appear to provide weak policy support for section 9522. First, there is no reason for Congress to impose a different continuity standard for section 355 distributions versus the continuity standard used in connection with acquisitive section 368 reorganizations. Second, corporate level gain recognition is inconsistent with device since device is a shareholder level concern rather than a corporate level concern.

new shareholders have not acquired a more than 50 percent interest in Controlled. In a similar vein section 9522 also would not apply to essentially the same factual situation involving a spin off/merger transaction.

VI. Conclusion

Although the imposition of corporate level tax on spin off transactions resembling corporate sales appears well-founded, Congress should substantially revise the statutory language of section 9522 of the Budget Bill. The redrafted language should focus on movements (cash/asset distributions and/or liability assumptions) between the distributing and controlled corporations. It is these asset transfers that create the potential for disguised corporate sales rather than post-spin off shareholder control of the distributing and controlled corporations.

STATEMENT
OF
THE FAIR INSURANCE COALITION
IN RESPONSE TO
THE HOUSE COMMITTEE ON WAYS AND MEANS
REQUEST FOR COMMENTS
ON
NEW REVENUE PROVISIONS IN THE
PRESIDENT'S FISCAL YEAR 1997 BUDGET

This statement is respectfully submitted on behalf of the Fair Insurance Coalition in response to the Committee's request for comments on revenue provisions that were included in President Clinton's fiscal year 1997 budget but not in the Balanced Budget Act of 1995. The Coalition appreciates the Committee's interest in public comments on the Administration's new revenue proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular -- the proposal to modify the taxation of captive insurance companies and their policyholders. As explained below, the Coalition believes that this proposal could have negative consequences for both the domestic captive industry and the many U.S. taxpayers that receive economically efficient insurance protection through domestic and foreign captive insurance companies. The Coalition respectfully urges the Committee to reject this ill-conceived proposal.

BACKGROUND ON CAPTIVE INSURANCE

As the Committee is aware, the cost of insurance is a major expenditure for U.S. businesses, associations and other entities. In order to be competitive, these taxpayers must find ways to control their insurance costs and to manage their risks effectively. Thus, as the costs of attaining adequate coverage have risen in the traditional commercial insurance markets, these entities increasingly have turned to alternative sources of insurance coverage, such as captive insurance companies (or captives). Further, taxpayers have turned to captives in order to receive coverage that is unavailable in the traditional markets.

Captives typically are insurance companies that have been established in order to meet the particular risk management needs of their owners. Significant business benefits flow from insuring through a captive, including: lower costs of insurance coverage; protection against loss from activities for which coverage is unavailable in the traditional commercial markets; centralized claims management; better control over cash flow and risk management; and reduced exposure to the volatility of the commercial insurance markets. As a result of these and other nontax benefits, a large number of U.S. businesses in a wide range of industries - - as well as hospitals, universities, associations, and other entities - - currently receive insurance protection from domestic and foreign captive insurance companies. Indeed, over $20 billion in premiums is associated with captive insurance companies. Over 350 captive insurance companies are domiciled in States such as Vermont, Georgia, Delaware, Illinois, Tennessee, Colorado, and Hawaii.

The Federal tax laws governing captives and their policyholders have evolved through years of costly and burdensome litigation between the Internal Revenue Service (IRS) and taxpayers addressing whether a relationship between a captive and its policyholders constitutes insurance for Federal tax purposes. If the relationship constitutes insurance, the insured shareholders can deduct their premium payments and the captive is taxed as an insurance company under Subchapter L of the Internal Revenue Code. Although IRS agents have been dissatisfied with the results of some of this litigation, the ensuing judicial decisions have produced a workable set of principles governing the tax treatment of captives and their policyholders. These judicial decisions flow from the Supreme Court's holding in *Helvering v. Le Gierse*, 312 U.S. 531 (1941), that a relationship must involve both risk shifting and risk distribution in order to be treated as insurance for Federal tax purposes. For example, these cases, which were addressed in the Tax Court as well as in a variety of circuits, establish that:

- captives must be adequately capitalized, must deal with their owners at arm's-length, and must be subject to prudent regulatory control by the jurisdiction in which domiciled;

- transactions between a parent shareholder and its wholly-owned captive generally will not constitute insurance if the captive insures only the parent's risks;

- transactions between a captive and its brother-sister affiliates will constitute insurance as long as certain requirements are satisfied; and

- transactions between captives that have multiple unrelated owners (*i.e.*, group captives) and their owners create adequate risk shifting and risk distribution, and will be respected as insurance.

See *Humana, Inc. v. Commissioner*, 881 F. 2d 247 (6th Cir. 1989); *Malone & Hyde, Inc. v. Commissioner*, TC Memo 1993-585; *AMERCO, Inc. v. Commissioner*, 96 T.C. 18 (1991), *aff'd* 979 F. 2d 162 (9th Cir. 1992); *The Harper Group and Includible Subsidiaries v. Commissioner, 96 T.C. 45 (1991), aff'd* 979 F. 2d. 1341 (9th Cir. 1992); and *Sears Roebuck and Co. v. Commissioner*, 96 T.C. 61 (1991), *aff'd* 972 F. 2d 858 (7th Cir. 1992). See, also, *Carnation Company v. Commissioner*, 640 F. 2d 1010 (9th Cir., 1981); *cert denied* 454 U.S. 965 (1981); *Beech Aircraft Corporation v. United States*, 797 F. 2d. 920 (10th Cir. 1986); *Crawford Fitting Company v. U.S.*, 606 F Supp 136 (N.Dist. Ohio, E. Div., 1985); *Commissioner v. Treganowan*, 183 F. 2d 288 (2d. Cir. 1950), *cert. denied* 340 U.S. 853 (1950).

These judicially-established principles have formed the foundation for the structure of today's captive insurance arrangements. For example, group captives that shift risks among the owners have been formed in reliance upon these principles. Similarly, many captive insurance companies have agreed to shift and distribute risk by insuring a sufficient level of third-party risk.

THE ADMINISTRATION'S PROPOSAL

The Treasury currently is asking the Congress to modify the principles provided by the courts and to enact arbitrary rules that the IRS was not successful in establishing through litigation. Although the specifics of Treasury's proposal are extremely complex, the proposal in essence would impose a new requirement that, in order to constitute an insurance company for Federal tax purposes, no more than 50 percent of a captive's premiums could be derived from insuring risks of its "large shareholders." For this purpose, a large shareholder would be broadly-defined as including both (1) any 10-percent shareholder, and (2) any person "related" to such a shareholder (applying attribution and constructive ownership rules). Moreover, Treasury would have broad regulatory authority to define as related a person who otherwise would be unrelated -- such as a client or supplier of a large shareholder. If a captive failed to satisfy this new definition of insurance company, its 10-percent shareholders, as well as any persons related to those shareholders, would not be able to deduct premiums paid to the captive. Further, the captive would not be subject to the specially-crafted rules for insurance companies under Subchapter L of the Internal Revenue Code and would not be eligible for tax exemption under Section 501(c)(15) (relating to certain small insurance companies).

The proposal also would provide a number of additional rules for foreign captives. For example, a new category of foreign personal holding company income would be created with respect to premiums received from, and claims paid to, large shareholders. Further, as suggested above, if a foreign captive failed to meet the new definition of insurance company, it would not be able to claim reserve deductions for its insurance policies or to use any other subchapter L rules for purposes of determining the amount passed through to its shareholders under Subpart F. In addition, even though the captive might fail to be an insurance company for Federal tax purposes, the current excise tax applicable to premiums paid by a U.S. company to a foreign insurer still could apply to premiums paid by large shareholders if the ultimate insured claimed a deduction for premiums paid.

The proposal also would allow Treasury to impose new administrative burdens upon a broad range of taxpayers and transactions. Specifically, every person who directly or indirectly received insurance from a company of which it is a shareholder, or who received insurance from a company that has a shareholder to which the insured is considered related, would have to comply with recordkeeping and information reporting requirements set forth by Treasury. The penalty for failing to comply with these requirements would be denial of a deduction for premium payments for the insurance -- even if the person otherwise would have been entitled to such a deduction.

The proposal would be effective for taxable years beginning after the date of enactment.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

The Coalition believes that the Administration's proposal could have drastic adverse consequences for domestic captive insurance companies, as well as the many U.S. businesses and other entities that have sought to obtain insurance, decrease their insurance costs, and better manage their risks through the alternative insurance markets. As explained below,

- enactment of the proposal would significantly increase the costs of doing business for many U.S. taxpayers, would threaten the solvency and viability of many captives, and could drive the domestic captive industry offshore (due to State law restrictions on the amount of third-party risks a captive may insure);
- the proposal would decimate years of judicially-crafted law on which taxpayers have relied, without any justifiable policy rationale;
- the proposal would add increased complexity to the Internal Revenue Code and would impose substantial new compliance burdens on American taxpayers;
- the proposal fails to address a number of critical technical issues with significant policy implications; and
- **according to the Joint Committee on Taxation, the proposal would result in revenue loss -- not gain -- to the Federal Government over a 10-year period.**

Thus, the Coalition strongly urges the Committee not to adopt the Administration's proposal in any form at any time.

A. Enactment of the proposal would drastically increase the costs of doing business for many U.S. taxpayers, would threaten the solvency and viability of many captives, and could drive the domestic captive industry offshore.

As indicated above, today's captive insurance arrangements have been structured as insurance relationships based on workable principles established by the courts after years of litigation. If the Administration's proposal were enacted, many of these relationships suddenly would no longer qualify as insurance for Federal tax purposes. As explained below, such a change in the law could have crippling economic consequences, not only for the many U.S. businesses and associations that manage their risks through captives, but also for the over 350 domestic captives that provide revenues and jobs in States such as Vermont, Georgia, Delaware, Illinois, Tennessee, Colorado and Hawaii.

For example, if the proposal were enacted, businesses that receive insurance protection through domestic and foreign captives would see their tax burdens substantially increased due to the loss of premium deductions (and, in some cases, the deemed receipt of additional income under Subpart F). This additional tax burden not only would increase their costs of doing business, but also could make it too expensive for them to insure certain risks for which protection only has been available through the alternative risk markets. If these risks ultimately were to occur, the lack of insurance could have negative consequences not only for the uninsured business, but also for its shareholders, creditors, and any persons directly or indirectly harmed by the occurrence of the risk. In addition, the increased costs of insuring through a captive would make captive insurance a less desirable (if not undesirable) product, to the detriment of the captive insurance industry. Moreover, because captives would be subject to different Federal tax rules than their competitors in the traditional markets, they would be placed at a severe competitive disadvantage.

Admittedly, it is possible that a captive might try to restructure its relationships in order to meet the Administration's new definition of an insurance company and to avoid the increased tax costs described above. In such a case, the captive would have to substantially increase the amount of third-party risks it writes. However, experience shows that captives that insure a large amount of third-party risks are less able to predict and to control their exposure to loss, and are more likely to become insolvent.

Indeed, precisely because of concerns regarding the solvency of captives that insure a large amount of unrelated business, domestic captive jurisdictions, such as Vermont, tend to limit the amount of unrelated business that can be written by a captive. Thus, absent a change in State law that would allow captives to engage in activity that could threaten their solvency, many U.S. captive insurance companies may be unable to restructure their activities to satisfy the new definition of an insurance company. As a result, U.S. businesses and associations may turn their backs on domestic captives, and seek insurance protection from captives in foreign jurisdictions that allow larger amounts of third-party business in captives.

B. The proposal would decimate years of judicially-crafted law on which taxpayers have relied, without any justifiable policy rationale.

As explained above, the courts have established principles regarding when captive relationships are, and are not, considered to be insurance for Federal tax purposes. Although the IRS may not be satisfied by all of the principles established by the courts, these principles have been abided by, and relied upon by, captive insurance companies and their policyholders in structuring their business affairs. It would be grossly unfair to change these principles now and to adopt an arbitrary new definition of insurance that is far stricter than that established by the courts.

Moreover, the judicially-established principles already ensure that captive relationships involve a sufficient amount of risk shifting and risk distribution. Thus, there is no policy reason to replace these principles with a formulaic definition of what constitutes insurance. Indeed, the definition of insurance that the Administration would impose is internally inconsistent and makes little sense from a risk distribution perspective. For example, the proposal arbitrarily would conclude that a captive that is equally-owned by each of three parties does not adequately distribute risk. However, in such a case, two-thirds of the captive's business would be unrelated to each owner; this is well over the proposal's 50-percent litmus test for risk distribution.

Further, the Administration's proposal is completely at-odds with Congressional intent in enacting the Risk Retention Act of 1981. That legislation was intended to encourage the formation of group captives in order to increase competition in the product liability insurance marketplace and to reduce the subjectivity involved in underwriting risks. By contrast, the Administration's proposal would discourage the formation of group captives, would impair competition in the insurance marketplace, and, in effect, would penalize group captives that have carried out legislative intent by underwriting risks based upon the experience of their owners.

Finally, the Administration's proposal cannot be justified on the ground that captives are vehicles for tax abuse and avoidance. As explained above, numerous U.S. businesses and other groups have turned to the alternative insurance markets primarily for nontax, business reasons. For example, a business that insures through a captive can reduce its risk management costs, protect itself against otherwise uninsurable risk, centralize claims management activities, and reduce its exposure to the volatility of the commercial insurance markets. Thus, no tenable tax policy justifies the economic burden the Administration's proposal would impose upon the captive insurance industry.

C. The proposal would add even more complexity to the Internal Revenue Code and would impose unjustifiable new administrative burdens on American taxpayers.

As indicated above, the Administration's proposal would replace principles that taxpayers understand with a new set of highly-complex statutory rules. In addition, the proposal would provide Treasury with the opportunity to add yet another layer of complexity through the promulgation of regulations on a variety of issues -- such as when parties who are not otherwise related should be treated as related for purposes of the proposal. It clearly would be inappropriate to add such needless complexity to our Nation's tax system. Such action would exacerbate the current level of frustration that taxpayers have with the tax laws and would be inconsistent with Congressional interest in simplifying and reforming the Internal Revenue Code.

Moreover, the proposal would subject a wide range of taxpayers to increased administrative burdens without policy justification for the substantive provisions. For example, as indicated above, every person who directly or indirectly receives insurance from a company of which it is a shareholder, or who receives insurance from a company that has a shareholder to which the insured is considered related, would have to comply with recordkeeping and information reporting requirements set forth by Treasury -- regardless of whether the insurance company satisfies the proposal's definition of an insurance company. Complying with these increased administrative burdens would require the devotion of resources and the expenditure of money that otherwise could be devoted to productive business use.

D. The proposal fails to address a number of critical policy and technical issues.

Notwithstanding the complexity of the Administration's proposal, the proposal fails to address a number of issues with significant policy implications. For example, it provides no guidance as to how the new rules would affect captives that are controlled foreign corporations, but that have made elections to be taxed as domestic insurance companies under Section 953(d) of the Internal Revenue Code. Further, it contains no transition rules for companies that suddenly would find that they no longer are insurance companies for Federal tax purposes. Resolution of these, and other, technical issues would have significant policy consequences and almost certainly would increase the complexity of the proposal and its burdens on U.S. businesses even further.

E. The proposal is not just a policy loser -- it is a REVENUE LOSER.

Although the Administration has offered its proposal as a mechanism for raising revenue, the Congressional Joint Committee on Taxation (JCT) has estimated that the proposal actually would **lose** revenue ($23 million) over the 10-year period following enactment. The JCT estimates that the proposal would raise revenue only in its first two years (thereby generating a small net revenue gain in the 5-year period following enactment); however, in each of the following eight years , the JCT estimates that the proposal would lose revenue. Thus, the proposal clearly should not be viewed as a way to raise revenue.

RECOMMENDATION

For the reasons set forth above, the Coalition strongly urges the Committee not to include the Administration's proposal in any tax legislation, this year or in the future. The Coalition appreciates the Committee's interest in its views on this significant issue.

FLAHERTY &
CRUMRINE
INCORPORATED

INVESTMENT COUNSEL
301 E. Colorado Blvd. · Suite 720 · Pasadena, California 91101 · (818) 795-7300

May 14, 1996

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 Mr. Moseley: In re: Request dated 4/15/96 for written comments on new revenue provisions in President's fiscal year 1997 budget

We wish to comment on the Administration's proposal to reduce the intercorporate dividends received deduction ("DRD") from 70% to 50%.

Flaherty & Crumrine Incorporated (**"F&C"**) is an investment adviser registered with the SEC that specializes in the management of preferred stock portfolios. Our clients include three New York Stock Exchange listed closed-end investment companies and a small number of large corporate investors. Assets under F&C's management total approximately $1.2 billion, the great bulk of which is preferred stocks.

The three publicly held investment companies for which F&C is the investment adviser, Preferred Income Fund, Preferred Income Opportunity Fund and Preferred Income Management Fund, have submitted a separate letter covering the effects of the proposal on over 30,000 shareholders of those funds. The discussion here will supplement, rather than overlap, those comments.

ANTICIPATED IMPACT OF THE PROPOSED REDUCTION IN THE DRD

From our viewpoint as practitioners in the preferred stock market, we believe the proposed cut in the DRD would alter important economic relationships and result in:

- **Substantial shrinkage of the preferred stock market** which is an important sector of the capital markets.
- Predictable shifts in financing and investment practices that **challenge the expectation of a revenue gain to the Treasury.**

Furthermore, these concerns do not depend upon any "futurist vision." Rather, they are **based upon well demonstrated, currently operating forces** that would clearly be accentuated by a reduction in the DRD. Our reasoning follows.

SIGNIFICANCE OF THE U.S. PREFERRED STOCK MARKET

The United States has the **only well developed preferred stock market in the world**. Traditionally, the DRD has allowed domestic issuers, particularly utilities and banks, to obtain lower cost equity capital in the preferred stock market by partially shielding corporate investors from an additional layer of corporate taxation. Foreign issuers commonly access the U.S. market, often taking advantage of favorable tax treatment at home or under treaty with the United States.

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The preferred stock market also provides a **"safety valve" for companies in need of equity capital.** This was best demonstrated by the **crisis in the U.S. banking industry in the early 1990's.** When the banks were unable to raise additional equity capital in the common stock market, their needs were **accommodated through the issuance of preferred stocks.** To this day, only preferreds eligible for DRD can meet this need for U.S. banks, in particular, since banking regulators do not allow "Tier 1" capital treatment for the more recently created so-called "tax deductible preferreds," which are based upon a debt instrument issued to an intermediary and are not eligible for the DRD.

Preferred stock dividends account for a **disproportionately large share of total dividend income received by corporate investors.** The yields of preferreds are much higher than those of common stocks, and the majority of all outstanding DRD eligible preferreds are owned by corporations. We estimate that preferred stock dividends received by corporate investors amount to roughly $3 billion per year, which is a substantial portion of the total dividend income of corporate investors. Thus, **structural changes in the preferred stock market** that take place in response to a change in the DRD will have **a substantial impact on the amount of tax revenues gained or lost.**

CURRENT STATE OF THE PREFERRED STOCK MARKET

As shown in Exhibit I, we estimate that the market value of preferred stocks outstanding on December 31, 1995 consisted of roughly **$66 billion of DRD eligible preferreds** and almost **$26 billion of non-DRD eligible** preferreds. The latter group included over $14 billion of "tax deductible preferreds" plus some foreign and a few miscellaneous issues.

A more dynamic view of the market is provided by the chart in Exhibit II which shows the dollar amount of new issues and redemptions of DRD eligible preferreds and non-DRD eligible preferreds from 1991 to the present. Since **"tax deductible preferreds"** were introduced in late 1993, they have been **rapidly replacing DRD eligible preferreds.** From the start of 1994 through May 9, 1996, almost $19 billion of "tax deductible preferreds" were issued while over $8 billion net of DRD eligible preferreds were redeemed.

Many currently outstanding DRD eligible preferreds" will become redeemable over the next two years. A further look at the chart in Exhibit II reveals that over $25 billion of DRD eligible preferreds were issued in the three years from 1991 through 1993. Many of those preferreds become callable by their issuers five years after their initial offering dates, and they are highly likely to be redeemed when that occurs given the substantial decline in interest rates since the early 1990's. It is an open question at this point whether the preferreds that are refinanced will be replaced with debt instruments, "tax deductible preferreds," or DRD eligible preferreds.

IMPACT OF A DRD CUT ON PREFERRED STOCK INVESTORS

Reducing the DRD to 50% would obviously make DRD eligible preferreds less attractive to corporate investors who are the marginal buyers of these securities. All other things being equal, the **after-tax yields to such investors would fall**, causing the market prices of DRD eligible preferreds to decline also. We estimate **potential price depreciation in the range of 1 1/2% to 7%** from current market levels, depending upon the dividend rate and the other terms of the specific issue of preferred stock in question.

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The **interaction of DRD eligible preferreds with other market sectors** would also be an important factor if the DRD were cut. If only corporate investors were involved, reestablishing market equilibrium could require prices to decline and pre-tax yields to rise enough to bring preferred yields after corporate taxes back to the levels existing prior to the DRD cut. However, that sort of market adjustment would also cause the pre-tax yields on DRD eligible preferreds to rise relative to interest rates on bonds. Ultimately, that would make DRD eligible preferreds competitive with fully taxable bonds on a pre-tax yield basis, and **"total return investors"** such as pension funds would then become **potential buyers of DRD eligible preferred** stocks.

In a broad range for the DRD around 50%, we believe **DRD eligible preferreds would be "neither fish nor fowl."** Lower after-tax yields of DRD eligible preferreds would cause some corporate investors to lose interest. At the same time, the pre-tax yields of such preferreds would not be high enough to stimulate many total return investors to reorient their investment practices to include such preferreds. DRD eligible preferreds would be cushioned to a degree against further price decline, but the market's "audience" would shrink. This would be matched by shrinking supply, as discussed in the following section, which would **greatly reduce the depth of this important market sector.**

IMPACT OF A DRD CUT ON THE ISSUANCE OF PREFERRED STOCKS

Domestic corporations have a **strong bias toward financing with debt instead of equity**, particularly in good economic times. It is simply a matter of interest being deductible for income tax purposes while dividends are not. **A lower DRD would accentuate this bias** in favor of debt financing.

The proposed reduction of the DRD would **further increase the incremental cost of capital of issuing DRD eligible preferreds** versus financing with debt. The dividend rates on such preferreds would certainly rise relative to interest rates on bonds and other forms of debt, as discussed in the section immediately above. Since dividend payments are not deductible, higher dividend rates on newly issued preferreds would increase the issuer's after-tax cost of capital dollar for dollar with no corresponding increase in the cost of debt financing.

The experience of the last several years is abundant proof that corporate **financing decisions are extremely sensitive to the after-tax cost** of issuing DRD eligible preferreds versus debt. "Tax deductible preferreds", which stem from underlying debt, have replaced DRD eligible preferreds at a rapid pace, even with the DRD at 70%. Reducing the DRD to 50% in the face of the substantial potential redemptions of DRD eligible preferreds over the next several years would **open the floodgates for replacement of equity financing by debt.**

We are aware that the budget for fiscal 1997 contains some newly **proposed restrictions on "tax deductible preferreds."** Even if the features of those securities that are most "equity like" were prohibited, the **incentive and the means to replace preferred equity with debt would still exist.** Wall Street has learned how to package and sell corporate debt instruments to the retail market. That will not go away.

IMPLICATIONS FOR REVENUES TO THE TREASURY

The proposal to cut the DRD to 50% is **not just an incremental change** that would increase Treasury revenues without changing much else. It would bring the DRD to a level that would **set in motion structural changes** in the market for DRD eligible preferreds. Those changes must be taken into account in estimating the revenue impact.

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Our analysis of the revenue impact is based on a **computer model** developed by F&C We will comment here only on a conceptual level, but we are making the full model **available to the staff of the Joint Committee on Taxation.** We hope it will provide a "worm's eye" view of the technical market ramifications of the proposal that might not be spotted by conventional macro models.

We should point out that the system is producing **tax revenues that might not exist if there were no DRD.** When one corporation pays a dividend to another, an effective tax of 10.5% is imposed. If the same transaction took place in the form of interest on debt, the interest deduction to the payer would offset the interest income taxable to the payee, and no tax liability would be created on balance. In actuality, the process would be considerably more complex than this example, of course, but the point remains the same. It is quite **possible to reduce tax revenues** by raising the tax rate on a financial sector **if, as a result, the financial sector shrinks in size.**

As the proposal applies to DRD eligible preferreds, actual tax revenues would depend on a number of **critical variables.** Several of the most important ones are very likely to have a negative revenue impact. These include **a resulting shrinkage in the universe of DRD eligible preferreds,** a strong preference for **refinancing retired preferreds through the issuance of debt** including "tax deductible preferreds", and a general **reduction in holdings of equity securities by corporate investors.** It is less clear **how corporations would redeploy surplus funds** no longer invested in equity securities, but we doubt that the range of possibilities is wide enough to be a driving factor. Numerous minor factors also play a part in the analysis, but they are not significant next to these critical variables.

We think the best use of our model is to **test the sensitivity of revenue projections to changes in the critical underlying assumptions.** This process indicates that cutting the DRD as proposed would produce no increase in revenues from DRD eligible preferreds if, as a result, issuers redeemed or refunded as little as one-sixth of the outstanding DRD eligible preferreds. Recognizing the lack of precision inherent in predicting the future, we have considered an alternative case of the market being required to shrink by one-third, or twice as much as the model indicates would produce break-even revenues. In each case, we conclude that reducing the DRD with respect to DRD eligible preferreds would be **more likely to reduce overall tax revenues than to increase them.**

We would be more than **willing to share our model** with the Committee.

THE "FAIRNESS ARGUMENT"

We have heard it argued that the DRD is not fair because it allows a corporate investor holding a diversified portfolio of stocks to pay a tax that is significantly lower than an individual investor would pay in the same situation. This argument ignores the reality that all taxes are ultimately borne by individual consumers and investors. Corporate investors are merely one step higher up the investment "food chain." It **is impossible to make the system fairer by taking more money out of the chain** before it gets to them. The system already falls between double and triple taxation of the same dollars before individuals get the benefit of them.

APPLICATION OF MODEL TO COMMON STOCKS

We have confined the foregoing comments to preferred stocks only because that is where our special expertise lies. Nonetheless, we believe that **many of the same arguments also apply to common stocks.** The obvious exception is that the portion of

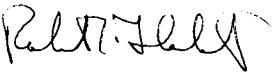
May 14, 1996

common stocks owned by corporate investors is much too small to cause significant price adjustments or a shrinkage of that market. The arguments for reducing multiple layers of taxation apply with full force.

CONCLUSION

It is essential to **distinguish between corporate welfare and the structures that make the capital markets in United States so efficient** and the envy of the rest of the world. Reducing the DRD is a proposal that has come up many times before as a potential revenue raiser and has been turned down as counterproductive. We believe that any revenue produced by cutting the DRD would be meager in relation the administration's budget estimates and would come at a cost of damaging the DRD eligible preferred stock market. The recent shrinkage of that market would escalate, and its traditional base of corporate investors would be fragmented. This raises **issue of whether the market would have the capacity to rise to the occasion again if there were another crisis** on the scale of the domestic banking industry's problems in the early 1990's.

Very truly yours,



Robert T. Flaherty
President

EXHIBIT 1

SIZE OF THE PREFERRED STOCK MARKET AS OF 12/31/95

($ IN BILLIONS)

	$ OUTSTANDING
DRD ELIGIBLE	
PUBLIC	
Adjustable Rate	$4.63
Sinking Fund	8.29
Perpetual	33.69[1]
Auction or Remarketed	14.79[2]
PRIVATE (primarily sinking funds)	5.00[3]
TOTAL DRD ELIGIBLE	$66.40
NON-DRD ELIGIBLE	
MIPS (or similar structures)	$14.44
Foreign Issuers	9.98
REITS	1.57
TOTAL NON-DRD ELIGIBLE	$25.99

Source: Bosley Financial, Inc. and Salomon Brothers Inc.

(1) Includes "old money" issues totaling $2.11 billion.
(2) Source: Lehman Brothers, includes private placements.
(3) Estimate by Salomon Brothers Inc.

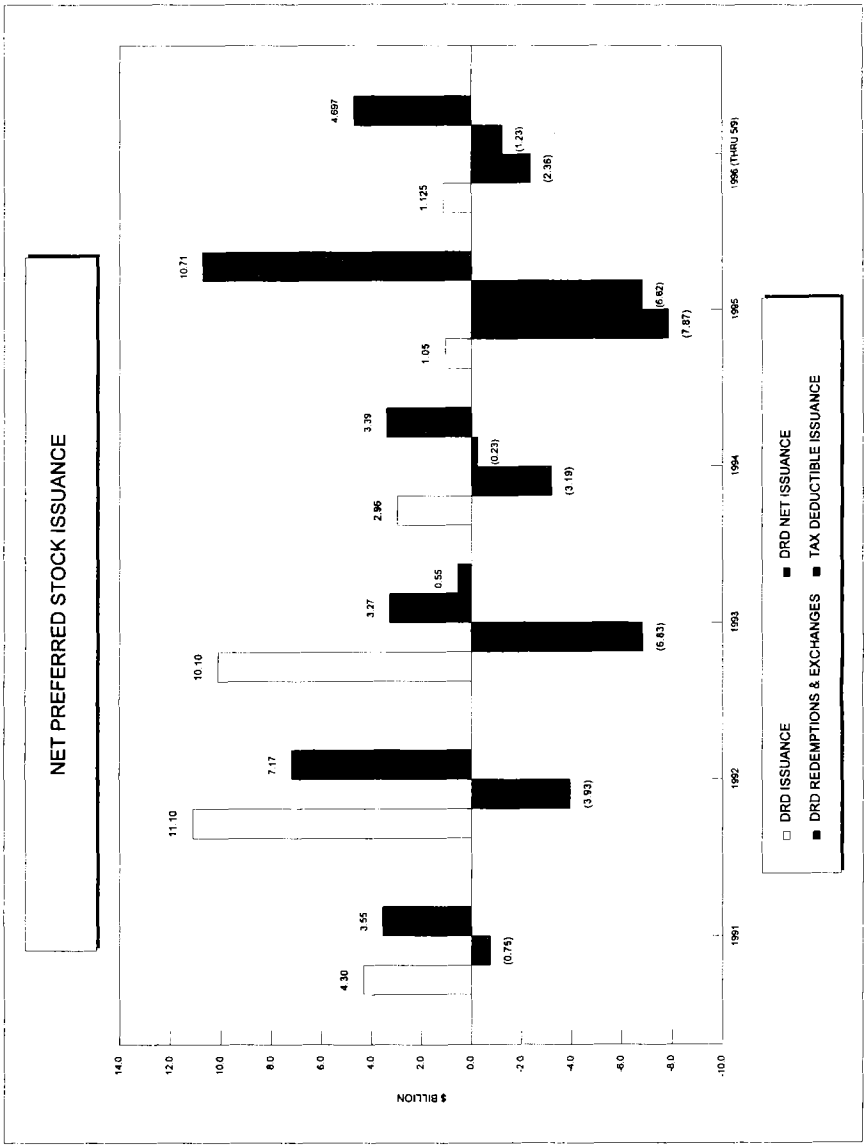

NET PREFERRED STOCK ISSUANCE
$ BILLION
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
1991
1992
1993
1994
1995
1996 (THRU 5/9)
4.30
3.55
(0.75)
11.10
7.17
(3.93)
10.10
3.27
0.55
(6.83)
2.96
3.39
(0.23)
(3.19)
1.05
10.71
(6.62)
(7.87)
1.125
4.697
(1.23)
(2.36)
DRD ISSUANCE
DRD REDEMPTIONS & EXCHANGES
DRD NET ISSUANCE
TAX DEDUCTIBLE ISSUANCE

EXHIBIT 2

ICMA RETIREMENT CORPORATION

Girard Miller, President and Chief Executive Officer

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777 North Capitol Street, NE
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May 14, 1996

Chairman Bill Archer
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Archer:

I am writing with respect to your solicitation for comments on President Clinton's fiscal year 1997 budget request. I am limiting my remarks strictly to the provisions that affect section 457 deferred compensation plans for public sector employees.

The ICMA Retirement Corporation represents more than 4,500 public employers and more than 240,000 of their employees for whom we administer retirement plans. Our exclusive concern is the retirement security of public sector employees.

As you know, the requirement that section 457 plan assets remain under the ownership of the Employer, subject to the claims of its general creditors until made available to the plan participant, has become controversial in light of events in Los Angeles County and Orange County, California.

We support the provision in the Administration's budget proposal that would enable public sector employers to establish trusts so that 457 assets may only be used to pay benefits for plan participants and beneficiaries.

While endorsing President Clinton's inclusion of this language in his budget request, we also wish to acknowledge your critical role in initiating the process to correct this serious flaw in the statutes.

The Retirement Corporation wishes to be on record as strongly supporting measures to protect the retirement savings of public sector employees. We strongly urge Congress and the Administration to enact legislation that contains these important section 457 provisions.

Thank you for your attention to our views on legislation that will benefit millions of state and local government employees. Your continued active support is appreciated.

Sincerely,

GM/kmh

ICMA-RC Services, Inc. is a wholly owned broker-dealer subsidiary of the ICMA Retirement Corporation. Member NASD and SIPC

Larry F. Altenbaumer
Chief Financial Officer
Treasurer and Controller

illinova

Illinova Corporation
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Decatur, IL 62525-1805
Tel 217 424-6678
Fax 217 362-7417

May 13, 1996

Honorable Bill Archer
Chairman
Committee on Ways & Means
United States House of Representatives
1102 Longworth Building
Washington, D.C. 20515-6348

Dear Mr. Chairman:

This letter is filed in opposition to one of the "revenue raisers" contained in President Clinton's FY 1997 budget document.

The Treasury Department proposes to change the tax treatment of captive insurance companies to establish a statutory threshold of 50% unrelated business risk to qualify a captive for tax treatment as an insurer. The proposed change would have a significant impact on the operating costs of Illinova Corporation.

Illinova is establishing a new captive to serve many of the property, liability and similar insurance needs of Illinova and its subsidiaries, Illinois Power Company, Illinova Generating Company, Illinova Energy Partners, and Illinova Power Marketing, Inc. This new captive will enable Illinova to achieve considerable savings over its current practice of using outside commercial insurance carriers and will greatly assist the company in addressing its risk management needs. Illinova's captive will be organized and capitalized like any other insurance company, with its own loss reserves and pricing practices based on actuarial science.

Because Illinova's insurance company will provide services to its other affiliates, it will not meet the 50% unrelated business test, even though it will act as an insurance company in every respect. If this change in the tax law is enacted by Congress, it will cost Illinova over $1.0 million per year. Illinois Power is the largest company in the Illinova family, so much of the cost ultimately could be borne by the ratepayers.

The proposal would penalize Illinova for choosing a more cost-effective insurance alternative and establish an unfair double standard for insurance. Illinova's premium payments would lose their status as a tax-deductible expense, while premiums paid by others to outside commercial insurance companies would still be treated as deductible business expenses.

There are other reasons that the captive insurance proposal is bad policy:

- The proposal would severely hamper the domestic captive insurance industry. Captive insurers are a legitimate and important option for companies who chose them for reasons of cost, availability of insurance, and other valid business reasons. The industry is an important business in many states. Illinois, for example, recently enacted laws to encourage formation of captive insurance companies.

- Many of the companies that rely on this form of insurance would face higher costs, as Illinova's projections attest.

- Although the Treasury Department justifies its proposal by citing a "lack of clarity under current law," there is in fact ample case law. A new statute would be disruptive and most likely launch a new round of litigation involving many of its provisions.

On balance, the short-term revenue gains from this proposal do not justify the negative consequences for American companies large and small. We believe that this proposal should not become law.

Sincerely,

Larry F. Altenbaumer

c: Hon. Phil Crane

ISDA
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC

1270 Avenue of the Americas
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Rockefeller Center
New York, New York 10020-1700
(212) 332-1200
FAX (212) 332-1212

February 26, 1996

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The International Swaps and Derivatives Association ("ISDA") is a trade association representing 277 leading financial institutions worldwide that engage in privately negotiated derivatives transactions. ISDA is therefore vitally concerned with the proposals made by the Administration to impose a new tax regime with respect to certain hedging transactions.

As the enclosed memorandum demonstrates, the proposals would make a significant change in long standing tax policies and thus pose important questions of substance and scope. We therefore urge that your committee take no action on these proposals until after full hearings have been held with an opportunity for all interested parties to comment. Pending such hearings, ISDA and its representatives would welcome the opportunity to discuss our concerns with you and your staff.

Very truly yours,

Gay Evans

Gay Evans
Chairman

attachment

cc: Honorable Sam Gibbons

International Swaps and Derivatives Association, Inc.

February 23, 1996

Comments on Administration Tax Proposal
Concerning Equity Swaps and Similar Transactions

Executive Summary

On January 12, 1996, the Administration announced that it was considering tax legislation that would impose a new tax regime on certain hedging transactions (the "Proposal"). On behalf of the International Swaps and Derivatives Association ("ISDA"), we respectfully submit the following comments on the Proposal:

- The Proposal would tax the appreciation in a position before that appreciation has been realized. The realization requirement has been a sound guide to fairness and administrability in our system, and exceptions to that requirement should be made only after adequate consideration. ISDA believes that the Proposal's suspension of the realization requirement for certain hedging transactions should not be made without an appropriate period of examination and consideration.

- ISDA believes that the Proposal's "constructive sale" rule for certain hedging transactions should not be enacted because it is based on a flawed analogy between certain hedges and actual sales and because it imposes tax before cash is available to pay that tax.

- ISDA believes that the scope of the Proposal is poorly defined and thus will unintentionally deter many economically useful transactions.

- ISDA believes that the enactment of a "constructive sale" rule will have unintended consequences, in large part because the suspension of the realization requirement opens a host of questions that have not been considered or reviewed by the Administration or Congress.

Comments

ISDA is an international organization whose membership comprises 277 of the world's largest commercial, merchant and investment banks. ISDA's members represent a broad cross section of the institutions that act as dealers and end-users of derivatives. ISDA has worked closely with legislative bodies and tax authorities throughout the world to address issues associated with privately-negotiated derivatives transactions, including hedging transactions.

The Proposal would require a taxpayer to recognize taxable gain, but not loss, on the "constructive sale" of appreciated stock, debt instruments or partnership interests. A constructive sale would occur if a hedging transaction "substantially eliminates the taxpayer's risk of loss and opportunity for gain" with respect to the appreciated position.

We respectfully suggest that it would be a serious mistake to enact this constructive sale proposal, for the reasons set forth below. We urge the Administration and Congress to act in a more considered and deliberate manner so that novel changes in the tax law are well considered and do not inadvertently penalize bona fide financial transactions that both the Administration and Congress have previously recognized as important to our economy.

1. The Proposal would make dramatic changes in the tax system without an appropriate period of examination and consideration. One of the most basic principles of our tax system is the realization requirement, which holds that a taxpayer should recognize its gain or loss in a transaction when that gain or loss has been "realized", i.e., turned into to cash or other property. The realization requirement ensures that in our self-policed tax system taxpayers know when they are subject to tax, and that taxation generally occurs when a taxpayer obtains cash to pay the tax.

There are, of course, several exceptions to the realization requirement that have been added to the Internal Revenue Code over time. Those exceptions are, however, relatively few, because the realization requirement has been considered to be an important guide to fairness and administrability in the tax system. Departures from the realization principal have been made only in the most compelling circumstances, and then only in a carefully circumscribed way.

For example, the scope of the mark-to-market rules in Section 1256 and Section 475 are quite precise, and there is relatively little uncertainty about whether those provisions apply to a particular transaction. In each case, before the exception to the realization requirement was enacted, there was exhaustive review by Congress, the staffs of the tax writing committees, experts in the Treasury and the Internal Revenue Service and taxpayers who would be affected.

By contrast, the Proposal would, if enacted, impose a partial mark-to-market regime for gains in certain hedging transactions without the benefit of review and debate about the need for a departure from the realization requirement or the scope of that departure. It appears that news accounts of a particular transaction have triggered a headlong rush to abandon long-standing tax policy. That rush is having a predictable effect: a legislative proposal has been made that sweeps well past its intended boundaries, and a piecemeal reaction to one reported transaction appears to be taking the place of the comprehensive review of the taxation of financial transactions that the Administration has previously announced.

We suggest that any legislation that would abandon the realization requirement should be aired for widespread review and debate. The Proposal should be the subject of hearings so that interested parties inside and outside of the Government can address it thoughtfully, with full consideration of its intended and unintended consequences. We believe that the enactment of the Proposal without full vetting will seriously undermine taxpayers' confidence in the Code's fairness.

We also suggest that the uncertain scope of the Proposal and its retroactive effective date have chilled taxpayers' ability to engage in important legitimate risk management techniques in fear of retroactive tax consequences. We urge the Administration and Congress to refrain from making disruptive retroactive proposals of novel legislation in the future.

2. There is no need for a "constructive sale" rule for equity swaps and similar transactions. The underlying premise of the Proposal is that a taxpayer who has entered into an equity swap has effectively sold its position and thus should be taxed as if it made an actual sale. This premise is incorrect. In a sale, the taxpayer exchanges its position for cash or other property, which it may then use as it pleases. In an equity swap, the taxpayer does not generate any cash; instead, it agrees by contract to make payments measured by one index in order to receive payments measured by another index, for the term of the contract. The differences are many and are important. Among the most significant are these:

First, in a conventional equity swap the taxpayer does not generate any cash. It is locked into receiving taxable periodic payments based on a specified index for the life of the contract and has no liquidity to change its investment except by negotiating a termination of the contract. Thus, the contract is illiquid, and is not a means to achieve the liquidity available from a sale. Moreover, the Proposal would impose tax on a transaction before that transaction has generated sufficient cash to pay that tax.

Second, in an equity swap the taxpayer retains "counterparty risk", meaning that it will not be paid if the counterparty to the contract defaults. The taxpayer is not fully insulated from market risk on its underlying hedged position. There is no similar risk faced by a taxpayer that sells its position.

Third, the typical equity swap is a temporary arrangement. A sale is a permanent disposition of a position. Equity swaps typically have terms that may be measured in months, and only rarely exceed five years. At the end of the equity swap the taxpayer is in the same posture with respect to the hedged position as it was before the transaction.

Thus, an equity swap is a temporary hedging transaction in which the taxpayer does not achieve the liquidity, the absence of counterparty risk or the permanence of risk transfer that it could achieve in a sale. We therefore believe that entering into an equity swap is not an appropriate occasion for recognizing gain in a position. We do not believe that a convincing case has been made to create an exception to the realization requirement for equity swaps and similar transactions, particularly in the absence of time for full consideration of the merits of the Proposal.

3. The scope of the "substantial elimination of risk" standard is extremely unclear. The Proposal does not achieve its goal of treating as "constructive sales" a specific class of transactions that are perceived to be economically similar to actual sales. A critical question raised by the Proposal is how to identify whether a transaction "substantially eliminates the taxpayer's risk of loss and opportunity for gain" with respect to a position. How closely does the payment index need to track the economics of an underlying position before the opportunity for gain and loss in that position is "substantially eliminated"? Is it sufficient to retain 10% of the upside potential? 15%? 20%? 25%?

Can the tolerances be closer if both upside and downside risk are retained? If a taxpayer enters into a "collar", how tight can it be without triggering a "constructive sale"? (A collar is a combination of a "cap" and a "floor" in which the holder of a hedged position receives a payment to the extent the value of the position falls below the floor, and makes a payment to the extent that the value of the position rises above the cap.)

Is there a constructive sale if the taxpayer retains a significant portion of the upside (or downside) potential, but not the first portion (e.g., the taxpayer retains the benefit of appreciation of between 15% and 30%)? Is risk "substantially eliminated" if the value of the underlying equity makes up only a small part of the relevant index? What if the index does not include the underlying equity, but includes other equities in the same industry?

These are not hypothetical questions. If the Proposal is intended to address situations where the taxpayer has cleanly traded its economic interest in one position for another, that intention is not clear from the text of the Proposal.

4. The Proposal may have many unintended consequences. One predictable effect of enacting a vague standard that overturns a longstanding central tax policy without adequate consideration is that it will have unpredictable consequences. For example, is the Proposal intended to treat a short-term interest rate swap as a "constructive sale" of investment grade debt securities owned by a taxpayer, even if the swap is not intended to hedge those securities? Will entering into a borrowing be treated as a constructive sale of a debt instrument held as an asset, if that new liability effectively insulates the taxpayer from changes in the price of the asset due to interest rate fluctuations?

After a "constructive sale" of a share of stock by a taxpayer, who is taxed on the dividends paid on the stock? When an equity swap terminates, is the taxpayer deemed to purchase the underlying equity for purposes of determining its holding period? For purposes of the wash sale rules? For purposes of Section 338? For purposes of Section 382?

Can a taxpayer with expiring loss carryovers trigger gain to absorb those losses without selling any asset by entering into a short-term equity swap? Can a taxpayer manage its foreign tax credit position by entering into a "constructive sale" of illiquid assets?

This is not meant to be an exhaustive list of issues raised by introducing the notion of a "constructive sale" into the Code. Instead, it is intended to highlight the fact that departing from the fundamental realization requirement opens a host of new questions that need to be answered.

5. Summary. ISDA believes that the realization requirement has been a sound guide to fairness and administrability in our system, and that exceptions to that requirement should be made only after thorough consideration. ISDA is doubtful that a "constructive sale" rule is needed to curb perceived abuses created by the use of equity swaps or similar transactions. If such a rule is considered to be advisable, ISDA urges that it have a clear purpose, that it be drafted in a manner that will achieve that purpose without chilling useful economic activity, and that the ramifications of that rule be fully reviewed. The Proposal in its present form does not do so.

STATEMENT
OF THE
INVESTMENT COMPANY INSTITUTE

ON NEW REVENUE PROVISIONS IN
PRESIDENT CLINTON'S FISCAL YEAR 1997 BUDGET

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

MAY 15, 1996

The Investment Company Institute (the "Institute") [1] submits for the Committee's consideration the following comments regarding proposals to (1) require sellers of securities to calculate gains and losses using an average cost basis, (2) increase the penalties under section 6721 for failure to file correct information returns, and (3) modify section 1374 of the Internal Revenue Code [2] to require current gain recognition on the conversion of a large C corporation to an S corporation. These proposals are in President Clinton's Fiscal Year 1997 budget, but were not included in the Balanced Budget Act of 1995.

I. Average Cost Basis For Securities

Background

Taxpayers who sell stocks or other securities are allowed to account for the disposition in one of several ways under section 1012 and the regulations thereunder: by specifically identifying the securities sold, or by using the first-in-first-out method. In addition, the regulations under section 1012 provide that dispositions of shares in a regulated investment company ("RIC") may be accounted for using an average cost basis, determined using either the "double-category" or the "single-category" method. [3]

Proposal

The President's Fiscal Year 1997 budget includes a proposal which would require taxpayers to calculate gains and losses on dispositions of substantially identical securities, including shares of a RIC, using an average cost basis determined under the single-category method. For purposes of determining whether gain or loss on a disposition is short-term or long-term, a taxpayer generally would be deemed to dispose of substantially identical securities on a first-in-first-out basis. The proposal would not apply to certain contractual financial products, such as over-the-counter options, and the proposal would give the Treasury Department authority to treat securities that are substantially identical as not subject to the required use of the average cost basis method if the securities have a special status under the Internal Revenue Code (e.g., securities contributed to a partnership with built-in gain). The proposal would apply to securities sold more than 30 days after enactment of the proposal.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes **5,876 open-end** investment companies ("mutual funds"), **448 closed-end** investment companies and **10 sponsors** of unit investment trusts. Its mutual fund members have assets of about **$2.994** trillion, accounting for approximately 95% of total industry assets, and have **over 38 million individual shareholders.**

[2] All references to "sections" are to sections of the Internal Revenue Code.

[3] The double-category method divides all shares in an account at the time of each disposition into two categories based on whether the shares have been held for the long-term holding period, and permits the taxpayer to specify from which category shares are sold. The single-category method does not divide shares in an account into different categories, but provides that shares are deemed to be sold on a first-in-first-out basis.

. Recommendation

The Institute strongly opposes the average cost basis proposal. The proposal would increase taxes on securities investors, and thus reduce incentives to save and discourage capital investment. Moreover, the proposal would discourage reinvestment in successful companies, but would have no effect on those who purchase a particular type of security only once.

Requiring use of the average cost basis method would complicate, rather than simplify, tax calculations. For example, if a RIC investor purchased shares and reinvested quarterly dividends for ten years, the investor's cost basis for a single share would not be the price paid for that share, but would instead be an average of 41 different purchases occurring over a ten year period. It would not be unusual for an investor's cost basis for a single share to be an average of more than 41 different purchases, because investors often hold shares longer than ten years, and some RICs pay dividends monthly instead of quarterly (an investor purchasing shares and reinvesting monthly dividends for 15 years would calculate the cost basis for a single share as the average of 181 different purchases occurring over the 15 year period).

Complex attribution rules also would be needed to prevent avoidance of the average cost basis requirement through the use of related persons and controlled entities. For example, attribution rules would be required to prevent avoidance by (1) having securities held by the taxpayer's children or other relatives, (2) holding securities in joint accounts, and (3) establishing separate partnerships, trusts and other entities to hold securities. Thus, the average cost basis method of accounting for dispositions of securities would substantially complicate basis calculations for millions of securities investors.

In many circumstances, a securities investor would not be able to rely on a broker or the RIC in which the investor holds shares to perform the average cost basis calculations required by the proposal. In part, this is due to the effective date of the proposal--it would apply to all securities sold more than 30 days after enactment. While RICs often provide average cost basis information to their shareholders, they typically do so only for accounts opened after (or shortly before) the implementation of a system for providing average cost basis information. The provision of average cost basis information to new accounts reflects the fact that the RIC cannot calculate the average cost basis with respect to old accounts from which shares were redeemed prior to the establishment of the system to calculate average cost basis. In addition, in many cases a RIC would not be able to provide average cost basis calculations to investors who acquire shares by gift or inheritance, or to investors who otherwise did not purchase the securities from the RIC seeking to provide the average cost basis calculations. Thus, it cannot be assumed that the necessary average cost basis calculations will in all events be provided to investors.

Finally, the proposal would be retroactive, affecting every investor who purchased securities previously, when specific identification of securities sold was a permissible method to determine basis.

II. Increased Penalties for Failure to File Correct Information Returns

Background

Current law imposes penalties on payers, including RICs, that fail to file with the Internal Revenue Service ("IRS") correct information returns showing, among other things, payments of dividends and gross proceeds to shareholders. Specifically, section 6721 imposes on each payer a penalty of $50 for each return with respect to which a failure occurs, with a maximum penalty of $250,000.[4] The $50 penalty is reduced to $15 per return for any failure that is corrected within 30 days of the required filing date and to $30 per return for any failure corrected by August 1 of the calendar year in which the required filing date occurs.

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[4] Failures attributable to intentional disregard of the filing requirement are generally subject to a $100 per failure penalty that is not eligible for the $250,000 maximum.

Proposal

The President's Fiscal Year 1997 budget contains a proposal which would increase the $50-per-return penalty for failure to file correct information returns to the greater of $50 per return or five percent of the aggregate amount required to be reported correctly but not so reported. The increased penalty would not apply if the total amount reported for the calendar year was at least 97 percent of the amount required to be reported.

Recommendation

The Institute opposes the proposal to increase the penalty for failure to file correct information returns. Information reporting compliance is a matter of significant concern to RICs. A premium is placed on providing the IRS and RIC shareholders with timely, accurate information returns and statements. As a result, a high level of information reporting compliance is maintained within the industry.

The Internal Revenue Code's information reporting penalty structure was comprehensively revised by Congress in 1989 to encourage voluntary compliance. Information reporting penalties are not designed to raise revenues.[5] The current penalty structure provides powerful incentives for RICs to promptly correct any errors made.

III. Conversions of Large C Corporations to S Corporations

Background

Section 1374 generally provides that when a C corporation converts to an S corporation, the S corporation will be subject to corporate level taxation on the net built-in gain on assets held at the time of the conversion if the assets are sold within 10 years. In Notice 88-19, 1988-1 C.B. 486, the 10-year rule for the recognition of built-in gain in section 1374 was extended administratively by the IRS to C corporations that convert to RIC or real estate investment trust ("REIT") status. Notice 88-19 provides that, pursuant to the repeal of the General Utilities doctrine, the IRS intends to promulgate regulations under section 337(d) providing that a C corporation which converts to a RIC or REIT will be treated as if the corporation had sold all of its assets and liquidated, thus requiring the corporation to recognize any net built-in gain on assets held at the time of the conversion. However, Notice 88-19 provides that the regulations will permit the corporation to avoid the immediate recognition of built-in gain if the RIC or REIT elects to be subject to rules similar to section 1374.

Notice 88-19 was supplemented by Notice 88-96, 1988-2 C.B. 420, which states that the regulations to be promulgated under section 337(d) will provide a safe harbor from the recognition of built-in gain in situations in which a RIC fails to qualify under Subchapter M for one taxable year and subsequently requalifies as a RIC. Specifically, Notice 88-96 provides a safe harbor for a corporation that (1) immediately prior to qualifying as a RIC was taxed as a C corporation for not more than one taxable year, and (2) immediately prior to being taxed as a C corporation was taxed as a RIC for at least one taxable year. The safe harbor does not apply to assets acquired by a corporation during the C corporation year in a transaction that results in its basis in the assets being determined by reference to a corporate transferor's basis. Nor does the safe harbor apply to a corporation that has not previously qualified as a RIC.

Proposal

The President's Fiscal Year 1997 budget proposes to repeal section 1374 for large corporations. For this purpose, a corporation is a large corporation if its stock is valued at more than five million dollars at the time of the conversion to an S corporation. Under the proposal, a conversion of a large C corporation to an S corporation would be treated as a liquidation of the C corporation, followed by a contribution of the assets to an S corporation by the corporation's shareholders. Both the converting corporation and its shareholders would recognize gain upon the conversion. The proposal further provides that Notice 88-19 would be revised to provide that the conversion of a large C corporation to a RIC or REIT would result in

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[5] In the Conference Report to the 1989 changes, Congress recommended to IRS that they "develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 661 (1989).

the immediate recognition of the corporation's net built-in gain. Thus, the Notice, if revised as proposed, would no longer permit a large corporation that converts to a RIC or REIT to elect to apply rules similar to the 10-year built-in gain recognition rules of section 1374.

Recommendation

Because the safe harbor set forth in Notice 88-96 is not based upon the 10-year built-in gain rules of section 1374, the repeal of section 1374 for a large C corporation converting to an S corporation should have no affect on Notice 88-96. Instead, the safe harbor is based on the recognition that the imposition of a significant tax burden on a RIC that fails to qualify for a single year would be excessive. Moreover, the imposition of tax would fall directly on the RIC's shareholders, who are typically middle-class investors.

The Institute understands from discussions with the Treasury Department that the proposed revision to section 1374 and the related change to Notice 88-19 are not intended to impact the safe harbor provided by Notice 88-96.

Should the Congress adopt this proposal, the Institute recommends that the legislative history include a statement, such as the following statement, making it clear that the proposed revision to section 1374 and the related change to Notice 88-19 would not impact the safe harbor set forth in Notice 88-96 for RICs that fail to qualify for one taxable year:

> This provision is not intended to affect Notice 88-96, 1988-2 C.B. 420, which provides that regulations to be promulgated under section 337(d) will provide a safe harbor from the built-in gain recognition rules announced in Notice 88-19, 1988-1 C.B. 486, for situations in which a RIC temporarily fails to qualify under Subchapter M. Thus, it is intended that the regulations to be promulgated under section 337(d) will contain the safe harbor described in Notice 88-96.

STATEMENT OF
DR. RICHARD L. BERNAL
AMBASSADOR FROM JAMAICA TO THE UNITED STATES
SUBMITTED TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

IN RESPONSE TO ITS REQUEST FOR WRITTEN COMMENTS ON PROVISIONS IN THE PRESIDENT'S FY 1997 BUDGET

MAY 15, 1996

Thank you for allowing me to submit a statement in connection to two provisions that were contained in the President's FY 1997 budget request -- NAFTA parity and the modifications to the Section 936 tax credit.

This statement reviews the twelve years during which US/Caribbean trade has flourished under the Caribbean Basin Initiative (CBI) legislation. In addition, it examines the structure of the US/Jamaican and US/Caribbean trading partnership, assesses the impact of the North American Free Trade Agreement (NAFTA) on US/Caribbean trade flows, and discusses the importance of Caribbean parity legislation before Congress -- The Caribbean Basin Trade Security Act (S. 529, HR 553) -- to rebuild confidence in US/Caribbean economic relations. Finally, this statement will also note Jamaica's concern over attempts to scale back or eliminate the Section 936 tax program, which benefits Jamaica through the Qualified Possession Source Investment Income (QPSII) provision.

I. Overview

In 1996, the Caribbean Basin is faced with two fundamental, yet conflicting trade trends. On one hand, as it stands now, NAFTA has emerged as an immediate challenge to the viability of the US/Caribbean trading relationship. In providing preferential access to a number of Mexican products, which form an important base of the Caribbean export portfolio, NAFTA will cause substantial erosion of the Caribbean competitive position vis-a-vis the US market. On the other hand, NAFTA represents a building block in the establishment of a hemispheric free trade area, a goal that has been enthusiastically endorsed by Jamaica as part of the Free Trade Area of the Americas (FTAA) process.

The Caribbean Basin Trade Security Act (S. 529/HR 553) -- which has attracted widespread bi-partisan support and the backing of the Clinton Administration -- creates a mechanism to address and reconcile these diverging trends. First, the Caribbean Basin Trade Security Act will provide a short term remedy to the trade and investment imbalances caused by NAFTA. Second, this measure will create a transitional framework through which Caribbean countries like Jamaica can attain the long term goal of integration into hemispheric free trade. ***Quick passage and enactment of this important measure, therefore, is vitally important to sustain the US/Caribbean economic and trade partnership.***

II. The Caribbean Basin Initiative at Twelve

In August 1995, the Caribbean Basin Initiative (CBI) marked its 12th anniversary. In the dozen years since it was established, the CBI has emerged as an important stimulus of economic development in the Caribbean Basin and of trade linkages throughout the region. The effect has been felt -- not only in Kingston and Montego Bay -- but also in Miami, Baltimore, New Orleans, New York, and hundreds of other communities throughout the United States. In many ways, the CBI has exceeded the expectations of the drafters of the CBI legislation who wrote in 1990 amendment to the CBI, "The Congress finds that...a stable political and economic climate in the Caribbean region is

necessary for the development of the countries in the region and for the security and economic interests of the United States."[1]

Through its combination of trade, investment, and tax policies, the CBI legislation has progressively established a framework that has allowed mutually beneficial US/Caribbean economic links to flourish. In turn, Jamaica and other Caribbean countries have matched the liberalizing reforms enacted by the CBI to launch their own trade and investment economic reform programs. Together, the United States and Caribbean countries have created a trade partnership that now exceeds $24 billion a year.

The successes of the CBI legislation are reflected in the figures signalling robust growth in the US/Caribbean trade partnership. Since the mid-1980's, US overall exports to the Caribbean have expanded by over 100 percent and Caribbean exports to the United States have climbed by more than 50 percent. The Caribbean Basin now comprises the tenth largest market for the United States, and is one of the few regions where the United States consistently posts a trade surplus.

With US exports exceeding $15.3 billion in 1995, US/Caribbean commercial links support more than 300,000 jobs in the United States. During the past decade, more than 18,000 American jobs have been created each year as US trade links with the Caribbean have expanded. Throughout the Caribbean, where the economies are much more dependent upon trade, increased exports to the United States has generated hundreds of thousands of additional jobs. Such employment growth has been felt in both export industries, as well as in the many sectors that cater to these industries.

Such trade and employment growth reveals a fundamental characteristic of US/Caribbean production cycles. The existence of CBI market access agreements, combined with the proximity and skills of the Caribbean workforce, has made Caribbean production an attractive and profitable element of any US production strategy. For example, through offshore assembly agreements, the Jamaican private sector has developed an active partnership with US industry to take advantage of the most efficient productive activities that each country offers. In a host of industries, US and Jamaican firms cooperate to produce finished goods using a combination of Jamaican and American skills, capital, and technology. It is this complementarity of Jamaican/US production that maintains the competitiveness of the final product in the global marketplace and even in the US market.

The new structure of trade means that economic growth and development in the Caribbean now directly translate into expanded export opportunities for the United States. Roughly 70 cents of each dollar Jamaica earns from exports to your country is spent in the United States buying American-made consumer goods, food products, industry inputs, and capital equipment. When compared with each dollar of Asian imports, which only generates about 10 cents worth of subsequent US purchases, trade with the Caribbean becomes an important priority for the United States.

Moreover, by providing a mechanism to enhance US/Caribbean commercial links, the CBI has created a sound basis for cooperation in other areas, such as environmental protection, counter-narcotics activities, the promotion of democracy, and regional security measures.

III. NAFTA and the CBI

A. NAFTA's Preferential Access over the CBI

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[1] Section 201 of the Caribbean Basin Economic Recovery Expansion Act of 1990. Codified at [19 USC 2701nt; PL 101-382; Title II]

This established structure of trade in the region, ensures that the impact of NAFTA will be substantial, both in the United States and throughout the Caribbean. In effect, NAFTA alters the successful formula for sound economic development in the Caribbean by granting Mexico access to the US market on terms more favorable than those available for CBI exporters.

While the CBI program provides for duty free treatment for a vast number of products, it statutorily excludes a few items -- such as textiles and apparel, footwear, luggage, watches, tuna, and petroleum -- that are among the Caribbean Basin's most valuable exports. This means that a portion of each CBI country's exports will not enjoy CBI treatment. As much as 40 percent of Jamaica's actual exports are not covered by the duty free treatment scheduled under the CBI or Generalized System of Preferences (GSP) programs. Moreover, some of these products -- such as textiles and apparel and sugar -- also face quota-based trade barriers in addition to these duties.

In contrast, NAFTA eliminates the duty and quota treatment for these same articles, either immediately or over a phase-out period. Under NAFTA, import duties were immediately removed on the overwhelming majority -- approximately 80 percent -- of Mexican apparel exports to the United States. The remaining 20 percent benefits from an accelerated implementation of free trade, with annual duty cuts and quota liberalization set to be completed by the year 2000. To be fair, NAFTA also phases out the duties on the products for which the CBI countries already enjoy duty free treatment.

But the result is far from even. Mexico gains parity with the Caribbean countries for CBI-covered products, establishing a level playing field for those items on which Mexican and Caribbean exporters face no duty. But on the products excluded from the CBI, such as textile and apparel products, Mexico gains access to the US market, exceeding that granted to the Caribbean countries. This tilts the playing field in Mexico's favor, and gives Mexican exporters a distinct advantage over Caribbean exporters. When combined with Mexico's access to cheap energy, lower transport costs, greater economies of scale, and low wage rates, this advantage becomes quite substantial.

NAFTA also grants Mexico an extremely valuable exception to tough textile and apparel "rule-of-origin" requirements -- the so-called tariff preference levels (TPLs) -- to allow for preferential entry into the US market of textile and apparel products that contain fabrics from countries other than Mexico, Canada, and the United States. This provision is intended to provide flexibility for the Mexican garment industry to meet the changing demands of US clothing purchasers. TPLs work through a tariff-rate quota, providing low duty rates each year to non-originating products before applying a high tariff to any amount above quota. In allowing such a price break, NAFTA enables Mexican exporters to lower the average cost of their products while maintaining high volumes to satisfy US importers and retailers.

CBI textile and apparel exporters -- and their customers -- enjoy no such flexibility. Without similar TPL provisions for CBI countries, non-originating Caribbean garment exports -- even if Caribbean parity is enacted -- face the higher tariff rates. This would give Mexico, and even low-cost producers in Asia, a distinct price-advantage in competing in certain product areas. At the same time, Caribbean exporters would lose sales opportunities since the CBI and CBI parity incentives would be to shift production away from items that were not cut and sewn in the United States. Faced with such restrictions, US importers, retailers, and investors, would begin to pass over the Caribbean Basin as a profitable place from which to do business.

B. NAFTA's Effects on the US/Caribbean Partnership

Broadly speaking, NAFTA's implementation -- and advantages over the CBI -- poses four clear risks for the US/CBI partnership. The elimination of quotas and the phase-out of tariffs on Mexican products removes the advantage enjoyed by CBI exports to the US market, ***diverting trade flows***

from CBI countries to Mexico. In the two years since the NAFTA was implemented, there has already been a measurable diversion of trade from the CBI to Mexico. The American Apparel Manufacturer's Association (AAMA) reports that the growth rate of US apparel imports from the CBI region dropped by 60 percent from 1993 to 1994. During that same period, the growth rate of apparel imports from Mexico nearly doubled. Moreover, trade statistics from 1995 indicate that Mexican garment exports to the United States continued to expand at three times the rate of those from CBI countries. As this trend continues, Caribbean countries could witness a broad diversion of American demand from suppliers in CBI countries to firms in Mexico, thus reducing CBI exports and income.[2]

Another consequence of NAFTA's implementation has been the ***diversion of new investment.*** One of the primary indicators has been the fact that in the last 4 years there has been a pause in investment in the region, as investors first waited to evaluate the NAFTA provisions and then established new operating facilities in Mexico, instead of in the Caribbean. This trend, which is now being fully realized, as long been anticipated by the US Government. The United States International Trade Commission's (ITC's) 1992 report entitled, "Potential Effects of a North American Free Trade Agreement on Apparel Investments in CBERA Countries", has concluded that "NAFTA will introduce incentives that will tend to favor apparel investment shifts away from the CBERA countries to Mexico".[3]

As existing investors begin to source their products out of Mexico, others are rushing to ***transfer or close existing productive capacity*** -- particularly in "foot-loose" industries which can easily be relocated -- to take advantage of Mexico's market access. In many Caribbean Basin countries, particularly throughout Central America, NAFTA directly reverses past successes of the CBI program, effectively turning back the clock of Caribbean development.

An erosion of export access to the United States will eventually translate directly into a ***contraction of economic activity in the CBI region.*** Such a contraction would lower regional incomes, and, ultimately, the demand for imports from the United States. In such a scenario, US exports of goods and services to the CBI would decline while ***regional instability -- fostered by a decrease in economic opportunities -- would rise.*** Judging from past patterns, the resulting unemployment in the United States would be met with an increase in immigration from displaced Caribbean workers and a rise in narcotics trafficking.

IV. The Caribbean Basin Trade Security Act as an Immediate Remedy

Although it is difficult to assess the Administration's proposal, since specific legislative language has not yet been released, Congress does have before it a workable proposal to effect parity of market access between Caribbean countries and Mexico. The Caribbean Basin Trade Security Act (S 529/HR 553) very simply will restore a level playing field between Mexico and the Caribbean Basin countries. It will provide for non-discriminatory access into the US market for those products on which NAFTA gives Mexico an unintended advantage.

S. 529/HR 553 builds on the existing CBI program and legislation. It does not establish a new set of criteria by which countries can become eligible for the benefits, but rather links the enhanced benefits to the existing

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[2] See Martin, Larry "Testimony of Larry Martin, American Apparel Manufacturing Association," before the House Ways and Means Subcommittee on Trade on HR 553, the Caribbean Basin Trade Security Act. Serial Report 104-4. p. 93.

[3] See "Potential Effects of a North American Free Trade Agreement on Apparel Investment in CBERA Countries." Report to the United States Trade Representative on Investigation No. 332-321. USITC Publication 2541. July 1992.

program criteria. In this way, S 529/HR 553 recognizes that many Caribbean countries --through trade liberalization and economic reform measures -- have already undertaken steps that exceed the criteria outlined in the original legislation. Moreover, it also ***ensures that additional, valuable time is not lost -- and the US/Caribbean partnership further undermined - as CBI countries satisfy new "entrance criteria."***

Another important feature of the Caribbean parity bill is that it ***includes all products that are currently excluded by the CBI.*** As our economies liberalize, it becomes increasingly difficult to erect artificial barriers between product categories. Extending parity for only certain textile and apparel products would have a limited effect on the situation that we are trying to address. Enacting a comprehensive parity bill, however, is both economically more feasible and symbolically more consistent with the notion of free and open trade.

In this regard, S. 529/HR 553 includes a welcome provision giving the Administration authority to negotiate tariff preference levels for non-originating textile and apparel products. Such a provision does not compel the use of TPLs, but merely recognizes that -- ***with similar TPLs available for Mexico - the fairness of a fully level playing field requires the same for the Caribbean.***

Finally, S. 529/HR 553 is a ***cost-effective way for the United States to conduct foreign trade and economic policy in the region***, especially in this era of budget cutbacks. Any losses to the reduction in tariffs should be more than offset by two factors. First, even without Caribbean parity, the United States can expect to lose tariff revenue as trade and investment is diverted to the duty free export platforms in Mexico. Restoring those exports to the Caribbean, by cutting the tariffs faced by imports from the Caribbean, will not represent a new loss of tariff revenue, but merely a recognition of tariff revenue that is already being lost.

Second, a preliminary calculation suggests that the gains of trade liberalization and economic growth should generate alternative sources of revenue for the US Government to offset any tariff revenue losses. The CBI has helped create an average of 16,000 US jobs each year for the past decade. If each of these jobs generates an additional $5,000 in tax revenues during the first year, trade liberalization with the CBI could yield roughly $80 million in new revenues in that year alone. In the second year, as 16,000 additional jobs are created, US revenues will expand by $160 million. Over five years, such figures yield roughly $1.2 billion, exceeding the CBO estimates by several hundred million dollars.

V. The Caribbean Basin Trade Security Act as a Transitional Mechanism for Hemispheric Integration

S 529/HR 553 -- both explicitly and implicitly -- recognizes a greater goal of bringing the Caribbean Basin countries into a hemispheric free trade area. In this regard, S 529/HR 553 furthers the agenda developed at the Miami Summit with one critical difference. While much of the attention has focused on linking the larger economies of South America with that of the NAFTA, ***S 529/HR 553 puts forth a tangible framework to determine how the Caribbean economies will be joined in this free trade arrangement as well.*** It very much recognizes that the spirit of Miami exists in all the countries throughout the Caribbean.

Specifically, S 529/HR 553 provides for a transitional period during which full parity with Mexico will be provided for Caribbean countries. Jamaica supports an appropriate and realistic time frame to provide Caribbean Basin countries an opportunity to complete the trade liberalization and economic reform steps necessary for accession to a free trade agreement with the United States. While some countries -- such as Jamaica -- are now

ready to negotiate free trade agreement with the United States, others may need a longer period outlined in the Caribbean parity bills.

A reasonable period will also create ***a viable time frame that will help restore "confidence" in the Caribbean*** that has been eroded as previous plans have been proposed and discarded. As investors and traders see that time period, they will be able to grasp a tangible expression of the US commitment to its trade relationship with CBI countries. One concern, however, is that the time frame not be seen as an excuse to put Caribbean countries – ***which have established a close trade relationship with the United States and which have already met many of the NAFTA entry requirements -- at the back of the NAFTA accession line.*** Jamaica's hope is that NAFTA accession will include those countries that have made viable strides toward trade liberalization, and not just those representing the largest export markets for US firms.

In addition, in making the period temporary, ***S 529/HR 553 creates a viable incentive for Caribbean countries to complete their reform programs.*** Each Caribbean country will spend the next decade working to enact and implement the measures necessary to ensure smooth negotiation of a free trade agreement with the United States.

The bill ***initiates a dialogue between the Administration and the Caribbean Basin countries on ways to preserve and strengthen the US/Caribbean trading relationship***. Even in the absence of specific trade negotiating authority, such a dialogue is important to help maintain the momentum of the Miami Summit. In addition, the bill requires the Administration to perform a series of studies and reports on the US/Caribbean trade relationship. In a sense, S 529/HR 553 asks the Administration to continually ask the question: "What will be the impact of a specific policy change on the Caribbean." Such a questions should have been asked as NAFTA was considered. This emphasis is appropriate, partly because of the close trade relationship between the United States and the Caribbean. In addition, this focus will help ensure that eventual free trade talks with the Caribbean Basin countries -- which are among the most committed trade liberalizers -- are not delayed by a need to initiate trade talks with the larger economies of the Hemisphere.

VI. Jamaica's Commitment to Trade Liberalization

Jamaica is deeply committed to an open multilateral trading system is a stimulant to economic growth, both through the static gains from increased efficiency in the utilization of its existing resources and the dynamic gains from the opportunities to expand productive capacity through new technology, investment, and innovative entrepreneurship.

Jamaica is an advocate of trade liberalization within the hemisphere and of a multilateral trading system that approaches free trade as far as possible. Jamaica subscribes to, and its policy has always been fully consistent with, the principles and disciplines of the GATT. Jamaica joined the GATT in the early 1960's and has been an active participant in, and has contributed to, successive negotiating rounds aimed at further liberalization of global trade.

Moreover, Jamaica actively participates in several regional trade-liberalization arrangements with the United States (the Caribbean Basin Initiative -- CBI), Europe (the LOME Convention), Canada (CARIBCAN), and the other English speaking countries in the Caribbean (the Caribbean Common Market - CARICOM). All of these arrangements are intended to promote trade between the member countries. Finally, Jamaica also has supported the creation of free trade within the Western Hemisphere using the North American Free Trade Area (NAFTA) as a first building block of free trade within the hemisphere.

Jamaica realizes that there is now a new phase of globalization of production and finance which is rapidly sweeping away national barriers to the movement of goods, services, capital, and finance. During the 1980's, Jamaica's economic policies focused on economic reform, stabilization, and structural adjustment in an attempt to create an environment conducive to a private sector-led, market-driven, outward-looking growth strategy. An important aspect has been a comprehensive program of trade liberalization involving substantially reduced tariffs and the elimination of quantitative trade restrictions. This has been complemented by freeing market forces within the domestic economy through the abolition of price and exchange controls by a vigorously implemented campaign of privatization and fiscal and monetary discipline. A stable, market-determined exchange rate system is operating successfully, preventing any disruptive changes in the value of the Jamaican dollar.

In the last four years there has been a substantial acceleration in the process of liberalizing the trade regime of Jamaica, with an emphasis on the removal of import restrictions and the lowering of tariffs. In many ways, US products in the Jamaican market are accorded better access than Jamaican products in the US market because Jamaica does not rely upon quotas as a tool of trade policy. Jamaican sugar and apparel products, for example, still face US quotas.

This commitment to outward-looking trade and development policies is firmly based on the knowledge that the benefits to be derived are those of higher growth rates and enhanced capacity to adjust to external shocks. Expanding trade contributes to Jamaica's growth by enabling the economy to improve its productivity by specializing in exports in which it has a comparative advantage. Production for the world market allows firms to achieve the economies of scale which are precluded by a small domestic market. Exposure to competition from imports serves to improve cost efficiency and benefits consumers by lower prices.

Jamaica now sees the CBI program as a springboard to greater hemispheric free trade liberalization. In many cases, we have already taken steps that exceed the requirements of the CBI to help accelerate this goal. ***Jamaica has signed a bilateral investment treaty (BIT) and an intellectual property rights (IPR) agreement with the United States. We were also one of the first countries to include new anti-circumvention language in our bilateral textile agreement with the United States.***

Jamaica is ready and has a demonstrated commitment to enter the next stage of trade liberalization with the United States -- that of negotiating a free and reciprocal trade agreement.

VII. Note on Section 936

Jamaica has also followed, with growing concern, Congressional efforts to scale back or eliminate the Section 936 tax program. Any action to dilute this program could dampen Caribbean economic development in a manner analogous to NAFTA's adverse effect on the US/CBI trading relationship.

Although the program initially targets Puerto Rico growth and development, it has been extended to support economic growth and development in the Caribbean as well. Currently, the Section 936 code contains a provision through which investors in Puerto Rico receive an income tax credit on Qualified Possession Source Investment Income (QPSII). Jamaica and several other CBI beneficiaries benefit from this section since the QPSII funds may be used to finance projects in eligible CBI countries.

Jamaica is concerned about the elimination of such a program for several reasons. First, the QPSII program provides a substantial source of private sector funding for Jamaican development programs. Since the mid 1980's, when Jamaica became eligible for the program, Section 936 funds have

supported over $500 million worth of investments in development projects, including the privatization of the tourism industry. Because investors earn tax free income on their investment income, they are able to make the funds available for development projects in the Caribbean at relatively low rates. This makes the Section 936 program a particularly attractive and appropriate source of funds for Caribbean countries, who have difficulty raising capital on international markets.

Second, as foreign aid dollars decline, Jamaica is looking increasingly toward private sector sources of financing such as the Section 936 program. If the Section 936 program goes as well, the increased pressures on the private capital markets from all Caribbean countries will drive up interest rates, making future development projects prohibitively expensive. This would undermine the past decade of success with the Section 936 program as well as the entire CBI program.

Third, eligibility of access to CBI funds depends upon successful implementation of a Tax Information Exchange Agreement (TIEA) with the United States. To date, the following countries have signed Tax Information Exchange Agreements: Barbados (1984), Jamaica (1986), Grenada (1987), Dominica (1988), Dominican Republic (1989), Trinidad and Tobago (1990), St. Lucia (1991), Costa Rica (1991), Honduras (1991), and Guyana (1992). At the time these agreements were signed, the understanding was that 936 funds would be available for investments in the Caribbean. Elimination of the Section 936 program calls into question a fundamental US commitment supporting this treaty obligation.

Finally, as little as two years ago, Congress considered and rejected a move to modify the QPSII income tax credit. Dilution of this important program for the Caribbean made little sense in 1993. It makes even less sense now. For many of the same reasons why Caribbean parity legislation should be enacted, Congress should continue to resist efforts to eliminate or dilute the QPSII tax credit in the Section 936 program.

VIII. Conclusion

The CBI has proven to be an unqualified success. It has relied upon tax and trade incentives to foster a strong, and interdependent, economic relationship between the United States and the Caribbean.

The potential for NAFTA to divert trade and investment from the Caribbean is nothing new, and has been discussed extensively since the idea for NAFTA was first raised. The Administration and Congress have long recognized this problem, but have so far been unable to find a satisfactory formula to rectify it. In 1994, the United States came close to enacting a partial fix by considering the Clinton Administration's Interim Trade Program (ITP). Although the ITP was not enacted, it did heighten the awareness of this problem and the need to resolve it quickly. In the search for ways to keep the US/Caribbean partnership healthy and build the framework to make the free trade spirit of Miami a reality, the Caribbean needs a full, transitional mechanism to help it work towards a more compelling free trade objective.

In addition, in order to keep the wheels of free trade lubricated, the Caribbean Basin needs access to capital to help finance investment and trade projects. US official development assistance once played an important role in that respect. But as foreign aid flows are diminishing, the Caribbean Basin will turn increasingly toward private sources of capital like the Section 936 QPSII program.

The Caribbean Basin Trade Security Act (S 529/HR 553) is a well-conceived measure that will help Jamaica and other CBI countries achieve that goal. At the same time, Congress should take care not to hobble that progress by weakening the Section 936 program, a key financing mechanism for the Caribbean.

US/CBI Trade Statistics (1985 - 1995)
(Millions of US Dollars)

Year	US Imports	US Exports	Annual Export Growth	Trade Balance
1985	6687	5942	--	-745
1986	6065	6362	7.1%	297
1987	6039	6906	8.6%	867
1988	6061	7690	11.4%	1629
1989	6637	8290	7.8%	1653
1990	7525	9569	15.4%	2044
1991	8372	10013	4.6%	1641
1992	9627	11263	12.5%	1636
1993	10378	12428	10.3%	2050
1994	11495	13441	8.1%	1946
1995	12673	15306	13.8%	2633

Average Annual U.S. Export Growth: 9.96%

Note: 1995 marked the 10th straight year of U.S. trade surpluses

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Number of US Workers Dependent on
Trade with the Caribbean Basin Nations

Year	Total Number of US Workers*	Number of New U.S. Jobs Created Per Year
1985	118,840	--
1986	127,240	8,400
1987	138,120	10,880
1988	153,800	15,680
1989	165,800	12,000
1990	191,380	25,580
1991	200,260	8,880
1992	225,262	25,002
1993	248,552	23,290
1994	268,814	20,292
1995	306,120	37,306

Average Annual Job Creation: 18,731

* Assuming that $1 billion in US exports creates 20,000 US trade-related jobs.

Source: US Department of Commerce
US International Trade Commission Updated: April 9, 1996

STATEMENT OF MERRILL LYNCH & CO., INC

Response to Treasury Tax Proposals

These comments respond to several of the tax proposals released by the Treasury Department on December 7, 1995. Merrill Lynch believes that the goal of sound tax policy should be to increase saving and foster productive investment, in order to ensure U.S. economic growth and our continued leadership in the global economy.

While Merrill Lynch applauds the ongoing efforts to balance the federal budget, it is unfortunate that some of the tax changes proposed by the Administration move in exactly the wrong direction. We are seriously concerned about the damage these proposals have caused -- and will continue to cause -- to the capital-raising activities of American business and the investments these companies are making for future growth.

We will limit our comments to the Treasury proposals to deny interest deductions on certain debt instruments, defer original issue discount deduction on convertible debt, and limit the dividends-received deduction. We believe these proposals are anti-investment and anti-capital formation. If accepted by Congress, they would increase the cost of capital for American companies.

We also have serious concerns about the other proposals in the President's budget affecting the securities markets. We endorse the comments submitted to the Committee on these provisions by the Securities Industry Association and the Public Securities Association.

The U.S. enjoys the world's broadest and most dynamic capital markets. They allow businesses to access the capital needed for growth, while providing investment vehicles individuals can rely on to secure their own futures. Our preeminent capital markets have long created a competitive advantage for the U.S., helping our nation play its leading role in the global economy.

Unfortunately, the Administration's proposals would serve to limit the financing alternatives available to businesses, harming both industry and the individuals who invest in these products. We believe this move by the Administration to curtail the creation of new financial alternatives runs directly counter to the long-run interests of our economy and our country.

Merrill Lynch believes that these proposals are ill-advised, for three central reasons:

- **Increase Cost of Capital**. While Treasury officials have stated their tax proposals will primarily impact the financial sector, this is simply not so. In reality, the burden will fall on issuers of these securities -- that is, American business. Treasury's proposals would force companies to abandon efficient and cost-effective means of financing now available and turn to higher-cost alternatives, which will limit productive investment.

- **Disrupt Capital Markets**. Sudden and capricious tax law changes have a chilling effect on business investment and capital formation. Indeed, the Treasury proposals have already caused a significant disruption in capital-raising activities, causing companies to reevaluate their plans. Furthermore, this disruption has been magnified by the fact that Treasury announced its proposal as retroactive, without providing transition rules or an opportunity for companies to explore other financing alternatives.

- **Fail to Generate Promised Revenue**. The Treasury's proposals are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance -- ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

Merrill Lynch also has deep concerns about the manner in which the Administration introduced its proposals. These provisions are significant changes and have already had a major impact in the capital markets. Nevertheless, the Administration chose to propose them without consultation with industry or financial market participants, without a single congressional hearing, and without sufficient time for careful review. We believe it would be a serious mistake to move forward on proposals of this magnitude without extensive hearings and full consideration.

It is also unfortunate that the Treasury has chosen to characterize these proposals as "loophole closers" that would eliminate "abusive transactions." The fact is, the tax regulations at issue here have been carefully reviewed -- some for decades -- by Treasury and IRS officials, and have been deemed to be sound tax policy. Far from being "abusive," transactions based on these regulations are undertaken by a wide range of the most innovative and respected manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

At a time when the private sector and the federal government should together be pursuing ways to strengthen the U.S. economy, these proposals would weaken it by disrupting capital raising activities across the country. Merrill Lynch strongly urges the Administration and Congress to set aside these proposals. Looking forward, we would be delighted to participate in full and open discussions on these proposals, so that their ramifications can be explored in depth.

The following are detailed responses and reaction to the three Treasury proposals that would directly affect capital-raising and investment activities in the U.S.

I. Proposal to Defer OID Deduction on Convertible Debt

The Treasury's proposal to defer or eliminate deductions for original issue discount ("OID") on Original Issue Discount Convertible Debentures ("OIDCDs") ignores established authority, is based on demonstrably false assumptions about market behavior and offers reasons for change which are inconsistent with clearly observable facts. This proposal also disregards regulations adopted after nearly a decade of careful study by the Treasury and the Internal Revenue Service. Consequently, Treasury's proposal would hastily reverse the results of years of careful study. In addition, the proposed elimination of deductions for OID paid in stock is at odds with the tax law's general treatment of expenses paid in stock.

In a poorly reasoned attempt to draw a distinction between OIDCDs and traditional convertible debt Treasury misstates current law with regard to the deduction of accrued but unpaid interest on traditional convertible debentures.

Finally, the proposal would destroy the symmetry between issuers and holders of debt with OID. This symmetry has been the pillar of tax policy regarding OID. The Treasury offers no rationale for repealing this principle.

While billed as a revenue raiser, it is also clear that adoption of the Treasury's proposal would in fact reduce tax revenue.

TREASURY'S PROPOSAL IGNORES ESTABLISHED AUTHORITY, IS BASED ON DEMONSTRABLY FALSE ASSUMPTIONS ABOUT MARKET BEHAVIOR AND OFFERS REASONS FOR CHANGE WHICH ARE INCONSISTENT WITH CLEARLY OBSERVABLE FACT.

The Treasury's December 7, 1995 proposal to, among other matters, defer OID deductions on convertible debt offers the following as its stated "Reason for Change".

> **"Reason for Change**
>
> The line between debt and equity is uncertain, and it has proved difficult to formulate general rules to classify an instrument as debt or equity for all purposes or to bifurcate an instrument into its debt and equity components. While the IRS has taken the position that some purportedly debt instruments with substantial equity features should be treated as equity, other instruments have not been specifically addressed. Taxpayers have exploited this lack of guidance by, among other things, issuing instruments that have substantial equity features (including many non-tax benefits of equity), but as to which they claim interest deductions. In many cases, these instruments have been issued in exchange for outstanding preferred stock."

It is critical to recognize that not one sentence in Treasury's stated "Reason for Change" applies to OIDCDs.

First, the IRS has formally reviewed all the issues concerning OIDCDs and issued a private letter ruling confirming that the issuer of such securities may deduct OID as it accrues. PLTR 9211047, December 18, 1991. Obviously issuers of OIDCDs have not "exploited this lack of guidance" from the IRS and quite the contrary have relied on official IRS guidance in the form of a private letter ruling. That the IRS issued a ruling on this topic confirms that OIDCDs do not exploit any ambiguity between debt and equity. Obviously, if any such ambiguity existed the IRS would not have issued its ruling.

Second, there is no uncertainty regarding OIDCDs' status as debt. These securities are booked on the issuers' balance sheets as debt and are treated as debt by the credit rating agencies. Therefore, issuers receive no "non tax benefits of equity".

Third, we are aware of no exchange of OIDCDs for outstanding preferred stock.

The Treasury's proposal goes on to state that it applies to:

> "Certain debt instrument that are convertible at the holder's option when it is substantially certain that the right will be exercised. Thus, the proposal would not affect typical convertible debt."

In this segment of Treasury's proposal specifically addressed to OIDCD securities, Treasury sets forth yet another "Reason for Change":

> **"Reason for Change**
>
> In many cases, the issuance of convertible debt with OID is viewed by market participants as a de facto purchase of equity."

The above two statements combine to evidence the fact that Treasury's proposal is based on demonstrably false assumptions about real world market behavior. Treasury makes clear that its proposal would not affect "typical" convertible debt on the grounds that the "typical" convertible debentures are not certain to convert. Since OIDCDs have been available in the market place in substantial volume for over ten years, it is possible to compare the conversion experience of so-called "typical" convertible debentures with the conversion experience of OIDCDs, nearly all of which has been zero coupon convertible debt. The data shows that "typical" convertible debentures are much more likely to convert to equity, that is, to be paid off in stock, than zero coupon convertible debentures.

An analysis of all 85 zero coupon convertible debt securities sold in the public debt markets between 1985 and 1995 shows that forty-seven of those issues have already been retired.*/ Of those 47, only 14 were finally paid in stock. The other 33 were paid in cash. The remaining 38 of the 85 issues were still outstanding in December 1995. If those 38 securities would have been called in December 1995, only nine of them would have converted to stock and the other 29 would have been paid in cash. In other words, the conversion features of only 9 of the 38 issues remaining outstanding were "in the money". Overall, only 27% of the 85 public offerings of zero coupon convertible debt securities have been (or would be if called in December 1995) paid in stock. Thus in only 27% of the issuances has the conversion feature ultimately controlled.

However, an analysis of all 555 domestic issues of "typical" convertible debt retired from 1985 to 1995 shows just the opposite results. Seventy-nine percent (79%) of these offerings converted into the issuer's common stock. Treasury's statement that "the proposal would not affect typical convertible debt" because of the uncertainty of conversion is completely inconsistent with the historical data.

The Treasury's proposal is clearly without logic. It makes no sense to say that an instrument that has a 27% probability of converting into common stock is "viewed by market participants as a de facto purchase of equity," and therefore the deduction for OID on that instrument should be deferred, while an instrument that has a 79% probability of conversion should be treated for tax purposes as debt.**/ All zero coupon convertible debentures are treated as debt on the issuer's

*/ Data supporting the points made in this paper is available upon request.

**/ Given this data, even if one accepted the Treasury's assertion that probability of conversion in some way governed appropriate tax treatment, the proposal obviously addresses the wrong convertible security.

balance sheet and are treated as debt by the rating agencies. In addition, zero coupon convertible debentures are typically sold to risk averse investors who seek the downside protection afforded by the debentures. Thus, both issuers and investors treat convertible bonds with original issue discount as debt, not equity. The Treasury's offered "Reason for Change" is simply false. We understand that Treasury did not have these facts available to it when it made these proposals.

TREASURY'S PROPOSAL IS AN ARBITRARY ATTEMPT TO REVERSE TAX POLICIES WHICH WERE ADOPTED AFTER NEARLY A DECADE OF CAREFUL STUDY.

The manner in which this legislative proposal was offered is a significant reason to doubt the wisdom of enacting a rule to defer or deny deductions for OID on convertible debentures. When the Treasury issued proposed regulations interpreting the 1982 Act and 1984 Act changes in the Code regarding OID discount, the Treasury asked for comments from the public regarding whether special treatment was necessary for convertible debentures. 51 Federal Register 12022 (April 18, 1986). This issue was studied by the Internal Revenue Service and the Treasury through the Reagan, Bush and Clinton administrations. Comments from the public were studied and hearings were held by the current administration on February 16, 1993. When the Treasury Department of the current administration adopted final OID regulations in January of 1994, the final regulations did not exclude convertible debentures from the general OID rules. After nearly nine years of study under three administrations and after opportunity for public comment, the Treasury decided that it was not appropriate to provide special treatment for OID on the convertible debentures. We suggest that it is not wise policy to reverse, in the heat of budget negotiations and without opportunity for hearings or study, a tax policy which the Treasury had adopted after nearly a decade of study.

TREASURY'S PROPOSAL IS INCONSISTENT WITH THE FUNDAMENTAL PRINCIPLE THAT PAYMENT IN STOCK IS EQUIVALENT TO PAYMENT IN CASH.

As discussed above, the current law is clear that an issuer of a convertible debenture with OID is allowed to deduct that OID as it accrues. The Service's private letter ruling confirms this result. We would now like to focus not on the timing of the deduction but on the portion of the Treasury proposal that would deny the issuer a deduction for accrued OID if ultimately paid in stock. The proposal is inconsistent with the general policy of the tax law which treats a payment in stock the same as a payment in cash. A corporation which issues stock to purchase an asset gets a basis in that asset equal to the fair market value of the stock issued. There is no difference between stock and cash. A corporation which issues stock to pay compensation, rent, interest or any other deductible item may take a deduction for the item paid just as if it had paid in cash.

More precisely on point, the 1982 Tax Act added section 108(e)(10) to the Code to repeal case law which allowed a corporate issuer to escape cancellation of indebtedness income if the issuer retired corporate debt with stock worth less than the principal amount of the corporate debt being retired. The policy of that change was to make a payment with stock equivalent to a payment with cash. Section 108(e)(10) clearly defines the tax result of retiring debt for stock. As long as

the market value on the stock issued exceeds the amortized value of the debt retired, there is no cancellation of indebtedness income. The Treasury's proposal to treat payment of accrued OID on convertible debt differently if the payment is made with stock rather than cash is inconsistent with the fundamental rule that payment with stock is the same as payment with cash. The Treasury's proposal would create an inconsistency without any reason for that inconsistency.

TREASURY'S PROPOSAL MISSTATES CURRENT LAW.

We point out that Treasury's statement of "Current Law" misstates the law regarding interest which is accrued but unpaid at the time of conversion. The Treasury suggests that the law regarding "typical" convertible debt is different from the law for convertible debt with OID. This is clearly not the case. The statutory OID rules have since 1982 required daily accrual of interest income and deductions. Case law from the pre-daily accrual era established that whether interest, or OID, which is accrued but unpaid at the time an instrument converts is an allowable deduction depends on the wording of the indenture. In Bethlehem Steel Corporation v. United States, 434 F.2d 1357 (Ct. Cl. 1971), the Court of Claims interpreted the indenture setting forth the terms of convertible bonds and ruled that the borrower did not owe interest if the bond converted between interest payment dates. The Court merely interpreted the indenture language and concluded that no deduction for accrued but unpaid interest was allowed because no interest was owing pursuant to the indenture. The Court stated that if the indenture had provided that interest was accrued and owing, and that part of the stock issued on conversion paid that accrued interest, a deduction would have been allowed. Since the indentures controlling all of the public issues of zero coupon convertible debt were written to comply with the Bethlehem Steel opinion, the indentures for all of these offerings provide that, if the debentures convert, part of the stock issued on conversion is issued in consideration for accrued but unpaid OID. Thus, there is no tax law principle which requires a difference between "typical" convertible bonds and zero coupon convertible debentures on this point. The only difference is a matter of indenture provisions.

TREASURY'S PROPOSAL OBLITERATES THE LONG ESTABLISHED PRINCIPLE OF TAX SYMMETRY BETWEEN ISSUERS AND HOLDERS OF DEBT WITH ORIGINAL ISSUE DISCOUNT.

The Treasury's proposal reverses the policy of symmetry between issuers and holders. Since 1969, when the tax law first addressed the treatment of OID, the fundamental policy of the tax law has been that holders should report OID income at the same time that the issuer takes a deduction. The Treasury's proposal obliterates this symmetry for convertible debt with OID. Not only would the holders report taxable income before the issuer takes a deduction, but if the debt is converted, the holders would have already reported OID income and the issuer would never have taken an offsetting deduction. The Treasury does not offer any justification for this unfairness.

TREASURY'S PROPOSAL REGARDING ORIGINAL ISSUE DISCOUNT CONVERTIBLE DEBENTURES WOULD REDUCE TAX REVENUE.

While billed as a revenue raiser, adoption of Treasury's proposal with respect to OIDCDs would in fact reduce tax revenue for the following reasons:

- Issuers of OIDCDs view them as a debt security with an increasing strike price option imbedded to achieve a lower interest rate. This a priori view is supported by the historical analysis of OIDCDs which indicates that over 70% have been, or if called at December 12, 1985 would have been, paid off in cash as debt.

- If OIDCDs were no longer economically viable, issuers would issue straight debt.

- Straight debt rates are typically 200 to 300 basis points higher than comparable rates. Therefore, issuers' interest deductions would be significantly greater.

- According to the Federal Reserve Board data, at June 30, 1995 over 60% of straight corporate debt is held by tax deferred accounts versus less than 30% of OIDCDs held by such accounts.

Consequently, if OIDCDs are not viable, issuers will issue straight debt with higher interest rates being deducted by issuers and paid to a significantly less taxed holder base. Treasury's proposal would therefore reduce tax revenue while at the same time interfering with the efficient operation of the capital markets.

Giving full consideration to the above data, much of which we understand Treasury did not have at its disposal at the time it prepared its proposal, we believe rejection of the proposal with respect to OIDCDs is warranted and the reason for doing so compelling.

II. Proposal to Deny Interest Deduction on Certain Debt Instruments

Debt with Maturity Over 40 Years

The Treasury Department has proposed to deny interest deductibility on any debt obligation with a maturity over 40 years. Merrill Lynch believes this is bad tax policy. With regard to any financial instrument, it is wrong to base the deductibility of interest on an arbitrary maturity limit. Instead, deductibility should be based on whether the instrument possesses the following five critical attributes of debt:

- A reasonable maturity date.
- The right to receive a sum certain in cash upon maturity of the instrument.
- The right to receive periodic payments of interest.
- The right to enforce payment of principal and interest in the event of a default.
- A claim on the issuer's assets that is senior to all classes of equity of the issuer and at least *pari passu* with the issuer's general unsecured creditors.

On all but the first of these attributes, it is immediately obvious that debt obligations with maturities over 40 years enjoy exactly the same features as other debt instruments. On the remaining attribute -- a reasonable maturity date -- it has been well established that a debt obligation with a maturity over 40 years will be deemed to possess a "reasonable maturity date" if the issuer's business is expected to continue for the period the obligation remains outstanding.

In addition, recent public offerings of debt obligations with maturities greater than 40 years were priced to provide investors with a debt return, not an equity return. The fact that investors were willing to purchase such obligations *priced as debt* concretely shows that investors view these instruments as possessing the characteristics of debt -- including the attribute of a reasonable maturity date.

Finally, if this Treasury proposal were adopted, Merrill Lynch believes most issuers would simply shift to long-term debt with a maturity under 40 years -- not to equity. This seems to be contrary to the assumptions which underlie Treasury's "scoring" of this proposal. Given that issuers would respond to this proposal by continuing to issue debt -- and therefore deduct coupon payments -- we believe it is unlikely that there will be an increase in revenue to the U.S. Treasury resulting from this proposal.

Deny Deductibility on Other Debt Obligations

Treasury has also proposed to deny interest deductibility on obligations with a maturity greater than 20 years, which are not shown as indebtedness on the issuer's balance sheet. This proposal appears to be aimed at eliminating the interest deductibility of innovative new financial instruments, such as Monthly Income Preferred Securities (MIPS) and Trust-Originated Preferred Securities (TOPrS).

Merrill Lynch believes that a careful analysis of these instruments reveals that they possess *all* of the critical attributes of debt listed above. Indeed, Treasury's proposal does not rely on any of these attributes to curtail the interest deductibility of these instruments. Rather, Treasury has focused on the fact that MIPS, TOPrS, and similar products are not typically shown as debt on a company's balance sheet. The reality is, balance-sheet treatment of these instruments has never before been relevant to their tax treatment and whether they are identified as debt obligations for tax purposes.

TOPrS are a case in point. A company utilizing these instruments issues debt obligations to a trust which, in turn, issues trust securities (i.e., TOPrS) to investors. The transaction is structured in this way to improve the attractiveness of the securities to the public. Because these debt obligations are issued through a trust, TOPrS are not shown on the issuers' balance sheet as debt, although the status of the obligations as indebtedness is clearly disclosed in a footnote to the company's balance sheet.

The balance-sheet characterization of TOPrS -- or MIPS -- as a non-debt *liability* does not alter the conclusion that the underlying debt securities possess all the critical attributes of debt. This is clearly illustrated by the facts that:

- Investors in these instruments are the legal owners of an undivided interest in the underlying debt obligations, and they enjoy all the legal rights and economic benefits as if they had purchased the debt obligations directly from the issuer rather than certificates from the trust.
- Issuers of these securities -- despite their ability to extend an interest payment period for up to five years -- have an absolute obligation to pay interest and principal at maturity.

Merrill Lynch firmly believes that MIPS, TOPrS, and similar instruments are debt obligations, not equity, and they should be taxed as such.

Contrary to Treasury's revenue projections, we also believe this proposal will fail to raise revenue. Issuers that are impacted by the proposed legislation will either choose to issue MIPS- or TOPrS-like securities with a maturity of 20 years or less, or they will maintain the 20+ year maturity of the instruments and issue them directly to investors, rather than through a partnership or trust. Either way, Treasury's proposal will ultimately fail to reduce the amount of interest issuers deduct, and it will therefore be unlikely to raise tax revenue.

Conclusion

With regard to both of these Treasury proposals, it is crucial to recognize that no other major industrialized country has adopted such restrictive and arbitrary limitations on interest deductibility. Our global competitors instead look to the rights of a holder of an instrument under corporate law to determine its categorization for tax purposes. If enacted, the Treasury proposal would restrict financial flexibility of U.S. corporations. Ironically, under this proposal, foreign issuers would be allowed to access the U.S. capital markets with instruments (such as long-dated or perpetual debt) far more desirable to both issuers and investors -- exploiting the vacuum created in part by this Treasury proposal.

III. Proposal to Reduce Dividends-Received Deduction and Modify DRD Holding Period

The Treasury Department has proposed to reduce the dividends-received deduction (DRD) from 70% to 50% on inter-company dividends where ownership is less than 20% of outstanding shares, and also to modify the DRD holding period.

It has long been recognized that the "double taxation" of dividends under the U.S. tax system tends to limit saving, investment, and growth in our economy. The DRD was designed to mitigate this multiple taxation, by excluding some dividends from taxation at the corporate level.

Unfortunately, Treasury's proposal to reduce the DRD would significantly undermine this policy. In the process, it would further increase the cost of equity capital and negatively affect capital formation. Indeed, Treasury's proposal would boost the effective tax rate on inter-corporate dividends by 67%. Ultimately, the burden of the resultant triple taxation will be borne by the individual investor at a maximum effective overall tax rate of 67.6%.

From an economic standpoint, Merrill Lynch believes this would have two distinct negative impacts:

- **Dampen Economic Growth**. If the DRD reduction were enacted, issuers would react to the potentially higher cost of capital by: lowering capital expenditures, reducing working capital, moving capital raising and employment offshore, and otherwise slowing investments in future growth. In particular, American banks, which are dependent on the preferred stock market to raise regulatory core capital will see a significant increase in their cost of capital and, hence, may slow their business-loan generation efforts.

- **Limit Competitiveness of U.S. Business**. The reduction in the DRD would also further disadvantage U.S. corporations in raising equity vis-à-vis our foreign competitors, especially in the UK, France, and Germany. In these countries, governments have adopted a single level of corporate taxation as a goal, and inter-corporate dividends are largely or completely tax free. As long as American firms compete in the global economy under the weight of a double- or triple-taxation regime, they will remain at a distinct competitive disadvantage.

Treasury has also proposed a modification of the DRD holding period -- a change which Merrill Lynch believes would impair trading-market liquidity. Currently, investors have to be "at risk" (i.e., unhedged) for 46 days on their equity portfolio securities to qualify for the DRD. Given the volatility of the equity markets, the risk inherent in a 46-day holding period is already significant. The Treasury proposal to have a "rolling" holding period prior to every dividend payment date is unwarranted and will cause disruption for dealers attempting to provide liquidity in the equity markets.

While the overall revenue impact of Treasury's DRD proposal may be positive, Merrill Lynch believes the revenue gains will not be nearly as large as projected, due to anticipated changes in the behavior of preferred-stock issuers and investors.

- **Issuers of Preferred Stock.** Reducing the DRD will increase the cost of preferred-stock financing and cause U.S. corporations to issue debt instead of preferred stock because of interest deductibility. This overall increase in deductible interest would result in a net revenue loss to Treasury.

- **Secondary Market for Preferred Stock.** Currently, the market for outstanding preferred stock is divided into two segments:

  (1) A $15 billion to $20 billion variable-rate preferred stock market where dividends are set via Dutch auctions. The dividend rate on these securities will necessarily increase to adjust for the lower DRD, and may cause some of these issuers to call these preferred securities at par and replace them with debt. This will result in a revenue loss to Treasury.

  (2) A $45 billion to $55 billion fixed-rate preferred stock market where the issuing corporations cannot immediately call the securities. Retail investors, who comprise 80% of this market cannot utilize the DRD and therefore pay full taxes on dividends. Hence, there will be no meaningful revenue gains to Treasury from this market segment.

This Treasury proposal may also create losses for individual investors. Institutions, which own approximately 20% of all fixed-rate preferred stock, may sell their holdings given the increased taxation. In fact, market prices for fixed-rate preferred stock have already dropped in reaction to the announcement of the Treasury proposal. Individual investors will bear the brunt of any price decline, since they currently account for about 80% of the fixed-rate preferred market. These capital losses, when taken, will offset any capital gains and result in revenue loss to Treasury.

At a time when U.S. tax policy should be moving toward fewer instances of "double taxation," Merrill Lynch believes it would be a mistake to reduce the DRD and make "*triple* taxation" even more pronounced in, and burdensome on, our economy.

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May 15, 1996

Mr. Philip D. Mosely
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Mosely:

This letter contains a summary of the position of my client, the National Association of Convenience Store's ("NACS"), covering the revenue provision of the President's 1997 Budget Proposal. NACS has a significant interest in two of the President's revenue proposals: extension of the tax imposed to fund for the Leaking Underground Storage Trust Fund ("LUST") and extension of the Targeted Jobs Tax Credit ("TJTC"). NACS opposes the extension of the LUST fund tax unless the funds collected are spent on enforcement of the 1998 tank upgrade deadline, clean up reimbursements, and program improvements as set forth in H.R. 3391, introduced by Rep. Dan Schaefer (R-CO) on May 2, 1996. NACS supports the extension of the TJTC, which is included in the President's proposals, provided concerns about the credit's effectiveness are addressed.

NACS is a national trade association with over 1700 member companies in all 50 states. These member companies operate approximately 70,000 convenience stores in the United States, employing over 500,000 workers. NACS retail members that operate retail petroleum outlets and have upgraded their tanks to comply with the 1998 deadline have spent approximately $75,000 per outlet on the upgrade, which does not include the cost of remediation of any leaks discovered.

NACS opposes extension of the LUST tax unless the funds will be truly dedicated to the purposes for which they are collected. NACS is concerned that LUST Trust Fund monies will be used to

assist owners of underground tanks to avoid the 1998 deadline for replacement of tanks. Such assistance could take the form of direct loans, low interest loans, or loan guaranties for upgrades after the 1998 deadline.

The 1998 deadline should not be extended for anyone. Owners of underground tanks who went to the expense of upgrading their tanks before the deadline should not be forced to compete with tank owners who did not and are then rewarded with an extension and subsidized replacement. The deadline will have been known for 10 years when it is reached. Anyone who is unable to meet the deadline in 10 years should not be permitted to operate.

NACS would support the extension of the tax if the funds were actually appropriated to the states to (1) supplement tank assurance funds; (2) enforce existing regulatory requirements; and (3) clean up releases beyond the current statutory period. H.R. 3391 would authorize such uses. LUST Trust Fund appropriations dropped to $45 million in 1996 from $70 million in 1995. With approximately $1 billion in trust fund, Congress should appropriate these monies for these purposes.

NACS supports the extension of the TJTC because it benefits workers and it rewards employers who make the extra effort to employ individuals who, for a variety of reasons, would be overlooked. This incentive is good for employees, it is good for employers and it is good for society as a whole. Providing basic work skills to someone who has been "structurally unemployed" is crucial in the long term for the U.S. economy. Furthermore, several studies have shown that the TJTC does, in fact, create jobs. While specific numbers are difficult to pin down, even small growth in job opportunities for low-skilled workers is important in our economy.

Many who qualify for TJTC need that extra help to get access to employment opportunities. To some extent, it is expected that workers with little or no skills will necessarily try a number of jobs until the right match is made. By working in a convenience store, these workers can learn essential job skills that will help them boost their income either within the industry or in other positions where their skills can be utilized. Very basic skills such as coming to work on schedule, personal hygiene, and customer courtesy must be learned. Other skills such as operating a cash register can be transferable as well. In addition, the convenience store industry has a strong history of promotion from within and rewarding good workers with managerial positions.

Critics of the program have often cited the costs associated with TJTC. Yet, the net cost per TJTC certification are significantly lower than the gross tax credit claimed. Three studies have estimated the reductions in transfer payments that result from these hires, along with any additional tax payments to the U.S. Treasury substantially reduces the cost per hire. While long term benefits from job training are harder to quantify, this criticism is a typical example of "penny wise-pound foolish" economics. Furthermore, many NACS members are not using the

credits to reduce their tax liability because of the AMT, which further reduces the cost to the Treasury, while not substantially affecting participation by these companies.

The TJTC program has experienced a rather complicated procedure for reauthorization over the years. Three disruptions in the program have resulted in declining participation levels and some target population penetration rates have suffered as a result of these uncertainties. In addition, the 22-24 age group was an important category for NACS members. Because many convenience stores sell alcoholic beverages, they often must have employees who are at least 21 years old. Restoration of this age group would be helpful to the industry.

NACS recognizes the Administration's concerns with the effectiveness of the program. NACS is looking forward to working the the Administration and the Congress on the permanent extension of the TJTC.

NACS appreciates this opportunity to comment on the President's 1997 Budget Proposals. NACS looks forward to working with the Committee on Ways and Means on these and other tax measures during the coming months.

Sincerely,

J. KEITH AUSBROOK
Counsel to the
National Association of Convenience Stores

Comments
of
The National Association of Independent Insurers
on
Revenue Provisions of the President's 1997 Budget Proposal
to the
House Committee on Ways and Means

April 26, 1996

The National Association of Independent Insurers (NAII) is a trade association representing 565 property and casualty insurance companies domiciled in 46 states and transacting business in all 50 states. The NAII was founded 50 years ago on the principles of open competition and pricing flexibility in the insurance industry. Our members range in size from the very largest national writers to the smallest one state writers. They write over $63 billion in direct premiums for all types of property-casualty insurance, including auto first party personal injury protection, auto liability, workers compensation, general and other liability, and property insurance lines. Among our members are mutual and stock companies, reciprocal exchanges, and Lloyds plan affiliates, as well as excess and surplus lines companies that write on a non-admitted basis. Their marketing strategies range from providing the widest range of insurance products to those specializing in a relatively few product lines. They use virtually every kind of product distribution channel, including independent agents, captive agents and direct marketing. The NAII membership is literally a cross-section of the U.S. property-casualty insurance industry.

On behalf of our members companies we respectfully submit the following comments on the revenue provisions of the President's 1997 budget. At the request of the committee these comments are limited to provisions of the budget proposal which were not included in the Balanced Budget Reconciliation Act of 1995.[1] The NAII is also opposed to several provisions of the 1995 reconciliation bill which are included in the President's budget.

Dividends Received Deduction

Current law provides corporations with a deduction equal to 70 percent of the dividends they receive from corporations in which they own less than 20 percent of the stock by vote and value.[2] The dividends received deduction is designed to mitigate the double and triple taxation on corporate earnings. The President proposes to reduce the dividends received deduction available to 50 percent. NAII strongly opposes such a reduction.

The property-casualty insurance industry invests its assets primarily in bonds and securities. A far higher proportion of the assets of property and casualty insurers are held in these investments than are held by nonfinancial corporations. In 1994, 11.3 percent of the property-casualty industry's $704.6 billion assets were held in marketable securities; $10.8 billion in preferred stocks and $70.3 billion in common stock.[3] Reducing the dividends received deduction would result in a 66.7 percent tax increase on these investments, severely impacting insurers and policyholders.

A reduction in the dividends received deduction raises the effective tax rate on dividends, raising the cost of capital and further disadvantaging U.S. equity investment. Market experts estimate that reducing the deduction from 70 to 50 percent would result in price declines of one and one half to seven percent for preferred stocks.[4] For industries, such as property-casualty insurance, this increased tax expense will significantly depreciate the market value of their portfolios. As a result, property-casualty insurance premiums could likely increase. Alternatively, reduced portfolio values would result in a corresponding decrease in surplus, thus impairing the capacity of the U.S. insurance industry to support existing and new business.

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[1] H.R. 2517
[2] Internal Revenue Code § 243
[3] Best's Aggregates and Averages - Property-Casualty, A.M. Best Company, 1995, p. 2
[4] Flaherty and Crumrine, Inc., Dec. 1995

It can be argued that even the current taxation of dividends is a contentious tax area because it represents a punitive system that taxes the same income multiple times. In addition to its punitive nature, the current system also places U.S. investment at a distinct disadvantage. Many of our trading partners have a 100 percent dividends received deduction, thus providing international competitors with an advantage in raising capital in the U.S. market. The President's proposal would also exacerbate these problems.

Extension of Interest Deduction Disallowance

Current law disallows a deduction for interest on debt incurred or continues to purchase or carry tax-exempt bonds.[5] In general, a deduction is disallowed only when indebtedness is directly related to tax-exempt obligations. Taxpayers may establish the purpose of the interest either by direct or circumstantial evidence. Direct evidence exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when the tax-exempt instruments are used as collateral. In the absence of direct evidence, a deduction is disallowed only when the totality of the facts and circumstances establishes a sufficiently direct relationship between the tax-exempt instruments and the indebtedness.[6] Financial institutions, however, are subject to allocation of their interest expense. Interest deductions for financial institutions are disallowed in the same proportion as the average basis of their tax-exempt obligations bear to the average basis of all their assets.[7]

The President's proposal would extend the financial institutions rule to all taxpayers, except insurance companies and other corporations in the cases of nonsalable tax-exempt debt received from state and local governments in payment for goods and services. NAII opposes extension of the pro-rata interest disallowance to non-financial institution taxpayers and the application of the rule to consolidated groups. If the proposal is adopted we urge the Committee to follow the President's proposal to exempt the insurance industry.

Property-casualty insurers already are penalized by proration, which requires the inclusion of at least a portion of tax-exempt interest in their regular tax base and in their alternative minimum tax base under the adjusted current earnings rule. Extension of the pro-rata disallowance to insurers would eliminate practically any remaining incentive for a property-casualty insurer to invest in tax-exempt bonds. The property-casualty insurance industry currently invests considerable sums in state and local tax-exempt bonds. Although mutually beneficial, these investments represent a positive, socially responsible, investment practice. Extension of the disallowance rules to the insurance industry would severely diminish this valuable source of funding for state and local governments at the very time when Congress seeks to move more responsibilities the state and local level. Further, the application of the rule to consolidated groups is an unfair and punitive treatment of substantially independent entities, especially, insurance entities.

Penalty for Failure to File Correct Information Returns

Businesses are required by law to file an informational report with the Internal Revenue Service for each service provider to whom it makes payments which in aggregate total $600 or more per year.[8] These reports must include the name, address and taxpayer identification number of the service provider, as well as the amount of the payments.

Under current, law taxpayers who fail to timely file correct information returns, such as a Form 1099, are subject to a penalty of up to $50 per return, up to $250,000 during any calendar year. Maximum penalties for companies with average taxable incomes of less than $5 million for the previous three years are reduced to $100,000.[9] President Clinton proposes to increase the penalty for failure to file information returns to the greater of $50 per return or five percent of the amount required to be reported. The yearly maximum penalties would remain the same. In cases where

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[5] Internal Revenue Code § 265
[6] Rev.Proc. 72-18, 1972-1 C.B. 740
[7] Internal Revenue Code § 265
[8] Internal Revenue Code § 6041 and 6041A
[9] Internal Revenue Code § 6723

businesses correctly report in aggregate 97 percent of the aggregate amount required to be reported, the penalty would remain $50 per return. NAII opposes this provision.

The additional reporting requirement will be particularly burdensome and costly for property-casualty insurers. Property-casualty companies make tens of millions of payments each year on behalf of policyholders to third-party service providers, such as auto repair shops, towing services, construction companies, doctors, and hospitals. Typically, the insurer has no role in selecting the service provider or control over the information provided by the third-party. Insurance personnel generally do not contract with the service provider. In fact, some states prohibit insurers from requiring claimants to utilize a specific service provider. The first notice the insurer has of the arrangement is often the receipt of an invoice from the service provider. Such arrangements make it extremely difficult for insurers to obtain timely and accurate taxpayer information. Nevertheless, the President's proposal would punish an insurer for an inaccurate report that occurs through no fault of its own.

The provision would also be particularly onerous for property-casualty insurers who face extensive state requirements to assure timely payment of claims. The Unfair Claim Practice Laws of most states require that insurers attempt in good faith to make prompt payment of insurance claims. Individual states often impose specific payment deadlines, such as California which requires that payments for auto repairs be made within 10 days from the receipt of the invoice.[10] Several states, including Florida, Kentucky and Louisiana , impose penalties or interest on insurers if payments are not made within specified time periods following a proof of loss.[11] Insurance companies face the almost insurmountable task of acquiring information from third-parties with which they often have no contractual arrangement in a very compressed period of time. The President's proposal would unfairly penalize property-casualty insurers for errors which they did not intend and cannot avoid.

Net Operating Loss Carryback

Taxpayers are permitted under current law to carryback a net operating loss (NOL) for three years and carryforward for 15 years.[12] The President proposes to reduce the carryback period for NOLs arising in tax years beginning after 1995 to one year and extend the carryforward period to 20 years. NAII strongly opposes this proposal.

The NOL carryback enables taxpayers to spread the effects of losses and to properly reflect the effects of activities on taxable income. The ability to spread the effects of loss is particularly important for the property-casualty industry. Property-casualty insurers often experience losses which are directly related to activities in prior taxable years. Claims, particularly liability, relating to coverage written and premiums collected in a taxable year are often not paid until several years later. The NOL carryback provision allows property-casualty companies to more accurately reflect income and spread the effect of such losses to profitable years.

In recent years, the property-casualty industry has suffered enormous catastrophic losses. In terms of inflation-adjusted losses, seven of the eight most severe U.S. catastrophes have occurred since 1989. In fact, the industry experienced over $67 billion in catastrophic losses from 1989-1995—more than 50 percent greater than the losses of the entire 1980's.[13] The catastrophic losses of the past seven years represent approximately 30 percent of the industry's collective surplus, and the industry is examining many alternatives to try to deal with this issue. The likelihood of more devastating losses in the future is very real—increasing the potential for significant loss periods. There is a 25 percent chance that the property-casualty industry could experience losses exceeding $10 billion in any given year and a 20 percent chance that single year catastrophic losses could top $50 billion during any ten-year period.[14]

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[10] California Insurance Code § 560

[11] Florida Insurance Code § 627.4265
Kentucky Insurance Code § 304.12-235
Louisiana Insurance Code § 22:658

[12] Internal Revenue Code § 172(b)(1)(A) & (B)

[13] Lighting Candles in the Wind, Conning & Co., Hartford, 1994, p. 29

[14] Catastrophe Risk: A National Analysis of Earthquake, Fire Following Earthquake, and Hurricane Losses to the Insurance Industry, Risk Management Solutions, Inc. and ISO, 1995, p.8

A reduction in the NOL carryback period would hamper the ability of the industry to respond to such disasters by eliminating a significant mechanism for capital restoration. The recovery of taxes previously paid and the ability to spread tax liability to profitable years allow the industry to weather catastrophic losses by providing a needed infusion of capital and spreading of risk. The President's proposal would threaten the capacity of insurers to support existing and new businesses, reduce availability, and drive up the cost of insurance products.

Superfund Excise Tax and Corporate Environmental Income Tax

The Superfund program was created by Congress is 1980 to ensure cleanup of America's most hazardous waste sites. Prior to January 1, 1996, the Superfund Trust Fund was supported by imposition of a 9.7 cent per barrel excise tax on domestic and imported crude and refined products, an excise tax ranging from 22 cents to $4.87 per ton on certain hazardous chemicals, and an excise tax on imported substances which use any of the taxed substances in their manufacture or production.[15] In addition, corporations were subject to a .12 percent tax on the amount of modified alternative taxable income exceeding $1 million.[16] The President proposes to reinstate the three excise taxes effective with enactment of the legislation and to reinstate the corporate environmental income tax for taxable years beginning after December 31, 1995.

In the last 15 years billions of tax dollars have been collected and spent on Superfund cleanup, yet very little progress has been made in ridding the nation of toxic waste. Currently, nearly half of every Superfund dollar goes toward bureaucratic overhead and for legal expenses to settle disputes between the Environmental Protection Agency and Potentially Responsible Parties (PRPs) at a given site, between PRPs and their insurance companies, and between PRPs and others brought into Superfund litigation through third-party lawsuits.

As NAII supports meaningful reform of the Superfund law, we believe extension of the Superfund excise tax and the corporate environmental income tax should be a part of that reform.

NAII, therefore, recommends that these proposals in the President's budget proposal not be adopted.

Respectfully submitted,

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[15] Internal Revenue Code §§ 4611, 4661, 4671
[16] Internal Revenue Code § 59A

Comments of the

National Association of Real Estate Investment Trusts®

to the

Committee on Ways and Means
U.S. House of Representatives

regarding certain

Revenue Provisions in the President's

Fiscal Year 1997 Budget

Submitted by Stanford J. Alexander, NAREIT Chair and
Chairman and Chief Executive Officer, Weingarten Realty Investors

May 15, 1996

As requested in Press Release No. FC-15 (April 15, 1996), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Ways and Means Committee's review of certain revenue provisions presented to the Ways and Means Committee as part of the President's Fiscal Year 1997 Budget. NAREIT's comments will address the Administration's proposal to amend section 1374 of the Internal Revenue Code to treat an "S" election by a large C corporation as a taxable liquidation of that C corporation. We appreciate the opportunity to present these comments.

NAREIT represents over 270 real estate investment trusts (known as "REITs"), over 220 of which trade on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ. In addition, NAREIT represents over 1,600 analysts, investment bankers, lawyers, accountants, and others that provide services related to the REIT industry.

Congress established REITs in 1960 to allow small investors to obtain the diversification and professional management of capital-intensive real estate that beforehand were only available to large, sophisticated investors.[1] The market capitalization of publicly traded REITs has blossomed from under $9 billion at the beginning of 1991 to about $70 billion today, as hundreds of thousands of small investors assisted in the recapitalization of portions of America's premier commercial real estate properties.

This growth in the use of the public equity market as a source of funds for real estate has played a critical role in solidifying the foundation of many quality real estate operating companies, as well as improving the assets of banks, insurance companies and pension plans. It also has resulted in an opportunity for achieving Congress' goal of providing small investors with the opportunity to become owners of those properties along with the best real estate managers in the country.

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[1] Congress ensured that REITs operate in that manner by instituting various ownership tests comparable to those applied in the identification of a personal-holding company. See I.R.C. sections 856(a)(5) and (a)(6).

I. APPLICATION OF SECTION 1374 TO REITs

As the Committee knows, prior to its repeal as part of the Tax Reform Act of 1986, the holding in an old court case named General Utilities permitted a C corporation to elect S corporation or REIT status (or transfer assets to an S corporation or REIT in a carryover basis transaction) without incurring a corporate-level tax. With the repeal of the General Utilities doctrine, such transactions arguably would have been subject to tax but for Congress' enactment of section 1374. Under section 1374, a C corporation making an S corporation election can elect to have the S corporation pay any tax that otherwise would have been due on the "built-in gain" of the C corporation's assets, but only if those assets were sold or otherwise disposed of during a 10-year "recognition period." The application of the tax upon the disposition of the assets, as opposed to the election of S status, worked to distinguish legitimate conversions to S status from those made for purposes of tax avoidance.

In Notice 88-19,1988-1 C.B. 486 (the "Notice"), the Internal Revenue Service (the "IRS") announced that it intended to issue regulations under section 337(d)(1) that in part would address the avoidance of the repeal of General Utilities through the use of REITs and RICs. In addition, the IRS noted that those regulations would permit the REIT to be subject to rules similar to the principles of section 1374. Thus, under regulations that have to yet been issued, C corporations would have the ability to elect REIT status and incur a corporate-level tax only if the REIT sells assets during the "recognition period."

In a release issued February 22, 1996, the Department of the Treasury (the "Treasury Department") announced that it intends to revise Notice 88-19 to conform to the Administration's proposed amendment to limit section 1374 to corporations worth less than $5 million, with an effective date similar to the statutory proposal. This proposal would result in a double layer of tax: once to the shareholders of the C corporation in a deemed liquidation and again to the C corporation itself upon such deemed liquidation.

Because of the Treasury Department's intent to extend the proposed amendment of section 1374 to REITs, the remainder of these comments addresses the proposed amendment as if it applied to both S corporations and REITs.

II. ARGUMENTS IN SUPPORT OF THE CURRENT APPLICATION OF SECTION 1374 TO REITS

As stated above, the Administration's proposed amendment would limit use of the 10-year election to REITs valued at less than $5 million. NAREIT believes that this proposed amendment would contravene Congress' original intent regarding the formation of REITs, would be both inappropriate and unnecessary in light of the statutory requirements governing REITs, would impede the recapitalization of commercial real estate, likely would result in lower tax revenues, and ignores the basic distinction between REITs and partnerships.

A fundamental reason for a continuation of the current rules regarding a C corporation's decision to elect REIT status is that the primary rationale for the creation of REITs was to permit small investors to make investments in real estate without incurring an entity level tax, and thereby placing those persons in a comparable position to larger investors. H.R. Rep. No. 2020, 86th Cong., 2d. Sess. (1960).

By placing a toll charge on a C corporation's REIT election, the proposed amendment would directly contravene this congressional intent, as C corporations with low tax bases in assets (and therefore a potential for a large built-in gains tax) would be practically precluded from making a REIT election. As previously noted, the purpose of

the 10-year election was to continue to allow C corporations to make S corporation and REIT elections when those elections were supported by non-tax business reasons (e.g., access to the public capital markets), while protecting the Treasury from the use of such entities for tax avoidance.

Additionally, REITs, unlike S corporations, have several characteristics that support a continuation of the current section 1374 principles. First, there are statutory requirements that make REITs long-term holders of real estate. The REIT "thirty-percent gross income test"[2] and prohibited transactions tax[3] are direct compliments to the 10-year election mechanism.

Second, while S corporations may have no more than 35 shareholders, a REIT faces no statutory limit on the number of shareholders it may have, are required to have at least 100 shareholders, and in fact some REITs have hundreds of thousands of beneficial shareholders. NAREIT believes that the large number of shareholders in a REIT and management's responsibility to each of those shareholders preclude the use of a REIT as a vehicle to be used primarily in the circumvention of the repeal of General Utilities. Any attempt to benefit a small number of investors in a C corporation through the conversion of that corporation to a REIT is impeded by the REIT widely-held ownership requirements.

In addition, REIT management has a legal and fiduciary responsibility to determine the timing and reasons for the disposition or distribution of the entity's assets with the intention of benefiting all shareholders. Thus, there is no tax avoidance if a REIT sells assets in the first 10 years, but rather only a deferral.

The consequence of this proposal would be to preclude C corporations in the business of managing and operating income-producing real estate from accessing the substantial capital markets infrastructure comprised of investment banking specialists, analysts, and investors that has been established for REITs. In addition, other C corporations that are not primarily in the business of operating commercial real estate would be precluded from recognizing the value of those assets by placing them in a professionally managed REIT. And in both such scenarios, the hundreds of thousands of shareholders owning REIT stock would be denied the opportunity to become owners of quality commercial real estate assets.

Furthermore, the $5 million dollar threshold that would limit the use of the current principles of section 1374 is unreasonable for REITs. While many S corporations are small or engaged in businesses that require minimal capitalization, REITs as owners of commercial real estate have significant capital requirements. As previously mentioned, it was Congress' recognition of the significant capital required to acquire and operate commercial real estate that led to the creation of the REIT as a vehicle for small investors to become owner's of such properties. The capital intensive nature of REIT's makes the $5 million threshold essential meaningless for REITs.

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[2] Section 856(c)(4).
[3] Section 857(b)(6).

It should be noted that this proposed amendment is unlikely to raise any substantial revenue with respect to REITs, and may in fact result in a loss of revenues. Because of the high cost that would be associated with making a REIT election if this amendment were to be enacted, it is unlikely that any C corporations would make the election and incur the associated double level of tax without the benefit of any cash to pay the taxes. In addition, by remaining C corporations, those entities would not be subject to the REIT requirement that they make a taxable distribution of 95% of their income each tax year. While the REIT is a single-level of tax vehicle, it does result in a level of tax on nearly all of the REIT's income each year.

Last but far from least, the Administration justifies its de facto repeal of section 1374 by stating that "[t]he tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its conversion to a partnership." Regardless of whether this stated reason for change is justifiable for S corporations, in any event it should not apply to REITs because of the differences between REITs and partnerships.

Unlike partnerships, REIT cannot (and have never been able) to pass through losses to its investors. Further, REITs can and do pay corporate level income and excise taxes. Simply put, REITs are C corporations. Thus, REITs indirectly are less susceptible to the tax avoidance concerns raised by the 1986 repeal of the General Utilities doctrine.

III. SUMMARY

The 10-year recognition period of section 1374 currently requires a REIT to pay a corporate-level tax on assets acquired from a C corporation with a built-in gain, if those assets are disposed of within a 10-year period. Combined with the statutory requirements that a REIT be a long-term holder of assets and be widely-held, current law assures that the REIT is not a vehicle for tax avoidance. The proposal would frustrate Congress' intent to allow the REIT to permit small investors to benefit from the capital-intensive real estate industry in a tax efficient manner.

Accordingly, NAREIT believes that tax policy considerations are better served if the Administration's section 1374 proposal is not enacted as it applies to REITs. If you would like to discuss this in greater detail, feel free to contact Tony M. Edwards, NAREIT's Vice President and General Counsel, at (202) 785-8717.

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 new revenue provisions in the President's fiscal year 1997 budget.

NCSHA is a national, nonprofit organization created in 1970 to assist its members in advancing the interests of lower income and underserved people through the financing, development, and preservation of affordable housing. NCSHA's members are Housing Finance Agencies (HFAs) with statewide authority. NCSHA members 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 programs: 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.

State HFAs have provided more than 2 million lower income families the help necessary to buy their first home through the MRB program. MRB mortgages typically go to families earning much less and buying homes costing much less than congressionally-imposed 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.

444 North Capitol Street, NW, Suite 438 Washington, DC 20001 (202)624-7710 FAX (202)624-5899

We strongly oppose the President's proposal to extend pro-rata disallowance of tax-exempt interest expense to all corporations. This proposal would repeal the "two percent rule," which provides an essential "safe harbor" to corporations which hold tax-exempt bonds by sparing them the burden of tracing all the cash flows within the corporation.

Denied this safe harbor, many corporations simply will not find it practical to invest at all in municipal bonds, including MRBs and multifamily housing bonds. Reduced demand will increase borrowing costs for municipal bond issuers such as HFAs. The bottom line is that first-time homebuyers and low income renters will pay the difference--or be shut out of the market completely--as higher borrowing costs for HFAs translate into higher interest rates on bond-backed mortgages.

The proposal's chilling effect on corporate investment in municipal bonds was vividly illustrated last winter, when the Federal National Mortgage Association (Fannie Mae), a significant investor in municipal housing bonds, was forced to curtail its investment in MRBs almost immediately after the Administration called for an immediately effective repeal of the two percent rule. Other corporations followed suit. Fannie Mae only returned to the market after Ways and Means Committee Chairman Archer wrote Representative English that he intended to fully resist a two percent rule repeal in any balanced budget agreement.

We urge the Chairman and the members of this Committee to continue their strong stand against the Administration's proposal to repeal the two percent rule.

Sincerely,

Barbara J. Thompson
Director of Policy and
Government Affairs

STATEMENT OF THE NATIONAL MINING ASSOCIATION

TO THE COMMITTEE ON WAYS AND MEANS OF THE

U.S. HOUSE OF REPRESENTATIVES

ON THE ADMINISTRATION'S

FISCAL 1997 TAX PROPOSALS

MAY 15, 1996

The National Mining Association (NMA) appreciates the opportunity to submit this statement for the Committee's record on the President's fiscal 1997 tax package. The NMA is an industry association representing most of the Nation's producers of coal, metals, industrial and agricultural minerals. Our membership also includes equipment manufacturing firms and other providers of goods and services to the mining industry.

Mining employs some 300,000 workers directly and supports 3 million jobs in allied industries. Processed material of mineral origin such as coal, copper, gold, zinc and silver total $360 billion, or about 5 percent of the U.S. gross domestic product. The headquarters of operations of NMA member companies are located in 42 states--represented in Congress by 397 members of the House and 84 Senators. Some form of mining represented by the NMA occurs in all 50 states.

Of primary concern to our industry is the proposal in the Administration's budget to repeal the percentage depletion allowance for minerals mined on lands where mining rights were originally acquired under the Mining Law. Simply stated, we are adamantly opposed to this proposal. It is a major tax increase on companies that have mines located primarily in the western United States. As it is not uncommon for ownership of mineral deposits to change hands, the proposal would especially penalize mining companies who purchased their properties from original claimants or other intermediary mining concerns.

From our perspective, the President's depletion proposal has more to do with mining on public lands in the western states than it does with tax policy. The NMA and its member companies continue to support responsible amendments to the Mining Law, including a reasonable royalty provision. This reform effort has been stymied at every turn by anti-mining groups. Those opposing responsible Mining Law amendment seek changes that would make mining on public lands nearly impossible. The Administration's proposal to increase the tax burden on hardrock mines would appear to be a coordinated effort to accomplish that goal.

Increasing the tax burden on the mining industry is effectively an increase in production costs. Because minerals are commodities traded in the international marketplace at prices determined by world-wide supply and demand factors, mining companies cannot recover higher costs by raising prices. Most mines affected by this proposal will see their tax burden increase by as much as 8 percent to 10 percent.

This tax increase is likely to have the following short- and long-term disruptive effects on the industry:

- Force the early closing of marginally economic mines. Minerals that would otherwise have been economic to extract will remain in the ground and not be recovered, resulting in poor stewardship of our natural resources. Existing jobs, federal, state and local tax revenues will be lost.

- Higher taxes will reduce the ability of companies to make the necessary investment in existing operations to improve production efficiencies and comply with new environmental, health, safety and pollution control laws and regulations.

- Investment in new projects will suffer. This change to long-standing tax policy will adversely affect the economics of new projects. Many new projects will become uneconomic, resulting in lost opportunities for new jobs and tax revenues.

The long-term consequences of tax increases are serious. Without continuous investment in new domestic projects to replace old mines, production in the United States will decline. As the country's demand for mined products continues to grow the short-fall between demand and domestic production will be satisfied by imports of minerals mined by foreign workers. Our exports will be jobs.

The purpose of the depletion allowance is to help foster mining investment. For over 60 years Congress has recognized that because the major asset of a mining company depletes over time a different method of capital recovery is needed. The mining industry is characterized by relative rarity of commercially viable mineral deposits, high economic risks, geologic unknowns, extreme costs and long lead times for developing new mines. For a variety of reasons, even without inflation, the costs of replacing a mineral deposit are generally far greater that the cost of the deposit currently being mined. The depletion allowance is a reasonable and practical method of addressing the unique needs of the extractive industries.

The capital needs of the mining industry are enormous. It is not uncommon to spend in excess of $400 million to bring a domestic world-scale mine into production and to invest a substantial amount on state-of-the-art processing facilities (a new smelter can have capital costs of nearly $1 billion).

The mining industry (and other capital-intensive industries) already pay high effective tax rates through the application of the corporate alternative minimum tax (AMT). The General Accounting Office in a 1995 study reported that the average tax rate for mining under the AMT is 32 percent. As the Ways and Means Committee is well aware, the AMT gives the United States the worst capital cost recovery system in the industrialized world.

The President's proposal will **increase** the tax burden on mining at a time when many noted economists and analysts agree that the tax burden on capital-intensive industries should be **reduced** by reform or outright repeal of the AMT. NMA supported previous efforts of the Committee to accomplish this goal and continues to support substantive reform of the AMT.

The U.S. Department of Labor reports that the mining industry provides some of the highest paying non-supervisory jobs in the United States. The average mining wage in 1994 was $43,653 (not including benefits and overtime pay)--far above the nation-wide average wage of $26,940. We believe that tax policy should foster the creation of more of these high-paying jobs. Unfortunately, the Administration's proposal does just the opposite.

We urge the Committee and the Congress to reject this job-killing tax increase on the mining industry and pass legislation to foster investment and economic growth in mining and other capital intensive industries.

NATIONAL RETAIL FEDERATION

May 15, 1996

The Honorable Bill Archer
Chairman
Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20510

Dear Chairman Archer:

On behalf of the National Retail Federation (NRF), it is my pleasure to respond to your request for comments on revenue provisions in the President's Fiscal Year 1997 Budget. The NRF is the world's largest retail trade association with membership that includes the leading department, specialty, discount, mass merchandise and independent stores, as well as 33 national and 50 state associations. NRF members represent an industry that encompasses over 1.4 million U.S. retail establishments, employs more than 20 million people, 1 in 5 American workers, and registered 1995 sales of $2.3 trillion. There are two provisions in the President's Budget that strike at the heart of retailing and would be very damaging to our job creating industry.

First, and most importantly, the **retail industry is unanimously opposed to repealing the "lower of cost or market" (LCM) inventory accounting method** included in the President's FY 97 Budget. This proposal, unfortunately, is not a new one. It was first proposed as one of the revenue raisers for GATT and has been on the Administration's list ever since.

The LCM method of accounting has been part of our tax laws since 1917 and is consistent with Generally Accepted Accounting Principles (GAAP). This is not a corporate loophole, but a well-established accounting method. Using LCM, the value of inventories that are unsalable at normal prices are reduced to reflect the fact that the market value of the goods has permanently dropped below their cost.

LCM allows retailers to write down the value of their inventories at the time the value of the goods drop -- rather than when the item is eventually sold. Without LCM, the value "on the books" of retail inventory could be significantly overstated compared to the actual value of the goods "on the shelves".

The World's Largest Retail Trade Association
◆
Liberty Place, 325 7th Street NW, Suite 1000
Washington, DC 20004
202.783.7971 Fax: 202.737.2849

Why are the prices reduced? Either because a newer product has been introduced (i.e., computers or software), the goods are damaged or the product was seasonal and has been permanently put on sale (i.e., winter jackets). Once a product's price is *permanently* marked down, retailers are never able to sell the product -- like a rose bush at the end of the summer growing season -- for more.

If LCM were repealed as the Administration has proposed, retailers whose inventory value has been drastically and permanently reduced, would not be able to deduct the lost value until the goods are finally sold or they are determined to be worthless -- which could be months, even years. Therefore, retailers who are suffering because their goods are worth less would also be socked with higher taxes. Many taxpayers, especially smaller retailers, would be forced to keep two sets of books -- one for accounting and the other for taxes. Retailers would also be forced to change the nature of their business. Repealing LCM will push premature bulk sales of inventories from retailers to liquidators and consolidators -- which could cause this provision to actually lose federal revenue. It will also encourage retailers on FIFO (first in first out) to switch to LIFO (last in first out), a deductible expense, reducing or eliminating any projected revenue pick-up.

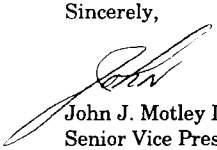
Second, NRF urges the Congress not to distort **the treatment of grace period interest** also included in the President's FY 97 Budget. This provision would require retailers who issue credit cards to pay tax on grace period interest before having a fixed right to the income. The proposal would require credit card issuers to include in taxable income an estimate of the amount of grace period interest that will accrue in the future. This estimate would be based on the credit card issuer's assumptions of the likelihood that its credit card customers will not pay their entire balance before the end of the applicable grace period -- which could be highly inaccurate.

Interest on debt instruments (including credit card receivables) is currently accrued under the historic "all events test" whereby taxpayers pay federal income tax on taxable income determined by reducing fixed and determinable income by fixed and determinable expenses. Accrual method taxpayers are not entitled to deduct estimates of future expense (such as bad debts) which, based on experience, are highly likely to be incurred. Prediction of uncertain future events, which the Administration's proposal advocates, have long been rejected as a basis for tax accounting on both the income and the expense side.

Under no circumstances should either of these two proposed changes be viewed as closing a "loophole" or as eliminating "corporate welfare." On the contrary, adopting these proposals can only be viewed as a tax increase and an arbitrary departure from well established tax policy to raise short-term revenue for the federal coffers at the expense of the retail industry and one in five American workers.

Thank you for your careful consideration of these important issues for retailers. We look forward to working with you.

Sincerely,



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Sheila C. Bair
Senior Vice President
Government Relations

NYSE
New York
Stock Exchange, Inc.

May 6, 1996

The Honorable Bill Archer
Chairman
Ways & Means Committee
U.S. House of Representatives
1236 Longworth House Office Bldg.
Washington, D.C. 20515-4307

The Honorable William V. Roth, Jr.
Chairman
Senate Finance Committee
U.S. Senate
104 Hart Senate Office Bldg.
Washington, D.C. 20510-0801

The Honorable Sam M. Gibbons
U.S. House of Representatives
2204 Rayburn House Office Bldg.
Washington, D.C. 20515-0911

The Honorable Daniel P. Moynihan
U.S. Senate
464 Russell Senate Office Bldg.
Washington, D.C. 20510-3201

Gentlemen:

I am writing to express The New York Stock Exchange's (NYSE) strong views on two proposals included in Title IX of the Administration's Fiscal Year 1997 Budget Proposals, released March 19, 1996.

Average Cost Basis Proposal

The NYSE is strongly opposed to the proposal that would require the use of an average cost basis for purposes of determining gain or loss on the sale or other disposition of securities. The average cost basis proposal would reduce the after-tax return on an investment in securities, discouraging new investment, inhibiting job growth and impeding economic expansion. Moreover, the transition to using average cost basis would result in downward pressure on securities markets as investors accelerate sales of securities prior to the effective date of the proposal.

Under current law, investors may specifically identify securities to be sold. Investors who do not specifically identify securities to be sold must use the first-in-first-out method of accounting to determine the adjusted basis. Under the average cost basis proposal, investors would be required to determine gain or loss on the sale or other disposition of securities using an average cost basis of all substantially identical securities held at the time of disposition. If investors sell less than all of the substantially identical securities, the investors would be treated as having disposed of the securities first acquired for purposes of determining the holding period of the securities sold and of the remaining securities.

The average cost basis proposal effectively increases the capital gains tax by accelerating gain recognition in the case of a sale of less than all of an investor's substantially identical securities having different adjusted bases. This is

contrary to the Administration's stated goals of increasing savings[1] and promoting economic growth[2]. Continued economic expansion and the resulting creation of jobs depends in part on the availability of low-cost capital. By reducing the after-tax return on investments in securities, the average cost basis proposal would tend to discourage savings and increase the cost of capital, thus limiting new investment in plants, equipment and technology. In addition, to the extent investors continue to hold existing securities to avoid the increased tax exposure created by this proposal, the average cost basis proposal restricts the efficient flow of capital to its highest and best use, which also will inhibit economic growth. Moreover, we note that middle-income investors will be hardest hit by this proposal because it is these investors who will not be able to avoid selling securities in order to pay for certain expenses, such as college tuition.

Because the average cost basis proposal increases the tax burden on capital gains, it is likely that investors will accelerate sales of securities after enactment of the proposal and before its effective date. In its current form, the average cost basis proposal would apply to sales of securities beginning 30 days after the date of its enactment. We believe that this effective date provision could create substantial downward pressure on securities markets.

In light of the foregoing, we strongly encourage you not to include provisions such as those embodied in the average cost basis proposal in any budget or tax legislation. In the event you decide to include the average cost basis proposal or similar measures -- and the NYSE strongly urges that you do not -- to reduce the downward pressure on securities markets, we ask that the average cost basis proposal apply only to securities acquired on or after the date of enactment.

Constructive Sale Proposal

The NYSE is concerned about the proposal that would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of an appreciated position in either stock, a debt instrument or a partnership interest. This provision is overly broad and would not only address abusive transactions but also would discourage legitimate risk management transactions.

We applaud the Administration's desire to combat abusive transactions such as those which are structured to permit a taxpayer to avoid permanently the realization of capital gains on an appreciated stock or debt instrument position in order to permit a stepped-up basis on the taxpayer's death. However, many legitimate risk management transactions also would be covered by the

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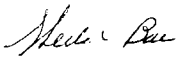
[1]*See, e.g.*, Letter from Robert E. Rubin to Rep. Michael N. Castle, 96 TNT 57-66, March 13, 1996, *available in* LEXIS, Fedtax Library, TNT File (stating that the President's Fiscal Year 1997 Budget, submitted February 5, 1996, balances the budget with sufficient savings for modest tax cuts that, among other things, will spur long-term savings).

[2]President Clinton's Fiscal Year 1997 Supplemental Budget Message (Budget Supplement Chapter 12: Promoting Tax Fairness) (legislative proposal), 96 TNT 56-42, March 19, 1996, *available in* LEXIS, Fedtax Library, TNT Files (stating the budget proposes tax reforms that "encourage activities that foster economic growth"); Administration's News Conference Presenting the Administration's Fiscal Year 1997 Budget Proposal, 1996 FDCH Political Transcripts, March 19, 1996, *available in* LEXIS, Nexis Library, CURNWS File (President Clinton stating "our nation must change course and once again provide growth and opportunity for the American people" and emphasizing the Administration's commitment to job creation, low inflation and productivity).

Administration's constructive sale proposal. We believe that it is counterproductive to attack a relatively few abusive transactions with a proposal so broad that it would prevent a large number of taxpayers from entering into prudent, short-term (for example, transactions of nine months or less) risk management transactions.

In light of the foregoing, we urge that any provision relating to constructive sales in any budget or tax legislation be narrowly drawn so as to capture only abusive transactions while not encompassing legitimate, short-term hedging transactions.

Sincerely yours,



Sheila C. Bair

MAYER, BROWN & PLATT

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202-778-0604

May 13, 1996

Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, D.C. 20515

Re: President's Proposal To Tax S Corporation Conversions and Need for S Corporation Reform

Dear Phil:

These comments are submitted in response to the Chairman's April 15 request for public comments on the Clinton Administration's proposal to impose income tax upon certain S corporation conversions.

In summary, the proposal should be rejected. It is inconsistent with sound realization principles of current law and policy and it would further complicate the tax law. Moreover, it is inconsistent with much-needed S corporation reform and simplification which should be promptly enacted.

Current Law

Under current law, an S corporation election is not a taxable event. Under section 1374, however, the net built-in gain on appreciated assets of a C corporation that makes an S corporation election is taxed at the highest corporate rate if the electing corporation sells such assets within ten years of the election. Such gain, net of the corporation's tax, is also taxed at the shareholder level. If the S corporation holds the appreciated assets for continued use in its trade or business, no tax is imposed on the built-in gain.

The Clinton Proposal

The Clinton Administration has proposed to tax both corporations and shareholders on the built-in gain on appreciated assets at the time of an S corporation election, if the electing C corporation is valued at more than $5 million. A conversion, whether by a C corporation electing S corporation status or by a C corporation merging into an S corporation, would be treated as a liquidation of the C corporation followed by a contribution of the assets to a S corporation by the recipient shareholders. Thus, the proposal would require immediate gain recognition by both the corporation (with respect to its appreciated assets) and its shareholders (with respect to their stock) upon the conversion to S corporation status.

The Proposal Is Inconsistent with Basic Realization Principles

The proposal is inconsistent with the long-standing realization requirement. Gain or loss generally is not taxable unless a taxpayer sells or disposes of assets, for two important reasons.

First, if an event is deemed taxable but produces no liquid assets with which to pay the tax, the imposition of the tax presents both an undue hardship upon the taxpayer and encourages or requires the diversion of other productive assets to pay the tax.

Second, the imposition of the income tax upon the mere adapting of an ongoing business would discourage productivity. This principle is reflected in the various non-recognition provisions of the income tax law, including the reorganization provisions and current section 1374.

For precisely these reasons, an S corporation election is not a realization event. Because no asset is sold, no cash with which to pay either the corporate or individual tax is generated. In addition, the capital and assets of the C corporation would continue to be utilized in the same business; there is no shifting or transfer of assets in any meaningful economic sense. Thus, the proposal contradicts the established and fundamental principle that the income tax is imposed upon dispositions, not upon mere appreciation.

The Proposal Would Further Complicate the Tax Law

Enactment of the proposal would complicate existing law by requiring valuations of the electing (non-publicly traded) corporation and of its appreciated assets. These valuations are expensive, time-consuming and generate litigation.

The Proposal Is Inconsistent with the Much Needed S Corporation Reforms in the Balanced Budget Act

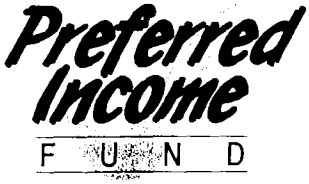
In addition to its inconsistency with the underlying principles of the income tax law, the proposal contradicts the general tax policy reflected in the Balanced Budget Act.

Enactment of the President's proposal would impose confiscatory corporate and shareholder level tax upon an S corporation election, regardless of whether the appreciated assets continue to be used by the S corporation in its business. This undoubtedly would have a chilling effect on S corporation elections.

The Balanced Budget Act included over one dozen non-controversial proposals to simplify and encourage the use of S corporations. They should be adopted without further delay. Enactment of the President's proposal would substantially contradict and undermine the Balanced Budget Act's policy of facilitating S corporations. Moreover, the proposal also undercuts the pro-investment and capital formation policies of the Balanced Budget Act. It should be rejected.

Accordingly, the Committee should reject the President's proposal and approve the much need S Corporation reform and simplification.

Sincerely,



May 14, 1996

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 Mr. Moseley: In re: Request dated 4-15-96 for written comments on new revenue provisions in President's fiscal year 1997 budget

On behalf of over 30,000 shareholders of the Preferred Income Fund and its two "sister funds", the Preferred Income Opportunity Fund and the Preferred Income Management Fund, we want to express our strong opposition to the **proposed reduction in the Intercorporate Dividends Received Deduction ("DRD") from 70% to 50%** contained in the fiscal 1997 budget recently submitted by the Administration.

These three funds, which I shall refer to collectively as the "Funds", are closed-end investment companies listed on the New York Stock Exchange with total assets of approximately $625 million. Their portfolios are invested almost exclusively in traditional preferred stocks that qualify for the Dividends Received Deduction.

The holders of the Funds' common stocks are primarily small individual investors, ordinary people seeking secure income for themselves and their IRAs. They include relatively few corporate investors who are able to take advantage of the DRD. The Funds have also issued a total of $205 million of auction rate preferred stocks, ranking senior to their common shares, which are typically held by taxpaying domestic corporations.

If the effective tax rate on dividends were increased as proposed, the holders of the Funds' common stock would suffer both an increase in the cost of the senior capital raised by the Funds in the auction rate preferred market and significant depreciation in the market value of the Funds' portfolios. In response to the announcement, in December 1995, of the proposed reduction in the DRD, the cost of issuing auction rate preferred stock increased by roughly 3/8%. In addition, the market prices of the Funds' common stocks declined by 5%-6% in the week following the announcement, an aggregate loss of market value of about $20 million for the holders of the Funds' common stock.

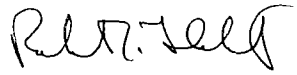
The proposed reduction in the DRD reflects a basic misconception about the structure of the preferred stock market. As covered in a separate comment letter being submitted by Flaherty & Crumrine, Incorporated, the Funds' investment adviser, it is unlikely that the change would produce significant additional revenue for the Treasury because of its impact on yield relationships in the market. Moreover, the Administration's proposal appears to be preoccupied with corporate recipients of dividends. Our Funds are only one example of the large role that individual investors now play in the preferred stock market.

PREFERRED INCOME FUND INC., 301 E. COLORADO BLVD., SUITE 720, PASADENA, CA 91101 (818) 795-7300

May 14, 1996

We strongly urge that the reduction in the Intercorporate Dividends Received Deduction be rejected as an ineffective attempt at raising corporate tax revenue that would inflict unwarranted damage upon all investors in preferred stocks, corporate and individual alike. A change in fundamental tax policy such as this should not be made without thorough consideration of its pervasive impact on the capital markets in the United States.

Very truly yours,



Robert T. Flaherty,
Chairman of The Board and CEO
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Statement of the Public Securities Association

to the Committee on Ways and Means U.S. House of Representatives

on Tax Proposals in the President's 1997 Budget

May 15, 1996

The Public Securities Association (PSA) appreciates the opportunity to present our views on certain tax provisions contained in the president's fiscal year 1997 (FY 97) budget proposal. PSA is the bond market trade association, representing securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. Although we have commented before the Ways and Means Committee on numerous occasions in the past, we have only recently begun focusing on issues related to the corporate bond market and capital financing for corporations.

PSA strongly supports a balanced budget. We believe that balancing the federal budget would engender greater capital investment and economic growth. We are pleased and encouraged that the budget debate has progressed so far over the past 17 months. Both the Congressional leadership and the administration now support a balanced federal budget by 2002. Differences remain over the details related to achieving balance, but significant progress has been made, and we remain hopeful that an agreement will eventually be reached.

Although we are encouraged that the administration has proposed a balanced budget, we are firmly opposed to several tax provisions contained in the proposal. If enacted, these tax proposals would discourage capital formation and would make it more expensive for state and local governments and corporations to finance new investment. PSA believes that capital investment, both public and private, is a fundamental component of higher economic productivity and, ultimately, of improved living standards for all Americans. It is vital to our continued competitiveness in the world economy. Indeed, one of the most important benefits of balancing the federal budget would be higher savings rates brought about by less government borrowing and lower interest rates, which would foster more capital investment. We believe that our tax system should encourage and support savings and investment. Unfortunately, many of the tax provisions in the administration's budget would do just the opposite. It is ironic that the administration would propose legislation that is designed to balance the federal budget, thereby lowering interest rates and fostering investment, and at the same time propose tax changes that would make it more difficult for state and local governments and corporations to finance such investment.

This statement focuses principally on four of the tax proposals contained in the administration's budget: 1) extending *pro rata* disallowance of tax-exempt interest expense to all corporations; 2) denying interest deductions on certain debt instruments; 3) deferring original issue discount deductions on convertible debt; and 4) reducing the dividends-received deduction to 50 percent. Together, these proposals represent an attack on capital formation and new investment, and we urge their defeat.

PSA is deeply troubled by the characterization of these proposals as "corporate loophole closers" and as the "elimination of unwarranted benefits." We take particular issue with Treasury's description of its proposals as ways to curb "abusive transactions." These tax proposals represent fundamental departures from long-standing tax policy related to corporate interest expense deductions and the multiple taxation of corporate earnings. The only way that provisions in current law affected by the administration's proposals could be considered "loopholes" is if permitting corporations to keep their income after being taxed only once or twice were a loophole. In that vein, in addition to discussing the specific proposals described above, our statement will also address some overriding

policy considerations related to the taxation of financial instruments, multiple taxation of investment income, and the distinction for tax purposes between corporate debt and equity.

When the administration's tax provisions were first proposed on December 7, 1995, many were offered with an immediate effective date. As the balanced budget negotiations between Congress and the administration proceeded in late 1995 and early 1996, there was considerable uncertainty and confusion regarding whether financing transactions which would be affected by the proposals would be subject to the December 7 effective date if the proposals were enacted into law with a balanced budget bill. Although the administration attempted to address this uncertainty with a series of statements related to the effective dates of the proposals, the statements applied to only a very limited number of pending transactions. The uncertainty created by the existence of tax proposals with a retroactive effective date essentially shut down the market for certain financial instruments. Corporations that had been planning to issue securities to finance new investment had either to employ alternative and costly financing mechanisms or to simply put off their investment until the issue of effective dates was resolved.

The March 29, 1996 joint statement by House Ways and Means Committee Chairman Bill Archer and Senate Finance Committee Chairman Bill Roth on the future effective dates of the pending proposals put to rest the market's concerns over when the administration's tax proposals would be applied if they are ever enacted. The statement by Chairmen Archer and Roth has permitted market participants to continue to raise capital in the most cost-effective way to finance new investment. We are grateful to the two Chairmen for their efforts in this regard.

Since the administration first offered the above tax proposals late last year, many individuals and groups, including numerous members of Congress, have expressed vocal opposition to their enactment. The complete list of individuals and organizations opposing the administration's proposals is much too lengthy for inclusion in this statement. However, several communications by members of Congress are noteworthy. We are aware of the following statements of opposition to the administration's proposals by members of the House of Representatives and Senate, both Republicans and Democrats:

- Letter from 35 Senators to Treasury Secretary Rubin opposing the administration's *pro rata* disallowance proposal, March 6, 1996
- Letter from Ways and Means Committee Chairman Bill Archer (R-TX) opposing the *pro rata* disallowance proposal, January 19, 1996
- Letter from Ways and Means Committee Chairman Bill Archer (R-TX) to President Clinton opposing certain administration tax proposals, December 11, 1995
- Letter from 13 Republican members of the Ways and Means Committee opposing the *pro rata* disallowance proposal, December 15, 1995
- Letter from 21 freshman Republican House members opposing the administration's corporate tax proposals, December 20, 1995
- Bipartisan letter from 16 members of the Ways and Means Committee opposing the *pro rata* disallowance proposal, December 22, 1995
- Letter from Sen. Patrick Moynihan (D-NY) to Treasury Secretary Rubin opposing the *pro rata* disallowance proposal, March 6, 1996
- Letter from Sen. Alfonse D'Amato (R-NY) to Sen. Robert Dole (R-KS) opposing the administration's corporate tax proposals, December 20, 1995
- Letter from Sen. Kay Bailey Hutchison (R-TX) to Treasury Secretary Rubin opposing the *pro rata* disallowance proposal, April 4, 1996
- Letter from Rep. Phil English (R-PA) opposing the administration's corporate tax proposals, February 27, 1996
- Letter from Rep. Kenneth Bentsen, Jr. (D-TX) opposing the *pro rata* disallowance proposal, January 10, 1996

Municipal Finance Proposal

Extend pro rata disallowance of tax-exempt interest expense to all corporations

Under current law, investors, including corporations, are not permitted to deduct the interest expense associated with borrowing to finance purchases of tax-exempt securities. Financial institutions that earn non-qualified tax-exempt interest are automatically disallowed a portion of their interest expense deduction in proportion to the ratio of municipal bond holdings to total assets. Non-bank corporations that earn tax-exempt interest, in order to avoid a loss of interest-expense deduction, must demonstrate that they did not borrow to finance their purchases. Under an IRS procedure in place since 1972, as long as a corporation's tax-exempt bond portfolio does not exceed two percent of its total assets, the IRS does not attempt to determine whether the corporation borrowed to finance its municipal bond holdings. This is the so-called "two-percent *de minimis* rule." The administration's proposal would effectively repeal this "safe harbor" and automatically deny corporations that earn tax-exempt interest a *pro rata* portion of their interest expense deduction.

The administration's proposal would raise the costs of borrowing for state and local governments, and would make it more expensive to finance new investment. The Treasury Department argues that the proposal would not significantly affect municipal borrowing rates. In an April 23, 1996 letter to 35 Senators who actively oppose the administration's proposal, Treasury Secretary Rubin argues that "eliminating the 2 percent *de minimis* rule will not materially affect the costs of borrowing for State and local governments" because non-financial corporations hold only about 5 percent of outstanding tax-exempt bonds. In other words, the administration argues, the departure of non-financial corporations will at worst have only a minimal influence on total municipal market conditions. While it is true that non-financial corporations account for a small percentage of total municipal securities outstanding, the administration's argument fails to recognize the absolutely vital role they play in three important market segments: short-term municipal notes, state and local government housing and student loan bonds, and municipal leasing transactions. The effects of the administration's proposal would be most felt by state and local governments in these three areas.

Short-term municipal note market

State and local governments issue short-term securities to finance a variety of programs and services. The most common use of short-term financing is to fund mismatches between revenues and expenditures. States and localities may incur expenditures before they receive tax and other revenues. Through short-term borrowing, state and local governments can finance temporary cash-flow shortfalls. States and localities also issue longer term bonds that are designed to behave like short-term instruments in order to appeal to certain investors and to take advantage of prevailing market conditions. These longer term "variable rate demand notes" (VRDNs) are issued to finance a variety of public investment projects.

Non-financial corporations are major purchasers of short-term municipal notes and VRDNs. Corporations buy short-term municipals as a cash management vehicle. In doing so, corporations finance their municipal investments from surplus cash and working capital accounts, not from the proceeds of borrowing. Corporate investment in the municipal market is almost never tied to corporate borrowing in any way. By participating actively in the short-term market, corporations help to keep municipal borrowing rates incredibly stable. Currently, short-term municipal borrowing rates are approximately 65.5 percent of comparable taxable rates. This ratio has remained virtually constant in recent years, due largely to participation in this market by corporations. Indeed, during rare occasions when corporations as a group for cyclical reasons reduce their investment in the municipal market, short-term municipal borrowing rates suffer, sometimes rising as much as a percentage point for short periods of time. The ratio of longer term municipal borrowing rates to taxable rates is much more volatile, ranging in recent years from 75 to 90 percent, since corporations do not actively participate in the market for longer dated municipal bonds. The administration's proposal would effectively discourage virtually all corporate investment in the municipal market. In doing so, the proposal would significantly raise the cost of short-term borrowing for state and local governments and would make short-term municipal rates more volatile relative to taxable rates.

The administration argues that current rules related to the deduction of interest expense permit inappropriate manipulation of tax liability by non-financial corporations. In his April 23 letter, Secretary

Rubin alleges that the law as presently written is used by non-financial corporate taxpayers "to extend the benefits of exempt interest income to debt-financed holdings." Implicit in the administration's argument is the assumption that corporations have deliberately engaged in arbitrage practices by borrowing in the short-term market and investing in tax-exempt obligations. Actually, there is no evidence to suggest that corporations are engaging in abusive, arbitrage-motivated transactions. Holdings of municipal bonds have averaged only 0.47 percent of the financial assets and 0.15 percent of the total assets of non-financial corporations since 1987,[1] a level that has remained fairly consistent. Moreover, given that the top corporate income tax rate is 35 percent and the short-term tax-exempt/taxable yield ratio hovers around 65.5 percent, the level of after-tax return available to corporations in the municipal market simply does not justify arbitrage transactions.

Also in his April 23 letter, Secretary Rubin explains that the benefits of the two-percent *de minimis* rule "are not available, nor should they be, to banks, securities brokers and dealers, or insurance companies. Eliminating the *de minimis* rule . . . will result in all corporations being treated in a more even-handed manner." In reality, the proposal would result in grossly unfair treatment for a large number of corporations which, under current law, may legitimately invest in the tax-exempt bond market by clearly showing they did not borrow to do so. It would do this through a provision that would extend the *pro rata* disallowance of interest expense on a combined basis to "affiliated companies" that file consolidated returns and by eliminating the present-law analysis of the intent of the corporation.

Assume, for example, that a corporate subsidiary invests in municipal securities and that the subsidiary carries no debt, incurs no interest expense, and can therefore conclusively demonstrate that it did not borrow to finance its municipal bond holdings. Assume also that a second corporate subsidiary incurs interest expense but does not invest in municipal securities, and that the two subsidiaries are "affiliated" and file a consolidated tax return. Under the administration's proposal, the consolidated corporation would be disallowed a portion of its interest expense deduction even though it could prove conclusively that the first subsidiary did not borrow to finance its investment in tax-exempt securities.

The above example is similar to a situation that exists currently. Traveler's check and money order companies, due to state regulatory constraints on their investments, invest considerable sums in tax-exempt securities, although they carry no debt and incur no interest expense. Under the administration's proposal, to the extent that these corporations file consolidated returns with affiliated companies that do incur interest expense, they would be discouraged from investing in state and local bonds. The proposal would effectively discourage all corporate investment in the municipal bond market, regardless of whether corporations do, indeed, engage in unwanted arbitrage transactions.

The proposal would explicitly exempt insurance companies from the affiliated companies provision. When it was first announced in December 1995, there was considerable concern among municipal market participants that the proposal would apply to property and casualty insurance companies, which are major investors in the municipal market. Early this year, when the administration released proposed legislative langage for its proposal, it became clear that insurance companies would be largely exempt from the provision's potential effects. If it had been structured to apply to property and casualty insurers, the proposal would have had truly catastrophic effects on municipal bond issuers. As it is, municipal financing costs would rise substantially under the provision. Nevertheless, we are pleased that insurance companies have been "carved out" of the proposal.

Non-financial corporations currently purchase a substantial portion of newly issued short-term state and local securities. They are, in effect, buyers of last resort that prevent excessive interest rate volatility. This becomes evident at certain times of the year, such as the weeks preceding federal tax payment due dates, when tax-exempt money-market funds, the only other major source of demand for short-term state and local securities, tend to sell large blocks of securities to meet shareholder redemptions. Short-term tax-exempt interest rates tend to rise, inducing corporations that have excess cash available to purchase the municipal paper being sold. Thus, corporations are a major force in helping to keep short-term tax-exempt rates stable. In their absence, short-term tax-exempt rates may have to rise in times when other short-term investors are net sellers. Non-financial corporations would not be major buyers of short-term municipals in the future under the proposal, with the result being higher, more volatile state and local borrowing rates.

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[1] Source: Federal Reserve Board.

The proposal would also affect rates on shorter term, interest-bearing municipal bonds with maturities of, for example, two to five years, so called "short serial" bonds. Short serial bonds are issued to finance a wide variety of public facilities and projects. Even though corporations are not major investors in this segment of the market, yields on these instruments are closely related to yields in the municipal note market. As rates on municipal notes rose, so would rates on short serial bonds, albeit to a lesser degree. The proposal would also significantly affect the municipal swaps market. State and local governments regularly enter into swap contracts as a way to manage their liabilities and reduce their costs of financing. The proliferation of municipal swaps over the past several years has improved the efficiency of the municipal bond market. Many municipal swaps are tied to an index of short-term municipal borrowing rates, the PSA Municipal Swap Index. If the administration's proposal were enacted, short-term municipal borrowing rates would be higher and more volatile. This would make it less efficient and more expensive for states and localities to use swap contracts to reduce their borrowing costs.

Municipal leasing transactions

The proposal would also have profound effects on municipal leasing. States and localities routinely lease assets and equipment, such as school buses, police cars, and computers. If the administration's proposal were adopted, equipment lessors estimate that their cost of financing for state and local governments would increase dramatically. After originating municipal lease transactions, most lessors generally sell their financing contracts to private funding sources to generate the capital they need to continue to operate their business. Those who invest in tax-exempt leasing include corporations, commercial banks and investment banks. Individuals and mutual funds, through certificates of participation, also purchase tax-exempt leases. Although the administration's proposal would not apply "to certain nonsalable tax-exempt bonds acquired by a corporation in the ordinary course of business in payment for goods and services sold to a state or local government," this intended relief is illusory. The vast majority of equipment manufacturers who sell to state and local governments prefer not to hold municipal leases because they do not want to tie up their capital. These companies generally sell their financing contracts to third party investors.

Even where a manufacturer owns a captive finance company, the manufacturer's exemption is lost when the lease is sold to the finance subsidiary. Even in the limited cases where a manufacturer may wish to retain a leasing obligation on its books, the ability to sell the asset in the future if necessary — the liquidity of the municipal leasing market if the vendor were to sell the obligation — serves to reduce lease financing costs for states and localities. The administration's proposal would discourage vendor financing of capital equipment leased to states and localities. As a direct result, the cost of new capital investment by state and local governments would rise substantially.

Housing and student loan bonds

The housing and student loan sectors of the municipal market would also be negatively affected by the administration's proposal. State and local governments issue bonds to finance home mortgage loans for low- and moderate-income families as well as loans for low-income multi-family rental projects. Both these programs provide limited, targeted, below-market financing for housing. Over the past several decades, state and local housing bonds have provided tens of billions of dollars in rental housing for low-income families and have made home ownership available to families who may not have been able to finance a home through any other source. Student loan bonds are issued to finance below-market loans to college students who may not otherwise be able to obtain tuition financing.

Together, Fannie Mae, Freddie Mac, Sallie Mae and other government-sponsored corporations and agencies hold about $8.6 billion of outstanding municipals. These entities invest primarily in state and local housing bonds (Fannie Mae and Freddie Mac) and student loan bonds (Sallie Mae). Under the administration's proposal, these organizations would simply stop buying municipals. State and local housing and student loan agencies would become almost completely dependent on individual investors, acting directly or through mutual funds. Individuals tend to be more volatile and less consistent sources of demand. Higher financing costs in these sectors ultimately mean less financing of low- and moderate-income single family and multi-family housing and less student loan financing.

The loss of virtually all non-financial corporate demand in the municipal market would inevitably cause borrowing rates to rise for states and localities throughout the country. Since they would be captive to individual investor sentiment and fund flows, municipal rates would become much more volatile and would remain substantially higher than under current law. Specifically, short-term rates

would be more volatile, particularly when, for seasonal reasons, individuals are net sellers of municipals. Housing and student loan bond rates would tend to increase.

The administration's proposal would effectively represent a tax imposed by the federal government on state and local governments in the form of higher borrowing rates. Corporate investors in the municipal market would pass on to state and local bond issuers 100 percent of the costs imposed by the proposal. Industry analysts have estimated that increases in state and local financing costs in certain market sectors could range from 20 to 75 basis points. Increases in lease financing costs could be even higher. The proposal is short-sighted and counter-productive, and we urge its rejection.

Corporate Finance Proposals

The characterization of debt and equity

Three of the administration's proposals relate to the taxation of financing instruments issued by corporations. The proposals reflect a fundamentally new approach to the characterization for tax purposes of corporate debt and equity, an approach which is a radical departure from accepted tax policy and which would entail negative consequences for corporate investment in capital assets. Indeed, the administration's proposals represent a significant departure from existing Internal Revenue Service (IRS) rules and practices regarding the classification of debt and equity. Currently, in distinguishing between the two, the IRS considers the following eight factors[2]:

- whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- whether holders of the instruments possess the right to enforce the payment of principal and interest;
- whether the rights of the holders of the instruments are subordinate to rights of general creditors;
- whether the instruments give the holders the right to participate in the management of the issuer;
- whether the issuer is thinly capitalized;
- whether there is identity between holders of the instruments and stockholders of the issuer;
- the label placed upon the instruments by the parties; and
- whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.

According to the IRS, "no particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account."

The existing guidelines leave unanswered questions regarding the tax status of particular financial instruments and products. Even more important, the guidelines fail to recognize some fundamental differences in the nature of the income derived from debt and equity instruments and place undue emphasis on accounting factors in distinguishing between the two. PSA believes that there are several general, guiding principles that should apply in defining debt and equity for tax purposes. Before addressing the administration's proposals specifically, a discussion of these principles would be useful.

Single taxation of corporate earnings

The problem of double and triple taxation is a fundamental concern for PSA under prevailing tax law. Under current law, corporations generally may deduct interest payments to creditors, but may not deduct dividend payments to equity investors. Because interest payments are deductible and dividend payments are not, current law favors debt over equity as a means of corporate finance, not from any justifiable policy consideration, but simply as a historical anomaly. Make no mistake: tax considerations play a role in a corporation's choice of financing mechanism.

Because corporate equity is not afforded the same tax treatment as debt, corporations' earnings are often taxed multiple times. If a corporation holds stock in another corporation, it is taxed on the dividends paid on that stock to the extent that the dividends do not qualify for the dividends received

[2] Internal Revenue Service, Notice 94-47.

deduction (DRD). It is also, of course, taxed on its earnings from all other sources. If the corporation pays dividends to a tax-paying investor, that investor pays taxes on the dividends. To the extent that accumulated, unpaid earnings are represented in the appreciated price of a stock, those earnings are taxed as capital gains when shares are sold by a taxable investor. If the stock is part of an estate, the holdings are taxed when the estate is distributed. The effect of these multiple levels of taxation is to raise financing costs for corporations, reducing incentives for capital formation, and creating serious concerns about global competitiveness.

Ultimately, the solution to the problem of multiple taxation of corporate earnings — short of moving to an entirely new system of taxation, such as a consumption tax — is to integrate fully the corporate and individual tax systems. Many of the proposals for corporate tax integration which have been circulated in recent years suggest either abolishing the corporate income tax altogether and taxing all corporate earnings at the level of investors, or exempting investment earnings from taxation at the individual level and fully subjecting all corporate earnings, whether paid as interest or dividends, to the corporate income tax.[3] PSA would fully support further study and consideration of the issue of corporate tax integration with the goal of amending the federal tax code to ensure that corporate earnings are not taxed more than once. Ultimately, we would favor a tax system without arbitrary distinctions between debt and equity and where financing decisions were made solely on the basis of the lowest cost source of capital. Short of fully integrating the individual and corporate tax systems, however, we firmly believe that in cases where a reasonable question exists as to the characterization of an instrument as debt or equity, tax law should favor treatment as debt so as to minimize the problem of multiple taxation.

The nature of equity investment

Equity and debt investments are fundamentally different in an important sense. An investor buys an equity instrument as a way to participate directly in the long-term growth of the issuing corporation. Such is the case with common stock. Debt investments do not afford this benefit to holders. In buying a debt instrument, an investor is purchasing an income stream or interest accrual, not a participation in the success or failure of a company. It is true that a debt investor can benefit from a corporation's strong performance — if a corporation's financial condition improved enough so that its credit rating were upgraded, for example — or can be hurt by a corporation's poor performance — if a corporation were downgraded or the company went bankrupt. However, the potential risks and rewards of a corporate debt investment related to the performance of a company usually represent only a very small aspect of an investor's total return on his or her investment.

Ultimately, the characterization of an instrument as equity or debt should rest on whether by buying the instrument in question, an investor is purchasing a direct participation in the long-term growth of the issuing corporation, or a stream of cash flows based on an agreed upon rate. For most financial instruments, this distinction is obvious. Common stock clearly is equity. Senior and subordinated corporate bonds clearly are debt. Traditional preferred stock, since it represents an interest in a stream of fixed dividend payments, also would fall under the definition of debt. Hybrid instruments — securities which are debt in virtually all respects except for their accounting treatment, also known as preferred debt securities, fixed-rate capital securities, and by numerous proprietary product names — also represent interests in fixed streams of payments, and therefore would be debt.

Accounting treatment and tax policy

How a financing instrument is treated under accounting rules should play no role in determining its tax treatment. Distinguishing between debt and equity for accounting purposes serves a goal fundamentally different from that for tax purposes. The characterization of financial instruments under accounting rules is based on an issuer's payment obligations and an investor's rights in bankruptcy. The rules also provide common definitions and conventions so that the accounting statements of one company are easily comparable to those of another. The distinction under the tax code exists so that similar types of income are afforded similar tax treatment. There is no reason to expect that the treatment of a given financial instrument under the tax code should necessarily mirror its treatment under generally accepted accounting principles (GAAP) or under the information disclosure requirements of securities statutes and regulations.

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[3] See, for example, U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, January 6, 1992.

Indeed, relying on accounting rules as the basis for how a particular instrument is taxed would effectively grant tax policy authority to the Financial Accounting Standards Board and the Securities and Exchange Commission (SEC). With all due respect to these two highly regarded organizations, PSA firmly believes that tax policy authority should rest with Congress and, to the extent such authority is granted in law, the Treasury Department. The designation of certain hybrid financial instruments as non-debt liabilities in SEC filings, for example, relates to accounting concerns with respect to their status in bankruptcy, not to the nature of the income or other benefits received by the holder or to the obligations of the issuer.

Deny interest deduction on certain debt securities

The administration's budget plan contains a proposal to deny corporate interest expense deductions for debt with a maturity longer than 40 years and instruments with maturities longer than 20 years not characterized as debt in an issuer's SEC filings. This proposal appears to be aimed at eliminating the interest deductibility of innovative new financial instruments, such as hybrid preferred debt and long-dated corporate bonds, on alleged grounds that they are improperly treated as equity for accounting purposes and debt for tax purposes. The administration has characterized this proposal as a way to curb "abusive" transactions. However, there is no evidence that corporations have in any way attempted to skirt existing distinctions between debt and equity or have otherwise engaged in "abusive" activity. PSA disagrees with the administration that the current tax treatment of these instruments needs to be changed.

A careful analysis of the affected instruments reveals that they possess the critical attributes of debt. Indeed, Treasury's proposal does not rely on any of these attributes to curtail the interest deductibility of these instruments. Rather, Treasury has focused on the fact that hybrid preferred debt products are not typically shown as debt on a company's balance sheet. The reality is, balance-sheet treatment of these instruments has never before been relevant to their tax treatment and whether they are identified as debt obligations for tax purposes.

Hybrid instruments issued through a trust are a case in point. A company utilizing these instruments issues debt obligations to a trust which, in turn, issues trust securities to investors. The transaction is structured in this way to improve the attractiveness of the securities to the public. Because these debt obligations are issued through a trust, they are not shown on an issuer's balance sheet as debt, although the status of the obligations as indebtedness is clearly disclosed in a footnote to the company's balance sheet.

The balance-sheet characterization of hybrid preferred instruments as a non-debt liability does not alter the conclusion that the underlying debt securities possess all the critical attributes of debt. This is clearly illustrated by the facts that:

- Investors in these instruments are the legal owners of an undivided interest in the underlying debt obligations, and they enjoy all the legal rights and economic benefits as if they had purchased the debt obligations directly from the issuer, rather than certificates from the trust. In addition, holders of these instruments do not enjoy any participation in an issuing corporation's growth, as do holders of common stock.

- Issuers of these securities — despite their ability to extend an interest payment period for up to five years — have an absolute obligation to pay interest and principal at maturity.

Contrary to Treasury's revenue projections, this proposal would likely fail to raise revenue. Issuers that are affected by the proposed legislation would either choose to issue hybrid preferred securities with a maturity of 20 years or less, or they would maintain the 20-plus year maturity of the instruments and issue them directly to investors, rather than through a partnership or trust. In virtually no case would an issuer substitute its hybrid financing with equity. In any case, Treasury's proposal will ultimately fail to reduce the amount of interest issuers deduct, and it will therefore be unlikely to raise tax revenue.

The administration has proposed capricious and arbitrary distinctions as to what qualifies as debt financing eligible for interest-expense deduction. Under the proposal, two otherwise identical debt securities, one with a maturity of 40 years and the other with a maturity of 41 years, would be treated in entirely different ways. The definition of equity should rest on more defensible grounds by encompassing only securities where returns are directly related to the long-term growth of the issuing

corporation, such as common stock. Neither long-dated corporate bonds nor debt/equity "hybrids" afford this benefit to holders. In both cases, the holder is buying an income stream, not an equity participation. Any distinction based solely on one factor — the maturity of an instrument — ignores long-standing definitions and conventions regarding what constitutes debt financing.

Defer original issue discount on convertible debt

The administration has proposed to change the tax treatment of original issue discount (OID) on convertible debt securities. OID occurs when the stated coupon of a debt instrument is below the yield demanded by investors. The most common case is a zero-coupon bond, where all the interest income earned by investors is in the form of accrued OID. Under current law, corporations that issue debt with OID may deduct the interest accrual while bonds are outstanding. In addition, taxable OID investors must recognize the accrual of OID as interest income. Under the administration's proposal, for OID instruments which are convertible to stock, issuers would be required to defer their deduction for accrued OID until payment was made to investors in cash. For convertible OID debt where the conversion option is exercised and the debt is paid in stock, issuers would lose the accrued OID deduction altogether. Investors would still be required to recognize the accrual of OID on convertible debt as interest income, regardless of whether issuers took deductions.

The administration's proposal is objectionable on several grounds. First, convertible zero-coupon debt has efficiently provided corporations with billions of dollars in capital financing. The change the administration proposes would significantly raise the cost of issuing convertible zero-coupon bonds, and in doing so would discourage corporate capital investment. Second, the administration's presumptions for the proposal are flawed. The administration has argued that convertible zero-coupon bonds represent a *de facto* equity investment, and should be treated as such. However, performance does not bear out this claim. In fact, of the convertible zero-coupon debt retired since 1985, approximately 70 percent has been retired in cash, and only 30 percent has been converted to stock. Indeed, the market treats convertible zero-coupon bonds more as debt than as equity.

Third, and perhaps most important, the administration's proposal violates the basic tenet of tax symmetry, the notion that the recognition of income by one party should be associated with a deduction by a counterparty. This fundamental principle exists to help ensure that income is taxed only once. Under the proposal, investors would be taxed fully on the accrual of OID on convertible zero-coupon debt, but issuers' deductions would be deferred or denied. The proposal would compound problems associated with the multiple taxation of investment income, thereby raising the cost of corporate capital.

Because the proposal would exacerbate problems of multiple taxation of corporate income and because it would raise the cost of corporate capital investment, PSA urges the rejection of the administration's proposal.

Limit dividends-received deduction (DRD)

Under current law, corporate taxpayers that earn dividends on investments in other corporations are permitted a tax deduction equal to at least 70 percent of those earnings. The deduction is designed to mitigate the negative economic effects associated with multiple taxation of corporate earnings. The administration has proposed reducing the minimum dividends-received deduction (DRD) to 50 percent, which would increase the taxation of corporate earnings and discourage capital investment. A companion proposal to modify the DRD holding period would also have a number of negative market effects.

A generous DRD is important because it reduces the effects of multiple taxation of corporate earnings. As discussed earlier, when dividends are paid to a taxable person or entity, those funds are taxed twice, once at the corporate level and once at the level of the taxpayer to whom the dividends are paid. These multiple levels of taxation raise financing costs for corporations, create global competitiveness problems, and generally reduce incentives for capital formation. The DRD was specifically designed to reduce the burden of one layer of taxation by making dividends largely non-taxable to the corporate owner.

Scaling back the DRD would exacerbate the effects of multiple taxation. The change would be tantamount to a tax increase on corporate earnings since the minimum deduction available to certain

investors would fall. This tax increase would flow directly to issuers of stock, especially preferred stock, who would face higher borrowing costs as investors demanded higher pre-tax yields. Preferred stock is an especially important source of capital for certain corporations and industries, such as commercial banks and utility companies. In response, corporations would tend to cut capital expenditures, reduce working capital, move capital raising and employment overseas, and otherwise slow growth-oriented investment. Amplifying the competitive disadvantages of multiple taxation of American corporate earnings would be the fact that many of our largest economic competitors have already adopted tax systems under which inter-corporate dividends are largely or completely untaxed. The administration's DRD proposal would thus have a wide range of unintended consequences that would harm the national economy.

Summary

Again, we appreciate the opportunity to comment on the tax proposals contained in the administration's FY 97 budget proposal. Although we strongly oppose many of the administration's proposals on the grounds that they would discourage capital formation and public and private investment, we welcome the Ways and Means Committee's attention to these important issues. We are especially pleased that the proposals are being considered in a more formal and systematic manner than they were during the hectic days of the balanced budget negotiations in late 1995 and early 1996.

We urge the committee's opposition to the four tax proposals we have discussed in our statement. We feel that their ultimate effects are contrary to many of the committee's goals of the past eighteen months: to foster savings and investment and encourage capital formation. We hope our comments are useful, and, as always, we are prepared to offer any additional assistance the committee may need in its continued deliberations.

STATEMENT
OF
THE S CORPORATION COALITION
IN RESPONSE TO
THE HOUSE COMMITTEE ON WAYS AND MEANS
REQUEST FOR COMMENTS
ON
NEW REVENUE PROVISIONS IN THE
PRESIDENT'S FISCAL YEAR 1997 BUDGET

This statement is respectfully submitted on behalf of the S Corporation Coalition in response to the Committee's request for comments on revenue provisions that were included in President Clinton's fiscal year 1997 budget, but not in the Balanced Budget Act of 1995. The S Corporation Coalition is a group of companies from across the country representing a wide range of industries that strongly supports the needed reform of the Subchapter S rules that is contained in the S Corporation Reform Act of 1995 (H.R. 2039).

The Coalition appreciates the Committee's interest in public comments on the Administration's new revenue proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular -- the proposal to treat conversions to S status (and certain transactions involving S corporations) as taxable liquidations. As explained below, the Coalition believes that this proposal is short-sighted, would be harmful to small business, and represents a giant step backward from the goals of Subchapter S. The Coalition respectfully recommends that the Committee reject this proposal, and instead continue its efforts to enact the reform provisions contained in the S Corporation Reform Act.

BACKGROUND

The Administration is proposing to repeal Section 1374 of the Internal Revenue Code and to treat the conversion of a "large" (greater than $5 million in value) C corporation to a Subchapter S corporation as a taxable liquidation of the C corporation, followed by a contribution of assets to the S corporation by the shareholders. The proposal also would apply to transfers of assets from a large C corporation to an S corporation in certain carryover basis transactions (such as mergers). The net effect of the proposal is that converting to S corporation status, or participating in merger transactions involving S corporations and C corporations, could trigger substantial tax liability at both the corporate level (with respect to unrealized asset gain) and at the shareholder level (with respect to stock).

The Administration currently is recommending that its proposal be effective for conversions that are effective for tax years beginning after January 1, 1997, and for asset acquisitions after December 31, 1996.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

As explained below, the Coalition believes that the Administration's proposal would impose an unjustifiable new tax on conversions to S status and mergers with S corporations, would discourage desirable and productive business behavior, would harm small business, and would run completely contrary to Congressional efforts to enact Subchapter S reform legislation.

1. The Proposal Would Make the Tax Cost Too High for Small Businesses to Be Able to Convert to S Status

The Administration's new "toll charge" on converting from a C corporation to an S corporation would represent a substantial new tax burden on small businesses. In effect, the proposal would require a C corporation to pay tax on its conversion to S status as if it had distributed all its assets in liquidation -- even though a converting corporation does not actually dispose of any assets and does not receive any infusion of cash upon conversion. Because of the size of the resulting tax burden, it is very likely that companies that are formed as C corporations simply will not be able to afford to convert to S status.

Consider the case, for example, of a small "Mom and Pop" operation that did not have the benefit of sophisticated legal and accounting advice when it was formed and, as a result,

did not know of the possibility of electing to be taxed under Subchapter S. Several years later, however, the company faces a new competitor that has been formed as an S corporation. After consulting with an accountant, the company establishes that it, too, is eligible to elect to be taxed as an S corporation and to be taxed in the manner that Congress deemed appropriate for companies with its characteristics. If the Administration's proposal were law, the company in all likelihood would not be able to convert to S status and to compete on a level-playing field with its competitors; the tax cost of conversion would simply be too high to pay. Clearly, this is not the right result.

2. **The Proposal Would Discourage Productive Business Activity between S Corporations and C Corporations**

The Administration's proposal to impose a new tax on the merger of a C corporation into an S corporation would substantially increase the cost of certain business combinations and would provide a severe disincentive to engaging in these activities. In this regard, the proposal fails to recognize the important role that mergers and other business combinations can play in making businesses more efficient and improving the productivity of U.S. businesses.

Moreover, the proposal would create an arbitrary set of rules whereby the merger of a C corporation into an S corporation would be taxed very differently from other kinds of merger transactions (such as the merger of two C corporations or of two S corporations). These arbitrary rules would severely distort business decision-making. The decision of whether or not two companies should merge should be based on an evaluation of the business costs and benefits associated with the transaction -- not on tax law considerations that arbitrarily increase the cost of certain kinds of merger transactions

Finally, the Administration's proposed tax on mergers of C corporations into S corporations would represent a substantial departure from well-accepted principles of Federal income tax law governing tax-free reorganizations that have been developed by courts and the Congress over the course of many decades. It would be short-sighted to abandon this body of law and to change fundamental principles of taxation in this manner. Instead, mergers should continue to be treated as tax-free events -- regardless of whether the parties are S corporations, C corporations, or a combination thereof.

3. **The Proposal Is Not Necessary to Prevent Tax Abuse**

The Treasury previously has suggested that its new tax on conversions and mergers is justified by the need to prevent C corporations from converting to S status as a means of avoiding the Subchapter C corporate level of tax on asset gain. Under current law (Section 1374 of the Tax Code), a corporation that converts to S status pays corporate-level tax on the appreciation in its assets at the time of conversion only if it disposes of those assets within the ten-year "recognition" period following conversion. Treasury has suggested that companies may convert to S status, hold their "built-in gain" assets for ten years, and then, on the expiration of the recognition period, sell their assets. In such a case, the asset gain would be flowed through to the shareholders, but would not be subject to corporate level tax.

This suggestion, however, holds no water. Any company that hopes to be around for ten years has to make its decisions as to whether to sell or hold assets based on business considerations. Indeed, it is hard to imagine a company refusing to sell an asset to a willing buyer simply to avoid the current built-in gains tax.

Moreover, it is important to recognize that converting to S status (or engaging in a merger with an S corporation) is in no way abusive. Indeed, Congress enacted Subchapter S precisely because it determined that companies meeting certain specific eligibility requirements should be able to elect to be taxed in a different manner than under Subchapter C. Thus, companies that convert to S status are not engaging in any inappropriate or abusive conduct; to the contrary, they are engaging in the very activity Congress sought to encourage in enacting Subchapter S.

Finally, it should be noted that Congress already has included a set of rules designed to prevent corporations from converting to S status as a means of engaging in various perceived abuses. For example, as indicated above, Section 1374 currently is designed to prevent C corporations from electing S status in anticipation of an asset sale. Further, Sections 1362 and 1375 are intended to prevent C corporations from electing S status as a means of bailing out

their C corporation earnings and profits; these sections, respectively, provide for the termination of the S status of, and the imposition of a corporate level tax on, S corporations that have significant passive investment income and C corporation accumulated earnings and profits. There is no evidence that these rules are not working as intended, As such, there is no reason to impose a draconian new tax on conversions.

4. The Administration's Proposal Is Completely Contrary to Congressional Goals

The Administration's proposal also runs completely counter to repeated Congressional efforts to enact Subchapter S reform legislation that would enhance S corporations' access to capital, help preserve family-owned businesses, remove technical traps that befall the unwary, and simplify many of the cumbersome and complex rules that currently apply to S corporations. As you know, the Congress included many of these reform provisions in the Balanced Budget Act of 1995 that was vetoed last fall. In addition, the Committee included many of these provisions in the small business job protection bill it ordered reported yesterday (May 14). Further, previous Congresses have included reform provisions in other tax legislative vehicles, such as The Revenue Act of 1992 (H.R. 11) and the Tax Fairness and Economic Growth Act of 1992 (H.R. 4210). The Administration's proposal represents a drastic departure from the goals pursued by the Congress in these bills and should be rejected.

RECOMMENDATIONS

For the reasons set forth above, the Coalition strongly urges the Committee not to include the Administration's proposal to treat the conversion to S status as a taxable liquidation in any tax legislation, this year or in the future.

Further, the Coalition strongly encourages the Committee to continue its efforts to enact the provisions contained in the S Corporation Reform Act. These reform provisions are good for small business and good for our economy. They remove unneeded complexity from the tax laws, help family-owned business, and enhance small business's access to capital. The Coalition applauds the Committee for including many of the provisions from this bill in the Balanced Budget Act of 1995 and in the small business protection bill it ordered reported yesterday. The Coalition looks forward to continuing to work with the Committee on Subchapter S reform in the future.

The Coalition appreciates the Committee's interest in its views on these significant S corporation issues.

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION
TO THE HOUSE COMMITTEE ON WAYS AND MEANS CONCERNING
CERTAIN REVENUE PROVISIONS IN PRESIDENT CLINTON'S
FISCAL YEAR 1997 BUDGET
U.S. HOUSE OF REPRESENTATIVES

May 15, 1996

The Securities Industry Association ("SIA") is pleased to provide comments concerning some of the proposals that were introduced by the President as part of his 1997 budget plan. We are grateful for the opportunity to offer our views to Congress.

Many of the President's proposals would, if adopted, affect the tax consequences of issuing and holding financial instruments, or of entering into various financial transactions (hereafter, the "financial transactions proposals"). SIA brings together the shared interests of about 700 securities firms throughout North America to accomplish common goals. SIA members--including investment banks, broker-dealers, specialists, and mutual fund companies--are active in all markets and in all phases of corporate and public finance. In the United States, SIA members collectively account for approximately 90 percent, or $100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. In light of the above, SIA believes it is uniquely qualified to comment on the President's financial transactions proposals, and to offer insights concerning the potential consequences of their implementation.

In general, SIA is strongly opposed to the President's financial instruments proposals. We think it apparent that many of the proposals are desultory responses to a few well-publicized transactions and that they do not represent a coherent approach to the tax treatment of financial instruments and transactions. Indeed, many of the proposals conflict not only with each other, but also with broader principles of federal income taxation and the policies underlying those principles. Set out below are our specific comments on each of the President's financial instruments proposals.

Lowering of the Dividends Received Deduction to 50%

The President's 1997 budget plan includes a proposal to lower the dividends received deduction from 70% to 50%. SIA strongly opposes this proposal, for important policy reasons.

The dividends received deduction is designed to prevent multiple levels of corporate taxation when corporations invest capital in the equity of other corporations. SIA believes the deduction should if anything be increased from 70% back to 80% (where it stood for most of the 1980s), so as to encourage the free flow of capital from "mature" corporations, which have limited opportunities to profitably invest capital, to "growth" corporations which can most productively employ that capital and expand the economy. Surely the imposition of double and triple-level corporate taxation on capital seeking its most productive use is a serious mistake.

Moreover, we believe that lowering the dividends received deduction would have several undesirable collateral effects: First, it would encourage corporations to lend capital to other corporations, rather than make equity investments. The

resulting increase in corporate leverage would weaken the stability of the corporate sector. Second, it would reduce the international competitiveness of U.S. corporations by effectively increasing the rate of U.S. corporate-level taxation, a rate which is already much higher than the rate imposed on foreign competitors by many of our trading partners, most of which have already integrated their corporate-level taxes. Finally, it would disrupt capital markets by leading to sudden and unanticipated drops in the values of preferred and other yield-oriented equities that were issued assuming a 70% dividends received deduction.*

Modification of the DRD Holding Period

The President's 1997 budget proposal includes a provision which would effectively eliminate the dividends received deduction if a corporation was hedged against exposure to risk of loss from the relevant stock at the time any dividend was received. Current law simply requires a corporation to hold stock unhedged for at least 46 days before hedging, so as to prevent certain potentially abusive "dividend stripping" transactions where taxpayers are never exposed to any risk of loss at all.

Thus, the proposal would, if adopted, effectively turn a limited anti-abuse rule into a broad prohibition on hedging transactions. It would effectively force corporations to choose between hedging their equity positions for perfectly valid business reasons and retaining the dividends received deduction.

For reasons similar to those set out above in connection with the proposed lowering of the dividends received deduction, SIA strongly opposes this proposal. This proposal would, if adopted, effectively prevent corporations from prudently moving capital to those places in the economy where it can be put to the most productive use. Moreover, SIA believes that the prudent hedging of corporate equity positions should (barring certain limited abuses which are already adequately addressed by a variety of anti-abuse statutes) be actively encouraged by Congress as increasing the stability and flexibility of the corporate economy.

If Congress nevertheless chooses to adopt this proposal, we believe it should be made effective only for transactions entered into after the date on which the proposal is enacted. Many taxpayers have already entered into long-term hedging transactions--such as issuances of exchangeable debt instruments--which cannot be reasonably terminated or otherwise unwound.

Deny Interest Deductions on Certain Debt Instruments

The President's 1997 budget proposal includes a provision which would disallow deductions for interest paid on certain debt instruments that are viewed by the President as having substantial equity characteristics. SIA strongly opposes this provision on two grounds: first, it unnecessarily impedes corporations in their efforts to meet beneficial (and in some cases government mandated) financial objectives designed to maintain their longterm stability; second, it does not provide a cohesive and logical precedent for the characterization of financial instruments.

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* In this regard, if Congress does chose to enact such a provision, we believe it should be made effective only for dividends received on stock acquired by the relevant taxpayer after the date of enactment of the provision.

We understand that the Treasury Department has recently grown concerned with innovations in the structuring of debt instruments. It has observed that some of these structures permit issuers to meet financial, rating agency, regulatory or accounting objectives that can also be met by issuing equity. It has concluded on this basis that the structural innovations are eroding the corporate tax base. Rather than make use of the authority already granted by Congress under Section 385 of the Internal Revenue Code to coherently define the distinction between equity and debt, however, the Treasury Department has returned to Congress seeking an ad hoc disallowance of interest deductions on certain kinds of structured debt instruments--specifically, the instruments that have been most successfully issued over the past two years.

These instruments are plainly debt instruments under general principles of federal income taxation. They include such popular and well-received instruments as 100-year debt, which is designed to permit issuers to lock in low rates of interest for a long period of time; 30-year debt held through a trust, which is designed to help issuers maintain investment-grade credit ratings; and certain investment units consisting of debt and forward contracts, which are designed to permit issuers to issue stock in the future should a business downturn, or new regulatory requirements, make such an issuance prudent. In short, corporations generally issue these instruments to improve their longterm financial stability and flexibility, and to comply with various regulatory requirements. We think Congress should approve of this.

It is well-known that U.S. corporations can pay less corporate-level tax by issuing more debt and less equity. In this regard, the general increase in the leverage of U.S. corporations poses a much greater threat to the corporate-level tax base than does routine innovation in the structure of any particular debt instrument. Many academics and economists are in favor of integrating the corporate-level tax. Regardless of one's views on the subject, however, the role of debt issuance in our tax system is a complex subject, with arguments on many levels. We simply do not see the advantage of eliminating successful and economically beneficial transactions on an ad hoc basis.

We recognize that investment and commercial bankers actively structure the terms of proposed issuances of corporate debt to meet the needs of their clients. We also recognize that in doing so, they actively consider their clients' financial, rating agency, accounting, balance sheet, regulatory and other objectives. We see nothing wrong with this, however. Rather, we believe that such structuring directly benefits U.S. corporations and the U.S. economy. In fact, public utilities and other highly regulated industries are among the most frequent issuers of structured debt securities. We see no reason, therefore, why Congress should accept an invitation to disallow interest deductions on these instruments on an ad hoc basis without any coherent legal, economic or policy rationale.

Defer Interest Deductions on Convertible Discount Debt

The President's 1997 budget plan contains a proposal to defer deductions for interest accruing on zero-coupon debt that is convertible into the stock of the issuing corporation until the interest is actually paid. If the holder exchanged the right to receive such accrued but unpaid interest for stock before the instrument matured, the interest deduction would effectively be disallowed altogether.

SIA strongly opposes this provision as lacking a coherent policy rationale. The only possible rationale for the proposed disallowance is that an issuance of convertible discount debt is economically similar to an issuance of equity, and an issuer should therefore not be entitled to deduct interest accruing on discount debt that is ultimately converted into equity. The President has made no proposal, however, to disallow deductions for interest paid on current-pay convertible debt. SIA observes that current-pay convertible debt is far more likely to be converted into equity than is zero-coupon convertible debt. A converting holder of zero-coupon debt must give up the right to receive accrued but unpaid interest; a converting holder of current-pay debt does not give up this right, because the interest has already been received.

This is borne out by the fact that approximately 79% of all current-pay convertible debt instruments are converted into stock prior to maturity, whereas only 30% of all zero-coupon convertible debt instruments are ultimately converted. In other words, it is generally the zero-coupon instruments, not the current-pay instruments, which in fact pay principal at maturity.

Morris Trust Proposal

The President's 1997 budget plan contains a proposal which would effectively impose corporate-level tax on an otherwise tax-free "spinoff" (i.e., distribution to shareholders) of an active business that is planned in contemplation of a merger of the distributing corporation into an acquiring corporation (a so-called "Morris Trust transaction"). Such a spinoff generally occurs because the acquirer is not interested in acquiring the spun-off business, or otherwise does not view itself as in a position to manage the spun-off business in an efficient manner.

SIA strongly opposes this proposal. SIA does not believe the proposal makes sense as a matter of economic policy, legal analysis or technical analysis, and that it stands in the way of transactions serving a bona fide business purpose.

A tax-free spinoff in effect permits deferral, rather than elimination, of corporate-level tax on gain from the appreciation of corporate-level assets. The assets remain in corporate solution for ultimate taxation. In the past, the most important condition which Congress has required for deferring imposition of corporate-level tax on such appreciated assets is that there be a bona-fide business purpose for the spinoff. The business purpose for a spinoff in a Morris Trust transaction--that the acquirer is not willing to own and manage the spun off business--is as compelling and logical a business purpose as taxpayers ever have for wanting to distribute an active business to their shareholders. Indeed, it has in the past been among the business purposes that are most readily accepted by the Internal Revenue Service in issuing spinoff rulings.

There are already many limits on a corporation's ability to effect a tax-free spinoff. These include not only the business purpose requirement discussed above, but also that both the distributing and distributed corporations have been engaged for at least five years in active businesses, and that the spinoff not otherwise constitute a device for the distribution of corporate earnings without imposition of a tax on dividends. In addition, shareholders must have an ongoing continuity of interest in both the distributed corporation and the corporation which acquires the distributing corporation.

The new proposal would require that shareholders actually control the corporation which acquires the distributing corporation, rather than merely retain an ongoing interest in it.

This goes far beyond what is needed to assure continuity of interest in a reorganization. The reorganization and spinoff provisions are designed to permit reorganization of the ownership, management and control of corporate-level businesses so as to create a more productive return for shareholders and the economy at large. We believe the new proposal adds nothing to the already stringent requirements for a tax-free spinoff, and that it unnecessarily impedes the purpose of the spinoff and reorganization provisions.

Short-Against-the-Box Proposal

The President's 1997 budget plan contains a proposal that would treat certain appreciated positions in stock and other financial assets as constructively sold in any case where a taxpayer "substantially eliminates both risk of loss and opportunity for gain for some period".

SIA strongly opposes this provision. As currently drafted, the provision applies not only to transactions which are economically equivalent to sales of appreciated property because they eliminate all of the burdens and benefits of ownership, but also to a broad range of transactions where taxpayers eliminate most, but not all, of the burdens and benefits of ownership. Unless it is substantially revised, the proposal is likely to confuse and chill large, active and beneficial hedging markets merely to eliminate a few highly publicized transactions.

We therefore urge Congress to clarify that constructive sales treatment will not apply merely because a taxpayer enters into hedging transactions--such as swaps, futures, forwards and options--which eliminate most of the economic burdens and benefits of ownership if the taxpayer retains burdens or benefits that prevent the transaction from being the economic equivalent of a sale. For example, Congress should clarify that retention of the benefit of substantial dividends or other income from appreciated property, or retention of the benefit of some amount of appreciation or depreciation of the property (e.g., 5%), will not result in a constructive sale.

We also urge Congress to apply constructive sales treatment only in cases where a taxpayer eliminates all risk of loss and opportunity for gain for a sustained period of time. We believe, for example, that nine months would be a reasonable period of time, since that is the initial term of most options issued on securities exchanges. Elimination of risk of loss and opportunity for gain for but a short period of time does not resemble an outright sale of appreciated property as an economic matter. Rather, it resembles the active and beneficial hedging transactions that are routinely entered into on the nation's securities and commodities exchanges. We observe, in this regard, that if the basis for treating a short-term hedge as a constructive sale is that it is economically equivalent to selling appreciated property and then buying it back, then all appreciated stock should be marked to market, since doing nothing with appreciated stock is also economically equivalent to selling it and then buying it back.

As currently drafted, moreover, the proposal is uncertain and confusing, as to both the mechanics of its application and the consequences of its application. As adequately documented by numerous articles and Bar submissions, the sparse language of this provision raises so many questions that it is impossible to even speculate on how it affects routine business transactions. We respectfully submit that a proposal such as this has simply not been sufficiently thought out to permit Congress to adopt it at this time.

In this regard, if Congress does choose to enact a provision similar to the one proposed by the President, and if Congress grants the Treasury Department authority to treat transactions other than short-against-the-box transactions as resulting in constructive sales, we urge Congress to permit the Treasury Department to apply that authority on a prospective basis only to transactions that are entered into after the date of issuance of detailed and fully considered regulations. In other words, we urge Congress to apply a date-of-enactment effective date to at most certain so-called "short-against-the-box" transactions under which a taxpayer disposes of all of the burdens and benefits of ownership of appreciated stock by borrowing identical stock and selling it short in the marketplace. We note that Congress has taken a similar approach in the past to new rules designed to eliminate abusive straddle transactions and dividend-stripping transactions.

Average Stock Basis Proposal

The President's 1997 budget plan includes a proposal to eliminate the longstanding "identification rule" under which a taxpayer who buys shares of the same stock at different times and later sells less than all of the shares may identify which shares are being sold (usually the shares with the highest basis). Instead, the taxpayer would be treated as having sold shares with an "average basis".

SIA is opposed to this proposal for two reasons. First, we believe it runs directly counter to the broader federal income tax treatment of sales of stock and securities, and therefore leads to anomalous results. If a taxpayer purchases shares of stock A on day one and stock B on day two, the taxpayer is perfectly entitled to choose to sell the shares of stock B, which have a higher basis, rather than the shares of stock A, which have a lower basis. We do not see why the rule should change merely because stock A and stock B are substantially identical. We understand that this proposal may have something to do with the President's concern about short-against-the-box transactions, but the President has already addressed this concern with a more direct proposal.

Second, we believe the provision would, if enacted, lead to greater complexity in the record-keeping and reporting of purchases and sales of stock. Taxpayers (and their agents) would have to maintain and consult with historical records for all of the taxpayer's transactions relating to a given stock each time a taxpayer undertook to sell a few shares. Each sale would change the basis of the remaining shares (presumably under detailed regulations which would explain precisely how the average basis rule works), so that the basis calculations for subsequent sales would depend in part on the mechanics of previous sales. We do not think this approach would be well-suited to routine equity transactions, given their sheer volume and the number of individuals they affect.

Increased Penalties for Failure to File Information Returns

The President's 1997 budget plan includes a proposal to increase penalties for failure to file information returns, including all standard Form 1099s. SIA opposes this provision as unwarranted, in light of the securities industry's generally excellent record for compliance.

The securities industry is proud of the resources and energy which it has devoted to its compliance efforts, and of the cooperative spirit which the industry has demonstrated in joining with the IRS to assure that taxpayer income is fully reported. IRS statistics bear out the fact that compliance levels for securities industry filings are already extremely high. Any

failures to file on a timely basis generally owe to the late reporting of year-end information by issuers of securities, or to other unavoidable problems. Under these circumstances, we believe an increase in the penalty for failure to timely file returns would be unfair, and would constitute a failure to recognize and credit the industry's substantial compliance efforts.

Effective Dates

SIA wishes to commend Congressman Archer and Senator Roth for the announcement they made on March 17, 1996 stating, as we understand it, that any of the proposals described above would, if ultimately enacted by Congress, be effective for transactions entered into after the date of appropriate Congressional action. SIA has been troubled by the Administration's recently-developed policy of introducing new proposals for the taxation of financial instruments and transactions effective for transactions entered into after the date of the proposal. SIA has been particularly concerned because the proposals in question have not involved routine or ministerial changes to the taxation of financial transactions, but rather complex and far-reaching changes with many uncertain, and in some cases unintended, consequences.

SIA has a number of objections to the Administration's approach. First, it effectively destroys legitimate business transactions by casting a cloud of uncertainty over their tax treatment before Congress has had a chance to consider the merits of the relevant proposal. Second, it effectively preempts Congress by eliminating transactions which Congress may ultimately approve of. Third, it eliminates the relevant transactions without any hearing as to their merits, or as to the merits or consequences of the relevant proposal. Finally, it eliminates transactions in progress notwithstanding the very substantial costs associated with taking a proposed transaction (over the course of several months) from a mere "mandate" to a mature issuance, complying in a voluntary and cooperative spirit with a maze of regulatory requirements, lining up potential buyers, and forgoing other meaningful and important business alternatives.

SIA understands that the Administration has adopted this policy partly to prevent issuers from "rushing to market" with transactions during the "window period" before Congress enacts a provision which will change their tax consequences. SIA wishes to clarify, however, that most substantial financial issuances and transactions involve a great deal of time, effort and energy. SIA does not believe there would have been any "rush to market" if the President's proposals had been made effective for transactions entered into after the date of enactment. Rather, there would have been "business as usual", and SIA believes that this is what issuers are entitled to unless and until Congress enacts the relevant proposals into law.

JOINT STATEMENT OF:
SECURITIES INDUSTRY ASSOCIATION;
MERRILL LYNCH & CO., INC.;
and
CITICORP

WRITTEN TESTIMONY SUBMITTED TO THE
WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

REGARDING A PROPOSAL INCLUDED IN PRESIDENT CLINTON'S
FISCAL 1997 BUDGET

TO INCREASE PENALTIES FOR FAILURE TO FILE CORRECT
INFORMATION RETURNS

MAY 15, 1996

The undersigned companies and associations strongly oppose the Administration's proposal to increase penalties for failing to file correct information returns. The proposal is extremely broad, applying to all types of information returns such as Forms 1099-INT, -DIV, -OID, -B, and -MISC, as well as Form W-2. We believe the proposal is flawed in many respects.

The financial services community devotes an extraordinary amount of resources to complying with current information reporting rules, and information returns play a key role in tax administration. The undersigned companies and trade associations represent a significant portion of the informatoin returns that would be impacted by this proposal. In light of the current reporting burdens imposed on our industry and the benefits derived by the IRS, we believe it is highly inappropriate to raise penalties for inadvertent errors.

<u>Current penalty structure is sufficient</u>

We believe the current penalty structure -- which includes severe sanctions for intentional reporting failures -- gives filers more than enough incentive to comply with information reporting requirements. In general, the current penalty structure is as follows:

- The combined standard penalty for failing to file correct information returns and payee statements is $100 per failure, with a penalty cap of $350,000 per year.

- Significantly higher penalties -- generally 20 percent of the amount required to be reported (for information returns and payee statements) with no penalty caps may be assessed in cases of intentional disregard. It is important to note that the IRS has not hesitated to assess penalties under the intentional disregard provisions.

- Payors also may face liabilities for failure to apply 31 percent backup withholding when, for example, a payee has not provided its taxpayer identification number (TIN).

Furthermore, there is no evidence of a substantial lack of compliance with information reporting requirements. Given the incentives under the current penalty structure, reporting compliance is high and the proposed penalty increase is unnecessary.

Proposal represents significant shift in policy

It seems that any revenue raised by the proposal would result only from higher penalty assessments. None of the added revenue is expected to come from increased compliance with information reporting.

Any reliance on a penalty provision to raise revenue would mark a significant shift in Congress' policy on penalties. A 1989 IRS Task Force on Civil Penalties concluded that penalties "should exist for the purpose of encouraging voluntary compliance ***and not for other purposes, such as the raising of revenue.***"[1] Congress specifically endorsed the IRS Task Force's conclusion in the Omnibus Budget Reconciliation Act of 1989.[2] The Service's Internal Revenue Manual now includes a policy statement reflecting these principles.[3]

There appears to be no justification for Congress to abandon its present policy, which is based on fairness and clear standards. Particularly in light of the high compliance rate for filing information returns, any decision to increase penalties for revenue purposes is completely unjustified.

We also urge you not to rely on the 97-percent substantial compliance "safe harbor" provision of the current proposal as a way of ensuring that the higher penalties apply only to relatively few cases. Although some information reporting rules are straightforward (e.g., interest paid on deposits), the requirements for certain new financial products are often unclear, and there is certainly a risk of inadvertent reporting errors for complex transactions. We also believe there is significant confusion about Form 1099-MISC reporting requirements.[4] Any reporting "errors" resulting from such ambiguities could easily lead to a filer not satisfying the 97 percent safe harbor.

Relief needed for multiple penalty cap problems

If Congress does move forward with the proposal, there is clearly a need to make changes relating to the potential application of multiple penalty caps. Under current law, the $250,000 penalty cap for information returns (section 6721(a)(1)) generally protects the filing community from clearly excessive penalties. Under the proposal, the $250,000 cap would continue to apply, although a filer would reach the penalty cap much faster than under current law. Unfortunately, the effectiveness of the proposed penalty cap is substantially limited for institutions that file information returns under several -- perhaps hundreds -- of different payor names. The problem for these institutions is that the $250,000 cap applies separately to each payor.

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[1] *See* Statement of IRS Commissioner Gibbs before the House Subcommittee on Oversight (February 21, 1989) (p. 5) (emphasis added).

[2] OBRA 1993 Conference Report at 661.

[3] Internal Revenue Manual Policy Statement P-1-18.

[4] For example, major questions regarding the identity of the payor -- obviously a fundamental question for accurate reporting -- exist in multiple party payment situations. *Compare, e.g.*, Rev. Rul. 93-70, 1993-2 C.B. 294 (paying agent required to file Forms 1099-MISC) and Temp. Reg. § 35a.9999-3, Q/A 1 (paying agent not required to file Forms 1099-MISC). A recent court also found the Form 1099-MISC instructions to be "complicated and ambiguous at best." *In re Quality Medical Consultants Inc.*, 76 AFTR 2d ¶ 95-5764.

The most common examples of these problems are described below. In each scenario, the penalty cap is illusory because it applies separately to each legal entity. Assuming Congress abandons its 1989 policy and enacts the current proposal, we recommend how the penalty cap provisions should be applied for each of the situations described below:

1. *Multiple nominees*

   A bank or broker/dealer may use several different nominees (i.e., street names) to hold securities on behalf of its individual customers. Each nominee is treated as a separate payor for information reporting and penalty purposes.

   Recommendation: Nominees used by a bank or broker dealer should not be treated as separate payors for purposes of applying the penalty caps.

2. *Related companies*

   A bank or broker dealer may be comprised of hundreds of affiliated corporations that offer different services and products to customers. Each corporation is treated as a separate payor for information reporting and penalty purposes.

   Recommendation: Different corporations within the same controlled group (as defined under section 267(f)) should be treated as a single payor for purposes of the penalty caps. Alternatively, section 1563(a) could be used as the standard for treating related persons as a single payor.

3. *Mutual funds*

   Each mutual fund within a family of mutual funds is treated as a separate payor for information reporting and penalty purposes.

   Recommendation: Different mutual funds within a single family of funds (i.e., funds with a common investment advisor or principal underwriter) should be treated as a single payor for purposes of applying the penalty cap.

4. *Paying agents*

   A bank may act as a transfer/paying agent for numerous issuers of stocks and bonds. Information returns filed by the bank as agent identify the issuer -- and not the bank -- as the payor. Although the issuer (payor) is technically liable for any penalties, the transfer agent may be required to indemnify the issuer for the penalties.

   Recommendation: A paying agent should be treated as a payor for purposes of applying the penalty cap.

Conclusion

As stated above, the proposal to increase penalties for failing to file correct information returns is unnecessary and is driven solely as a devise to raise revenue through the assessment of higher penalties. The additional revenue will not come from increased compliance as the current penalty structure provides more than enough incentive for filers to comply with information reporting requirements. If it does become necessary to consider this proposal, we would hope that the Committee would make the necessary changes to address the potential application of multiple penalty caps.

This testimony is being submitted by the following trade association and companies:

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May 15, 1996

Mr. Philip D. Mosely
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Mosely:

This letter contains a summary of the position of our client, the Society of Independent Gasoline Marketers of America ("SIGMA"), on the revenue provisions of the President's FY 1997 Budget Proposals. The President's proposals to require that kerosene be taxed at the terminal rack or dyed and to extend the tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund are of significant interest to SIGMA. SIGMA supports the President's proposal to tax or dye kerosene. SIGMA opposes the extension of the LUST tax, unless the funds are spent to enforce the 1998 tank replacement deadline, reimburse clean up costs, and implement other program improvements as set forth in H.R. 3391, introduced by Rep. Dan Schaefer (R-CO) on May 2, 1996.

SIGMA is a national trade association comprised of approximately 260 chain retailers and independent marketers of motor fuels that market motor fuels in all 50 states and in Puerto Rico. In 1994, SIGMA members sold 30.3 bilion gallons of motor fuels, or about 20 percent of all motor fuels sold in the United States. Of this volume sold, approximately 7.6 billion gallons is diesel fuel. SIGMA members who have replaced their underground tanks have spent approximately $75,000 per outlet to do so, not including remediation costs.

SIGMA supports the President's proposal to tax or dye kerosene at the terminal rack to reduce potential evasion of the tax. Since the enactment of the Omnibus Budget Reconciliation Act of 1993 ("1993 Act"), SIGMA has urged the Internal Revenue Service ("Service") to require

that the federal excise tax on diesel fuel be collected on kerosene at the terminal rack or that kerosene be dyed. The 1993 Act requires that any liquid, such as kerosene, that is suitable for use in a diesel powered engine be taxed or dyed upon removal from the terminal rack. The Service has declined to comply with this mandate in the 1993 Act.

The failure to require that kerosene be taxed or dyed provides a significant opportunity for tax evasion. The Service currently requires users of kerosene that blend kerosene with tax-paid fuel below the terminal rack to report such use and remit the tax. Kerosene is frequently blended with diesel fuel for use as a motor fuel in diesel powered trucks, especially during the winter months. Untaxed kerosene that is not dyed can easily be blended without payment of the tax because this type of evasion is not susceptible to enforcement by visual inspection of the fuel, which was the primary purpose of the dyeing requirement for diesel fuel in the 1993 Act.

Any concerns about the use of dyed kerosene by retail consumers in home space heaters can be resolved by permitting retailers of kerosene to obtain refunds of taxes paid on clear kerosene sold for such use. Without such a refund, users of kerosene in home space heaters who have been educated to use only clear fuel, could be faced with the options of using tax-paid fuel and applying for a refund or using dyed fuel. Permitting such a refund would eliminate the need for a consumer to apply for the refund or to use a fuel that he or she has been educated not to use. Such a refund should be paid within 20 days or accrue interest, and should be available only if such kerosene is sold from segregated storage, sold in small quantities, and dispensed through a short hose to prevent diversion of the kerosene to a taxable use.

In addition, marketers who have only one storage tank should be permitted to obtain a refund on tax paid kerosene that is blended with dyed diesel fuel if they can demonstrate that they added dye to the mixture to restore the mixture to the nontaxable fuel dye concentration levels and the fuel was sold for a nontaxable use. Without such a refund, some marketers could be unable to recover taxes paid on clear kerosene mixed with dyed fuel.

SIGMA opposes extension of the LUST tax unless the funds will be truly dedicated to the purposes for which they are collected. SIGMA is concerned that LUST Trust Fund monies will be used to assist owners of underground tanks to avoid the 1998 deadline for replacement of tanks. Such assistance could take the form of direct loans, low interest loans, or loan guaranties for upgrades after the 1998 deadline.

The 1998 deadline should not be extended for anyone. Owners of underground tanks who went to the expense of upgrading their tanks before the deadline should not be forced to compete with tank owners who did not and are then rewarded with an extension and subsidized replacement. The deadline will have been known for 10 years when it is reached. Anyone who is unable to meet the deadline in 10 years should not be permitted to operate.

SIGMA would support the extension of the tax if the funds were actually appropriated to the states to (1) supplement tank assurance funds; (2) enforce existing regulatory requirements; and (3) clean up releases beyond the current statutory period. H.R. 3391 would authorize such uses. LUST Trust Fund appropriations dropped to $45 million in 1996 from $70 million in 1995. With approximately $1 billion in the trust fund, Congress should appropriate these monies for these purposes.

SIGMA appreciates this opportunity to comment to the Committee on Ways and Means. SIGMA looks forward to working with the Committee on these and other tax issues.

Sincerely,

J. KEITH AUSBROOK
Counsel to
Society of Independent Gasoline
Marketers of America

STATEMENT OF TENNECO
ON NEW REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET

Introduction

Tenneco is pleased to submit this testimony in response to the Committee's request for comments on the new revenue provisions in the Administration's fiscal year 1997 budget. This testimony addresses the Administration's proposal to require gain recognition on certain distributions of controlled corporation stock under section 355 of the Internal Revenue Code. Tenneco opposes the Administration's proposal and supports retaining current law.

Tenneco is a diversified industrial corporation with 1995 sales of $8.9 billion. Tenneco owns and manages businesses in four major sectors: packaging (Tenneco Packaging), automotive parts (Tenneco Automobile) natural gas transmission and marketing (Tenneco Energy), ship design, construction and repair Newport News Shipbuilding)."

The Administration's Proposal

The Clinton Administration, as part of its fiscal 1997 budget plan, has proposed changing the tax treatment of certain corporate restructuring transactions in which a target corporation is acquired by another corporation after the target spins-off an unwanted subsidiary. These so-called Morris Trust transactions, named for the 1966 Fourth Circuit case that permitted this transaction, are treated under current law as tax-free spin-offs and reorganizations. The tax-free treatment of both transactions is rooted in the notion that the shareholders continue to own corporate assets without a change in their tax basis.

The Administration argues that tax-free treatment under Internal Revenue Code Section 355 is not justified in a Morris Trust transaction because the transaction effectively represents a disposition of business assets. The Administration's proposal requires any gain in the controlled corporation be taxed to the distributing corporation even though the distributed assets remain in corporate solution and all other statutory and regulatory requirements are met.

"Spin-Offs" Have Historically Received Tax-Free Treatment

Section 355 of the Internal Revenue Code permits the tax-free separation, including a spin-off, of a group of corporations into two or more corporations. Similar to the treatment of tax-free mergers, the treatment of spin-offs is derived from the notion that the shareholders continue to own corporate assets after the execution of a spin-off, although in a different form. In view of this continuing investment, the tax that would be realized had a sale or disposition occurred is deferred until such time that the assets actually leave corporate solution.

The requirements under Section 355 are designed to prevent taxpayers from using spin-offs for tax-avoidance purposes. These requirements include that (1) the spin-off be supported by a bona fide corporate business purpose, (2) the distributing and controlled corporations each conduct an active five year trade or business, and (3) the transaction not constitute a "device" to distribute earnings and profits.

More than twenty-five years ago, the Fourth Circuit, in *Comm'r v. Mary Archer W. Morris Trust*, 367 F2d 794 (4th Cir. 1966), approved a transaction in which a distributing corporation spun-off an unwanted subsidiary and then, as part of a planned transaction, was acquired in a tax-free merger. Since that case, this transaction, which combines a spin-off under Section 355 and a reorganization under Section 368, has been commonly referred to as a "Morris Trust Transaction."

Example of a Typical Morris Trust Transaction

To illustrate a Morris Trust transaction, assume that a candy business desires to acquire a toy business in a tax free reorganization. The target toy business owns a candy manufacturing company which the acquiring candy business does not wish to acquire because it has no need for the extra

manufacturing capacity. In order to accommodate the tax free merger of the toy business into the candy business, the target company spins-off the candy manufacturing company to its shareholders.

Thus, the target toy business shareholders own all of the outstanding stock of two corporations: the toy business and the spun-off candy manufacturing company. The acquiring candy company can now acquire the toy business in a tax free reorganization without also acquiring the unwanted candy manufacturing company. Following the tax free merger of the toy business into the candy business, the former toy business shareholders hold stock in the spun-off candy manufacturing company and the combined candy/toy business. No assets or stock investments have been sold by any shareholders, and the former toy business shareholders have a continuing investment in the toy business through holding the stock of the acquiring candy business stock.

The assets in this transaction never leave corporate solution and no cash is received by either the distributing corporation or any of the shareholders. Therefore, the distributing corporation should not recognize gain and incur a tax liability upon the spin-off of the unwanted subsidiary.

Acquisitive Reorganizations are Tax Free

Under the Internal Revenue Code's reorganization provisions, one corporation is permitted to acquire all (or substantially all) of the assets (or a controlling stock interest) of another corporation on a tax-free basis. This may be accomplished provided that, among other things, the shareholders of the acquired corporation maintain a continuing proprietary interest in the reorganized enterprise. A fundamental assumption underlying these reorganization provisions is that nonrecognition treatment is appropriate where there is a continuity of investment. Shareholders of the acquired corporation must maintain an economic interest in the underlying business through continuing stock ownership.

Importantly, the continuity of proprietary interest test looks to whether the shareholders of the acquired corporation received a sufficient amount of the stock of the acquiring corporation compared to the total value of their interest in the acquired corporation. The shareholders' investment in the acquired corporation is not compared to the total value of the acquiring corporation. After the exchange, the shareholders of the acquired corporation may own a smaller percentage of the acquiring corporation's outstanding shares than they had owned in the acquired corporation. Accordingly, one corporation can acquire another corporation on a tax-free basis by exchanging its stock.

Longstanding Tax Policy Favors the Continuation of Tax Free Treatment of Morris Trust Transactions

The Morris Trust Transaction is entirely consistent with the policies underlying Internal Revenue Code Section 355. In a Morris Trust Transaction, any corporate earnings or built-in gains in the distributing or controlled corporation remain fully within corporate solution and subject to corporate level tax. There is no distribution to shareholders. Accordingly, the Morris Trust Transaction cannot be used by a taxpayer to avoid repeal of the *General Utilities* doctrine. Such corporate earnings or built-in gains will be recognized and taxed at the point a sale or disposition triggers such recognition. The former shareholders of the distributing corporation maintain a continuing interest in the earnings and business of the corporation by virtue of the stock acquired in the reorganization exchange.

The President's proposal, if enacted, would significantly modify the judicially created continuity of shareholder interest test. Without any apparent policy basis, in the case of post spin-off acquisitions, the proposal would overturn the historic ability of a corporation to acquire another corporation on a tax-free basis by exchanging its stock.

The tax-free treatment of the spin-off/merger combination at issue in the *Morris Trust* case was a logical extension of the Federal tax law's treatment of spin-offs and tax free reorganizations. The IRS has accepted and approved the *Morris Trust* decision in a long line of public and private letter rulings issued over the last 25 years. During the Tax Reform Act of 1986, Congress thoroughly

reviewed corporate transactions when the *General Utilities* doctrine was repealed. At that time, Congress recognized the sound policy and business necessity of tax-free spin-off/merger transactions and retained them. In addition, although the Treasury Department's final regulations under Internal Revenue Code Section 355 substantially modified several aspects of spin-off treatment, the regulations left the *Morris Trust* result untouched.

Certainty in Business Planning

On March 29, 1996, House Ways and Means Committee Chairman Bill Archer and Senate Finance Committee Chairman Bill Roth announced that the revenue raising provisions included in President Clinton's fiscal 1997 budget, if approved by the Congressional tax-writing committees, would be effective "no earlier than the date of appropriate Congressional action." Tenneco strongly supports the Chairmen's action to ensure that any enacted provisions would not become effective retroactively as proposed by the Administration. This action by the Chairmen ensures that taxpayers can continue to rely on current law in their business planning activities. Thus, business will not "freeze" in anticipation of potential future tax law changes, and can continue day-to-day operations and strategic planning without interruption.

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