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PRESIDENT'S FISCAL YEAR 2001 BUDGET AND TAX PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

FEBRUARY 8, 2000

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COMMITTEE ON FINANCE

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PRESIDENT'S FISCAL YEAR 2001 BUDGET AND TAX PROPOSALS

TUESDAY, FEBRUARY 8, 2000

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Grassley, Hatch, Murkowski, Thompson, Coverdell, Moynihan, Baucus, Rockefeller, Graham, and Robb.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

Mr. Secretary, it is a pleasure to welcome you here, in your first appearance as Secretary of the Treasury. I have to admit that your position is somewhat enviable. America's economic future is as bright as any of us can ever remember. As President Clinton releases his new budget, our Nation essentially will be in its seventeenth year of economic expansion.

Since 1981, about 40 million new jobs have been created, unemployment has been cut almost in half, inflation has fallen along with interest rates, and the economy has averaged 3.2 percent annual growth, while markets have soared.

Now, these are the successes of the American people. They are the rewards of risk-taking entrepreneurs, hard-working men and women, and a generation of bright and promising young people entering the labor force.

Washington is certainly responsible for promoting sound economic policies, but it is across America that the economic growth we enjoy finds its life and future.

We must be certain that the programs we initiate and sustain in this city serve those who are creating the economic growth and surpluses that bless our Nation. That is the measuring rod I am using to assess the President's budget.

Unfortunately, measured against that standard, the President's budget does not do this to the degree that it should. Real tax cuts are too short, too few, reforms to the Tax Code are too timid, and new spending is far too high, to the detriment of debt reduction.

I am also disappointed that the President did not use his budget to introduce new comprehensive proposals for Social Security reform. These, I believe, are missed opportunities, opportunities that cannot afford to be lost.

Few times have conditions been so right to build a strong foundation for a promising future. Mr. Secretary, we need to give Americans everywhere the tools to excel in this new economy. We need to use this moment to preserve and strengthen important programs like Medicare and Social Security. We need to lessen the tax burden on the American family.

In studying the President's budget, there is no question that common ground exists between us. We share an interest in decreasing the Federal debt and further opening foreign markets to American products. The President agrees that we must reduce taxes, and we agree that a prescription drug benefit should be provided as part of comprehensive Medicare reform.

Let us build on this common ground. I believe that if we are determined to work together, if we do work together, then common ground can yield more success than we can imagine.

Then the American people will reap the rewards they richly deserve, and then the future will continue to be marked by prosperity and increasing opportunity. Then we can say that, here in Washington, we have been a contributing partner in a great and promising work.*

Senator Moynihan?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Well, thank you, Mr. Chairman. Welcome, Mr. Secretary. Ms. Mathews, how generous of you to come along.

You were saying, sir, that this is, in effect, the seventeenth year of economic expansion, and it is. I mean, there have been a few bumps, but the basic proposition is true.

You give credit to all manner of deserving folk, but you left out the economists. I think, in the presence of Secretary Summers, there ought to be a certain acknowledgement that knowledge has had an effect on all of this.

In 1933, recession, looking hopeless the world-round, John Maynard Keynes published a little booklet here, having previously appeared in England, called "Essays in Persuasion," which he said he really should have called "Essays and Prophecy."

The economic problem, as he put it, is really just a giant muddle. I mean, we will sort it out. He said, I think it will be just about done by the year 2030. He said, at which time per capita income and revenues will have grown about eight times.

Well, we are getting close. We are closer to 2030 than we are to 1933, and if the rate of growth of the last 17 years continues, we will be right at eight times that number when 2030 comes around.

So, thank you, Mr. Summers, and the brave band of macroeconomists who have brought us to this happy circumstance. I much agree with the Chairman that getting interest down, getting

* For further information on this subject *see also*, Joint Committee on Taxation reports: "Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal," March 6, 2000 (JCS-2-00); "Summary of Tax Previsions Contained in the President's Fiscal Year 2000 Budget Proposal," February 7, 2000 (JCX-13-00).

the debt down—which means getting the interest payments down—is so essential.

We peaked, in fiscal '96. Interest payments were 15.4 percent of the budget, about what defense is. We do not see it because we have to do it, and it goes through our committee without any comments.

But we are now down to 11 percent, and I think by the year 2013, the debt will have been paid off and we will have all of that resource. Although I hope the Secretary can comment to us, do you really want to pay off all the debt? Is there not a need in an economy for a certain amount of Treasury securities?

Finally, and again to agree, sir, it is a convenient myth to say that we are saving Social Security because we are using the surplus to pay down the debt, but of course we are not touching Social Security. It has not changed in any way.

We have, on this committee, put forward some pretty powerful proposals about Social Security itself. They do not come from the administration, which I think is to be regretted, but perhaps they will. Perhaps the Secretary or Ms. Mathews will think up something on the spot and make this an even more memorable occasion.

Thank you, sir.

The CHAIRMAN. Thank you, Senator Moynihan.

We now will turn to you, Mr. Secretary. Let me also welcome Ms. Mathews; it is a pleasure to have you here.

Ms. MATHEWS. Thank you, Mr. Chairman.

The CHAIRMAN. As you know, your full statement will be included as if read, so please proceed.

STATEMENT OF HON. LAWRENCE H. SUMMERS, SECRETARY OF THE TREASURY; ACCOMPANIED BY SYLVIA MATHEWS, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Secretary SUMMERS. Mr. Chairman, Mr. Ranking Member, thank you very much for providing us with the opportunity to appear before you to discuss the President's budget, and what I agree with you is an historic moment of opportunity for our country.

Just this morning, it was announced that productivity in the fourth quarter of last year had increased at a 5 percent annual rate, the kind of productivity growth and economic growth, more generally, that would have been thought unthinkable even a decade ago.

This economic success is a tribute, as your colloquy with Senator Moynihan suggests, Mr. Chairman, to many things. I will make no comment on the role of the economics profession, but we know that information technology, we know that hard work, we know that the entrepreneurial spirit made an enormous difference. It is a credit to American workers and to American business.

But I am convinced that it would not have been possible to unlock all of that economic energy had we not had the formidable fiscal success of the last decade.

Without that fiscal success, some $2 trillion of American savings that has gone into new plant and equipment, into crucial investments in research and development in information technology, would, instead, have gone into the sterile asset of government paper where it would not have contributed at all to productivity.

That is why the President's number one priority in developing his budget this year was to establish a framework of conservative budgeting in which we would plan realistically for continued surpluses, reductions in debt, and allow this virtuous circle of lower interest rates and increased economic growth leading to more revenue, still larger surpluses, to continue.

The budget has five crucial objectives. Let me address each in turn. First, establishing a framework for continued debt reduction. Debt reduction in the national debt is tantamount to a tax cut.

It is tantamount to a tax cut on American workers and families because it reduces their obligation to provide for future interest payments, to provide for future principal payments on debt that does not have to be issued.

It is tantamount to a tax cut because it reduces pressure on credit markets and, therefore, leads to lower interest rates, reducing costs borne by families. A one percentage point reduction in the interest rate is equivalent to a $250 billion cut in mortgage costs spread over the benefit of a decade. Debt reduction also leaves us in a better position to respond to any shocks that might arise in the future.

The President's budget provides for the elimination of the net debt by 2013. We believe this will have enormous beneficial effects on the economy by making room for productive new investment.

I would say to Senator Moynihan that we have given a great deal of thought to the issues involved in financial markets in such an environment, and there are, I think, a variety of ways in which the private sector can create what are effectively risk-free, or near risk-free, financial instruments that can serve the benchmark function so we can certainly benefit from allowing the government to recede from the credit markets, making room for investments in American businesses.

The second priority embodied in the President's budget is meeting the needs of an aging society. In addition to the benefits to the economy from debt reduction, there is a substantial benefit to the budget. Reducing the national debt increases fiscal space by obviating the need for the more than $200 billion that will be spent this year on net interest.

The decisions that we have all come together on to work towards an on-budget balance or on-budget surplus have created substantial room for debt reduction. The question arises where the savings should go.

The administration has made the judgment that the highest priority for those savings should be Social Security, and it therefore proposes that those interest savings be allocated to the Social Security trust fund and invested wisely, offering the potential to build a foundation for Social Security reform by extending solvency to 2054.

The administration's proposals also address Medicare in three critical ways. First, by proposing a prescription drug benefit that is universal—and we believe appropriate and overdue—at a time when prescription drugs are so crucial to the health care of our seniors.

Second, by providing for choice-based reform, broadens the range of choices for Medicare recipients, allows them to benefit from the savings that are possible through certain choices that they can make, but that avoids financial coercion that would break relationships between our seniors and their existing care givers.

Third, recognizing the impact of rising life expectancy, the aging of the aged, if you like, the growing size of our aged population, and the tremendous opportunities that health care research are providing, it is the judgment of most experts that Medicare requires additional financial infusions, even after reform.

That is why the President allocates close to $300 billion in his budget for debt pay-down and allocation to that Medicare trust fund, with the potential of extending solvency to 2025.

Third, targeted tax cuts. We believe that, after meeting the crucial priorities of paying down debt and strengthening Social Security and Medicare, it is possible to provide important tax relief to American families at crucial points in their lives.

The President's budget contains some $350 billion in tax cuts over 10 years. Some priority areas include the promotion of savings through a new program of retirement security accounts that builds, Mr. Chairman, on what you have worked so hard on in the past, the IRA program, by targeting 75 million or more Americans who do not have a private pension, 401(k), and generally receive little or no inducement to contribute to IRAs.

The expansion of educational opportunity, by allowing the deduction of as much as $10,000 in higher education costs for middle income families. Making health care more affordable by tripling the long-term care credit and offering a credit for individuals between 55 and 64 who have lost jobs and wish to buy in to the Medicare program, as well as credits designed to strengthen the market for health insurance among small businesses and those who are making transitions between jobs.

Support for working families, including a strengthened Earned Income Tax Credit, making the Child Care Tax Credit refundable, and targeted, appropriate marriage penalty relief.

Tax simplification through relief from the Alternative Minimum Tax, which has been recognized as an increasing problem, particularly for larger families with many dependents. There are additional measures in the President's proposals that address environmental concerns, address philanthropy, and address the digital divide.

Let me also highlight, Mr. Chairman, that our proposals contain approximately $100 billion in tax offsets, and within that area of tax offsets I would highlight one area as being of particular concern, and that is the growing significance of abusive corporate tax shelters.

There is, I would suggest, Mr. Chairman, ample room for debate over a range of subsidies and what some see as loopholes and others see as important benefits. But where we are discussing transactions that are devoid of economic substance and are marketed in secret to those who wish to play the audit lottery, I think we have a serious problem for the integrity of our tax system apart from any revenue consequences.

The administration's budget contains a number of proposals that are directed at deterring that kind of activity, and I hope they will be seriously considered by this committee.

Fourth, spending to targeted, to key, priorities. All the spending priorities in the President's budget come within a current services baseline, so that every new initiative is financed out of reductions in other programs.

Spending today, as a share of GNP, is lower than any time since 1966. Outlays as a share of GNP, under the President's budget, would fall by 2010 to a level lower than any time since the mid-1950's.

The reductions in the Federal labor force that have brought it to a level lower than any time since the 1960's would be preserved in the President's program, and discretionary spending in the President's program would grow more slowly than it did between 1981 and 1993.

These tough-minded assumptions are essential if we are to maintain our fiscal discipline. A failure to make realistic assumptions would put our fiscal discipline at risk because it would raise the prospect of making commitments based on spending projections that proved to be unrealistic down the road.

Just as we learned in the 1980's that unrealistically optimistic economic projections put us at risk of substantial deficit problems and interferences with fiscal prudence, we must also recognize the need to be realistic in our spending programs.

Within that current services budget, key spending priorities for the administration include health care, with a substantial initiative to extend insurance coverage to five million Americans and allow more Americans to buy into the Medicare program; education, where we would reduce class sizes, enable one million additional children to participate in Head Start by 2002 and address what is the increasingly serious problem of inadequate school facilities in our country; and law enforcement, where we are proposing the largest-ever expansion in the effort to prosecute firearms violations.

Finally, Mr. Chairman, let me just say a word about this moment of opportunity and our strength in the global economy. I would highlight two priorities that are of particular concern.

First, support for an open, global trading system, including the passage of the permanent Normal Trading Relations bill that is essential to supporting China's entry to the WTO, and the African Growth and Opportunity Act, and the enhanced Caribbean Basin Initiative.

Second, support for the poorest countries in the world who have now shared in this global prosperity. The President's budget includes further measures to support debt relief for the highly-indebted poor countries, and includes a number of proposed measures including, of particular importance to me, a new tax credit directed at motivating the discovery and delivery of vaccines for the infectious diseases, a small number of infectious diseases that kill more than one million people each year, such as AIDS, malaria, and tuberculosis.

Mr. Chairman, we have an historic moment of opportunity. What is important, in our view, is that we work together this year to preserve our progress and build our future. We look forward to working with you this year.

[The prepared statement of Secretary Summers appears in the appendix.]

The CHAIRMAN. Well, thank you, Mr. Secretary.

Let me turn to the question of marriage penalty relief, because I would like to give you the opportunity to clarify what the administration's position is on this matter.

In the State of the Union address, the President laid out a proposal to reduce the marriage tax penalty. Last week, however, I think you said, the President would sign marriage tax penalty relief only if the national debt was reduced, Medicare was reformed, and Social Security was reformed.

Now, I ask you, is it the administration's position that the President will veto any marriage tax penalty relief bill, including his own proposals, unless Social Security and Medicare reforms occur first?

Secretary SUMMERS. Mr. Chairman, the President's budget provides a targeted marriage penalty relief proposal that benefits those lower- and middle-income families that are most hurt by the marriage penalty.

We believe that marriage penalty tax relief, like other tax benefits, should be provided in the context of an overall framework in which we are able to see progress in debt reduction and measures progress in strengthening Social Security and Medicare is being realized. It can be done, but it needs to be done in the right way and at the right time.

The President is very concerned that we would not be able to recommend that he sign marriage penalty legislation in isolation from an overall budget framework for the year that assured that we were paying down debt and addressing the needs of Social Security and Medicare.

The CHAIRMAN. Well, my concern is that, in effect, you are sort of ruling out a tax cut. Take Social Security. I think, as was said earlier, the administration really has come up with no proposal of reform, so you are sort of laying down conditions that you have to recognize are not going to be realized. So, in effect, is that not assuring that there is no tax cut?

Secretary SUMMERS. It is not our intent to set unrealistic conditions or to set a bar that cannot be cleared. It is our intent to assure that we do not make substantial, irreversible commitments absent a framework where we know where we are going, a framework where we know what is going to happen in terms of the overall budget allocations, in terms of what we know about whether the integrity of the Social Security trust fund is going to be protected, in terms of what we know about whether resources are going to be reserved so that there is the prospect of increasing Medicare solvency. We do not think that we should take these steps without having an overall agreed framework.

To do so, it seems to us, would put us at risk of a situation that, through a collection of measures, we might take steps that would be completely unacceptable in the context of a single measure because of what they would mean for fiscal prudence, and, therefore, for the economy.

The CHAIRMAN. Well, I have to say, it seems to me this amounts to moving the goal post after the kick-off. I am bothered by your letter to Mr. Archer where you say, "I, and other senior advisors to the President, would not recommend that the President sign a tax bill of this magnitude until a proper framework for paying down debt, strengthening Social Security and Medicare, and funding critical initiatives have been established."

I see Mr. Coverdell here. Paul, I just want to welcome you. You are a new member of our committee, and we are delighted to have a person of your background and experience on our side.

Senator COVERDELL. Mr. Chairman, I appreciate that very much.

Senator MOYNIHAN. May I just join in welcoming our friend, who has a distinguished career spending American money abroad on good purposes. [Laughter.]

Senator COVERDELL. Thank you so much, Senator from New York.

The CHAIRMAN. Mr. Secretary, I am very much interested in solving the Medicare issues raised in calls and letters from seniors in my State of Delaware and around the country. It is clear that we need Federal management and benefit design reforms, including assistance to seniors with their prescription drugs.

Now, I have to tell you, many members on this committee are interested in stabilizing the Medicare+Choice program, introducing greater competition and choice in Medicare plans, improving Federal management to look more like the Federal Employees Health Benefit Plan.

I am encouraged that the President's reform package takes some steps to address these same problems. I do note that you would initiate about $200 billion in new spending just for the prescription drug benefit. That is quite a considerable sum.

Do you agree with those who say that prescription drug assistance must be done in the context of larger reform?

Secretary SUMMERS. I believe that it is appropriate to modernize Medicare in a holistic way, Mr. Chairman, and that we should act, both with respect to the prescription drug issue and with respect to the broader range of Medicare reforms, emphasizing as your question suggested.

The President has put forth proposals, as you know, in both areas and it would be my hope that we could all work together to implement those proposals, as well as measures to extend solvency this year. I think there is no question that that is the best way forward.

The CHAIRMAN. I would like to turn to trade. I am, frankly, much concerned by recent statements of the President in Davos, by you, I think, in India, suggesting that our trade agenda should not move forward until labor and environmental interests are added to the WTO agenda.

Now, these comments, as you know, follow the failure to launch a new round of trade negotiations at the WTO ministerial in Seattle. There, the administration's proposal for a labor working group was opposed by almost all of the WTO members and, frankly, was a principal cause of the failure to launch negotiations designed to provide market access for U.S. agricultural services and industrial goods.

Has the administration effectively set progress in the WTO on labor and environmental standards as a precondition for any further progress on trade? If that is the case, what am I going to say back home to my poultry farmers, to my auto workers who produce the Durango and Saturn, that foreign markets will remain closed until you have reached agreement with the 100-plus countries on labor and environment?

Let me say, we all agree that there are problems that ought to be addressed with respect to environment, with respect to labor, but we feel that there are other forums for doing so.

I am much bothered that we are, in effect, shutting off progress and market access to American-made products. The rest of the world pretty much has access to our markets; we want the same. I think this is very troublesome, indeed.

Secretary SUMMERS. Mr. Chairman, let me make three points, if I could. First, the administration shares your commitments to opening markets around the world, believes very much that a more open, more integrated global economy is enormously in our interests, not just economically, but also in terms of our National security, and is committed to that objective.

That is why, as I indicated in my statement, top legislative priority for the President this year is China's admission into the WTO and the passage of the Africa/CBI legislation.

Second, the President and all of us believe that the process of global integration is one that requires measures on the trade front, but also will require attention to other issues that become more important as we all come closer together, just as a whole range of issues became more important as the different States of the United States came to trade together much more at the turn of the past century.

Third, the administration's proposals only went so far as to discuss a study group in the WTO that would explore the relationship between issues relating to trade and the areas of labor and environment that you mentioned.

There were many difficulties that arose in Seattle, and perhaps particularly acute were the difficulties that arose in agriculture. We are working on consulting with other countries to try to find the best way forward with respect to the WTO.

But it is our commitment, and I think it is something that is very important to maintaining support and to having global integration work for everyone, that as we think about global integration, we think about all of its consequences.

It does have consequences for working people, it does have consequences for the environment, and those have to be considered as we move forward with global integration. That is our policy.

The President was very clear, however, to state in Davos that, while he had a range of concerns with respect to the way the WTO functioned, that it would be a serious mistake—for the reasons you suggested—to hold hostage any progress with respect to market opening until a full set of issues with respect to transparency, for example, in the WTO could be addressed.

So we are in consultation with others, and hope to move forward on the basis of a mutually-agreed approach as rapidly as possible.

The CHAIRMAN. Well, frankly, I do not think you can have it both ways. I was at Seattle and, frankly, it was the President coming out and laying down the conditions about labor and environment. Yes, it was agreed, a working group, but that turned off over 100 of the developing countries.

I just think that it is all very fine to say that we are for trade, we want to open up markets, but in order to do so we have to solve these other problems. It is just not going to work that way.

I think the most important thing we can do, is to proceed with market access for products made by American workers or produce grown by American farmers. Open up these markets. Yes, we do have these other problems, I agree with you. But what we are saying is, let us not tie up market access so no progress can be made.

I think this is a most serious matter that the administration needs to review, because we are entering a global economy, we must be on the cutting edge of trade, and we cannot play politics with it, and I fear that is what is being done.

Well, my time is up. I would turn to my good friend, Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, may I just agree with you, and I think most members of this committee would agree with you, in your last point. To say to our esteemed Secretary of the Treasury, these are not decisions you made. As a matter of fact, they have been institutionally separated from Treasury. And I do not know how good an idea that was, but they are.

But you cannot say we want a more open trading system and we want arrangements that will prevent such an open trading system from coming. There is, for the example, the International Labor Organization, which began its work down on Constitution Avenue in 1919. The United States was actively involved in its creation, joined it early.

The WTO, which now occupies the original headquarters of the ILO in Geneva, have said that labor matters belong in the ILO, which has the same membership as the WTO and a structure that has been there for 75 years.

I do not know that there is anything you could say about that, and I would encourage you not to say anything because it cannot be very comfortable for you.

Secretary SUMMERS. Could I?

Senator MOYNIHAN. Sir?

Secretary SUMMERS. If I could just make one and a half observations.

Senator MOYNIHAN. One and a half? That is an economist talking.

Secretary SUMMERS. Let me say, Senator Moynihan, that we have the greatest respect for the work of the ILO, believe it has a crucial role with respect to these issues, are very much aware of one of its greatest American students and scholars who has studied it——

Senator MOYNIHAN. Is he an economist or is he a politician? [Laughter.]

Secretary SUMMERS [continuing]. So extensively and believes that it definitely does have a major role with respect to these issues. But I think that, as the President said in Davos, while there are a set of separate organizations with separate mandates in these different areas, it is hard to imagine thinking about setting the rules of a global economy in ways in which we are entirely compartmentalized, and one set of rules we entirely ignore in interactions with another set of rules.

It is certainly not the way we go about setting a framework for commerce in the United States. We have separate organizations, separate committees of the Congress, if I might, with particular mandates, but we also recognize that there are interactions and that those interactions have to be considered.

I would not be able to support any approach that I thought was slowing the progress of global integration, which I think offers the best prospect for our own economic success.

But I have become convinced that an effort to completely ignore these issues or simply to say there is one organization that deals with them and there are no other interactions that should be considered would be an approach that would slow ultimate progress, both in our country and in others, towards global integration. That is not to say that we have found the answers in a satisfactory way, but that we need to keep looking.

Senator MOYNIHAN. I would only wish to say that this committee has supported this administration, and previous ones, on trade matters.

We will have, as you know, the African measure and Caribbean Basin Initiative have both passed out of this committee and passed the Senate, and we will be having a preliminary meeting with the conferees from the House tomorrow, so wish us well.

I will just state, after 60 years of expansion from the time of Cordell Hull on, American trade policy is in crisis. It is the only crisis on the horizon that could spoil the economic growth that you have described.

I would make two points further, then turn to our other colleagues. The President proposes that, starting in the year 2011 and going on to 2050, that there be annual transfers of general revenues to the Social Security trust fund.

Well, that means we will not make any structural changes in Social Security itself and we will surely run the risk of undermining the nature of Social Security as a contributory insurance program, where people pay in their contributions and have their benefits as a matter of right. Think about that; I am sure you will.

Lastly, I am sure the Chairman heard, as all members heard, your suggestion that there are beginning to be evidences of abusive tax shelters on the part of corporations, which is something new, but you always find something new in our economy. We dealt with a matter of individual tax shelters in the 1986 legislation, and I think we should address this matter.

It will be possible, Mr. Chairman, that you would invite the Secretary and Mr. Rossotti sometime early on this year to tell us what they know about this and suggest what we might do.

The CHAIRMAN. It is my plan, I would say to Senator Moynihan, to hold hearings on this matter.

Senator MOYNIHAN. Yes. Well, good. Now, who says these hearings never do anything more than exchange information that is already known and understood?

Thank you, Mr. Chairman. That is good. Thank you, indeed.

The CHAIRMAN. Next, we have on our list Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Secretary, I want to say how much I admire the leadership which you and your colleagues at the Treasury have given to this economy over the last 7 years.

It has been a remarkable achievement, and I agree with the observation of Senator Moynihan, that it did not just happen by chance, that it was the product of some very clear, tough-minded thinking by some very intelligent economists, and then the political will to put those into effect. I thank you for your contribution to both of those.

I have a concern similar to that raised in Senator Roth's questions, and that is, just what are the sequencing of priorities of the administration, and how will that sequencing reflect itself in specific political actions?

Last week, I voted against the bankruptcy bill. There were several reasons, but a primary reason was that it committed approximately $77 billion of the expected surplus over the next 10 years to a set of tax reductions.

Several of those tax reductions in the absolute, I would support, but in relation to other priorities, I could not support, particularly in the context of not having dealt with the two priorities of Social Security and Medicare.

The end of this question is, did I do a smart thing in voting against the Bankruptcy bill based on that proposition?

In his 1998 State of the Union speech, the President said, and I summarize: "tonight I propose that we reserve 100 percent of the surplus, that is every penny of any surplus, until we have taken all the necessary measures to strengthen the Social Security system for the 21st century. Let us make this commitment: Social Security first." That was 1998.

In his 1999 State of the Union address, the President stated, "We should put Social Security on a sound footing for the next 75 years. Last year, we wisely reserved all of the surplus until we knew what it would take to save Social Security. Again, I say we should not spend any of it, not any of it, until after Social Security is truly saved. First things first: once we have saved Social Security, we must fulfill our obligation to save and improve Medicare." That was January of 1999.

January of 2000, the statement is, "We must ensure that the benefits of debt reduction go to preserving two of the most important guarantees we make to every American, Social Security and Medicare. Tonight, I ask you to work with me to make a bipartisan down payment on Social Security reform by crediting the interest savings from debt reduction to the Social Security trust fund so that it will be strong and sound for the next 50 years.

Now, my question is, does the administration support the concept of using the on-budget surplus to extend the solvency of Social Security and strengthening and modernizing Medicare before using those resources for other programs or for tax cuts, and does the administration define solvency of Social Security as being a 50-year or a 75-year commitment?

Secretary SUMMERS. Senator Graham, perhaps it is presumptuous for me to judge, but let me say that yours was a wise vote, in the context, in our judgment. We believe that we can have targeted tax cuts, but that we should not agree on targeted tax cuts until we have got a framework that assures we have the most important benefit for American families, which is reducing their share of the national debt and until we have been able to take steps to use the surplus to fortify Social Security and Medicare.

It would be ideal to come together on an agreed framework for 75-year solvency. That does not appear likely this year, although it is something that we would very much like to see happen.

In any event, the President's budget lays out what we think represents a sound approach to laying a foundation for Social Security reform by pushing the exhaustion date out past the baby boom generation through a combination of transfers and modifications in investment policy.

We believe there is very substantial possibility of coming together this year on both structural reforms of Medicare and agreement on a prescription drug benefit, and measures to fortify solvency.

It would be our hope that, before we were in a position to debate the tax cuts, that we would come together on a framework for carrying forward those primary objectives which we have all been working towards over the last several years.

Senator GRAHAM. So is the answer to the question that I should continue to vote against proposals that would either increase spending or reduce taxes until such time as Social Security has been made solvent for 50 years, and Medicare strengthened?

Secretary SUMMERS. The administration will not support tax cuts, except within the context of an overall framework with respect to debt and Social Security and Medicare. We would hope to work together, in a bipartisan way, to agree on such a framework, perhaps in the context of the budget resolution.

Senator GRAHAM. That also would include opposition to tax cuts and opposition to additional spending until those same reductions occur in Social Security and Medicare.

Secretary SUMMERS. We think we should be budgeting this year within a framework that includes a realistic baseline and within a framework where we are seeking, first, to pay down debt and meet the primary objectives that you have been commenting on.

Senator GRAHAM. Thank you.

The CHAIRMAN. Thank you, Senator Graham.

Next, is Senator Hatch.

Senator HATCH. My question is a little bit on the flip side of that, Mr. Secretary. One thing about the President's budget that really puzzles me, and I hope you can clear it up, is last year the administration's budget proposed a net tax increase. At the same time, the budget projected a non-Social Security surplus of $750 billion over 10 years.

Now, this year it appears that the President has seen the light, at least in a limited way, and is proposing a net tax cut of about $169 billion over 10 years. Yet, this year's budget is projecting a non-Social Security surplus of only $746 billion, $4 billion less than last year.

Now, I am glad that the administration has changed its mind even a little on tax cuts, but why? And why, Mr. Secretary, in a budget where the President has found room for hundreds of billions of dollars of new spending, can we afford only a net tax cut of $169 billion?

Secretary SUMMERS. Let me respond to your question in three ways, Senator Hatch.

Senator HATCH. All right.

Secretary SUMMERS. First, the administration proposes a $350 billion gross tax cut. The difference represents a variety of measures which are justified in their own terms, such as the attack on corporate tax shelters, such as the tobacco policy which is justified on health grounds.

Senator HATCH. You have $182 billion in tax increases, so that is why I came up with the net $169 billion.

Secretary SUMMERS. I understand the arithmetic, but would argue that the tobacco policy, the closing of abusive corporate tax shelters, are not properly thought of as a tax increase. I understand, but there is a semantic question there.

Second, the administration's budget is very restrained and, in many ways, calls for cutbacks in the role of government. The share of government spending in GNP, under the administration's budget, declines over the next 10 years, discretionary spending grows less rapidly than it did during the years when President Reagan and President Bush were proposing budgets.

The Federal Government, today, has some 370,000 fewer people working for it than it did in 1993, and that figure will not grow in the administration's budget. So any new spending initiatives within the President's budget, on the discretionary side, are accommodated within the maintenance of a current services approach, which is more austere than what the country has done over a period of many years, and I think is important for responsible budgeting.

The President's budget does allocate some $300 billion to Medicare solvency and to debt paydown in the context of that Medicare solvency because we believe that that is meeting a future crucial obligation of the American people. That is not new spending, that is making sure that we have the capacity to meet an obligation that we have already incurred.

We believe that the President's budget represents a balanced approach that makes room for significant tax relief, even while doing what I think is most important for American families, which is reducing their share of the national debt and assuring our country's capacity to meet the other obligations that we have for Social Security and for Medicare.

Senator HATCH. The number one complaint I hear from Utahans about taxes, Mr. Secretary, even more than how high they are, is the complexity of our Tax Code. Now, many of my constituents tell me we ought to just throw out the Internal Revenue Code and start over again because it is so doggone complicated. I realize this is not going to happen this year, but I think we should start now to make the Tax Code easier to understand and to work with.

By my count, the President's budget includes 90 proposals for targeted tax cuts and 90 other proposals to raise revenues. The Treasury explanation of these proposals alone is 230 pages long.

Can you estimate for me how many additional pages would be added to the Code and regulations if the administration's proposals are enacted into law? Now, I also realize that some of your proposals do result in simplification as well, I want to be fair on that, but do you not think we should call a time-out to additional complexity and focus on tax changes that reduce, instead of increase, complexity?

Secretary SUMMERS. I think simplification is an important objective, but it is one that I think is served in a number of respects by the administration's proposals. For example, the relief from the Alternative Minimum Tax; for example, the increase in the standard deduction which will reduce the number of itemizers; for example, the conformity——

Senator HATCH. But the number of taxpayers subject to the AMT is estimated to grow from 1 million today to about 17 million by 2010. I think your AMT proposal is targeted to large families with modest incomes, like many in my home State, but I am still concerned about the effect of the AMT, with its complexity, on families.

It seems to me that the President's proposal still leaves, even after you try to do everything you can, almost eight million Americans subject to the Alternative Minimum Tax in 2010. I am sorry to interrupt you, but I just wanted to raise this question.

Secretary SUMMERS. I think there is a continuing concern with respect to the AMT, and I think the President's proposal makes a good start with respect to the AMT issue.

I should also say that, from my conversations with taxpayers and from the analyses that have been done, I think often what is stated as a concern about complexity is actually a concern about fairness, that there is a sense that there are complex provisions that others are taking advantage of that the individual taxpayers cannot.

A particularly large amount of legal and highly sophisticated activity is going into the corporate tax shelters area that I mentioned, and if we are able to agree on measures that would deter that kind of activity, I think we would achieve a substantial part of the benefits of reducing complexity.

I should say also, that I think the particular credits—for example, the HOPE scholarship, which has benefitted more than 5 million Americans, which does involve another line on the form—have been welcomed by those who have benefitted from that financial assistance in sending a child to college.

So I think we do need to continue to work on and focus on simplification, and that has been an important component in the design of our proposals. But I would hope that, as we work on simplification, we could also continue to work towards a tax system that better meets the needs of American working families.

Senator HATCH. Well, thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Hatch.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, I would just like you to kind of step back a bit and advise us how we deal with the future in such an increasing era of complexity and uncertainty.

For example, and Senator Moynihan alluded to it, we passed this big tax cut in the early 1980's, then this Congress 2 years later, then 2 years after that, had to enact tax increases because the earlier tax cuts were just too large. We were wrong, and it was very painful. We had to pass TEFRA, and DEFRA, and so on, and so forth.

In addition, just 2 years ago, January, the estimators—CBO and OMB—projected about a $900 billion deficit over 10 years. Now, 2 years later, and the chart shows this, that projection is almost a $2 trillion surplus over a 10-year period. That is a swing of about $3 trillion in over 2 years.

Add to that the astounding figure you gave earlier about labor productivity of 5 percent. That is, according to Senator Moynihan, who knows this better than anybody in this room, that is astounding. That is almost unimaginable.

It is due, I suppose, in part, to the advent of computer technology, the Internet, greater capital spending, greater efficiencies in the work force, and so forth.

It is also probably due to the globalization of the economy and to, in an interesting article I read in which your predecessor was referred to, a Wall Street Journal article about a week or so ago, about the degree to which capital markets have stimulated this economy with lots of different instruments, whether derivatives, and hedge funds, and so forth. It was very interesting how the people's wealth is held more in equity markets and debt is much less, comparatively, significant.

Then-Secretary Rubin said back then that he made a few phone calls when the Asian crisis was beginning to go down the tank, he could call some banks. Now he is not sure he can call any banks good, because the banks have comparatively less leverage today than then.

So I am really asking you, how do we deal with all of this in setting budgets, in setting fiscal policy? It is really two questions, if you can give us a little more of what your thinking is on how we deal with all of this uncertainty.

I am reminded of a conversation I had recently with the top CEO of a major telecommunications company. I asked him, how do they plan for the future? I said, do you have 5-year plans? He said, yes, we do. I said, do you stick with them? Well, not really. They really cannot plan even 5 years out very well. Now, granted, that industry is changing dramatically, and will continue to change dramatically.

So I guess the first question is, are we in a new age, where statistics do not mean as much any more, where the usual indicators are much less reliable? If so, what do we do about it, and what does that portend for whatever budget we may pass this year in tax policy?

My answer to the second question, and I would like your answer, is that in some way it portends that we have got to be very careful. There is not a lot of wiggle room here, because this could swing or change very quickly in any direction. If that is the case, we should be pretty circumspect and careful.

But your thoughts, please.

Secretary SUMMERS. I am not sure I can do justice to your very thoughtful question in the time available. Let me make just a couple of observations. First, I think that it is a very new economy, but that makes old virtues even more important. And the two virtues that I think are most important to cite, are saving and prudence.

Let me say something about saving, first. In a world where there were no productive investment opportunities, it would not be terribly costly to have savings channeled into government debt.

Having a $3 trillion debt that is in government paper instead of plant and equipment is not very important if there are not productive opportunities for plant and equipment.

But when there are the most productive opportunities that there have ever been, having that remaining government debt, having budget deficits, is much more costly than it ever has been in the past.

That is, I think, why we are coming to a recognition of the increased urgency of debt reduction as a crucial national objective and why—and I know this is an area where you have been a leader, Senator Baucus—we need to work not just on our government component of national savings, but also on the private component of national savings, where our personal savings rate is, as you have recognized in the pension area, and Senator Roth, of course, has recognized in the IRA area, a crucial priority.

Second, we need to be cautious in our budgeting. We need to hope ambitiously and plan conservatively. Your chart makes a very powerful point. There is a tendency, after the very happy news of the last 7 years, to think that all revisions will be upwards.

I can assure you that everything one knows about economics suggests that, over time, we will have revisions that are downwards as well as upwards, and that the further out you look, the less certain the forecast is.

That is why, it seems to me, that it would be particularly problematic to take large commitments with respect to the out-year budgets more than 5 years out of an irreversible kind, because I think to take large commitments with respect to those budgets today, either in the form of large new entitlements or large new tax cuts, the two portions of the budget that are irreversible, would put us at risk if we had a revision like the revision that you have illustrated here that was in the other direction of going back to the kind of economy that we had in the late 1980's and early 1990's with deficits, lagging productivity growth, rising interest rates, and a concern about whether the United States would be able to stay up in the world.

You know, 10-year budgeting was motivated in an entirely admirable objective of increasing fiscal discipline during a period of rising deficits in order to assure that we kept our focus on the long run. I think it would be very unfortunate if 10-year budgeting were ever to have the ironic consequence of leading us away from fiscal prudence by making it too tempting to take foreign advance commitments of an irreversible kind.

That is why the President's budget sets a realistic discretionary baseline, focuses on debt reduction, makes its largest commitment to Medicare in the form of an augmentation of the trust fund of the fruits of debt reduction so that you are further reducing debt and enjoying the flexibility that it brings.

If I might make just one final point. One of the things that I think we have an obligation to do now while our economy is strong, is to increase its resilience. One of the important ways we do that, is by reducing the national debt and, in a sense, reloading the fiscal cannon.

So there is the greater opportunity to allow the automatic stabilizers to operate in the event that we run into some kind of shock or problem at some point in the future.

But it is absolutely crucial that none of us become complacent or come to believe, as I think people sometimes may do after a long, good period, that all revisions will always be upwards, because that will not be the case.

Senator BAUCUS. And I appreciate that. I compliment you on your answer, particularly your point to the effect that we can sometimes be seduced by the projection of large numbers when times are good into thinking and being blinded by the large number, several trillion dollars over 10 years, based upon current projections. It is a very seductive concept that we get money to spend and we can do all these things, but that is not the case.

Thank you.

The CHAIRMAN. Senator Thompson.

Senator THOMPSON. Mr. Secretary, I would like to follow up on a point that Senator Moynihan raised briefly in his opening, and that is whether or not the total elimination of debt is a desirable thing.

Clearly, it is symbolic and politically attractive. , Clearly, less debt is better than more. But all of the scholarship that I have seen on it seems to indicate that total elimination, in terms of the impact would have on your flexibility, short-term borrowing, et cetera, would not be a desirable thing. What is your opinion?

Secretary SUMMERS. There are two sets of issues that arise, Senator Thompson. One set of issues arises from the impact of the Federal borrowing position on national savings.

In some countries—very few, but Singapore, for example—the government actually has a substantial net asset position. It has gone to zero debt and then it has run more surpluses and has, in effect, accumulated a large supply of net assets as a further contributor to national savings.

I do not think that is something that one would support systematically for the United States, although some would make that argument because of the aging society.

But I think, given that even with all the success we have had, our net national savings rate is perhaps the lowest, or one of the lowest, in the OECD countries. And while our National savings rate has doubled since 1992, it is still significantly lower than it was in the 1950's and 1960's.

Given the tremendous investment opportunities that are available in our country and the difficulties of foreign borrowing, it seems to me that the preponderance of risk is overwhelmingly on the side of too little national savings rather than too much and, therefore, all policies that reduce debt and increasing national savings, it seems to me, are desirable.

Separate from that more aggregate macroeconomic consideration is a set of considerations that go to the operation of financial markets and whether one needs a certain amount of government securities to provide a benchmark, to provide an instrument for those who wish to invest in a country without becoming involved in knowing its private sector.

I think those are an important set of issues, and they are a set of issues that we have discussed quite extensively with our Borrowing Advisory Committee.

I think—and this would be a useful subject to explore in more detail in the context of future hearings—our judgment at this point would be that, given the time available—we are talking about close to a decade before we get into a situation of this kind—that there are other ways in which benchmark securities could become available through overly capitalized subsidiaries, through the use of various kinds of guarantee mechanisms within the private sector that would create benchmark issues. Indeed, a number of private issuers are already moving to try to establish themselves as benchmark issuers.

So my judgment, and I think this is one that would be shared at the Federal Reserve, would be, at this point, particularly with a view to Senator Baucus' point about all the uncertainties in life, that the net balance of risk is overwhelmingly on the side of it being desirable to pay down debt as rapidly as possible, first, because of the national savings benefit, second, because of the insurance benefit that comes from the fact that we are uncertain as to how all this is going to play out, and any issues of their needing trading instruments are very much a reduced concern that could be addressed in other ways.

Senator THOMPSON. But there is some benefit, from a management standpoint, to having some debt?

Secretary SUMMERS. From a Treasury management standpoint, there is no very large issue. From the point of view of the conduct of the Nation's monetary policy, this is something that I want to say very little about because it is really the Fed's province.

There is a need, as they carry out their operations, to buy and sell some class of securities. So if there were not government debt securities, and let me just emphasize that we are talking about things that are 10 years out, a very large number of things can happen between now and then. They would have a need to carry out their operations with other securities and a suitable set of arrangements would have to be made.

Senator THOMPSON. Obviously, I have gotten in further than I meant to. I did not mean to take all of my time up with Senator Moynihan's question, although it was an excellent one.

The CHAIRMAN. Go ahead.

Secretary SUMMERS. I apologize.

The CHAIRMAN. Go ahead.

Senator THOMPSON. Perhaps I have time for one here, with the Chairman's indulgence. It is a follow-up, on your exchange with Senator Baucus about the uncertainties of projections.

With regard to the prescription drug benefit, since past Medicare cost estimates have missed the mark by so wide a margin—they were predicted to be $9 billion by 1990 and it turned out to be $67 billion, and the administration last year revised its cost estimate for prescription drug benefits up from $118 billion to $160 billion over 10 years, and that does not even include the new catastrophic benefit—is the administration at all afraid that the cost of this new benefit might explode in the future, further threatening the solvency of the Medicare program, especially in light of the fact that we have no, still, at long last in this golden age that we are living in, concrete proposal for Medicare reform?

If we are concerned about the delicacy of these projections that you have been discussing and acknowledging, does the same thing not apply when we are looking at something like a prescription drug that has already proven to be very difficult to estimate?

Secretary SUMMERS. Let me say, I think that is a very important issue, Senator Thompson. As a trustee of the Medicare trust fund, it is something that we have given a lot of thought to in the design of our proposals.

And I think it will be very important as we work together to be very mindful of those risks, and as we think about the arrangements of the insurance, as we think about the way in which benefits are going to be purchased, to be very mindful of the cost containment consideration.

But I do not think it would be prudent for us to respond to what is the inevitable—and I know this is not what you are suggesting—uncertainty in Medicare projections by simply saying that we are not going to make any changes in the program because we cannot project what will happen accurately.

The administration has proposed a rather elaborate——

Senator THOMPSON. This is not just any old program. We do know the structural deficiencies that it has.

Secretary SUMMERS. The administration has proposed a rather elaborate competitive choice model for Medicare, which we believe gets the benefits and economies of choice in competition without the risks of breaking established relationships that some other models would have. It would be our hope to work with others to implement some set of reforms that would provide for much greater competition.

Again, you and Senator Baucus are right to highlight that projections move in both ways. After some years when Medicare projections had been very consistently too optimistic, I think it is something we can note that the projections of savings from the 1993 reforms and the 1997 reforms proved to be very substantial underestimates of the savings, so we had what had historically been a rather rare instance.

Senator THOMPSON. The projections indicate it is going to go back up, though.

Secretary SUMMERS. I very much agree with you, in the design of this. This is something we really need to work together on. It is a very important issue.

Senator THOMPSON. Thank you very much. I have used my time. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Secretary Summers, Director Mathews, welcome. I have always been interested in the fact that the American people seem to turn aside from the idea of a major tax cut when confronted with the alternative of reducing the national debt, without knowing the data thoroughly. I think it is because they think it is the sort of fiscally responsible thing to do, and they understand that we are at a turning point.

What fascinates me, is that they do not see, as you have pointed out and which I think is the most significant thing to come from this hearing this morning, is that that represents a very, very substantial tax cut.

I do not think the American people at this point see that in credit cards, home mortgages, and student loans, and the rest of it, that lower interest rates equal lower payments, i.e., major, major tax cuts.

I wanted to make that point. I think that is a significant amount of work that we need to do to educate the American people, that debt reduction is substantial tax cutting, and particularly for people who need it most. That is a comment.

Second, Federal Reserve Chairman Greenspan said there is quite a wide disparity between budget assumptions between OMB and CBO. OMB sort of is on an inflation-based curve, CBO suggests that we should either do a freeze based upon a fiscal year 2000 basis or a kind of keeping the budget caps until the year 2002.

Now, those are just words, semantic words, but they have enormous consequences in what CBO has projected in the budget assumptions and what you all have projected in budget assumptions.

With your indulgence, Secretary Summers, I would like to ask Sylvia Mathews, if you were to follow the CBO projections of either a freeze or a maintaining of caps until the year 2002 rather than an inflation-adjusted approach to budgeting, what would be the effect—for example, we both come from the State of West Virginia—on programs like Head Start, the Older Americans Act, or, for that matter, more enforcement of gun laws and the other kinds of things?

Ms. MATHEWS. I think that when CBO presented its baselines this year, it actually presented three and said it is up to the policy makers to make the decision on which is the appropriate baseline.

I think we believe that there is only one realistic approach, and it really gets back to Senator Baucus' point and Senator Thompson's point about having realistic projections. If you look at a capped baseline—I think we have all agreed that we put caps in the budget and that the current caps are not realistic.

A freeze is not realistic either in terms of the cuts it would represent when you get into the out years, if you include defense. When we talk about a freeze, I think everyone knows the administration actually has defense policy in the out years, and our policy is a commitment to increase defense spending. So once you take care of an increase in defense, when you say freeze, it is even a deeper cut to the current programs.

I think our feeling is, those cuts will not happen. They are unrealistic. They get to 20-some percent when you get into the out years, and it will not happen. But the alternative is, if you are not willing to do those kinds of cuts, you will come back to spending the Social Security surplus, which we have all agreed not to do.

I think, getting back to Secretary Summers' point why it is so important to start at a realistic point where we all have the conversation about what should we do with the surplus, that we need to start in the right ball park. That number, for CBO, is about $838 billion, and our number is $746 billion.

But once you are in that realm, I think, you can have a policy discussion about how should you use it. Should you use it for spending, should you use it for debt reduction, or should you use it for tax cuts? I think we believe we have presented a balanced approach to taking care of a realistic surplus.

Senator ROCKEFELLER. Thank you.

One more question. In the health proposals that the President has made, one of the things that is not there are tax credits or deductions for health insurance. Now, I bring that up particularly in this committee because of the Breaux-Thomas Medicare Commission report.

The theory of a tax credit or deduction is that it represents equity and that people who have health insurance get it, and, therefore, people who do not have health insurance should get a tax reduction or a deduction.

My general reaction to that is negative, for the following reason. That is that, yes, you do get equity, but no, if you are uninsured, you do not get health insurance. Health insurance is what I presume the President is after.

If health insurance costs on average of $5,500 a year and you get a tax credit for $1,000 or $2,000, that is nice and it might put you on equity, somebody who is working for a General Motors plant, but you still do not have the money to buy the health insurance.

I would like to know if that is one of the reasons that you left out the concept of tax credits or deductions in terms of making health insurance affordable to Americans who do not have health insurance.

Secretary SUMMERS. Senator Rockefeller, I agree with your statement of the issues. There is an equity argument, as you suggest, and there is a question as to what the impact will be on coverage of a health insurance credit.

There would probably be some who would be aided in getting insurance, there would be others who might work for employers who would change their strategies in the face of such a credit.

While there is, as you recognized, a compelling equity argument, we felt that the highest priority objectives in terms of promoting health insurance and the things to which we would attach highest priority are the combination of a long-term care credit for taking care of an aging relative, the credit for small businesses to form health insurance cooperatives so that they could pool risks, even within smaller businesses, and therefore widen the net of employer-provided coverage, the Medicare buy-in for those between 55 and 64 who have lost a job, and the credit that is provided for COBRA for transition arrangements between jobs.

We felt that, within the existing budget resources and other priorities, those were the most effective things that we could do on the tax side to promote the availability of health care.

Then, as you are very much aware, and Ms. Mathews could discuss much more competently than I, the administration's budget also includes significant expenditure allocation, both with respect to extending coverage to children and to bringing their parents into that coverage on the expenditure side. We judge that package to be the most cost-effective way of moving ahead with what we all agree is the more common objective of more universal coverage.

Senator ROCKEFELLER. I thank you both.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Rockefeller.

Senator Grassley?

Senator GRASSLEY. My first issue is something I am just asking your help on. You probably will not be able to respond to it now, and it is not necessary to respond to it now. But it is in regard to some correspondences we had.

In October, my Judiciary Subcommittee on Administrative Oversight issued a report on the Defense Criminal Investigation Service, DCIS. The report substantiated allegations that a named investigator formerly at DCIS has a history of falsifying reports. The agent involved is now a special agent assigned to the Treasury Department's Office of Inspector General.

Since I wrote to you on October 28 about this, I have received new allegations involving misconduct by the same individual. My staff is in the process of checking this out. When that work is complete, I will be issuing another report and I will share that with you at the appropriate time.

In addition, the U.S. Attorney's Office in the Eastern District of Virginia had a team examine the Majority staff report on misconduct at the DCIS and, based on that review, the chief of the Criminal Division of the Eastern District of Virginia recommended that the allegations in the report warrant a criminal referral to the Public Integrity section of the Justice Department.

So, Mr. Summers, this is my concern. The individual in question is a Federal law enforcement officer. He is entrusted with a badge, a gun, the power to arrest people, yet has a known history of falsifying investigative reports.

I think he has hurt some people with these false reports. His track record would undermine the credibility of any testimony that he might give in court as a witness, or any other legal proceeding. In fact, under the Giglio rule, his track record might be used to disqualify him as a witness in a court of law. In his present position, he might be needed sometime in a court of law. So I would ask you if you would please look into this matter and let me know what actions you might be willing to take.

Secretary SUMMERS. Yes.

Senator GRASSLEY. All right.

The CHAIRMAN. That is very concise.

Senator GRASSLEY. On another point relating to something that Senator Roth brought up with you earlier asking why the President favors labor and environment conditions in trade agreements, you said that the President's proposal on labor only favored creation of a working group on labor rights.

So I would like to read to you something that the President actually said in Seattle on December 2, and it is quoted in the Washington Post, but it comes from an interview with the Seattle Post Intelligencer, which circulates strongly in that city.

It infers that Clinton went the extra step: the Labor Working Group should define what core standards are, "and then they ought to be part of every trade agreement. Ultimately, I would favor a system in which sanctions would come for violating any provision of trade agreement."

Based on that, does this statement represent the administration's position on the labor rights in the WTO, and if not, just exactly what is the administration's position?

Secretary SUMMERS. The administration's position, most fully articulated by the President in Davos, is that the process of global integration is one that has to be managed with some cohesion, in which the range of issues that are involved are addressed.

The President's statement that you refer to did not reference trade sanctions, and in the full context, was addressing the long-run aspiration of a system in which there would be rules governing and understandings between countries governing many aspects of their economic performance.

At this point, we believe only that these issues are worthy of discussion among nations as they consider the future of the world trading system within the WTO. I think, it seems to me, respectfully, difficult to make the case that issues of this kind should not even be discussed to look for and search for solutions that can represent common ground.

I must say, as I have traveled, I think there is an increasing recognition around the world that, while we need to be absolutely certain that these issues do not become a cloak for protection and we need to become absolutely certain that these issues do not become an impediment to moving forward with opening markets globally, that proper recognition of these issues and discussion about these issues can advance the objective of more open markets and a freer global trading system.

Senator GRASSLEY. My last question deals with a situation that has been discussed already, so I make this point to kind of counteract arguments made by my Democrat friends.

You have talked about the need for debt reduction. You argue that debt reduction is essentially a tax cut. But as the Fed continues raising interest rates to put brakes on the economy, it seems that this so-called tax cut ends up being very illusory.

I am sure that you would argue, well, interest rates would be even higher if the debt was not reduced. It seems to me that, as the debt goes down along with its pressure on interest rates, the Fed is going to have to have more incentives to raise interest rates to maintain some brakes on the economy. If that happens, then there is no so-called tax cut.

How do you know that reducing debt-related interest rates will not actually create offsetting rate increases by the Fed?

Secretary SUMMERS. Since we have had a 7-year policy of not commenting specifically on Fed behavior, it is difficult to respond very directly to your question. So let me address the issue of market interest rates rather than explicitly addressing Federal Reserve choices.

If we have smaller deficits and larger surpluses, there is a larger pool of national savings. Interest rates are set by supply and demand, like other prices. The supply of savings meets the demand for investment. A larger supply of savings means, other things equal, a lower level of interest rates that would result.

Another way of viewing the same phenomenon is through bond prices. If the Federal Government is selling more bonds, that drives the price of bonds down, which is, of course, the same thing as pushing interest rates up.

Another way of looking at the issue is through the question of the possible overheating of the economy and the avoidance of overheating of the economy.

If the government is contributing substantially to demand, there is a greater risk of overheating and, therefore, more upwards pressure on the level of interest rates.

So while you can find members of my profession to disagree on almost any proposition, I think the vast majority of economists would share the view that an environment of larger surpluses and an environment of lower debt would be an environment in which interest rates would be lower than they otherwise would be, and would agree that, the more progress we have in running surpluses and running down debt, the lower costs of capital and costs of mortgages would be.

Senator GRASSLEY. I am glad you did not use the words "on the other hand." [Laughter.]

Thank you very much.

The CHAIRMAN. Thank you.

Senator Robb?

Senator ROBB. Thank you, Mr. Chairman, Secretary Summers, Deputy Director Mathews. Thank you both for coming. I apologize I was not here to hear your opening testimony or the questions from some of our colleagues on the committee. I was over listening to Secretary Cohen and the chairman of Joints Chief of Staff also discussing a number of budgetary matters. I might say parenthetically to Sylvia Mathews, that comments that you made with respect to defense spending were echoed just across the hall.

As a matter of fact, I was echoing some of those. There is a real concern about the need to provide additional long-term procurement, particularly in the area of platforms.

If we are looking at an arbitrarily capped expenditure in the so-called discretionary spending cap, it just does not comport with reality to think that we are going to do that, or that the size of the projected budget surpluses that we sometimes look at with great anticipation are really going to be there.

So we need to come to a reality check from time to time, and I appreciate your doing it on that score, in particular, because it is an easy one to get your arms around.

Because I did not hear the previous questions, I would just like to make a couple of comments, if I could. First of all, thank you both for responding to a number of individual requests that were important to projects that I am interested in, not just on a parochial basis, but on a larger basis.

I think that your principal investment in paying down the debt, and I am going to look at everything in terms of investment, is exceedingly wise. I have long been one who subscribes to the view that, anything we can do in this area not only to the extent of the Social Security surplus as we designated, all of those dollars are fungible, but it still gives us a reason to do something that I think is fiscally correct.

To the extent that we increase that for the long-term security of Medicare, et cetera, is a step in the right direction, and I commend you to the extent that not only you have put down those markers, but will defend those markers against particularly large, and at this point unwarranted, tax cuts, as well as some of the spending that may be very beneficial, but does not necessarily comport with the dollars that are available or our willingness to raise the revenues to meet those programs and put them in that kind of a context.

I appreciate, in terms of the very targeted areas like school construction, which has been a long-term interest of mine, particularly on the QSABs, your continued commitment there. This is the kind of investment that we make in the future.

I appreciate what you are doing in new markets and the extension of the empowerment zones. I think those are steps in the right direction. Those constitute an investment in the future. They are targeted to do some good. To the extent that we put it into R&D, particularly the kinds of things that only the Federal Government can do, I think that is terribly important.

To the extent we put anything in extenders that we know we are going to pass on anyhow but we sometimes go through this little charade, and we went through it for an extended period last time, I think it makes some real sense.

Then to the extent that you are putting a real priority on trying to address all of the challenges created by the so-called digital divide. I think that really is a breakpoint that is of crucial importance to the long-term stability, much less the economic security of this country, and the whole global enterprise that we are talking about, those who end up on the wrong side.

So, to the extent that you have provided targeted incentives to upgrade both talent and the accessibility and the tools for those individuals who currently are on the wrong side of the digital divide, whose disadvantages would be exacerbated were we not to address some of those needs, I think you are moving in the right direction.

So, Mr. Chairman, I thank you. I think that we will have lots of areas on which we can disagree and help you work through as this budgetary process continues, but I think the general direction, it seems to me, is in a positive direction, particularly on some of the things that I talked about that are small and targeted. I look forward to working with you and to maintaining the larger commitment to paying down the debt, because it helps in so many different ways.

I might have just one question, and that is the consequences on interest rates and our balance of payments situation that paying down the debt would have. It has consequences that could be read in both directions.

If either one of you would like to comment on that question of the implications of being very fiscally responsible, I would welcome those comments.

Secretary SUMMERS. Less debt sales means a lower supply of bonds, means a higher price of bonds, and that means lower interest rates. Less debt sales, larger Federal surpluses, means more national savings. That means we can finance more of our investments domestically, that means less foreign borrowing, that means a lower trade deficit than we otherwise would need to have.

In a very strong economy, one of the concerns is the trade deficit and the right economic strategy with respect to that trade deficit, in our judgment, is to increase national savings—the budget surplus has a role in that—and to work to open markets abroad and to promote growth abroad.

Senator ROBB. Mr. Chairman, my time is up. I think I will rest my case on that answer, and I thank both of our witnesses.

The CHAIRMAN. Thank you, Senator Robb.

Mr. Secretary, I would like to go back to the question of spending and what the administration is proposing because, frankly, it is quite significant what this administration is proposing in increased spending. I think it amounts to something like over $1 trillion in the next 10 years.

One of the ways spending has been kept higher, is assuming a spending level that includes one-time spending, like the Census, like emergency spending, that they will continue for the next 10 years.

The result is, as I say, that the overall spending is held at a level that is much higher than it otherwise would be. Of course, the effect of this higher spending is, to quote you, less debt reduction and, of course, from my point of view, the possibility of less room for tax cuts. As I am sure you are aware, Federal Reserve Chairman Alan Greenspan believed both would be better than more spending.

So my question is, why are you keeping Federal spending artificially high at the expense of debt reduction and tax cuts?

Secretary SUMMERS. Let me highlight that, in the President's budget, spending this year as a share of GNP is smaller than at any time since the mid-1960's, steadily falling over the next 10 years.

Discretionary spending is growing less rapidly than it did during the Reagan/Bush years. Federal employment is lower than it has been in a generation, and further reductions relative to income, relative to population that has to be served.

So I would argue that, to budget more aggressively, to assume greater spending cuts than are assumed in the President's budget would be to invite the kind of errors that we made in the 1980's of relying on unrealistic assumptions that did not materialize and, therefore, setting the stage for a return to budget deficits and increases in our debt.

It seems to us that the right baseline for addressing policy is to start with the current level of spending and then ask what it takes to maintain that level of spending, and then to debate where one should come down relative to that level of spending.

The administration proposes, over a 10-year period, a path that is a little bit short of current services, but a more austere path than what the country has managed over the vast majority of our experience since the second World War.

It seems to me that, to make calculations based on a baseline that assumed the maintenance of Congressional caps or that assumed a nominal freeze would not be realistic and would, therefore, invite a return to higher deficits, higher interest rates, and a weakened economy. It is only by making projections on a baseline of that kind that one could do calculations at all, like the $1 trillion figure that you cited, Mr. Chairman.

The CHAIRMAN. Well, let me make a couple of observations. First of all, you talk about spending being less than in the past based on population and other grounds. I would also point out that taxes have never been higher since World War II.

I think the people that worked and earned are entitled to some relief. I have to say that an increase of $1 trillion is tremendous. The one comment that was generally made about the State of the Union address was that it was sort of a menu of increased spending. I mean, everything was mentioned, and then we increased spending. I do not think that is the way to go.

Let me ask you this basic question. Let us assume that you had to limit your priorities, whether it is from new spending, to general fund transfers, to debt reduction, or to new entitlement benefits. What would you say are the three priorities of this administration to be accomplished this year?

Secretary SUMMERS. If I could just take a moment to address your comment about taxes. You are, of course, correct in the statistic you cite about taxes relative to GNP, but the reason for it is that, because of the capital gains from the stock market and other factors, income relative to GNP is at a record high.

If you look at families with a given income, if you look at a family with a median income, a family with half the median income, a family with twice the median income, you look at what their tax burden is, either in terms of the income tax or in terms of the payroll tax, you find that their tax burden is lower than it has been, depending on just which measure you use, any time in the last two decades, or in the last three decades.

Taxes as a share of GNP figure are driven by two things. It is driven by there being more income relative to GNP because of capital gains, and it has been driven by the shift in income towards relatively high tax segments such as corporate profits.

The CHAIRMAN. Let me just make one observation. Last night I was at a rally at home of over, I would say, roughly 1,000 people. I do not think your argument that taxes are lower than ever is going to wash. There is a lot of unhappiness about the tax picture. But go ahead.

Secretary SUMMERS. I think there are real concerns, which is why my hope would be that we would give people the opportunity to take a deduction for their tuition, it will give them an opportunity to take a deduction for a credit when they take care of an aging relative, and it will help them retire.

With respect to the question you raised with respect to spending——

The CHAIRMAN. Priorities.

Secretary SUMMERS [continuing.] I think among the most crucial priorities would be the Medicare reform that we have been discussing, establishing a framework for a realistic discretionary spending path within which we can operate, if you like, on a pay-go basis under caps. I do not mean that in the technical sense. What I mean, is where any new initiatives will, within that current services approach——

The CHAIRMAN. That is what I am trying to find out, what are your three priorities? Not some kind of a framework, but, really, if you look at the entire picture, the menu that the President listed, not only in spending but in other areas, what are the three top priorities that Congress should be addressing in the judgment of the administration?

Secretary SUMMERS. Education, health care, and debt reduction.

The CHAIRMAN. Can we be more specific?

Secretary SUMMERS. I would be reluctant to circumscribe the ambition of what our country can do at a moment of this kind. The President's budget articulates what we think is the right framework to achieve a program for the next decade, and we would like to achieve it as much as we can.

The CHAIRMAN. A menu of $1 trillion in the next 10 years in increased spending.

Secretary SUMMERS. Well, I think the $1 trillion figure is, as I suggested, based on an arbitrary and unrealistic baseline that would be a passport to slowing our economy down.

The CHAIRMAN. I would like to go back and ask you an additional question on the marriage penalty relief. The administration's proposal really only covers half of those families facing the marriage tax penalty. The reason is, it only applies to those couples—which is roughly half—that take the standard deduction.

Let me just give you an illustration. You have got two families, the Joneses and the Smiths. Both families have income of $50,000. The Jones family buys a home and has a mortgage and, of course, pays mortgage interest, so the Jones family finds it advantageous to itemize their deductions. The Smith family, on the other hand, without a mortgage, takes the standard deduction.

Under the President's proposal, the Smith family gets marriage tax penalty relief, but the Jones family is left out. Now, it seems to me if we are going to give tax relief in this area, it ought to be across the board.

My colleague, Senator Moynihan, made a very interesting suggestion the other day of giving a choice to the taxpayer, either file jointly or separately, and that way everybody gets relief.

I guess my question is, is it appropriate to provide relief for only half of the couples? If you do agree that we should provide marriage tax penalty relief to all the couples who suffer from it, how much would you propose to provide, or how would you propose to provide the relief?

Secretary SUMMERS. Let me say that between 75 and 80 percent of all taxpayers take the standard deduction. Because of the way the standard deduction is designed for single and married taxpayers, it is a major source of marriage penalties. It is that source of marriage penalties that is addressed in the President's proposal.

For what are typically the somewhat higher income families who are not affected by the standard deduction and itemize their deduction, the President's overall budget framework would provide a number of benefits, such as the college opportunity deduction for such married families.

There is a question as to the appropriate targeting of marriage penalty relief, and we believe that it is appropriate to focus on the married couples, in part, for the reasons of simplification that we spoke to earlier by raising the standard deduction.

Clearly, this is an area where, if we can do what we need to do first and establish a framework for debt reduction and strengthen Social Security and Medicare, we would like to work with the committee.

The CHAIRMAN. I find it very difficult to justify a penalty for those that itemize as contrasted to those that use the standard deduction. The basic policy makes no sense and it should be corrected, not for one or a few, but for all.

Secretary SUMMERS. Senator Roth, the logic of the administration's proposal was that the calculation of the standard deduction for married couples does not reflect adequately the fact that there are two taxpayers there.

Therefore, we remove the marriage penalty that is inherent within the standard deduction by allowing a married couple, as makes sense, to have twice the standard deduction that a single individual does.

Whatever remaining marriage penalty there is arises out of a progressivity that is in the rate structure, and we believe that, while that is an issue that could be looked at, we believe that is a much more ambiguous issue because, while marriage penalty is an important principle, so also is progressivity an important principle, and so also is the principle that two families that have the same income should pay the same tax, regardless of the composition of how that income is earned between the two earners.

The CHAIRMAN. On the question of marriage penalty, again, I would invite you to come up and tell my blue collar workers why they are different. I think they will find it very hard to understand.

Senator Moynihan?

Senator MOYNIHAN. Yes. Let us put it this way. We would like to work with you on this matter. As you said earlier, the complexity in the Tax Code is real enough, but what is most troubling is when there is a sense of unfairness. I think it is clear that I think as many people get a "marriage bonus" as a marriage penalty. Those who get the penalty feel it is not fair.

The Chairman referred to a suggestion I have made, of which I know there are some complexities on, but if you just let everyone choose between filing individual returns or joint returns, the people can take their options.

There are a lot of marriage bonuses, a situation where one person has a high income and the other person has a low income, and by averaging it they come out better. It is not just low-income people. Let us think about this. It would be nice to just do something and say, hey, look what we did!

I think we are right, and Senator Thompson is right, to be careful. A 5 percent increase above projections, a 5 percent increase in productivity. That means productivity doubles every 14 years, if you kept up that rate. That is pretty astounding, and a little improbable, but so does 5 percent sound improbable.

Again, caution. Senator Packwood used to recall that the OMB, in 1980, projected enormous budget surpluses that roll on and on as inflation rolls on and on, only it did not turn out that way.

Again, to the point of fairness, and just to say, particularly, thank you for the thought, and thank you, Mr. Chairman, that you would come up and bring Commissioner Rossotti and talk to us about this question of corporate tax shelters, because that kind of tax shelter means it is unfair to the other corporations who do not work on the edge of probity and do what good citizens do. We do not want to reward unethical behavior.

I will never forget those wonderful mornings we had during the 1986 tax bill. We would all meet in Senator Packwood's office at 8:00 in the morning, and my job was to have gotten up early and read the Wall Street Journal that day and pick out three items. There would always be, "Merino sheep, guaranteed losses." That is how you made money. The less of that, the better. I see Ms. Mathews is agreeing.

Mr. Chairman, I have a letter I will be sending Ms. Mathews about the Social Security Administration budget, and I would appreciate it if I could get your counsel on that.

Thank you, sir.

The CHAIRMAN. Thank you.

Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman. Mr. Chairman, can I assume that we can submit questions for responses?

The CHAIRMAN. Yes. We will keep it open until the end of the legislative day.

Senator GRAHAM. Good.

I want to come back to this issue of the sequencing of decisions. I am a little confused, because there has been a lot of discussion about frameworks, which sounds as if, once there is an architecture in place, that then we can decide to build the roof first, or put in the door or the foundation first, as long as it is all part of the framework or fiscal architecture.

That is a little different than what the President said in his 1998 and 1999 State of the Union speeches which I quoted earlier. But in 1998, he said, "Tonight I propose that we reserve 100 percent of the surplus—that is every penny of every surplus—until we have taken all necessary measures to strengthen the Social Security system for the 21st century." So it was more than just having a plan, but actually having taken all necessary measures.

Then in 1999, he stated, "First things first. Once we have saved Social Security, we must fulfill our obligation to save and improve Medicare."

So I interpret that as being an action plan and a set of sequences, that, first, we must do Social Security and Medicare as if they were the foundations before we could start with the other parts of the architecture, such as the roof, even though it is an important part of the final structure.

So my question is, is the 1998 and 1999 action/fulfillment/salvation of Social Security and Medicare as first priorities still operative, or are we now saying that, if we have an architecture, that any part of the architecture can be done in any sequence?

Secretary SUMMERS. Senator Graham, to pursue your metaphor, there are better and worse ways to build a home. We think it would be best to establish that overall framework and then to move, first, to assuring we were paying down debt and addressing

Social Security and Medicare, or to come simultaneously to a bipartisan agreement that included all of these elements in which tax cuts could have a role.

But I think we would need to be very careful about establishing any system in which we would start down a road with respect to taxes without there being the certainty that we were getting to what we regard as being the most important—to mix the metaphor—component to the destination, which is the assurance of debt reduction and strengthening Medicare and Social Security.

Senator GRAHAM. That is a reassuring statement. It would be more reassuring if you also added the word spending to taxes. The President, in 1998 and 1999, did not put Social Security and Medicare's strengthening and salvation as an opposite to tax cuts, he put them as first before any activities which would use the surplus.

"I propose that we reserve 100 percent of the surplus—and that is every penny of every surplus—until we have taken the steps to strengthen . . ."

Secretary SUMMERS. I think that is a fair point. I can give you the reassurance you seek with respect to spending above an appropriate baseline. We think, as part of establishing integrity in the budget process, that this year it is crucial to use the kind of baseline that is included in the President's budget or in the CBO Option 3. Certainly with respect to spending relative to that baseline, we would share your conviction.

Senator GRAHAM. Since Social Security and Medicare are so central and are really the doors that would lead the way to the rest of the house, there has been some criticism, including this morning, that the administration has not submitted an adequate plan to strengthen Social Security and Medicare, and I think there is a subliminal—maybe not so subliminal—inference that maybe the plans that have been submitted have been pain free, i.e., they did not require any reform that caused some degree of sacrifice.

Have we received from the administration all that we are going to receive on Social Security and Medicare or is there more to come, and if so, when?

Secretary SUMMERS. The President's budget lays out the approach we would like to see, and we are certainly prepared to work with members in both parties and both Houses of the Congress on the Social Security and Medicare issues.

I would say to you, Senator Graham, that if one thought about the situation of new management looking at a corporate pension fund that was under-funded, it seems to me that responsible new management would look to the possibility of increased contributions, if it was a year when the company was extremely profitable, and would look to the question of the investment policy of a pension fund as first priorities to explore before looking to requiring workers to contribute more, and before looking to requiring a reduction in planned benefits. That is the approach that we have taken in emphasizing the contributions from interest savings and emphasizing the investment policy of Social Security, so I hope those proposals will receive careful consideration.

With respect to Medicare, the President has laid out quite a detailed blueprint of the elements of an approach involving choice, and elements of an approach involving prescription drugs, and elements of an approach for shoring up solvency.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Thompson.

Senator THOMPSON. Thank you, Mr. Chairman.

Mr. Secretary, I am not concerned about the details of the marriage penalty any more because I know there will not be a cut with regard to that.

I was hopeful when I heard the President's State of the Union, but now I understand that it is conditioned upon basically all of the other parts of the President's budget being accepted in an overall framework reform on Social Security and Medicare.

However, when the President submitted his so-called reforms this time, it turns out to be basically the same thing that he submitted before, in transferring general revenue to the Medicare trust fund, which is, of course, not really reform. But more relevant to this point, it was rejected by this committee 18 to 2 last year.

So the administration knows that that so-called reform is not going to be accepted by this committee because it is not real reform—HCFA getting authority to clamp down on providers again, and all that. Senator Breaux probably is the most eloquent critic of that approach. So, we can forget about the President signing any marriage penalty tax cut.

The second observation: while it is true that spending has declined somewhat as a percentage of GDP, it is also true that this is the largest request by government for funding in the history of civilization, and it is $400 billion more spending than when President Clinton first took office.

So while what you say about the percentage of GDP is true, I think we need to be very careful in creating new entitlements based upon a GDP that is extremely robust. It gets back to the predictions that we were talking about. So, that needs to be balanced also.

Flying slightly below the radar screen of GDP at a time like this and creating entitlements that will be there even if we have an economic downturn is cause for some pause.

Third—and then I will ask a question—I have got to put on my Governmental Affairs hat just a moment as I look at this budget. Forty-three new spending programs, as I count them, basically everything going on auto-pilot.

I read, and I am reminded in our other committee work, the GAO reported last year that "significant financial systems weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal controls continue to prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs.

To make fiscal 1998 financial statements of the government balance, the Treasury had to record a $24 billion plug to account for unreconciled transactions. During an election year, defense, education, and Medicare are the agencies with the biggest financial management problems, and these are the agencies that everybody wants to continue to throw more money at. So more and more money, less and less management.

It talks about the Department of Defense. DOD's Inspector General had to make a $1.7 trillion unsupported adjustment entry to prepare last year's financial statements: Department of Education took 8 months beyond its required due date to complete its fiscal financial statements, and even then independent auditors could not make the numbers add up.

For Medicare, the Inspector General now predicts that inflated payment rates will result in overpayments to managed care organizations of $11.3 billion over the next 5 years, and $34 billion over the next 10 years, so there is a handful of people robbing us blind and our reform is ratcheting down on the providers who are trying to abide by the rules.

So my point is, as we look at this overall picture, there is a big component that we are not considering, and that is the prejudice in favor of additional spending over not spending, or in favor of sound management. All programs go on auto-pilot, no program is eliminated, nobody is fired.

We had a big fight last year over a 1 percent discretionary spending cut. We suggested a 1 percent discretionary spending cut—about $3.5 billion—and we said we could not possibly, in light of all this fraud, abuse and waste, do that.

So now we are looking at 43 new spending programs. Behind every one of them is an agency that cannot balance its books and does not have any idea, really, what it is spending.

One thing that is currently on the table now that might help a bit in terms of us having a bit better oversight of some of these things, is the proposal for the biennial budget.

At the same time the administration is trying to implement the budget in appropriation bills Congress just passed, you are putting together 3,000 pages for the coming fiscal year and trying to get a jump on the funding needs for the fiscal year after that. Seventy percent of our votes, I think, had to do with budgetary matters last year.

While all this is going on, it seems to many of us that, if we had a biennial budget, at least it would give us all the time to sit down and work with you, the administration, and OMB to try to get a handle on some of these problems. We identified last year $220 billion that were lost, including $35 billion in fiscal 1998 alone. Billions of dollars of just sending out payments to people that were not justified.

I think the administration has made some statements about this in support in the past, but from your vantage point, how do you feel about the motion of the biennial budget?

Secretary SUMMERS. Let me make a couple of comments on the things you have said, then I would like to ask Ms. Mathews to respond in detail. Let me, first, say that we share your judgment on the importance of sounder controls and better Federal purchasing.

As chief financial officer of the government, this is something I take, and my predecessor Bob Rubin took, enormously seriously when we report the financial statement to the U.S. Government. I expect there to be a number of significant improvements this year relative to the situation last year.

One of the things we have tried to do in the government over the last few years is improve the quality of management. At Treasury, we are paying a lot less for our long-distance calls than we were a few years ago. We are contracting much more efficiency for package delivery than we were.

We are handling a lot more tax returns and a lot more people crossing the border with the 10 percent smaller work force. But you are absolutely right in your emphasis that there is a lot more that can be done. Certainly, we share your concern about Medicare fraud. That is something that we have worked very hard on.

I would stress that what is perhaps the simplest measure with respect to the size of government is the number of civilians who are working for the Federal Government. That was something that had moved steadily upwards, whether you included the Defense Department or whether you did not include the Defense Department.

That was a figure that had moved, basically, steadily upwards from the second World War until the early 1990's, and then it has come down quite substantially, by nearly one-sixth over the last 7 years.

Senator THOMPSON. A lot of outsourcing as part of that, too, though.

Secretary SUMMERS. Some of that has to do with outsourcing, but then you get to looking at the spending figures because that takes account of the outsourcing. And on spending, you have to take account of the fact that wages are higher in our economy than they were in the early 1960's, so spending relative to GNP, which I think most people would say is the right denominator for that if you look at domestic discretionary spending, and is lower than any time in the last 35 years and coming down in this budget.

So I would argue that this has been a much more tough-minded approach to getting more from less in government than we have seen in the past, though there is certainly a great deal more to do.

Let me, if I could, to ask Ms. Mathews to comment on the biennial question and other aspects of this.

Ms. MATHEWS. On the issue of biennial budgeting, the administration has consistently supported that approach, and we have for just the reasons you articulated.

I think we believe that it will help with the related issues you have raised in terms of our ability to better manage the government because of the way the cycles have developed. In our budget, you will see biennial budgeting again. I think you probably heard us testify for it a number of times.

On the questions of waste, fraud, and abuse and as we at OMB work with your committee on those issues, there has been some progress. In terms of Medicare, $490 million was returned to the Federal Government just last year. We have made some progress on child support.

In terms of contracting, we did a new contract for C-17 cargo planes, and because we did the contract in a new way, we were able to save $2.7 billion over the life of the contract. So we are working on a number of fronts, and I agree with you that there are many more.

In the budget, you will see our 24 priority management objectives, which we often spend time with your committee on. There is a lot of overlap with the GAO list, and we will look forward to trying to work on all of those this year.

Senator THOMPSON. I appreciate that. I agree that you have made some progress on those items. But my personal opinion is that until I see somewhere where some department or agency is eliminated, or somebody is fired, there will not be any real progress. Thank you.

Senator MOYNIHAN. Mr. Chairman, on the biennial budget proposal that Senator Thompson speaks of, since we all agree, why do we not just do it? It is your committee.

Senator THOMPSON. Senator Moynihan, we passed it out last year with a bipartisan vote. It also passed the Budget Committee. Both committees have jurisdiction. It is now ready for consideration. So, I appreciate your support.

The CHAIRMAN. Let me thank the distinguished Senator for his leadership on this matter. I think it is a most worthwhile, important reform, as one who, many years ago, proposed that it be done.

Mr. Secretary, you have been here a long time this morning. We appreciate that. I do have to say I am somewhat concerned with the message in the sense that, in many ways, it seems to me it is a road map for doing nothing. We keep talking about having to have a framework before we can proceed.

You say in a letter, "I and other senior advisors to the President would not recommend that the President sign a tax bill of this magnitude until a proper framework for paying down debt, strengthening Social Security and Medicare, and funding critical initiatives has been established."

Yet, we have no plan for Social Security. If there is going to be Social Security reform, there has to be strong leadership from the White House. The same thing is true of trade. I am very much bothered about that. I think it is essential that we proceed immediately on market access for American products and produce.

To say that we are not going to proceed there until we make progress on labor and environment—both important matters, no argument there—I think it is a road map for inaction and I would hope you would reconsider.

There are areas of common ground. We want to work with you. I think it is important that we do so in a bipartisan way. So, Mr. Secretary, thank you for being here today, and we look forward to your return.

Senator MOYNIHAN. And thank Ms. Mathews.

The CHAIRMAN. And Ms. Mathews, we particularly appreciate your contributions. Thank you for being here.

Secretary SUMMERS. Thank you very much for the opportunity. We share your sense that there is ample common ground for us to address this year, and speaking both personally and on behalf of the administration, we look forward to working with the Congress, and with this committee in particular, on the range of issues from tax policy to our programs for our seniors, to trade policy that have come up in conjunction with this hearing.

We look forward to working very closely with you and your members, and Senator Moynihan, and the members on his side. Thank you.

The CHAIRMAN. Thank you, Mr. Secretary. Have a good day.

The committee is in recess.

[Whereupon, at 12:27 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. PAUL COVERDELL

Mr. Chairman: Please let me take this opportunity to thank you for holding this hearing and Secretary Summers for coming before us to testify. There are parts of this budget that I can support, such as funding for the Drug War in Colombia, but that is a matter for review at another time. I am very concerned, however, about the President's revenue proposals. I believe they are long on tax increases and short on tax relief, especially the kind of relief that does not require choosing winners and losers. For instance, why tax relief for electric cars and solar panels? If we are going to provide tax relief for married couples, why pick and choose which couples will benefit?

This country is in need of real solutions to real problems. We need creative reforms for education that empower parents to ensure their children have the best education opportunities they can. Education savings accounts for K-12 are a vital part. We must and we will pass, in due time, this needed tool.

Our economy is experiencing record growth, the 108' month of uninterrupted growth. An expansion that began in the previous Administration and spans the current one. Despite this, I believe our nation faces a savings crisis that if left unchecked could jeopardize our continued economic expansion. We should take heed from the words of President Kennedy who, in his second State of the Union address said: "Pleasant as it is to bask in the warmth of recovery . . . the time to repair the roof is when the sun is shining." I couldn't agree more.

Sustained economic growth is directly connected to savings and investments. At this moment, the American savings rate is dangerously low. From 1960 to 1980, the U.S. savings rate averaged 8.1 percent of GDP. By 1992, the rate had declined to 5.7 percent. Now, it hovers at historic lows. If left unchecked, it could mean a sustained dip into the negatives for the first time since the Great Depression. I would encourage the Committee and the Administration to turn attention to this matter.

Why are we in this state? I believe it is because American families are taxed too much. We know that our economy has never supported as much in taxation as it does now since the Second World War. Ironically, we recently learned that the 1993 Tax Increase will generate, according to the Joint Committee on Taxation, nearly $1 trillion, that's right, $1 trillion in taxes over the next ten years. Put this fact up against the recent roughly $2 trillion non-Social Security estimated federal surplus by the Congressional Budget Office, it is not hard to conclude that tax increase was not only historically large, but also not necessary. When we also find that over the next ten years, over $115 billion will come to the federal government in taxes on Social Security, I would be curious to learn of the Administration's comments on this development. Hopefully, we will.

In closing, when the President said, "Some of you think I raised your taxes too much . . . it might surprise you to know that I think I raised them too much too," he was right . . . by $1 trillion.

PREPARED STATEMENT OF HON. ORRIN G. HATCH

Mr. Chairman, thank you for holding this very important hearing today on the President's fiscal year 2001 budget and tax proposals. I, along with my colleagues, want to express a warm welcome to you, Secretary Summers. I look forward to your testimony.

I always enjoy the beginning of the budget season each year, Mr. Chairman, because it always amazes me to see how creative the Executive Branch can be. This has especially been true of this Administration, and this year is no exception.

Several aspects of the President's budget puzzle me, Mr. Chairman. I would like to just briefly focus on three of them.

First, I remember very well last year's budget when the President told the American people that we could not afford a net tax cut. Every single dollar that President Clinton proposed in last year's budget was offset by tax increases somewhere else, and then some. Furthermore, the President reemphasized this message last summer when he vetoed the tax cut measure Congress passed. Let me note, Mr. Chairman, that last year's projected non-Social Security budget was $750 billion over ten years.

This year, the President has changed his mind and is proposing a net tax cut of about $169 billion. Yet, according to the President's budget numbers this year, the 10 year non-Social Security surplus has dropped to $746 billion. What gives? If we couldn't afford a tax cut last year, what is the logic that says we can afford one this year?

Don't get me wrong, Mr. Chairman, I am pleased that President Clinton finally recognizes that American taxpayers are paying too much. Some of his specific tax cut proposals are probably good ideas. However, the tax cut is too small. After reserving the Social Security surplus, with which we all agree, this budget finds room for hundreds of billions of dollars in new spending. Again, some of this spending may be justified and I might support it. But the mix between tax cuts and spending increases in this budget is far too skewed toward spending.

Secondly, Mr. Chairman, I am puzzled as to why the Administration keeps sending up large tax increase proposals. This year, the budget suggests tax increases totaling over $182 billion over 10 years, even more than last year. Many of these are the same proposals that Congress has rejected year after year. Closing illegitimate loopholes is one thing, and this Committee has an obligation to look carefully at the Internal Revenue Code to ensure that it is fair. But I cannot understand why the Administration wants to raise anyone's taxes when the Treasury's receipts are the highest peacetime level they have ever been, as a percentage of our economy.

Finally, I am concerned that the dozens and dozens of targeted tax cuts in this budget will add enormously to the complexity of our tax system. The number one complaint I hear from Utah taxpayers is that our tax code is so complicated. Yet, every time we turn around, we are looking at another proposal that would further muck it up. Let me just take one example. The President had an opportunity last year to get rid of one of the most complex provisions that affect individual taxpayers—the alternative minimum tax. The tax bill he vetoed last year's tax bill would have repealed this unfair and ever-encroaching provision. Now, we see that the President's budget would "provide AMT relief" by tinkering with the personal exemptions and the standard deduction. Mr. Chairman, let's take care of this impending nightmare that will soon improperly affect 17 million taxpayers by just getting rid of it. The longer we wait, the more reliant we are going to become on the revenue.

As I mentioned, I am happy to see the President has changed his mind on tax cuts. Now, I hope we can move the debate even further and get some meaningful tax relief for the American taxpayer.

PREPARED STATEMENT OF HON. JOHN D. ROCKEFELLER IV

Our country has reached an economic landmark—107 straight months of growth—the longest expansion in our nation's history. There are lots of reasons for this strong economy. I am quite proud of our work here in the Finance Committee, especially the tough votes we've cast over the years to get our economic house back in order. This fiscal discipline is showing real benefits with low inflation, low unemployment, and a good economy. We need to stay on course and continue to pay down our debt. As we pay down the debt, we reap billions of dollars in savings from our net interest payments. I believe that this amounts to what is essentially a meaningful tax cut for millions of Americans. The amount of our net interest payments is down to $208 billion—almost the amount we spend on Medicare. We can use this huge savings for important priorities—protecting Medicare solvency, and other key investments for our future.

One of these priorities should be health care. Despite our economic boom, the number of uninsured Americans grows by 1 million per year—now totaling 44 million people. This is indefensible in a country such as ours. I am very happy to see that the President is attempting to address this problem. The $110 billion he proposes to expand coverage to the uninsured would be the largest federal increase in health coverage since Medicare was enacted in 1965. I think this is a positive step and we should do all we can to see that it is adopted.

While I am thrilled about our good economy, I think we must remain prudent. Budget predictions of trillions of dollars in surpluses are exciting, but they are just predictions. We shouldn't spend money on tax cuts when the funds are just an estimate. We all know that estimates can change with a slight variation in inflation, interest rates, or federal spending—the much anticipated surplus could be much less, or could evaporate altogether.

PREPARED STATEMENT OF HON. LAWRENCE H. SUMMERS

Mr. Chairman, Senator Moynihan, Members of the Committee, it is a pleasure to speak with you today about the President's FY 2001 budget. Let me start by thanking this Committee for your hard work in helping bring about the enviable position in which we now find ourselves.

At the outset of this Administration, the President established a three-pronged economic strategy based on strong fiscal discipline, investing in people, and engaging in the international economy. Partly as a consequence of that strategy we have achieved the first back-to-back unified budget surpluses in more than 40 years.

It is no coincidence that this month the US economy also achieved the longest expansion on record. This historic accomplishment is a tribute to the hard work and entrepreneurial qualities of our workers, businesses and farmers. But without the budget agreements of 1993 and 1997 between the President and Congress, the economic expansion would not have been as impressive or as enduring.

Last year's surplus of $124 billion was the largest in our history. Even using conservative assumptions, the budget will move still further into the black this year. By the end of September, we expect that Federal debt held by the public will be $2.4 trillion less than was projected for that date in 1992. This represents scarce national savings that have been freed up for private sector investment in the productive economy: in American businesses, workers and homes.

In 1992, the Federal budget posted a record deficit of $290 billion—almost 5 percent of our gross domestic product. Since then we have achieved not only a unified budget surplus—comprising both the operating budget and the Social Security budget—but also a small surplus in our on-budget account. In other words, for the first time since 1960 all of last year's Social Security surplus was used to improve the government's balance sheet.

This dramatic improvement in our fiscal situation reflects some hard choices. Federal spending has fallen below 19 percent of GDP, a sharp drop from the 22 percent level that prevailed when the Administration came into office. And we have reduced the Federal civilian payroll by more than one-sixth in that period, a reduction of 377,000 full-time equivalent employees.

As a result of this discipline. we are now in a position to eliminate the debt held by the public by 2013, on a net basis. Paying down the remaining $3.6 trillion of Federal debt will help to intensify the remarkably positive interaction that we have witnessed between the budget and the economy over the last several years, whereby what was once a vicious cycle of more debt, higher interest rates, a weaker economy and still more debt has been replaced with a virtuous circle of declining debt, lower interest rates, and a stronger economy, in turn producing still less debt, further downward pressure on interest rates, and stronger growth.

As a result, unemployment is at its lowest rate in 30 years, more than 20 million new jobs have been created, productivity growth has increased even this far into the expansion, home ownership rates are at an all-time high, and real wages are rising across the board including for those at the bottom of the income ladder.

At the same time, our fiscal position also provides us with a rare opportunity to focus on crucial national priorities. Let me set out the five basic objectives of this budget before discussing each item in turn.

- Reducing Federal debt to safeguard our economic expansion.
- Meeting the needs of an aging society by laying the foundations for the secure retirement of the baby boom generation.
- Providing new incentives through the tax system to strengthen our communities and encourage people to work and save more.
- Pursuing well targeted initiatives that invest in health, education and other national priorities.
- Redoubling our commitment to opening markets and sustaining American leadership in order to bolster international economic opportunities for America and strengthen our national security in an uncertain world.

OVERVIEW OF THE FY2001 BUDGET

I. Safeguarding Our Economy by Reducing Federal Debt

For decades, Treasury's discussions with its Borrowing Advisory Committee centered on how we could finance growing budget deficits and whether the market would have the capacity to absorb the huge volumes of government debt that we needed to sell. In this new era of rising projected budget surpluses, our discussions now focus on how we can maintain liquidity in the market while reducing the volume of debt outstanding.

According to OMB and Treasury projections, this challenge will become even more apparent in the years ahead. Until now, debt reduction has been accomplished solely by retiring Treasury securities when they fall due. But from now on. we will have another tool available to help us manage the process of reducing the debt held by the public namely, the ability to buy debt back from the public that has not yet matured. Using this tool, we can both reduce debt and bolster liquidity in our key "benchmark" issues. In the April to June quarter of this year, we expect that Treasury's net borrowing will result in a record pay down of $152 billion worth of bonds. This puts us on track to pay down more debt this year than in 1998 and 1999 combined.

As I have explained, under the President's proposals we will eliminate the debt held by the public by 2013 on a net basis. This will generate substantial further Gains for the American economy. Reducing Federal debt functions like a tax cut in two respects. First, it removes the burden of interest and principal payments from the American taxpayer. Second, it maintains downward pressure on interest rates, and thereby helps reduce payments on home mortgages, car loans and other forms of consumer credit. We estimate that a 1 percentage point reduction in interest rates results in roughly a $250 billion reduction in mortgage interest expense over a decade.

Debt reduction also creates fiscal space, widening the range of choices available to us, and giving us greater capacity to respond to unforeseen problems. Today, the Federal Government is spending more than $200 billion a year on interest payments that would be eliminated under our proposals. The President proposes that resources not paid in interest be used to help ease the burden of the Social Security and Medicare costs that will arise once the baby-boom generation begins to retire.

II. Meeting the Needs of an Aging Society

As we create more fiscal space through continued fiscal discipline, we face a fundamental choice about how best to utilize that space. In this context, it is a vital objective of this budget to improve our ability to shoulder this country's obligations to its seniors.

Let me focus on two central elements: strengthening Social Security and modernizing Medicare.

1. Extending the solvency of Social Security to 2050 and beyond

It is a central tenet of our strategy that we will use all of the surpluses from Social Security to improve the government's net financial position. Compared to an alternative scenario, in which we merely balance the unified budget, the President's framework generates an increasing amount of savings on interest that would otherwise be paid to holders of the debt. Beginning in 2011, we propose to transfer these interest savings into the Social Security trust funds. These transfers would extend the solvency of the trust funds until 2050.

At the core of the President's proposal is a high level of fiscal discipline. In the Administration's framework, every dollar added to the trust funds is "backed" by a dollar's worth of pay down of the debt held by the public, and hence a dollar's worth of contribution to national savings. These are serious steps, and constitute important preparation for the retirement of the baby boom generation.

In line with private sector practice, we also propose to invest a sensible and measured proportion of the trust funds in the equity market with the safeguard that such investment be limited to 15 percent of the value of the trust funds. This would further extend the solvency of the trust funds to 2054.

2. Modernizing Medicare

Since Medicare was launched 35 years ago, accessible and affordable health care has dramatically improved the lives of Americans over the age of 65. But there is now a very broad consensus that it is time to reform Medicare to meet the challenges of the new century.

By extending competition

The President put forward a detailed Medicare reform proposal last year, and he remains committed to enacting comprehensive reform in this Congress. A key element of this proposal is the move to full price and quality competition between traditional fee-for-service Medicare and managed-care plans.

By letting consumers realize most of the cost savings from choosing more efficient health plans, genuine competition will give all health plans a strong incentive to deliver the most value for money. At the same time, our proposal would ensure that seniors who move to lower-cost plans do so out of choice and not because of financial coercion. We look forward to working with the Members of this Committee to achieve these important objectives.

By providing coverage,for prescription drugs

A second central element of Medicare reform is a voluntary prescription drug benefit that is affordable to all Medicare beneficiaries. Drug treatment has become an increasingly important part of modern health care, and no one would design a Medicare program today that excluded prescription drug coverage. Yet, roughly 3 out of 5 Medicare beneficiaries do not have dependable drug coverage today. and a majority of the uninsured have incomes greater than 150 percent of poverty. The Administration's proposal would provide a 50 percent subsidy for all seniors who choose to purchase the new Medicare drug benefit, with additional subsidies for lower-income seniors. The budget also includes a reserve fund of $35 billion for 2006 through 2010 to be used to design protections for beneficiaries with extremely high drug spending

And by extending the solvency of Medicare

A third aspect of responsible Medicare reform is the addition of new resources into the Hospital Trust Fund. In the coming decades we expect to see a doubling in the number of Medicare beneficiaries, and continued advances in the ability of modern medicine to improve the length and quality of seniors' lives. We cannot meet the rising future demands on Medicare through our structural reforms alone. But by enacting the combination of reforms and transfers in the President's budget, the projected solvency of the Medicare program could be extended to 2025.

III. Using Tax Cuts to Strengthen Our Communities

The President's budget creates room for prudent and targeted tax cuts totaling $250 billion on a net basis over the next decade and $350 billion on a gross basis. These tax initiatives would advance a broad range of national priorities, including: reducing poverty and stimulating the creation of small businesses in our deprived communities; strengthening incentives to work and to save; and making it easier for families to care for chronically ill relatives. The proposals would also close unfair tax loopholes and eliminate tax shelters.

Let me highlight briefly some of the most important tax cut proposals in the President's budget.

Retirement Savings

Almost one in five elderly Americans has no income other than Social Security; two-thirds rely on Social Security for half or more of their income. Half of all working Americans have no pension coverage at all through their current job. It is very clear that steps need to be taken to help Americans take greater responsibility for their own financial security in retirement, and new incentives should be targeted to moderate and lower-income working families.

The President proposes to address this situation by creating a new, broad-based savings account, Retirement Savings Accounts. These accounts would give 76 million lower- and middle-income Americans the opportunity to build wealth and save for their retirement.

Under our plan, individuals could choose whether to participate, on a strictly voluntary basis, either through a retirement plan sponsored by their employer. or through a special stand-alone account at a financial institution. The employer or the financial institution would match each individual's contribution and then recover the cost of the match from the Federal government in the form of a tax credit.

Individuals could contribute up to $1,000 per year. Low-income individuals would qualify for a two-for-one match on the first $100 contributed, and a dollar-for-dollar match on additional contributions. Higher income participants could qualify for a 20percent match, in addition to the tax incentives that apply to pension or IRA contributions. A person who participated in this savings program for his or her entire career could accumulate well over two hundred thousand dollars for his or her retirement.

In addition, the President proposes to make small employers eligible for new tax credits to help them set up or improve their retirement plans. Related proposals include measures to increase pension security and portability, and to improve disclosure to workers. Overall, the cost of these initiatives to expand retirement savings would total $77 billion over ten years.

Helping Working Families

The Earned Income Tax Credit has proved one of the most effective means of rewarding work and lifting people out of poverty. In 1998 alone, the EITC raised the income of 4.3 million working people above the poverty level. But many families still remain in poverty. The President proposes to help more families work their way out of poverty by increasing the Earned Income Tax Credit for the larger families that are most apt to be poor and relieving the marriage penalty under the EITC. The increases in the EITC would total $24 billion over the next ten years.

Under the budget plan we would also reduce the marriage tax penalty, strengthen work incentives, and cut taxes for the 70 percent of families who claim the standard deduction. To address the marriage penalty in a targeted way, the President proposes to make the standard deduction for two-earner married couples twice the standard deduction for singles. In 2005, when it is fully phased in, this proposal would raise the standard deduction for two-earner married couples by $2,150. Starting in 2005, the proposal would also simplify and reduce taxes for middle income taxpayers by increasing the standard deduction for single-earner married couples by $500 and for singles by $250. The proposal would make the child and dependent care tax credit refundable and raise the maximum credit rate to 50 percent.

Revitalizing our Communities.

By expanding the New Markets tax credit the budget would help spur $15 billion in new investment for businesses in inner cities and poor rural areas. The budget also proposes to extend and expand incentives for businesses to invest in empowerment zones.

Health

Last year the President proposed a tax credit that compensated families for the cost of looking after chronically ill relatives. But at $1,000, the credit was insufficient compensation for the rising burden that these families face. The President's FY2001 proposal triples the credit to $3,000. We also propose to provide tax credits for workers between jobs who purchase COBRA coverage from their old employers.

Education

The budget proposes to save taxpayers $30 billion over ten years through the College Opportunity Tax Cut. When fully phased in, this new tax incentive would give families the option of taking a tax deduction or claiming a 28 percent credit for up to $10,000 of higher education costs. This would provide up to $2,800 in tax relief to millions of families who are now struggling to afford the costs of post-secondary education. We also put forward a tax credit to help state and local governments build and renovate their schools.

Tax Simplification and Fairness

Although the Alternative Minimum Tax was originally intended to ensure that high-income taxpayers could not use tax breaks to avoid income tax altogether, we recognize that it is increasingly eating into the take-home pay of middle-income taxpayers, especially those with large families. We propose to redress this problem by allowing taxpayers to deduct all of their exemptions for dependents against AMT. By 2010 when it is fully phased-in, this change would halve the number of taxpayers affected by the AMT.

Corporate Shelters and Tax Havens

The proliferation of corporate tax shelters presents a growing and unacceptable level of abusive tax avoidance that reduces government receipts and consequently raises the tax burden on compliant taxpayers. Corporate tax shelters breed disrespect for the tax system—both by those who participate in the tax shelter market and by those who perceive unfairness. A perception that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a "race to the bottom."

The President's FY 2001 Budget again contains a comprehensive approach to addressing this problem. This approach is intended to change the dynamics on both the supply and demand side of this "market," making it a less attractive one for all participants "merchants" of abusive tax shelters, their customers, and those who facilitate these tax-engineered transactions. The main elements of the legislation include: requirements aimed at substantially improving the disclosure of corporate tax shelter activities; provisions to raise the penalty where there is substantial understatement of tax owed; and the codification of the economic substance doctrine. Enactment of corporate tax shelter legislation, combined with the efforts of the restructured IRS, will go a long way towards deterring abusive transactions before they occur, and uncover and stop these transactions when they do take place.

Another area that raises similar concerns is the growing use of tax havens. These jurisdictions, through strict bank secrecy and other means. facilitate tax avoidance and evasion. Curbing this harmful tax competition should help businesses to compete on a level playing field and encourage investment growth and jobs. Our budget includes several provisions intended to reduce the attractiveness of tax havens and to increase access to information about activities in tax havens.

Other Provisions

There are a number of other important proposals that I would like to mention. These include: incentives to increase philanthropic donations; tax credits aimed at bridging the "digital divide" by encouraging investment in technology in deprived communities, and measures to help reduce pollution and emissions of greenhouse gases.

IV. INVESTING IN HEALTH, EDUCATION AND OTHER NATIONAL PRIORITIES

The spending proposals in the President's budget are based on two fundamental principles.

The first principle is that we use realistic projections of the level of spending needed to maintain core government functions. To meet this requirement, we begin with a "current services" baseline under which discretionary spending is held constant on an inflation-adjusted basis.

Our budget policy would maintain defense spending at this baseline and reduce nondefense discretionary spending slightly below it, meaning that existing domestic programs would need to be trimmed by more than enough to finance new initiatives. In 1999, non-defense discretionary spending was a smaller share of GDP than at any point in at least 40 years; under our policy, it would represent a yet smaller share over the coming decade. Moreover, total outlays as a proportion of GDP would decline in 2001 and they would continue to decline on this basis for the rest of the decade.

The second fundamental principle of the President's spending proposals is to focus on critical national priorities, including health care, education, law enforcement, and technology. By focusing our initiatives in these and other key areas, we can meet people's needs in a fiscally disciplined way.

Let me briefly summarize our proposals in these four areas.

Health Care

The President has proposed a bold initiative to reverse the disturbing increase in the number of Americans without health insurance. Through the combination of targeted spending proposals and tax incentives, we can expand health coverage to millions of uninsured Americans.

A central part of this initiative is an expansion of the State Children's Health Insurance Program, known as S-CHIP, which was introduced two years ago with broad bipartisan support. In the FY2001 budget we would build on the success of this program by extending it to cover the parents of eligible children, most of whom are uninsured. Another important element of this initiative is providing a Medicare buy-in option for people close to the Medicare eligibility age. This year, to make this option more affordable, our budget includes a tax credit to offset some of the premium.

Education

Education is another key priority in the President's budget, as has been true since the beginning of this Administration. For next year we are proposing an additional $1 billion for the Head Start program and almost $150 million for Early Head Start, which would put us within reach of serving one million children by 2002. We are also proposing sufficient funding to take us almost halfway to the President's goal of hiring 100,000 new teachers in order to reduce class sizes.

Law Enforcement

Turning to law enforcement, the budget includes significant new resources to enforce our nation's gun laws. Last Friday we released a report from the Bureau of Alcohol, Tobacco and Firearms showing that 1 percent of gun dealers account for well over half of all crime guns traced last year. The information from gun tracing will help us target our enforcement efforts, but we also need more agents and inspectors at the ATF and more prosecutors—and our budget will provide them.

At the same time we are requesting funds that would pay for recruiting and training of 50,000 new police officers, and funds that would strengthen the National Money Laundering Strategy. Money laundering is a growing international problem, and we need this budget allocation to strengthen U.S. leadership in fighting this problem.

Technology and the Environment

Another important national priority must be investment in the science and technology that will spur economic growth and improve people's lives in the 21st century. The President's budget includes a nearly $3 billion increase in crucial investments, including a $1 billion increase in funding for biomedical research for the National Institutes of Health and a rise in funding for the National Science Foundation that is double the previous largest increase. These investments will enable Americans to continue to lead the world in many areas of science and technology, including biomedical research, nanotechnology, and clan energy.

The budget also contains $42 billion for high-priority environmental and natural resource programs, an increase of $4 billion over last year's enacted level. This includes $1.4 billion in discretionary funding for the Land's Legacy initiative to expand and protect our open spaces, an additional $1.3 billion to support farm conservation. and an additional $770 million to help combat global climate change.

V. AMERICAN LEADERSHIP IN THE WORLD

As we enter this new century, it is crucial that we continue to learn the lessons of the last one by working to build an ever-widening circle of more prosperous and more open international economies. This enables us to enjoy the benefits of peace and the spread of our core values. And we benefit more directly in the millions of high-paying jobs that exports create and the competition and innovation that openness to imports can promote. In short, globalization is not a zero sum game but a "win-win proposition" for America and its trading partners.

Let me outline several areas where we can strengthen this process while also enhancing our national security.

China

One of the President's top priorities this year is to seek Congressional approval for the agreement we negotiated to bring China into the World Trade Organization, by passing Permanent Normal Trading Relations with China as soon as possible. I firmly believe that China's entry into the WTO, under the terms of the trade agreement that we reached last November, is in our economic and national security interest.

- First, this is a good deal for American workers, farmers and businesses since the concessions all run one way, in our favor.
- Second, by integrating China into the rules-based world trading system, we will help promote reform within China and reduce the security threat that an isolated China can pose to America and the rest of the world.

Mr. Chairman, we will need your support to prevail, and look forward to working with you on this issue in the weeks and months ahead. We also look forward to working with you to implement the Caribbean Basin, African Trade, and Balkans Trade Initiatives.

Multilateral Development Banks

Obtaining adequate funding for U.S. participation in the MDBs remains a Treasury priority. Every dollar we contribute to the multilateral development banks leverages more than $45 in official lending to countries where more than three-quarters of the world's people live. These programs are the most effective tools we have for investing in the markets of tomorrow. This budget's request for $1.35 billion is $40 million less than we requested last year, yet it would fully cover our annual obligations to the MDBs as well as paying down some of our arrears to a global system that we were instrumental in creating.

Highly Indebted Poor Countries Initiative

Let me thank the Members of this Committee for your efforts in the FY2000 budget to provide broader, deeper and faster debt relief to the world's poorest and most heavily indebted nations. As a result, progress has been made. Writing off debts owed by countries that will never be able to repay them is sound financial accounting. It is also a moral imperative at a time when a new generation of African leaders is trying to open up their economies.

The President is asking for an additional $210 million this year and $600 million over the next three years to support multilateral and bilateral debt relief for countries under the Highly Indebted Poor Countries initiative. In doing so he is asking Congress to finish the enormously important work we began last fall.

Vaccines

The budget also contains requests that would help fulfill the President's Millennium Initiative for vaccines. By allocating $50m to the Global Alliance for Vaccines and Immunization, we could save many children's lives and at the same time help protect the health of American citizens. The President has also proposed a new tax credit that would help stimulate development of vaccines for malaria, HIV-AIDS and tuberculosis.

VI. CONCLUDING REMARKS.

I began my remarks today by focusing on the link between fiscal discipline and the performance of our economy over the last seven years. Having worked hard to help bring us to the remarkable economic moment that we are now enjoying, the Members of this Committee know well the value to our economy and our country of further paying down the national debt held by the public. If we can act to reduce the debts we bequeath to our children, while continuing to fund our obligations to seniors and pursuing the vital purpose of making the economy work for all our people and communities, then we can maximize the extraordinary opportunities with which we are now presented. I look forward to working together with this Committee and others in Congress to turn these high-class challenges into even higher-class solutions. Thank you. I would now be happy to respond to any questions that you might have.

RESPONSES TO QUESTIONS FROM SENATOR ROTH

Question:

Trade. Congress will have to take up legislation this year on granting China permanent Normal Trade Relations status as part of that country's accession to the WTO. This legislation is extremely important, but will face a very difficult time in Congress. In my view, it is vital that this legislation be evaluated on its own merits, without any amendments. Will the Administration work to defeat all amendments as the legislation moves through Congress even amendments on labor or the environment which, in other contexts, the Administration might favor?

Answer:

- The legislation granting China permanent normal trade relations (PNTR) status is the Administration's highest trade priority this year. The President and the entire Administration are working closely with Congress to secure passage as soon as possible.
- We have sent clean PNTR legislation to the Hill that we hope Congress will pass. We believe the merits of this agreement speak for themselves.
- The legislation granting China PNTR status must be consistent with our WTO obligations and could not, for example, impose conditions such as an annual renewal on receipt of NTR status.
- That said, the Administration is firmly committed to strong monitoring and enforcement of this Agreement, and to advancing our national interests across a range of issues, including human rights.
- We will have to evaluate proposals that the United States could implement independently, such as reports, monitoring, and strengthening resources for enforcement, on their merits.

Internal Background

Senator Roth submitted the written question above to Secretary Summers on February 9, following his budget testimony to the Senate Finance Committee. The answer above would be submitted in writing to Senator Roth and would serve as guidance to respond to other questions on the issue.

Question:

Public Debt. Mr. Secretary, the Administration proposes to completely eliminate the public debt. As you know, there are many other important uses for U.S. Treasury Securities other than financing Federal deficits. Two Questions. First, in your view what are the most important uses of Treasury Securities, and if debt was eliminated how would these other functions be met? Second, the Treasury's debt buyback program as well as debt reduction has apparently sparked volatility in the Government bond markets. Should we expect this to continue?

Answer: Treasury debt currently plays an important role in the global and U.S. capital markets. It is actively used for hedging purposes and serves as a pricing benchmark. This contributes to increased market efficiency and a lowering of the overall cost of capital in the U.S.

Treasury debt possesses two key attributes important to the financial markets: liquidity and credit quality. The market for U.S. government securities is the deepest and most liquid securities market in the world, and we expect that this will remain the case for some time. As we reduce issuance and buy back debt, the Treasury Department will focus on maintaining large and liquid benchmark issues.

Obviously, debt paydown results in a decreasing supply of Treasury securities, but we are confident that the markets will adapt to these changes. As Treasury debt continues to decrease, at some point the markets for corporate, municipal and agency securities will become larger and potentially more liquid than that for Treasuries. In the past, when the supply of Treasury debt has been limited, markets have turned to corporate and other securities as benchmarks. Indeed, as we have paid down our privately held debt by approximately 10% over the past 3 years, certain market segments have already begun to adjust. We are confident the market will find other vehicles for hedging and pricing benchmarks.

Market volatility can be the result of any number of factors. It would be inappropriate for me to speculate as to the cause of any recent or future market price movements.

Question:

Debt Reduction and Tax Cuts. Secretary Summers, in your testimony before the Committee, you made the point that reducing the public debt leads to lower interest rates, and that lower interest rates are effectively a tax cut—because Americans pay less for credit. Yet, over the past year we have seen both significant public debt reduction and higher interest rates. For example, according to the Federal Reserve since January 1999 new car loan rates have risen from 6.2 percent to 7.3 percent—an increase of 110 basis points. Moreover, a Wall Street Journal op-ed ("Debt Reduction is No Tax Cut," by James Grant, February 9, 2000) contends there is little correlation between interest rates and public debt. How then can you contend that reduced public debt—however meritorious—is effectively a tax cut?

Answer: Interest rates are affected by many factors, including not only Federal deficits and debt, but also inflation, business cycle conditions, international developments and associated capital flows, private saving and borrowing decisions, to mention only some of the factors aside from debt. The fact that so many variables influence interest rates implies that the relationship between debt and interest rates will not be simple. Indeed, I share Mr. Grant's conclusion that "whether market interest rates rise or fall in the immediate future depends in no small part on monetary and economic forces, about which the best minds on Wall Street agree to disagree." But I also firmly believe that reducing the government's public debt will, over time, allow for lower interest rates than would arise if the public debt increased or held steady.

This belief reflects a widely held consensus. Reducing government debt raises national saving, because private saving is supplemented by public saving rather than being drained by public borrowing. Additional national saving increases the supply of funds to credit markets and thereby reduces the price of that credit, or interest rates. More resources are made available for private investment, and capital accumulation proceeds more rapidly. A larger capital stock raises productivity and standards of living, and also helps to hold interest rates down, all else equal. The Congressional Budget Office used this chain of reasoning to project the effects of reducing the deficits of the 1980s, and it currently employs this logic when exploring the effects of alternative fiscal paths over the long run. (See CBO's Economic and Budget Outlook from January 1993, April 1995, August 1995, and January 1997, and its Long-Term Budget Outlook from December 1999.)

Moreover, there is no escaping the arithmetic that it will have a dramatic impact on the Federal government's interest expense. Currently, the Federal government's net interest payments exceed $200 billion per year; paying off the debt held by the public, as the President proposes to do, frees up that $200 billion for other more productive uses.

Question:

Taxes. There is a misperception in many reports that the President's budget's tax cuts are bigger than they in fact are. It is important that we establish an oranges-to-oranges and an apples-to-apples debate when it comes to taxes and spending. What is the amount of the spending component of the tax cut total you claim? How much money will be issued in checks versus a real reduction in tax liability?

Answer: The estimated budgetary impact of the tax incentives included in the President's FY 2001 Budget total $102.0 billion over FY 2000—FY 2005 and $351.6 billion over FY 2000–FY 2010. Of these amounts, increased outlays (i.e., issued checks) represent $14.6 billion and $37.3 billion, respectively.

Question:

Medicaid and S-CHIP. Six months ago, President Clinton declared that he found the states' implementation of the new children's health insurance program to be disappointing. I disagree. I think new programs take time to reach capacity and I'm encouraged that 2 million children are now covered by CHIP. However, isn't it premature to dramatically expand the scope of a program until it has proven that it is successful in meeting its original goals? Rather than more than doubling the size and scope of the program, shouldn't we instead focus on making sure CHIP helps children eligible but not yet enrolled in the program?

Answer: We believe that the State Children's Health Insurance Program (S-CHIP) is becoming increasingly successful, and that this is the right time to build on S-CHIP to cover parents. The President's health insurance initiative also includes important measures to further strengthen S-CHIP.

Now that all 50 states have their S-CHIP programs up and running, we are seeing a steady rise in enrollment rates nationwide. In fact, the program's enrollment doubled in less than a year, with two million children being served as of October 1, 1999. Thirty states have expanded coverage to children with family incomes up to 200 percent of the poverty level. Because of the growing success of this program, and the broad bipartisan support for its enactment, a wide range of groups—including the National Governors' Association, Families USA, and the Health Insurance Association of America—have called for its extension to parents. The President's FamilyCare program would do just that.

Adopting this plan would likely increase the enrollment of children in S-CHIP, as parents would enjoy a direct benefit to their own health care from joining the program. The plan also includes $5.5 billion over 10 years for other tools to accelerate the enrollment of uninsured children eligible for Medicaid and S-CHIP. These tools include: allowing school lunch programs (which cover 60 percent of uninsured children) to share information with Medicaid, expanding sites (including schools and child care referral centers) authorized to enroll children in S-CHIP and Medicaid, and requiring states to make their Medicaid and S-CHIP enrollment equally simple.

Question:

Customs: Automated Commercial Environment (ACE).

(a) What is the administration's reasoning in proposing another access fee to fund ACE?

Answer: The discretionary spending caps require difficult choices. When a government expenditure appears to offer disproportionate benefits to specific groups engaged in commerce, the Administration believes the choices are more obvious. The Administration remains committed to using general revenues to ensure continued reliability of the legacy Automated Commercial System (ACS). The improved business processes that will be made possible by the new ACE system will offer substantial benefits to a relatively small number of large importers. When a government expenditure appears to offer disproportionate benefits to specific groups engaged in commerce, the Administration believes the choice of a fee is appropriate. Given many urgent priorities for federal funds, a data access fee on importers to use a vastly improved trade information system appears fair.

(b) Does the administration have an alternative method of funding the ACE system in the likely event that this proposed access tax is not enacted?

Answer: The Administration's budget request for ACE funding in the Customs Automation Modernization account is $210 million under current law. If the authorizing committees do not accept the forthcoming legislative proposal, the Administration is prepared to work with the Appropriations Committees to determine what other options might be available to ensure this level of funding for ACE.

(c) Has the administration studied the potential consequences for the U.S. economy if trade is disrupted due to the failure to fund this critical modernization effort? If yes, what would these consequences be?

Answer: The administration believes the economic consequences of a U.S. trade disruption to be severe and totally unacceptable. That is why the administration remains committed to maintaining the reliability of the legacy ACS until ACE is a reality. This commitment includes a request of $123 million for FY 2001 ACS maintenance requirements.

(d) Assuming that the administration identifies an alternative method of funding ACE development, please explain how the proposed amount is adequate to meet Customs computer modernization needs?

Answer: Under the Automation Modernization budget proposal, $123 million is requested to ensure reliable operation of ACS. None of this proposed $123 million appropriation is intended for replacement by offsetting receipts from user fees. Another $210 million is proposed for appropriation for ACE, to be offset by user fees under legislation to be proposed. This $210 million is considered the first installment in the multi-year procurement of ACE.

Question:

Customs: Funding Levels. The Customs Service performs a unique role in the facilitation of trade and the protection of our nation's borders. The Finance Committee's oversight hearings last year reflected the challenges facing the Customs Service, as its workload increases to keep pace with the surge in international trade. The president's budget proposal lacks any increase, even in nominal terms, in the Customs Service' budget that would keep pace with the increase in Customs' workload. What does the Treasury Department plan to do to ensure that Customs has the necessary resources to carry out its essential dual mission of both trade facilitation and law enforcement?

Answer: Careful management of our trade compliance resources can result in the same kind of productivity improvements that are the norm in the private sector. Customs is required to expend a level of effort in trade compliance that is supported by the budget authority equivalent of receipts from the Merchandise Processing Fee. Initiatives within Customs such as Compliance Assessment and Account Management are intended to target these resources with greater precision. The FY 2001 request also includes one trade compliance initiative to intensify efforts against importation of products from forced child labor.

The law enforcement level of effort, dependent on appropriated budget authority from the General Fund and other resources such as the Treasury Forfeiture Fund Super Surplus, has received significant attention by both the Administration and Congress over the last several fiscal years. For FY 2001, the budget proposes $68 million and 264 staff years of additional effort related to various contraband enforcement and counter-terrorism issues.

Question:

Education. In the President's education package, there is not one proposal—not one dollar—devoted to helping families save for education. Mr. Secretary, I know that you generally share my concerns about savings—and are a strong proponent of savings in other areas. So why is there no savings piece in the education area? Shouldn't we do more to help families save for education?

Answer: The Administration has proposed a new tax incentive for savings. Retirement Saving Accounts (RSAs) would enable lower-and moderate-income families to contribute up to $2,000 per year, and receive additional matches of up to $2,200 per year. Although designed as a vehicle for retirement savings, withdrawals from RSAs could also be used for certain other purposes, including to pay for higher-education expenses incurred by the individual holder of the account, or by that person's spouse or dependent. In addition, the tax code already contains many incentives to save for higher education, including through 401(k) plans, traditional IRAs and Education IRAs, and Qualified State Tuition Plans. We believe that new savings incentives should be targeted at those who are least likely to benefit from existing tax incentives. The RSA proposal was designed to do that.

Question:

Installment Sales. The recently enacted Ticket to Work and Work Incentives Improvement Act of 1999 included an Administration proposal to prohibit the use of the installment method of accounting for accrual basis taxpayers. Numerous small business organizations are concerned that the installment sale provision has a significant negative impact on sales of small enterprises. Congress never intended this provision to impact the sale of small businesses. I urge you to issue guidance as soon as possible on this provision keeping in mind the Congressional intent not to impact the sale of small businesses. When will you issue guidance on the installment sale provision? Did the Administration intend for its installment sale proposal included in the recently enacted legislation to affect the sale of small businesses?

Answer: We intend to issue two sets of guidance, both of which are listed on the Treasury and IRS Priority Guidance List for calendar year 2000. The first will describe how the repeal of the installment method will operate with respect to common business transactions, such as the sales of corporate stock or partnership interests by individuals and the sales of assets by corporations and partnerships. This guidance was requested by small business groups, is in the final stages of review, and should be published shortly. The second guidance project will focus more broadly on providing guidance on who is eligible to use the cash method of accounting (and thus, the installment method, as well). As described in testimony provided by TLC Mikrut before the House Ways and Means Oversight Subcommittee on February 29, a portion of this guidance will allow businesses with average annual gross receipts of less than $1 million to use the cash method of accounting, whether or not they are so permitted under current law. This $1 million threshold will cover the vast majority of sole proprietorships, partnerships and S corporations. In addition, as part of this project, we are considering additional guidance and safe harbors that will facilitate the use of the cash method. We hope to publish this guidance by mid-year.

There are several legislative proposals to repeal the repeal of the installment method for accrual method taxpayers. Treasury continues to support the tax policy rationale for last year's provision that was enacted by Congress B that the installment method is more akin to the cash method of accounting and should be restricted to cash method taxpayers. However, we now understand that the provision had unforeseen and unintended negative consequences for small businesses. To address these concerns, we suggest that the installment method be made available to accrual method small businesses, while retaining the enacted prohibition for larger businesses.

COMMUNICATIONS

STATEMENT OF THE AMERICAN ASSOCIATION FOR HOMECARE

The American Association for Homecare is pleased to submit the following statement to the Senate Committee on Finance. The American Association for Homecare is a new national association resulting from the merger of the Home Care Section of the Health Industry Distributors Association, the Home Health Services and Staffing Association and the National Association for Medical Equipment Services. The American Association for Homecare is the only association representing home care providers of all types: home health agencies and home medical equipment providers, be they not-for-profit, proprietary, facility-based, freestanding or governmentally owned.

WHAT IS A HOME HEALTH AGENCY?

Home Health Agencies provide skilled nursing care, therapy and home health aide services to individuals recovering from acute illnesses and living with chronic health care conditions. Health care services in the home setting provide a continuum of care for individuals who no longer require hospital or nursing home care, or seek to avoid hospital or nursing home admission. The range of home care services includes skilled nursing; respiratory, occupational, speech, and physical therapy; intravenous drug therapy; enteral feedings; hospice care; emotional, physical, and medical care; assistance in the activities of daily living; skilled assessments; and educational services.

WHAT IS AN HME PROVIDER?

Home medical equipment (HME) providers supply medically necessary equipment and allied services that help beneficiaries meet their therapeutic goals. Pursuant to the physician's prescription, HME providers deliver medical equipment and supplies to a consumer's home, set it up, maintain it, educate and train the consumer and caregiver in its use, provide access to trained therapists, monitor patient compliance with a treatment regimen, and assemble and submit the considerable paperwork needed for third party reimbursement. HME providers also coordinate with physicians and other home care providers (e.g., home health agencies and family caregivers) as an integral piece of the home care delivery team. Specialized home infusion providers manage complex intravenous services in the home.

HOME CARE IS JUST BEGINNING

Over the last two decades, advances in medical technologies and changes in Medicare's payment structure have spurred a considerable growth in the use of home care. As in every other aspect of modern medicine, home health care has benefited from an explosion of new and emerging technologies. From the use of space-age materials to make wheelchairs and mobility aids lighter, to the application of microchip computer technology in implantable devices used to dispense critical medication, technology makes it possible for the care received in the home to equal or exceed that received in a hospital, at a fraction of the cost. Today, it is common for a Medicare beneficiary to undergo chemotherapy in the comfortable surroundings of his or her own home, a fete that was inconceivable just a few years ago. In the future, advances in tele-medicine and similar technologies will make it possible to further reduce health care costs and improve the quality of health care provided in the home. None of these advances could have been envisioned at Medicare's inception in 1965.

Recent changes to Medicare's payment system have also spurred a growth in home health utilization. In the late 1980's, the Health Care Financing Administration's (HCFA's) rigid definition of the coverage criteria for home health services was struck down by a United States District court, making it possible for more beneficiaries to access home health services. At roughly the same time, Medicare instituted a prospective payment system for hospital inpatient care, which reimbursed hospitals according to the patient's diagnosis regardless of the number of days spent in the institution.

Together, these changes have resulted in a situation where more Medicare-eligible beneficiaries are arriving home "quicker and sicker" than ever before. In turn, these beneficiaries require increasingly complex health services. All indicators show that as the 'baby-boomers' continue to age, this trend will continue. The American Association for Homecare believes that the increased utilization of home health care prompted by these changes should be seen as a rational response to the changing needs of Medicare beneficiaries and the increased ability of home health providers to meet these needs.

HOME CARE IS ECONOMICAL

Importantly, home care is not only patient-preferred, it is also cost effective. Numerous studies[1] have shown that home care providers are a cost-efficient component of the healthcare delivery system, as they help keep beneficiaries out of costly inpatient programs. One study, conducted by an independent research organization, particularly demonstrates these savings. This study, The Cost Effectiveness of Home Health Care, examines the highly successful In-Home/ CHOICE program instituted by the State of Indiana in 1985. Indiana provides 100% of the funding for this program, which covers the costs of home health care for qualified residents in need of long term care in order to prevent institutionalizations.

The authors of the Study note that the coming crisis in health care funding for America's rapidly growing elderly population could be alleviated by home health care programs such as Indiana's. By avoiding institutionalized care, Indiana was able to reduce inpatient caseload costs by 50% or more, while allowing patients to receive care in the comfort of their own homes. The cost savings associated with this increased reliance on home care were considerable. The study states that home care for the elderly in Indiana can be provided for one half the cost of skilled nursing facility care. Similar care for the disabled costs 1.5 times more in a skilled facility than in the home. In addition, the quality control and screening procedures used in the Indiana program have successfully avoided problems with fraud and abuse. The Hudson Institute Study concludes that "Properly crafted and administered, home health care can play a critical role in helping society meet the looming health care needs of the 'Baby Boom' generation."

RESIST THE RUSH TO COMPETITIVE BIDDING

The President's budget proposal includes a provision that would expand and strengthen Medicare's competitive bidding authority. The American Association for Homecare urges the Committee to withhold support for competitive bidding for Medicare Part B durable medical equipment, prosthetics, orthotics and supplies (DMEPOS) until the results of the current demonstration project can be fully evaluated.

As the Committee is aware, the first demonstration project testing competitive bidding for DMEPOS services has just begun in Polk County, Florida. This project is a necessary first step to determine whether Medicare can effectively administer a competitive bidding program, whether it will achieve savings, and whether it will maintain access to quality HME services. Currently, very little is known about the administration or long-term impacts of such a complicated change to the DMEPOS benefit. The demonstration project will not be completed until the end of 2002.

Our concerns about the undue rush to implement national competitive bidding are bolstered by the fact that competitive bidding for HME services has been tried and rejected in the Ohio, Montana, and South Dakota state Medicaid programs. These states cited increased administrative costs and serious management problems as reasons for dropping competitive bidding. Each state also experienced an actual reduction in competition among providers (and, consequently, higher bid prices) and reduced access to provider support services.

THE POLK COUNTY DEMONSTRATION

The American Association for Homecare is particularly concerned that HCFA's current competitive bidding plan threatens access to important health services. Home medical equipment (HME) such as oxygen equipment cannot be drop-shipped to patients; the therapeutic support services offered by HME providers are as crucial to positive health outcomes as the equipment itself. We are concerned that the 'winning' bidders in Polk County will face budget pressures that lead them to eliminate these important therapeutic services, which are not separately reimbursed by Medicare (e.g., preventative maintenance, patient education, 24-hour on call service, the professional care of respiratory therapists, and the furnishing of supplies). If these services are eliminated, beneficiaries will be much more likely to experience negative health outcomes.

Importantly, beneficiaries in the demonstration area have lost their ability to choose their own HME provider. These beneficiaries are not granted the option to "opt out" of the demonstration; they are forced to use the "winning" bidders if they want Medicare to continue to cover their HME needs. A beneficiary who is dissatisfied with the quality of products or the level of the services provided to him/her through the bidding program will have very limited alternatives. Medicare's winning bidders, therefore, are not being subject to the market forces of consumerism.

Although the demonstration is only months old, a number of problems have already emerged. In fact, the parent company of one winning bidder has filed for Chapter 11 protection and some beneficiaries have expressed confusion about the availability of providers. HCFA has not yet examined the impact of the demonstration on beneficiary satisfaction or health outcomes. The American Association for Homecare urges the Committee to examine carefully the results of this demonstration and the suitability of the demonstration design before expanding the demonstration to other areas.

ELIMINATE ADDITIONAL CUTS TO THE HOME HEALTH BENEFIT

The American Association for Homecare urges the Committee to maintain Medicare beneficiaries' access to home health agency services by eliminating the additional 15% payment cut scheduled to be implemented on October 1, 2001. Home health reimbursements have already been reduced by much larger amounts than originally forecasted, and the most frail elderly are experiencing problems with access to home health care. The addition 15% reduction will only exacerbate these problems.

The Balanced Budget Act of 1997 (BBA, P.L. 105-33) was originally scored to reduce the home health benefit by approximately $16.1 billion over five years. However, the actual impact of the BBA was much more dramatic. In March 1999, the Congressional Budget Office (CBO) revised their estimate to a reduction of more than $48 billion over five years, more than twice the intended amount. In January 2000, HCFA announced that home health services had a rate of growth of—4%, less than any other health care sector. Unfortunately, reductions such as this have an inevitable impact on the availability of the home health benefit. The most significant concern has been lack of access for eligible Medicare beneficiaries to the home health benefit.

The George Washington University's Center for Health Services Research & Policy has released two studies reviewing the impact of BBA 97 on home health patients and providers. The studies provide the following points:

1. The number of Medicare home health patients has declined by 50% from 1994 levels and by 21% as a percentage of all patients in 1998 alone.
2. Patients who were most likely to lose access to covered services under the interim payment system included those suffering from complex diabetes, congestive heart failure, chronic obstructive pulmonary disease, multiple sclerosis, skin ulcers, arthritis, and mental illness.
3. 68 percent of hospital discharge planners surveyed report increased difficulty in initially obtaining home health services for Medicare beneficiaries.
4. 56 percent of respondents report increases in the number of beneficiaries requiring substitute placements, primarily in skilled nursing facilities, in lieu of home health services.

The American Association for Homecare urges this Committee to avoid further disruptions in access to home health care by permanently eliminating the scheduled additional 15% reduction.

HOME HEALTH PROSPECTIVE PAYMENT SYSTEM

The American Association for Homecare strongly supports the implementation of the prospective payment system for home health agencies. The BBA mandated HCFA develop a PPS to be implemented in October 1999. HCFA requested a further delay until October 2000 and Congress granted that request.

During the development of PPS, the home health industry is being reimbursed under an interim payment system (IPS). The interim payment system was implemented for cost reporting periods beginning on October 1997. IPS changed the way home health agencies were reimbursed by setting new limits and removing the old cost-based incentives. As stated above, the IPS imposed significant losses on home health agencies and resulted in reductions more than double the 1997 baseline developed by the CBO.

Home health agencies were unable to receive from HCFA definitive information on what their reimbursement would be under IPS until a year or more into the new system. The home health agencies were then required to reimburse HCFA for overpayments made during the first year. The inability of home health agencies to access the accurate reimbursement information needed to plan appropriately for the care of beneficiaries negatively impacted home health patients and providers alike.

It is crucial for HCFA and Congress to work with home health providers as the new reimbursement system is implemented to ensure access to care for beneficiaries while providing needed information to home health providers and fiscal intermediaries.

CONCLUSION

Home health care continues to evolve and expand to meet the increasingly complex needs of today's Medicare beneficiaries. By capitalizing on technical innovation, home care providers can conduct increasingly complex medical and therapeutic regimens in the comfort of beneficiary's own homes. In addition, recent studies have shown that an expanded home care benefit would reduce Medicare expenditures by avoiding costly institutionalizations. We urge the Committee to recognize the many benefits of home care by strengthening Medicare's commitment to the home health benefit.

ENDNOTES

For recent studies, please see:

Styring, William & Duesterberg, Thomas, *The Cost Effectiveness of Home Health Care: A Case Study on Indiana's In-Home/CHOICE Program,* (Vol. 1, No. 11), November 1997, (Hudson Institute, Indianapolis, IN).

Mann, Williams C. et al., "Effectiveness of Assistive Technology and Environmental Interventions in Maintaining Independence and Reducing Home Care Costs for the Frail Elderly," *Archives of Family Medicine,* May/June 1999 (Vol. 8, pp. 210-217).

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION (ABA)

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on certain of the revenue provisions of the Administration's fiscal year 2001 budget.

The American Bankers Association brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

The Administration's Fiscal Year 2001 budget proposal contains a number of provisions of interest to banking institutions. Although we would welcome certain of those provisions, we are once again deeply concerned with a number of the Administration's revenue raising measures. Many of the subject revenue provisions are, in fact, thinly disguised tax increases rather than "loophole closers." As a package, they would inhibit job creation and inequitably penalize business. The package may also lead to the reduction of employee and retiree benefits provided by employers.

Our views on the most troubling provisions are set out below.

REVENUE INCREASE MEASURES

Modify the Corporate-Owned Life Insurance Rules

The ABA strongly opposes the Administration's proposal to modify the corporate-owned life insurance rules (COLI). We urge you not to enact any further restrictions on the availability of corporate owned life insurance arrangements. We believe that the Administration's proposal will have unintended consequences that are inconsistent with other congressional policies, which encourage businesses to act in a prudent manner in meeting their liabilities to employees. Corporate-owned life insurance as a funding source has a long history in tax law as a respected tool. The Health Insurance Portability Act of 1996 eliminated deductions for interest paid on indebtedness with respect to policies covering officers, employees, or financially interested individuals. However, that legislation allowed deductions with respect to indebtedness on COLI covering up to 20 "key persons" (defined generally as an officer or a 20-percent owner of the policy owner). The Taxpayer Relief Act of 1997 applied a pro rata formula to disallow the deduction of a portion of a taxpayer's total interest expense with respect to COLI. That legislation provided a broad exception for policies covering 20-percent owners, officers, directors, or employees. Accordingly, Congress has effectively ratified continued use of COLI, pursuant to the requirements of those rules. In this connection, taxpayers have, in good faith, made long term business decisions based on existing tax law. They should be protected from the retroactive effects of legislation that would result in substantial tax and non-tax penalties.

Moreover, federal banking regulators recognize that corporate-owned life insurance serves a necessary and useful business purpose. Bank regulatory guidelines confirm that purchasing life insurance for the purpose of recovering or offsetting the costs of employee benefit plans is an appropriate purpose that is incidental to banking.

The subject provision would effectively eliminate the use of corporate-owned life insurance used to offset escalating employee and retiree benefit liabilities (such as health insurance, survivor benefits, etc.). It would also penalize companies by imposing a retroactive tax on those that have purchased such insurance. Cutbacks in such programs may lead to the reduction of benefits provided by employers. We urge you to, once again, reject this revenue proposal.

However, should any legislative change in this area be contemplated, we would urge that the following principles apply. Any proposal should:

- Be prospective and should not put businesses that made decisions based on existing law in a disadvantaged position.
- Only apply to contracts entered into after the date of enactment. Any premiums paid after the date of enactment with respect to contracts written prior to the date of enactment should be grandfathered.
- Continue to allow tax-free exchanges of insurance contracts.
- Create a "safe harbor" exception to general interest disallowance for COLI to protect a certain level of COLI.

INCREASED INFORMATION REPORTING/SUBSTANTIAL UNDERSTATEMENT PENALTIES

The ABA strongly opposes the Administration's proposal to increase penalties for failure to file information returns. The Administration reasons that the current penalty provisions may not be sufficient to encourage timely and accurate reporting. We disagree. The banking industry prepares and files a significant number of information returns annually in good faith for the sole benefit of the Internal Revenue Service (IRS). The suggestion that the Administration's proposal closes "corporate loopholes" presumes that corporations are noncompliant, a conclusion for which there is no substantiating evidence. Further, there is no evidence available to support the assertion that the current penalty structure is inadequate. Certainly, the proposed penalty increase is unnecessary and would not represent sound tax policy. We urge you to, once again, reject this revenue proposal.

The ABA also opposes the Administration's proposals to modify the substantial understatement penalty. The proposed increases would be overly broad and could penalize innocent mistakes and inadvertent errors. The establishment of an inflexible standard could effectively discourage legitimate business tax planning. We urge you to reject this revenue proposal.

REQUIRE CURRENT ACCRUAL OF MARKET DISCOUNT

The ABA opposes the Administration's proposal to require current accrual of market discount by accrual method taxpayers. This proposal would not only increase administrative complexity but would raise taxes on business unnecessarily. We urge you to reject the Administration's proposal.

SUBJECT INVESTMENT INCOME OF TRADE ASSOCIATIONS TO TAX

The ABA opposes the Administration's proposal to tax the net investment income of trade associations. The proposal would impose a tax on all passive income such as interest, dividends, capital gains, rents and royalties. It would not only impact national organizations but smaller state and local associations as well. Dues payments generally represent a relatively small portion of an association's income. Associations maintain surpluses to protect against financial crises and to provide quality service to their members at an affordable cost. Indeed, investment income is used to further the exempt purposes of the organization.

The Administration's proposal would impose an overly broad, and ill conceived tax on well managed trade associations that would directly inhibit their ability to continue to provide services vital to their exempt purposes. We urge you to reject the Administration's proposal.

ENVIRONMENTAL TAXES

The ABA opposes the proposal to reinstate the Superfund environmental and excise taxes. We believe the burden of payment of the taxes will fall on current owners of certain properties (who may in many instances be financial institutions) rather than the owners at the time the damage occurred. It would, thus, impose a retroactive tax on innocent third parties. In any event, such taxes would be better considered as part of overall program reform legislation. We urge you to reject the Administration's proposal.

OTHER ISSUES

The Administration's proposal contains a number of other provisions to which we object as being harmful to banking institutions, as listed below:

- Prohibit deferral on swap fund contributions
- Modify treatment of ESOPs as S corporation shareholders
- Modify the treatment of closely held REITs
- Disallow interest on debt allocable to tax-exempt obligations
- Impose excise tax on purchase of structured settlements
- Penalty increases with respect to corporate tax shelters
- Treat certain foreign-source interest and dividends equivalents as U.S.-effectively connected income
- Recapture overall foreign losses when controlled foreign corporation stock is disposed
- Treat receipt of tracking stock as property
- Recover state bank exam fees

TAX INCENTIVE PROPOSALS

Expand Exclusion for Employer Provided Educational Assistance to Include Graduate Education

The ABA supports the expansion of the tax incentives for employer provided education to include graduate education. The banking and financial services industries are experiencing dramatic technological changes. This provision will assist in the training of employees to better face global competition. Employer provided educational assistance is a central component of the modern compensation package and is used to recruit and retain vital employees.

Retirement Savings Accounts

The ABA fully supports efforts to expand the availability of retirement savings. We are particularly pleased that the concept of tax-advantaged retirement savings has garnered long-standing bi-partisan support and that the Administration's plan contains many significant proposals to encourage savings.

Low-income Housing Tax Credit

The ABA supports the proposal to raise the low-income housing tax credit cap from $1.25 per capita to $1.75 per capita. This dollar value has not been increased since it was first set in the 1986 Act. Raising the cap would assist in the development of much needed affordable rental housing in all areas of the country.

Qualified Zone Academy Bonds

The ABA supports the proposal to authorize the issuance of additional qualified zone academy bonds and school modernization bonds and to modify the tax credit bond program. The proposed changes would facilitate the usage of such bonds by banking institutions in impacted areas.

Other Issues

The Administration's proposal contains a number of other provisions that we support, as listed below:

Increase limit on charitable donations of appreciated property Make Brownfields remediation expensing permanent Simplify the foreign tax credit limits for 10/50 company dividends

CONCLUSION

The ABA appreciates having this opportunity to present our views on the revenue provisions contained in the President's fiscal year 2001 budget proposal. We look forward to working with you in the future on these most important matters.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

Introduction

These comments are submitted by the American Petroleum Institute (API) for inclusion in the printed record of the February 8, 2000 Finance Committee hearing on the tax provisions in the Administration's FY 2001 budget proposal. API represents approximately 400 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing.

The U.S. oil and gas industry continues to be a leader in exploring for and developing oil and gas reserves around the world. However, this leadership position is being threatened due to the diminishing advantages enjoyed by the domestic industry in the areas of U.S. technology and investment capital. At the same time, the continuing depletion of U.S. petroleum reserves and federal and state government policies restricting reserve replacement domestically have forced U.S. petroleum companies to look increasingly overseas to replace their petroleum reserves.

A recent API study demonstrates that despite the fact that production outside the United States by U.S. companies increased by 300,000 barrels per day over the period from 1987 to 1996, that was not enough to offset the decline in U.S. production by those firms. Therefore, total global production by U.S. oil and gas companies actually declined during that period. As evidenced by recent events, ceding greater control over petroleum product supplies to OPEC can have a profound effect on the prices paid by U.S. oil and gas consumers.

A major factor behind the decline in the U.S. oil and gas industry's global competitive position is U.S. international tax policy. One of the provisions in President Clinton's budget proposal is aimed directly at the foreign source income of U.S. petroleum companies. The U.S. tax regime already imposes a substantial economic burden on U.S. multinational companies by exposing them to double taxation, that is, the payment of tax on foreign source income to both the host country and the United States. In addition, the complexity of the U.S. tax rules imposes significant compliance costs. As a result, U.S. companies are forced to forego foreign investment altogether based on projected after-tax rates of return, or they are preempted in bids for overseas investments by global competition. Congress can help to stem further losses in the global competitive position of the U.S. oil and gas industry by rejecting the Administration's proposal to increase taxes on their foreign source income, and the proposals to reinstate the Superfund taxes and the Oil Spill tax.

Administration Proposals

Our testimony will address the following proposals:

- modify rules relating to foreign oil and gas extraction income;
- reinstate excise taxes and the corporate environmental tax deposited in the Hazardous Substance Superfund Trust Fund;
- reinstate the oil spill excise tax;
- corporate tax shelters;
- Harbor Maintenance Tax Converted to User Fee; and
- tax investment income of trade associations

RULES RELATING TO FOREIGN OIL AND GAS EXTRACTION INCOME

President Clinton's budget proposal includes the following provisions:

- In situations where taxpayers are subject to a foreign income tax and also receive an economic benefit from the foreign country, taxpayers would be able to claim a credit for such taxes under Code Section 901 only 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.
- Effective for taxable years beginning after enactment, new rules would be provided for all foreign oil and gas income (FOGI). FOGI would be trapped in a new separate FOGI basket under Code Section 904(d). FOGI would be defined to include both foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI).

- 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.)

This proposal, aimed directly at the foreign operations of U.S. petroleum companies, seriously threatens the ability of those companies to remain competitive on a global scale, and API strongly opposes the proposal.

If U.S. oil and gas concerns are to stay in business, they must look overseas to replace their diminishing reserves, since the opportunity for domestic reserve replacement has been restricted by both federal and state government policy. The opening of Russia to foreign capital, the competition for investment by the countries bordering the Caspian Sea, the privatization of energy in portions of Latin America, Asia, and Africa-all offer the potential for unprecedented opportunity in meeting the challenges of supplying fuel to a rapidly growing world economy. In each of these frontiers, U.S. companies are poised to participate actively. However, if U.S. companies can not economically compete, foreign resources will instead be produced by foreign competitors, with little or no benefit to the U.S. economy, U.S. companies, or American workers.

With non-OPEC development being cut back, and OPEC market share and influence once again rising, a key concern of federal policy should be that of maintaining the global supply diversity that has been the keystone of improved energy security for the past two decades. The principal tool for promotion of that diversity is active participation by U.S. firms in the development of these new frontiers. Therefore, federal policy should be geared to enhancing the competitiveness of U.S. firms operating abroad, not reducing it with new tax burdens.

The foreign tax credit (FTC) principle of avoiding double taxation represents the foundation of U.S. taxation of foreign source income. The Administration's budget proposal would destroy this foundation on a selective basis for foreign oil and gas income only, in direct conflict with long established tax policy and with U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

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 is intended to prevent the same income from being taxed twice, once by the U.S. and once by the source country. 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, the 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 (except for 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 multiplying the tentative U.S. tax on worldwide income by the ratio of foreign source income to worldwide taxable income. The excess FTCs can be carried back two years and carried forward five years, to be claimed as credits in those years within the same respective overall limitations.

The overall limitation is computed separately for not less than nine "separate limitation categories." Under present law, foreign oil and gas income falls into the general limitation category. Thus, 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 easily changed; (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

Congress and the Treasury have already imposed significant limitations on the use of foreign tax credits attributable to foreign oil and gas operations. In response to the development of high tax rate regimes by OPEC, taxes on foreign oil and gas income have become the subject of special limitations. For example, each year the amount of taxes on FOGEI may not exceed 35 percent (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 extraction activities.

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 nor 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 grants 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 the taxing sovereign is also the grantor of mineral rights, the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "a specific economic benefit" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign has 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 in 1983 finalized 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 and 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, is considered a royalty). 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 Disallows FTCs Of Dual Capacity Taxpayers Where The Host Country Has No Generally Applicable Income Tax

If a host country had an income tax on FOGI (i.e., FOGEI or FORI), but no generally applicable income tax, the proposal would disallow 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 additional U.S. tax on foreign investment in the petroleum industry would not only eliminate many new projects; it could also change the economics of past investments. In some cases, this would 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 would also introduce more complexity and potential for litigation into the already muddled world of the FTC.

The unfairness of the provision becomes even more apparent if one considers the situation in which a U.S. based oil company and a U.S. based company other than an oil company are subject to an income tax in a country without a generally applicable income tax. Under the proposal, only the U.S. oil company would receive no foreign tax credit, while the other taxpayer would be entitled to the full tax credit for the very same tax.

The proposal's concerns with the tax versus royalty distinction were resolved by Congress and the Treasury long ago with the special tax credit limitation on FOGEI enacted in 1975 and the Splitting Regulations of 1983. These were then later reinforced in the 1986 Act by the fragmentation of foreign source income into a host of categories or baskets. The earlier resolution of the tax versus royalty dilemma recognized that (1) if payments to a foreign sovereign meet the criteria of an income tax, they should not 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, rather than being dependent on the foreign sovereign's fiscal choices.

The Proposal Limits FTCs To The Amount That 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 income tax 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 "scheduler" type of business income tax regime (i.e., regimes that tax only certain categories of income, according to particular "schedules"), merely because the foreign sovereign's fiscal policy does not include all types of business income.

For emerging economies in lesser developed countries that may not be ready for an income tax, as well as for post-industrial nations that may turn to a transaction tax, 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 regimes are defined by the country's economic maturity, business structure and accounting sophistication. The most difficult problems arise in the field of business taxation. 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 typical of 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 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 foreign tax credit regime that truly prevents double taxation.

To illustrate, assume foreign country X offers licenses for oil and gas exploitation and also has an 85 percent tax on oil and gas extraction income. In competitive bidding, the license will be granted to the bidder that assumes exploration and development obligations most favorable to country X. Country X has no generally applicable income tax. 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.

Because of the 35 percent 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 foreign company's return will be more than 50 percent greater than 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 limitation category or basket. There is no legitimate reason to carve out FOGI from the general limitation category or basket. The source of FOGEI and FORI is difficult to manipulate. The source of FOGI was determined by nature millions of years ago. FORI is generally derived from the country where the processing or marketing of oil occurs which presupposes substantial investment in nonmovable assets. Moreover, Treasury has issued detailed regulations addressing this sourcing issue. Finally, unless any FORI is earned in the extraction or consumption country, it is very likely taxed currently, before distribution, as Subpart F income even though it is definitely not passive income.

The FTC Proposals Are Bad Tax Policy

Reduction of U.S. participation in foreign oil and gas development because of misguided tax provisions will adversely affect U.S. employment, and any additional tax burden may hinder U.S. companies in 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. job losses and the loss of continuing evolution of U.S. technology. By contrast, foreign oil and gas development by U.S. companies increases utilization of U.S. supplies of hardware and technology. The loss of any major foreign project by 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. Many of the jobs that support overseas operations of U.S. companies are located here in the United States-an estimated 350,000 according to a 1998 analysis by Charles River Associates, a Cambridge, Massachusetts-based consulting firm. That figure consists of: 60,000 in jobs directly dependent on international operations of U.S. oil and gas companies; over 140,000 employed by U.S. suppliers to the oil and gas industry's foreign operations; and, an additional 150,000 employed in the United States supporting the 200,000 individuals who work directly for the oil companies and their suppliers.

Thus, the questions to be answered are: (1) Does the United States-for energy security and international trade reasons among others-want a U.S.-based petroleum industry that is competitive in the global quest for oil and gas reserves? (2) If the answer is "yes," why would the U.S. government adopt a tax policy that is punitive in nature and lessens the competitiveness of the U.S. petroleum industry? The U.S. tax system already makes it extremely difficult for U.S. multinationals to compete against foreign-based entities. This is in direct contrast to the tax systems of our foreign-based competitors, which actually encourage those companies to be more competitive in winning foreign projects. What we need from Congress are improvements in our system that allow U.S. companies to compete more effectively, not further impediments that make it even more difficult and in some cases impossible to succeed in today's global oil and gas business environment. These improvements should include, among others, the repeal of the plethora of separate FTC baskets, the extension of the carryback/carryover period for foreign tax credits, and the repeal of section 907.

The Administration's FY 1999 and FY 2000 budgets included these same proposals which would have reduced the efficacy of the FTC for U.S. oil companies. Congress considered these proposals at that time and rightfully rejected them. They should be rejected this year as well.

REINSTATMENT OF EXPIRED SUPERFUND TAXES

The Administration's proposal would reinstate the Superfund excise taxes on petroleum and certain chemicals through September 30, 2010 and the Corporate Environmental Income Tax through December 31, 2010. API strongly opposes this proposal.

It is generally agreed that the CERCLA program, otherwise known as Superfund, has matured to the point that most of the sites on the National Priorities List (NPL) are in some phase of cleanup. Problems, however, remain in the structure of the current program. The program should undergo comprehensive legislative reform and should sunset at the completion of cleanups of the CERCLA sites currently on the NPL. Issues that the reform legislation should address include liability, remedy selection, and natural resource damage assessments. A restructured and improved Superfund program can and should be funded through general revenues.

Superfund sites are a broad societal problem. Revenues raised to remediate these sites should be broadly based rather than unfairly burdening a few specific industries. EPA has found wastes from all types of businesses and government agencies at hazardous waste sites. The entire economy benefited in the pre-1980 era from the lower cost of handling waste attributable to standards that were acceptable at the time. To place responsibility for the additional costs resulting from retroactive Superfund cleanup standards on the shoulders of a very few industries when previous economic benefits were widely shared is patently unfair.

The petroleum industry is estimated to be responsible for less than 10 percent of the contamination at Superfund sites but has historically paid over 50 percent of the Superfund taxes. This inequity should be rectified. Congress should substantially reform the program and fund the program through general revenues or other broad-based funding sources.

REINSTATMENT OF OIL SPILL EXCISE TAX

The Administration proposes reinstating the five cents per barrel excise tax on domestic and imported crude oil dedicated to the Oil Spill Liability Trust Fund through September 30, 2010, and increasing the trust fund limitation (the "cap") from $1 billion to $5 billion. API strongly opposes the proposal.

Collection of the Oil Spill Excise Tax was suspended for several months during 1994 because the Fund had exceeded its cap of $1 billion. It was subsequently allowed to expire December 31, 1994, because Congress determined that there was no need for additional taxes. Since that time, the balance in the Fund has remained above $1 billion, despite the fact that no additional taxes have been collected. Clearly, the legislated purposes for the Fund are being accomplished without any need for additional revenues. Congress should reject this proposal.

CORPORATE TAX SHELTERS

In a sweeping attack on corporate tax planning, the Administration has proposed fifteen provisions purported to deal with corporate tax shelters. These proposals are overly broad and would bring within their scope many corporate transactions that are clearly permitted under existing law. Moreover, their ambiguity would leave taxpayers uncertain as to the tax consequences of their activities and would lead to increased controversy and litigation. Business taxpayers must be able to rely on the tax code and existing income tax regulations in order to carry on their business activities. Treasury's proposed rules could cost the economy more in lost business activity than they would produce in taxing previously "sheltered" income.

HARBOR MAINTENANCE EXCISE TAX CONVERTED TO COST-BASED USER FEE

The Administration's budget contains a placeholder for revenue from a new Harbor Services User Fee and Harbor Services Fund. This fee would raise $1.7 billion in new taxes, more than three times what is needed for harbor maintenance dredging. Despite the intense and uniform opposition from ports, shippers, carriers, labor and many Members of Congress, the Administration has provided few details about how the new user fee would be structured and has not sought stakeholder input since September 1998.

API strongly supports the use of such funds for channel maintenance and dredge disposal. We object to the Administration's proposal to use these funds for port construction and other services. The Administration should earmark these funds to address the growing demand for harbor maintenance and dredging. Furthermore, the Administration's proposal would force commercial shipping interests to bear the entire cost of the Army Corps of Engineers' harbor maintenance and dredging program rather than spreading the costs among all beneficiaries. We urge Congress to pass H.R. 3566 and create an off-budget trust fund for the Harbor Services Fund. Finally, API urges Congress to take the lead in seeking stakeholder input and developing a fair and equitable means of generating the needed revenue.

SUBJECT INVESTMENT INCOME OF TRADE ASSOCIATIONS TO TAX

The Administration's proposal would subject to tax the net investment income in excess of $10,000 of trade associations and other organizations described in section 501(c)(6). API opposes this provision that is estimated to increase taxes on trade associations and other similar not-for-profit organizations by $1.5 billion. We agree with the Tax Council and other groups that subjecting trade association investment income to the unrelated business income tax (UBIT) conflicts with the current-law purpose of imposing UBIT on associations and other tax-exempt organizations to prevent such organizations from competing unfairly against for-profit businesses. The Administration's proposal mischaracterizes the benefit that trade association members receive from such earnings. Without such earnings, members of these associations would have to pay larger tax-deductible dues. There is no tax abuse. Congress should reject this proposal.

STATEMENT OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES (ASAE)

(SUBMITTED BY MICHAEL S. OLSON, CAE PRESIDENT AND CHIEF EXECUTIVE OFFICER)

Mr. Chairman, my name is Michael S. Olson, CAE, President and Chief Executive Officer of the American Society of Association Executives (ASAE). ASAE is an individual membership society made up of 25,200 association executives and suppliers. Its members manage more than 11,000 leading trade associations, individual membership societies, and other voluntary membership organizations across the United States and in 48 countries around the globe.

I am here to testify in strong opposition to the budget proposal that has again been submitted to Congress by the Clinton Administration that would tax the net investment income of Section 501(c)(6) associations to the extent the income exceeds $10,000 annually. Income that would be subject to taxation, however, is not as narrow as would be expected from the characterization in the proposal of "investment income" but includes all "passive" income such as rent, royalties, interest, dividends, and capital gains. This provision, which is estimated by the Treasury Department to raise approximately $1.55 billion dollars over five years, would radically change the way revenue of these tax-exempt organizations is treated under federal tax law. In addition, if enacted this proposal would jeopardize the very financial stability of many Section 501(c)(6) organizations.

This proposal is identical to the provision included last year in the President's FY2000 budget. At that time, the proposed change was meet by broad and unified opposition from the professional society and trade association community that it targeted. It also created serious concern among charities and other Section 501(c) organizations who were alarmed with the dangerous precedent the provision, if enacted, would set in altering the fundamental tax treatment of tax-exempt organizations that has existed for nearly a century.

Last year, this proposal was received by Congress with broad, bipartisan opposition. In the House of Representatives, twenty-eight members of the House Ways and Means Committee sent a bipartisan letter to the chairman and ranking member of the committee, voicing strong opposition to the proposed tax on investment income. In the Senate, thirty-five Senators of both political parties sent a similar letter to the chairman and ranking member of the Senate Finance Committee. In addition, the entire Senate passed a resolution in opposition to this ill-conceived legislation. We are therefore troubled that the Administration has chosen to resurrect this measure given the broad-based opposition from Congress to the original proposal.

America's trade, professional and philanthropic associations are an integral part of our society. They allocate one of every four dollars they spend to member education and training and public information activities, according to a new study commissioned by the Foundation of the American Society of Association Executives. ASAE member organizations devote more than 173 million volunteer hours each year, time valued at more than $2 billion, to charitable and community service projects. 95 percent of ASAE member organizations offer education programs for members, making that service the single most common association function. ASAE member associations are the primary source of health insurance for more than eight million Americans, while close to one million people participate in retirement savings programs offered through associations.

Association members spend more than $1.1 billion annually complying with association-set standards, which safeguard consumers and provide other valuable benefits. Those same associations fuel America's prosperity by pumping billions of dollars into the economy and creating hundreds of thousands of jobs. Were it not for associations, other institutions, including the government, would face added burdens in the areas of product performance and safety standards, continuing education, public information, professional standards, ethics, research and statistics, political education, and community service. The work of associations is woven through the fabric of American society, and the public has come to depend on the social and economic benefits that associations afford.

The Administration has suggested that their proposal would only affect a small percentage of associations, that it is targeted to larger organizations, that the proposal targets "lobbying organizations," and that it somehow provides additional tax benefits to those who pay dues to associations. All of these assertions are misleading, ill-informed and incorrect.

Based on information from ASAE's 1997 Operating Ratio Report, this proposal will tax most associations with annual operating budgets as low as $200,000, hardly organizations of considerable size. In fact, the bulk of the organizations affected would include associations at the state and local level, many of whom perform little if any lobbying functions. Furthermore, existing law, as outlined below, already eliminates any tax preference, benefit, or subsidy for the lobbying activities of these organizations, and can even unduly penalize their lobbying.

The primary argument the Administration has used to support its proposal is that association members prepay their dues in order to enjoy a tax-free return on investment. This flawed argument fails to recognize (1) the existing outright ban on associations paying dividends to their members; and (2) the fact that association members do not tolerate any amount of excessive dues.

In many ways, this proposal attacks the basic tax-exempt status of associations, and runs counter to the demonstrated commitment of Congress to furthering the purposes of tax-exempt organizations. These exempt purposes, such as training, standard-setting, and providing statistical data and community services, are supported in large part by the income that the Administration's proposal would tax and thereby diminish. If Congress enacts this proposal, it will alter in a fundamental way the tax policy that has governed the tax-exempt community for nearly a century, and will set a dangerous precedent for further changes in tax law for all tax-exempt organizations.

I would now like to review more completely the existing tax law governing this area, and to specifically address some of the arguments that have been made in support of the Administration's proposal. I believe that a careful consideration of the issues involved will make the Committee conclude that this proposal is both ill-advised and ill-conceived, and should be rejected.

I. TAXATION OF SECTION 501(C)(6) ORGANIZATIONS UNDER CURRENT LAW

Section 501(c)(6) organizations are referred to in the tax law as "business leagues" and "chambers of commerce." Today they are typically known as trade associations, individual membership societies, and other voluntary membership organizations. These organizations are international, national, state, and local groups that include not only major industry trade associations but also small town merchants' associations or the local Better Business Bureau. Currently, the tax law provides that Section 501(c)(6) organizations are exempt from federal taxation on income earned in the performance of their exempt purposes. Associations engage primarily in education, communications, self-regulation, research, and public and governmental information and advocacy. Income received from members in the form of dues, fees, and contributions is tax-exempt, as are most other forms of organizational income such as convention registrations and publication sales. However, Section 501(c)(6) groups and many other kinds of exempt organizations are subject to federal corporate income tax on revenues from business activities unrelated to their exempt purposes ("unrelated business income tax" or "UBIT"). UBIT is applicable to income that is earned as a result of a regularly-carried-on trade or business that is not substantially related to the organizations' tax-exempt purposes. Section 501(c)(6) organizations are also subject to specific taxes on any income they spend on lobbying activities.

The UBIT rules were designed to prevent tax-exempt organizations from gaining an unfair advantage over competing, for-profit enterprises in business activities unrelated to those for which tax-exempt status was granted. Congress recognized, however, that Section 501(c)(6) tax-exempt organizations were not competing with for-profit entities or being unfairly advantaged by the receipt of tax-exempt income from certain "passive" sources: rents, royalties, interest, dividends, and capital gains. Tax-exempt organizations use this "passive" income to further their tax-exempt purposes and to help maintain modest reserve funds—to save for necessary capital expenditures and to even out economic swings. Indeed, the legislative history regarding UBIT recognizes that "passive" income is a proper source of revenue for charitable, educational, scientific, and religious organizations [Section 501(c)(3) organizations], issue advocacy organizations [Section 501(c)(4) organizations], and labor unions and agricultural organizations [Section 501(c)(5) organizations], as well as trade associations, individual membership societies, and other voluntary membership organizations [Section 501(c)(6) organizations].

Therefore, Congress drafted the tax code to expressly provide that UBIT for most tax-exempt organizations does not extend to "passive" income. As a result, exempt organizations such as associations are not taxed on rents, royalties, dividends, interest, or gains and losses from the sale of property. The proposal to tax "net investment income" of Section 501(c)(6) organizations would allow the IRS to impose a tax on all such previously untaxed sources of "passive" income. Contrary to its denomination, the scope of the tax is clearly much broader than just "investment income."

II. TAXATION OF SECTION 501(C)(6) ORGANIZATIONS UNDER THE ADMINISTRATION BUDGET PROPOSAL: TREATING PROFESSIONAL ASSOCIATIONS LIKE SOCIAL CLUBS

Under the Administration's proposal, Section 501(c)(6) organizations would be taxed on all "passive" income in excess of $10,000. This proposed tax would not be imposed on exempt income that is set aside to be used exclusively for charitable and educational purposes. Funds set aside in this manner by Section 501(c)(6) organizations could be taxed, however, if those funds are ultimately used for these purposes. In addition, the proposal would tax gains realized from the sale of property used in the performance of an exempt function unless the funds are reinvested in replacement property.

Essentially, the budget proposal would bring Section 501(c)(6) organizations under the same unrelated business income rules that apply to Section 501(c)(7) social clubs, Section 501(c)(9) voluntary employees' beneficiary associations, and Section 501(c)(20) group legal services plans. These organizations receive less favorable tax treatment due to Congress' belief that they have fundamentally different, and less publicly beneficial purposes than other tax-exempt organizations. The Clinton Administration proposes to equate trade associations, individual membership societies, and other such voluntary membership organizations with country clubs, yacht clubs, and health clubs.

Social clubs, for example, are organized under Section 501(c)(7) for the pleasure and recreation of their individual members. As case law and legislative history demonstrate, social clubs were granted tax exemption not to provide an affirmative tax benefit to the organizations, but to ensure that their members are not disadvantaged by their decision to join together to pursue recreational opportunities. Receiving income from non-members or other outside sources is therefore a benefit to the individual members not contemplated by this type of exemption.

With regard to associations exempt under Section 501(c)(6), however, Congress intended to provide specific tax benefits to these organizations to encourage their tax-exempt activities and public purposes. These groups are organized and operated to promote common business and professional interests, for example by developing training material, providing volunteer services to the public, or setting and enforcing safety or ethical standards. In fact, the tax code prohibits Section 501(c)(6) organizations from directing their activities at improving the business conditions of only their individual members. They must enhance entire "lines of commerce;" to do otherwise jeopardizes the organizations' exempt status. Social clubs have therefore long been recognized by Congress as completely different from professional associations, engaged in different activities that merit a different exempt status.

Social clubs have always been taxed differently from associations. This reflects their different functions. Associations are organized to further the interests of whole industries, professions, and other fields of endeavor. "Passive" income received by an association is reinvested in tax-exempt activities of benefit to the public, rather than in recreational/social activities for a limited number of people. Applying the tax rules for social clubs to associations imposes unreasonable and unwarranted penalties on those organizations. For example, under the Administration's proposal, these organizations would be taxed on all investment income unless it is set aside for charitable purposes. Income that is used to further other legitimate organizational activities of value to the industry, the profession, and the public would therefore be taxed. In addition, the proposal would tax these organizations on all gains received from the sale of property unless those gains are reinvested in replacement property. This tax on gains would apply to real estate, equipment, and other tangible property. It would also apply, however, to such vastly diverse assets as software, educational material developed to assist an industry or profession, certification and professional standards manuals, and other forms of intellectual property which further exempt purposes.

It is important to note that the Administration's proposal targets only Section 501(c)(6) organizations. No other categories of tax-exempt organizations would be taxed in this proposal. The Administration's proposal inappropriately seeks to impose the tax scheme designed for Section 501(c)(7) social and recreational clubs only on Section 501(c)(6) associations. Congress has recognized that organizations exempt in these different categories serve different purposes and long ago fashioned a tax exemption scheme to reflect these differences. The Administration's proposal runs counter to common sense and would discourage or prevent Section 501(c)(6) organizations from providing services, including public services, consistent with the purposes for which these associations were granted exemption.

III. TAXATION OF ASSOCIATION LOBBYING ACTIVITIES

Last year, the Administration's proposal was characterized by the former Secretary of the Treasury Robert Ruben as a tax on "lobbying organizations," suggesting that associations somehow now enjoy a favored tax status for their lobbying activities. This characterization was and still is incorrect. Many associations do not conduct any lobbying activity. Moreover, the lobbying activities of associations have no tax preferences, advantages, or subsidies whatsoever, and these expenditures are are fully taxed by virtue of the Omnibus Budget Reconciliation Act of 1993. That law imposed a tax on all lobbying activities of trade and professional associations, either in the form of a flat 35% tax on all funds that the organization spends on lobbying activities, or as a pass-through of non-deductibility to individual association members.

Indeed, not only is there no tax benefit or tax exemption for associations' lobbying activities, either for the members or for the entities themselves, but the 1993 law provides a tax penalty on any funds used to lobby. Lobbying tax penalties can arise in essentially three ways:

1. *Proxy Tax.* The "proxy" tax, an alternative to informing association members of dues non-deductibility because of association lobbying, is set at a flat 35% level. This is the highest level of federal income tax for corporations, paid only by corporations with net incomes over $18.33 million. Associations are denied the "progressivity" of the income tax schedule. Therefore, even though no associations ever achieve nearly that level of income, they must pay the proxy tax as if they did.

2. *Allocation Rule.* Under the "allocation rule," all lobbying expenses are allocated to dues income to determine the percentage of members' dues that are non-deductible. Most associations pay for their lobbying expenses using many sources of income. Increasingly, associations have far more non-dues income than dues income. The allocation rule, however, requires association members to pay a tax on all association income used to conduct lobbying activities, regardless of the percentage of lobbying actually paid from their dues. Indeed, under the "allocation rule," a business can pay more tax if it joins an association that lobbies for a particular government policy than if the business had undertaken the lobbying itself.

3. *Estimation Rule.* The "estimation rule" requires that associations estimate in advance how much dues income and lobbying expense they anticipate. The estimation forms the basis for the notice of dues non-deductibility, which must be given at the time of dues billing or collection. If the actual expense proves to be different from the estimates, the association or its members are subject to very high penalties. There is no way to ensure freedom from the penalty for underestimating short of ceasing to spend money on lobbying the moment the association reaches its estimate. There is no way to avoid the penalty for overestimating at all.

Associations are therefore already subject to more than tax neutrality and absence of exemption or subsidy for lobbying activities. The Administration's proposal would not change any provision with respect to lobbying activities of these associations, although it would certainly weaken the financial resources of associations and reduce their ability to advocate for industries, professions, and the public. Indeed, the Administration's characterization of the proposal as one that addresses "lobbying organizations" is tantamount to an Administration decision to further weaken and suppress the ability of tax-exempt organizations to lobby at all.

IV. TAXATION OF MEMBER DUES

The Administration's proposal has also been justified by its proponents as eliminating a double tax advantage claimed to be enjoyed by dues-paying association members. According to the Administration, association members already receive an immediate deduction for dues or similar payments to Section 501(c)(6) organizations. At the same time, members avoid paying taxes on investment income by having the association invest dues surplus for them tax-free.

This argument is flawed for a variety of reasons:

- The argument implies that members voluntarily pay higher dues than necessary as an investment strategy. While in some circumstances members of tax-exempt associations can deduct their membership dues like any other business expense, members receive no other tax break for dues payments. As discussed above, they are in fact denied a deduction for any amount of dues their association allocates to lobbying expenses.
- The argument implies that associations overcharge their members for dues, thereby creating a significant surplus of dues income. In fact, dues payments usually represent only a portion of an association's income; and dues are virtually always determined by a board or committee consisting of members, who would hardly tolerate excessively high dues. Finally, associations tend to maintain only modest surpluses to protect against financial crises, expending the rest on programs and services. Again, associations are member-governed; members would typically make certain that their associations do not accumulate a surplus beyond the minimum that is necessary and prudent for the management of their associations.
- The argument assumes that Section 501(c)(6) organizations somehow pay dividends to their members. Tax-exempt organizations do not pay dividends or re-

turns in any form to their members, let alone for payment of dues. Indeed, an organization's exempt status may be revoked if any portion of its earnings are directed to individuals.

In other words, the Administration suggests that association members are voluntarily paying higher than necessary dues, solely to avoid paying tax on their own investment income resulting when not all dues revenues are expended immediately. This is the same as suggesting that individuals donate to charities in hopes that the charities will earn investment income on un-spent donations. It is an argument that defies common sense and completely misunderstands the structure and operation of tax-exempt organizations.

V. EXPENDITURES ATTRIBUTED TO INVESTMENT AND OTHER "PASSIVE" INCOME WOULD GENERALLY QUALIFY AS DEDUCTIBLE EXPENSES IF INCURRED BY MEMBERS OF THE ASSOCIATION

The investment income and other "passive" income of associations is used to further the exempt purpose of the organizations. Most if not all of these expenditures for association programs and activities, which are made on behalf of the association's members, would be deductible if carried on directly by the members. This is because these expenses would otherwise be regarded as ordinary and necessary business expenses under Section 162(a) of the tax code or as a charitable contribution. Therefore, it is inappropriate to essentially deny this deduction by imposing the UBIT tax on this income. Under the Administration's proposal, this would in fact be the indirect result of subjecting the "passive" income of Section 501(c)(6) organizations to taxation.

VI. THE ADMINISTRATION'S PROPOSED TAX WOULD REACH ALL FORMS OF "PASSIVE" INCOME AND JEOPARDIZE TAX-EXEMPT PROGRAMS

Trade associations, individual membership societies, and other similar voluntary membership organizations typically receive only a portion of their income from membership dues, fees, and similar charges. In many such organizations, particularly professional societies, there are natural limits or "glass ceilings" on the amounts of dues that can be charged to members. As a result, these Section 501(c)(6) tax-exempt organizations have increasingly sought additional sources of income to enable them to continue their often broad programs of exempt activities on behalf of businesses, professions, and the public. One of those additional sources has been "passive" income—rents, royalties, dividends, interest, and capital gains—that may be earned from a variety of sources.

Section 501(c)(6) organizations rely heavily on "passive" income to support their exempt activities. The proposal would adversely affect virtually all associations, since most organizations from time to time receive some amount of rents, royalties, interest, dividends, or capital gains. These associations use "passive" income to further a host of beneficial activities, which would be threatened by imposition of the Clinton Administration's "investment" tax. For example, Section 501(c)(6) tax-exempt associations are responsible for:

- Drafting and disseminating educational materials.
- Establishing skills development seminars and programs.
- Creating training and safety manuals for various professions.
- Producing books, magazines, newsletters, and other publications.
- Increasing public awareness, knowledge, and confidence in an industry's or a profession's practices.
- Conducting and sponsoring industry research and surveys.
- Compiling statistical data for industries and professions, which is often requested or relied upon by government.
- Providing professionals and businesses with new technical and scientific information.
- Developing and enforcing professional safety and health standards.
- Developing and enforcing ethical standards for industry practice.
- Operating accreditation, certification, and other credentialing programs.
- Organizing and implementing volunteer programs.

The Administration's proposal imposes a broad-based, pervasive, and detrimental penalty on virtually all associations of any kind or size. A tax on the "investment income" of Section 501(c)(6) organization does not address any issue of income used for lobbying activities; all such activities by these organizations is already free of tax exemption or subsidy of any kind (indeed, it can be subject to offsetting "penalty" taxation). There is no double or special tax benefit to those who pay dues to associations. Instead, the Administration's proposal taxes significant sources of funding that associations use now for highly desirable services to entire industries, professions, and the public. Treating Section 501(c)(6) organization in the same manner as social clubs ignores the special, quasi-public purposes and functions of associations, and threatens the ability of such organizations to continue to provide publicly beneficial services in the future. In summary, this proposal is a threat, albeit ill-conceived, to the ongoing viability of thousands of America's membership organizations, and should be rejected by this Committee.

Thank you for this opportunity to submit this testimony. ASAE would be happy to supplement this testimony with answers to any questions you may have.

STATEMENT OF CLARK/BARDES

INTRODUCTION

Clark/Bardes appreciates the opportunity to present this statement to the Senate Finance Committee for the record of its hearing on the Administration's FY 2001 budget proposals. Our statement focuses specifically on a proposal that would increase taxes on companies purchasing insurance covering the lives of their employees.

Clark/Bardes is a publicly traded company headquartered in Dallas, Texas, and with offices around the country. We design, market, and administer insurance-based employee benefit financing programs. Our clients, which include a broad range of businesses, use insurance products as assets to offset the liabilities of employee benefits and to supplement and secure benefits for key executives.

Clark/Bardes strongly opposes the Administration's proposed tax increase on "corporate-owned life insurance" ("COLI"). The same proposal also was floated by the Administration in its FY 1999 and 2000 budget submissions and wisely was rejected by Congress. Perhaps in recognition of the fact that Congress has found no coherent tax policy justification for such a change, the Administration has branded COLI as a "corporate tax shelter"—an egregious characterization intended to build visceral support for the proposal. Regardless of the Administration's rhetoric, the reasons for rejecting the COLI tax increase remain the same:

- Employer-owned life insurance remains an effective means for businesses to finance their growing retiree health and benefit obligations.
- The Administration's proposal shares none of the same tax policy concerns that drove Congressional action on COLI in 1996 and 1997 legislation.
- The current-law tax treatment of COLI was sanctioned explicitly by Congress in the 1996 and 1997 legislation.
- The Administration's proposal is a thinly disguised attempt to tax the "inside buildup" on insurance policies—i.e., a tax on a long-standing means of savings.
- The Administration's proposal represents yet another move by the Administration—along a slippery slope—to deny deductions for ordinary and necessary business expenses.

USE OF EMPLOYER-OWNED LIFE INSURANCE

Before turning to the Administration's proposal, Clark/Bardes believes it is important to provide background information on employer-owned life insurance—a business practice that does not appear to be well understood.

Many employers, large and small, provide health and other benefits to their retired employees. While ERISA rules generally make "dedicated" funding impossible, employers often seek to establish a method of financing these obligations. This allows them not only to secure a source of funds for these payments but also to offset the impact of financial accounting rules that require employers to include the present value of the projected future retiree benefits in their annual financial statements.

Life insurance provides an effective means for businesses to finance their retiree benefits. Consultants, like Clark/Bardes, and life insurance companies work with employers to develop programs to enable the employers to predict retiree health benefit needs and match them with proceeds payable under the life insurance programs.

A simplified example may help to illustrate. ABC Company guarantees its employees a generous health benefits package upon retirement. Like all employers, ABC Company is required to book a liability on its balance sheet for benefits costs related to the eventual retirement of its employees, and needs to find ways to fund these obligations. As a solution, ABC Company takes out a series of life insurance policies on its employees. It pays level insurance premiums to the insurance carrier each year. The cash value on the life insurance policy accumulates on a tax-deferred basis and can be identified as a specific source of funds to meet benefit liabilities.

In the event that the contract is surrendered, ABC Company pays tax on any gain in the policy. In the event that covered employees die, ABC Company receives the death benefit and uses these funds to offset the cost of benefits payments to its retired employees. Actuaries are able to match closely the amount of insurance necessary to fund ABC Company's liabilities.

The Administration's COLI proposal effectively would take away an employer's ability to finance retiree benefit programs using life insurance, and thus could force businesses to severely limit or discontinue these programs. It is ironic that the President's proposal would hamstring a legitimate means of funding post-retirement benefits when a major focus of Congress is to encourage private sector solutions to provide for the needs of our retirees.

THE ADMINISTRATION'S COLI PROPOSAL

The Administration's proposal to tax employer-owned life insurance should be viewed in light of the basic tax rules governing life insurance and interest expense and recent changes made by Congress to the tax treatment of COLI.

Since 1913, amounts paid due to the death of an insured person have been excluded from Federal gross income. The present-law provision providing this exclusion is section 101 of the Internal Revenue Code of 1986, as amended (the "Code"). Amounts paid upon the surrender of a life insurance policy are taxable to the extent the amount received exceeds the aggregate amount of premiums or other consideration paid for the policy, pursuant to section 72(e) of the Code.

Section 163 of the Code generally allows deductions for interest paid on genuine indebtedness. However, sections 264(a)(2) and (a)(3) of the Code, enacted in 1964, prohibit deductions if the interest is paid pursuant to (i) a single premium life insurance contract, or (ii) a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract, unless the requirements of an applicable exception to the disallowance rule are satisfied. One of the exceptions to this interest disallowance provision, known as the "four-out-of-seven" rule, is satisfied if no part of four of the annual premiums due during a seven-year period (beginning with the date the first premium on the contract is paid) is paid by means of indebtedness.

The Tax Reform Act of 1986 (the "1986 Act") amended section 264 of the Code to limit generally deductions for interest paid or accrued on debt with respect to COLI policies covering the life of any officer, employee, or individual who is financially interested in the taxpayer. Specifically, it denied deductions for interest to the extent that borrowing levels on corporate-owned policies exceeded $50,000 of cash surrender value per insured officer, employee, or financially interested individual.

Congress in the Health Insurance Portability and Accountability Act of 1996 (the "1996 Act") eliminated deductions for interest paid on loans taken against the tax-free earnings under the life insurance contract. Specifically, the 1996 Act denied a deduction for interest paid or accrued on any indebtedness with respect to any life insurance policies covering an officer, employee, or financially interested individual of the policy owner. The 1996 Act provided a phase-out rule for indebtedness on existing COLI contracts, permitting continued interest deductions in declining percentages through 1998. After 1998, no deductions were permitted.

The 1996 Act provided an exception for certain COLI contracts. Specifically, the Act continued to allow deductions with respect to indebtedness on COLI covering up to 20 "key persons," [1] defined generally as an officer or a 20-percent owner of the policy owner, subject to the $50,000 indebtedness limit, and further subject to a restriction that the rate of interest paid on the policies cannot exceed the Moody's Corporate Bond Yield Average-Monthly Corporates for each month interest is paid or accrued. Other than this one exception, there is no longer any ability for a corporation to deduct interest on a life insurance policy covering its officers, directors, employees, or 20-percent owners.

The Taxpayer Relief Act of 1997 (the "1997 Act") added section 264(f) to the Code. This provision generally disallows a deduction for the portion of a taxpayer's total interest expense that is allocated pro rata to the excess of the cash surrender value of the taxpayer's life insurance policies over the amounts of any loans with respect to the policies, effective for policies issued after June 8, 1997. However, section 264(f)(4) provides a broad exception for policies covering 20-percent owners, officers, directors, or employees of the owner of the policy. Thus, the interest deduction disallowance provision in the 1997 Act generally affected only COLI programs covering the lives of non-employees.

The COLI proposal in the Administration's FY 2001 budget, submitted on February 7, 2000, would extend the section 264(f) interest deduction disallowance to COLI programs covering the lives of employees.[2] The proposal therefore would apply a proportionate interest expense disallowance based on all COLI cash surrender values. The exact amount of the interest disallowance would depend on the ratio of the average cash values of the taxpayer's non-leveraged life insurance policies to the average adjusted bases of all other assets.

LACK OF TAX POLICY JUSTIFICATION

The Treasury Department, in its "Green Book" explanation of the revenue proposals in the Administration's FY 2001 budget, implies that the COLI measures taken by Congress in 1996 and 1997 were incomplete in accomplishing their intended goals. A closer inspection of the tax policy considerations that gave rise to the 1996 and 1997 changes would suggest otherwise.

The 1996 Act changes to the tax treatment of COLI focused on leveraged COLI transactions (i.e., transactions involving borrowings against the value of the life insurance policies), which Congress believed represented an inappropriate and unintended application of the tax rules. The "Blue Book" explanation of the 1996 Act, prepared by the staff of the Joint Committee on Taxation, states that leveraged COLI programs "could be viewed as the economic equivalent of a tax-free savings account owned by the company into which it pays itself tax-deductible interest."[3] The Blue Book further states:

> . . . Congress felt that it is not appropriate to permit a deduction for interest that is funding the increase in value of an asset of which the taxpayer is the ultimate beneficiary as recipient of the proceeds upon the insured person's death. Interest paid by the taxpayer on a loan under a life insurance policy can be viewed as funding the inside buildup of the policy. The taxpayer is indirectly paying the interest to itself, through the increase in value of the policy of which the taxpayer is the beneficiary.[4]

The 1997 Act COLI provision grew out of concerns over plans by a particular taxpayer, Fannie Mae, to acquire corporate-owned life insurance on the lives of its mortgage holders. The 1997 Act changes, therefore, specifically targeted COLI programs developed with respect to non-employees. Both the House Ways and Means Committee Report and the Senate Finance Committee Report on the 1997 Act discuss an example involving a Fannie Mae-type fact pattern:

> If a mortgage lender can . . . buy a cash value life insurance policy on the lives of mortgage borrowers, the lender may be able to deduct premiums or interest on debt with respect to such a contract, if no other deduction disallowance rule or principle of tax law applies to limit the deductions. The premiums or interest could be deductible even after the individual's mortgage loan is sold to another lender or to a mortgage pool. If the loan were sold to a second lender, the second lender might also be able to buy a cash value life insurance contract on the life of the borrower, and to deduct premiums or interest with respect to that contract.[5]

The COLI proposal in the Administration's FY 2001 budget lacks any similarly compelling tax policy justification. Unlike the 1996 Act provision targeting leveraged COLI programs, the Administration's proposal would apply where there is no link between loan interest and the COLI program.[6] And unlike the 1997 Act provision targeting the use of COLI with respect to non-employees, this proposal does not involve a newly conceived use of COLI.

In explaining the rationale underlying the proposal, the Treasury Department argues that the "inside buildup" on life insurance policies in COLI programs gives rise to "tax arbitrage benefits" for leveraged businesses.[7] Treasury argues that businesses use inside buildup on COLI policies to fund deductible interest payments, thus jumping to the conclusion that COLI considerations govern decisions regarding when businesses incur debt. This view is clearly erroneous. Businesses incur debt for business reasons, such as business expansion.

COLI IS NOT A "TAX SHELTER"

Clark/Bardes strongly objects to the Administration's characterization of non-leveraged COLI as a "corporate tax shelter." The penalty provisions of the Internal Revenue Code define a tax shelter as any entity, plan, or arrangement with respect to which tax avoidance or evasion is a significant purpose.[8] A separate proposal in the Administration's FY 2001 budget proposes a new definition of "corporate tax shelter" under section 6662 that would apply to "attempts to obtain a tax benefit" in a "tax-avoidance transaction," defined as any transaction in which the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits.[9]

It is difficult to see how traditional COLI programs might reasonably be viewed as meeting any of these "corporate tax shelter" definitions. As discussed above, the

Administration's proposal would deny interest deductions on borrowings totally unrelated to COLI, for example, where a company owning life insurance policies on the lives of employees borrows money to construct a new manufacturing plant, or conversely, where a company that borrowed ten years ago to construct a plant now considers purchasing life insurance to help finance retiree benefits. It is difficult to see how these disparate actions could be collapsed and viewed as a tax-avoidance transaction. Does Treasury seriously suggest that a company holding life insurance that decides to borrow to fund construction of a new plant is motivated by tax considerations? The Treasury proposal would completely disregard the obvious business purpose underlying such a decision.

Under a broader view, a "tax shelter" might be thought of as an arrangement involving an unintended application of the tax laws. It is impossible to argue that current COLI programs are unintended. Few other areas of the tax law have received as thorough scrutiny in recent years. In the 1996 Act, Congress explicitly allowed COLI programs to continue so long as they were not leveraged. In the 1997 Act, Congress carefully crafted a specific exception (designed to preserve longstanding use of unleveraged COLI) to the pro rata interest expense disallowance provisions for COLI programs covering employees. In other words, current COLI programs involve an intended application of the tax law.

ATTACK ON "INSIDE BUILDUP," SAVINGS

The Administration's COLI proposal, at its core, is not about "tax shelters" at all. Rather, it is a thinly veiled attack on the very heart of traditional permanent life insurance—that is, the "inside buildup" of credits (or cash value) within these policies that permits policyholders to pay level premiums over the lives of covered individuals. Although couched as a limitation on interest expense deductions, the proposal generally would have the same effect as a direct tax on inside buildup. Thus, the proposal would reverse the fundamental tax treatment of level-premium life insurance that has been in place since 1913.

Congress in the past has rejected proposals to alter the tax treatment of inside buildup, and for good reason. The investment element inherent in permanent life insurance is a significant form of savings. Congress and the Administration in recent years have worked together in the opposite direction, considering new incentives for savings and long-term investment and removing obvious obstacles. It is odd that the Administration at this time would propose making it more difficult to save and invest through life insurance.

INAPPROPRIATE LIMITATION ON BUSINESS DEDUCTIONS

In some respects, Treasury's proposed denial of deductions for interest expenses for companies owning life insurance is not surprising. This proposal comes on the heels of other Clinton Administration proposals to chip away at deductions for expenses that long have been treated as ordinary and necessary costs of doing business. Another recent example is the provision in the Administration's FY 2001 budget that would deny deductions for damages paid by companies to plaintiffs groups.

But the proposal is troubling nonetheless, as illustrated by a simple example. The XYX company in 1998 borrows funds to build a new manufacturing facility. The XYZ company in 1998 and 1999 is able to deduct interest paid on these borrowings. In 2000, the XYZ company, responding to concerns over mounting future retiree health obligations, purchases insurance on the lives of its employees. IRS agents tell the XYZ company that it has just entered into a "corporate tax shelter." Suddenly, the XYZ company finds that a portion of the interest on the 1998 loan is no longer viewed by the government as an ordinary and necessary business expense. XYZ therefore is taxed, retroactively, on its 1998 borrowing.

The proposal becomes even more troubling when one considers the logical extensions of the Administration's rationale, which seems to be to deny interest deductions when a taxpayer at the same time enjoys the benefits of tax deferral. Might the IRS, using the same reasoning, someday seek to deny home mortgage interest deductions for individuals who also own life insurance? Might the government deny deductions for medical expenses for individuals that enjoy tax-preferred accumulations of earnings in 401(k) accounts or IRAs?

CONCLUSION

Clark/Bardes respectfully urges the Committee on Finance to reject the Administration's misguided COLI proposal, as it did in 1998 and 1999. As discussed above, the Administration once again has failed to articulate a clear or compelling tax policy concern over the current-law rules, and has sought to couch COLI, altogether inappropriately, as a "tax shelter." If enacted, the Administration's proposal would represent a significant departure from current law and longstanding tax policy regarding the treatment of life insurance. It would have a significantly adverse impact on the ability of businesses to solve a variety of needs including the ability to finance meaningful retiree health benefits. It also would provide a disincentive for savings and long-term investment and would represent yet another attack on deductions for ordinary and necessary business expenses.

ENDNOTES

[1] For many companies, the effective key person limit under this rule is five employees. See section 264(b)(3).
[2] By eliminating the section 264(f)(4) exception that currently exempts COLI programs covering the lives of employees, officers, and directors.
[3] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress (JCS-12-96), December 18, 1996, p. 363.
[4] Id, at 364.
[5] H.R. Rep. No. 105-148, 105th Cong., 1st Sess. p. 501; S. Rep. No. 105-33, 105th Cong., 1st Sess., p. 186.
[6] Current law is quite specific that interest deductions resulting from both direct and indirect borrowing, i.e., using the policy as collateral, are disallowed. Sec. 264(a)(3).
[7] General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals, Department of the Treasury, February 2000, p.137.
[8] Section 6662(d)(2)(C)(iii).
[9] As a separate matter, Clark/Bardes believes the Administration's proposed new definition of "corporate tax shelter" is unnecessary, ill-advised, and could be broadly applied by IRS agents to attack many legitimate business transactions.

STATEMENT OF THE COALITION FOR THE FAIR TAXATION OF BUSINESS TRANSACTIONS [1]

The Coalition for the Fair Taxation of Business Transactions (the "Coalition") is composed of U.S. companies representing a broad cross-section of industries. The Coalition is opposed to the broad-based "corporate tax shelter" provisions proposed by the Administration in their FY2001 budget because they believe that the proposals, if enacted, would have a far-reaching effect that unnecessarily harms legitimate business transactions. To the extent that abuses exist, current administrative remedies are available and sufficient to curtail overly aggressive tax shelter activity. In addition, IRS has been very successful in attacking tax shelters through the courts, which themselves have issued criteria for assessing potential tax shelters that should prove to be effective deterrents to abuse. Finally, if Congress feels compelled to legislate in this area, they should narrowly limit the category of transactions classified as corporate tax shelters so as not to penalize legitimate business transactions. This would necessitate recognizing the business purpose of the transaction.

This paper contains the Coalition's specific concerns with the President's FY2001 corporate tax shelter proposals. The Coalition has previously submitted testimony to the House Ways and Means and Senate Finance Committees with respect to the proposals contained in the Administration's FY2000 Budget, Treasury's White Paper and the Joint Committee Study.

I. INTRODUCTION

The Administration's FY2001 Budget, submitted to Congress on February 7, 2000, contains several proposals concerning the definition of and the penalties for corporate tax shelters. These recommendations fall into two general categories: those that affect corporate taxpayers that engage in tax shelter activity and those that affect other parties, such as tax shelter promoters and tax advisers.

Last year, on July 1, 1999, the Department of Treasury issued its much-publicized "White Paper"[2] on corporate tax shelters. Treasury's White Paper analyzes corporate tax shelter activity and proposes recommendations for modifying the Administration's corporate tax shelter proposals originally proposed in February 1999 as part of the FY2002 Budget. Many of Treasury's White Paper modifications have been incorporated in the Administration's FY2001 budget and are an improvement over the recommendations in the FY2000 budget. However, the substance of the Administration's underlying proposals remains problematic. The recommendations continue to characterize too broad a classification of activities as tax shelters. To this end, Treasury has proposed a set of recommendations that, instead of narrowly stopping abusive shelter schemes, will hit legitimate transactions, impose penalties on unsuspecting taxpayers, require burdensome disclosures and generally allow IRS agents to call into question virtually any transaction undertaken by a corporate taxpayer, regardless of the purpose, if it reduces the corporation's taxes.

Furthermore, we believe the IRS currently has the necessary tools to challenge abusive transactions and additional statutory changes are unwarranted. The IRS has the authority to issue administrative pronouncements (notices, rulings, or other announcements) to address perceived abusive transactions. In fact, the number of announcements the IRS has issued in the past few years addressing perceived tax shelter activity has been substantial. In addition, Treasury and the IRS have a wide range of general anti-abuse provisions already available to combat the perceived proliferation of corporate tax shelters. For example, if a taxpayer's method of accounting does not clearly reflect income, section 446(b) of the Code authorizes the IRS to disregard the taxpayer's method of accounting and to compute the taxpayer's income under a method of accounting it believes more clearly reflects income. Under section 482 of the Code, the IRS can allocate, distribute, or apportion income, deductions, credits and allowances between controlled taxpayers to prevent evasion of taxes or to accurately reflect their taxable income.

Moreover, the IRS has recently announced the formation of a working group to identify and target corporate tax shelter activity. This group should enable the IRS to identify tax shelter activity more quickly and should be a deterrent to abusive tax shelter activity particularly given IRS' stated intent to impose penalties more often. This working group should provide a formidable resource when coupled with existing IRS authority to issue administrative pronouncements and general anti-abuse authority available to IRS and Treasury.

Finally, as evidenced by recent court rulings, the IRS can and does challenge abusive transactions in the courts. The primary reason why it is so difficult to draft a broad-based tax shelter rule is because it is extremely difficult to provide a mechanism to evaluate a corporation's business purpose in a statutory framework. This is because evaluation of business purpose is a subjective evaluation.[3] However, the courts can and routinely do effectively make this evaluation, which has resulted in several recent successful challenges of tax shelters by the IRS. Thus, we believe that the Administration's corporate tax shelter proposals are not warranted.[4]

II. TAX SHELTER DEFINITION

Central to the approach taken by the Administration is an enhanced definition of corporate tax shelter.[5]

The definition of tax shelter is key to the penalty regimes contained in the proposals. In the Administration's budget, once a transaction is characterized as a tax shelter, the taxpayer can be subject to an increased substantial understatement penalty (40 percent), unless certain disclosure requirements are met. In addition, same test would be applied to disallow tax benefits from transactions that would be deemed to lack economic substance.

The Administration's FY2001 Budget proposal would modify the existing tax shelter definition[6] to provide that a corporate tax shelter would be any entity, plan, or arrangement in which a corporation obtained a "tax benefit" in a "tax avoidance transaction." The proposal defines a "tax benefit" as a reduction, exclusion, avoidance or deferral of tax (or an increase in a refund) unless the benefit was "clearly contemplated" by the applicable Code provision. The proposal defines a "tax avoidance transaction" as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. Additionally, a financing transaction would be considered a tax avoidance transaction if the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing.

One need look no further than the proposed new definition of corporate tax shelter to find the genesis of the problems with the Administration's budget proposals. The Administration has proposed an objective standard for determining what is a corporate tax shelter in order to avoid an overdelegation of authority to the IRS. Nonetheless, the definition remains too broad. The new definition does not adequately deal with the numerous day-to-day business transactions that do not lend themselves to a pre-tax profit comparison that are not financing transactions.

The Administration excludes tax benefits that are "clearly contemplated" from consideration as tax shelters, but this standard is too vague to provide much relief from the broad application of the definition. In determining the application of the "clearly contemplated" exception, Congressional purpose, administrative interpretations, and interaction of the provision with other provisions are to be taken into account. This standard would provide an IRS agent with extraordinary leeway in making a determination that a transaction did not meet the clearly contemplated standard, which will inevitably result in increased confrontations between taxpayers and revenue agents and a backlog of litigation in the Tax Court.

Thus, the Administration's proposed tax shelter definition would apply to a broad category of legitimate business transactions, which do not confer a direct profit stream. For example, a corporation may need to structure its affairs to conform to regulatory requirements or may reorganize its structure to gain access to certain foreign markets. A company may also restructure or reorganize to gain economies of scale. These transactions are motivated by business concerns, even though they do not directly produce a pre-tax economic return by themselves. If these legitimate transactions are done in a tax efficient manner, they apparently will be characterized automatically as a tax shelter because they do not produce a direct economic return. In addition, it is unclear as to what type of transaction will be affected by the proposal to deal with financing transactions other than a "stepped-down preferred transaction," which has already been addressed in recent Treasury guidance.[7]

Although the Administration claims that their tax shelter definition is rooted in case law, citing ACM Partnership,[8] Compaq Computer,[9] and Winn-Dixie,[10] the Administration's test fails to include as essential part of the analysis that is common to all of these cases—whether despite the fact that there is little or no direct economic effect of the transaction, there is a valid business purpose. For example, the circuit court in ACM Partnership appeal states, "(T)he inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'economic substance of the transaction' and the 'subjective business motivation' behind them. However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes."[11] Evaluating business purpose on a facts and circumstances basis is central to judicial application of the economic substance doctrine.

III. MODIFIED SUBSTANTIAL UNDERSTATEMENT PENALTY

The Administration's budget proposal would increase the substantial understatement penalty from 20 percent to 40 percent with respect to any item attributable to a corporate tax shelter.[12] A corporation can reduce the 40 percent penalty to 20 percent by fulfilling specific disclosure requirements. Specifically, a taxpayer would be required to disclose a tax shelter transaction to the IRS National Office by filing a statement with the tax return describing the transaction. If the taxpayer meets a strengthened reasonable cause standard the penalty can be reduced from 20% to 0, even if the transaction ultimately is deemed to be a corporate tax shelter. The reasonable cause exception would be modified and strengthened by requiring that the taxpayer have a "strong chance of sustaining its tax position" (rather than "more likely than not").

We commend the Administration for some of the improvements they have made to their FY2000 Budget Proposal. For example, in response to criticisms that the Coalition and others have made, they no longer propose eliminating the reasonable cause exception to the substantial understatement penalty. They also have eliminated the proposal to require that a tax shelter disclosure be made both 30 days after the transaction is completed, as well as with the tax return. Nonetheless, we remain concerned that the proposed 40 percent penalty is too harsh given the uncertainty that will result from the vague definition of "corporate tax shelter" in the Administration's proposal.

Revenue agents, who have no downside, can threaten to propose adjustments based on alleged corporate tax shelter transactions to extract unreasonable concessions by the corporate taxpayer on other issues. Incidents of "rogue" revenue agents abusing their authority in efforts to extort unfair concessions and settlements are not limited to individual taxpayers. In fact, the higher rate of corporate tax audits makes this a particularly worrisome proposal. The use of the increased substantial understatement penalty to obtain concessions from corporate taxpayers is inconsistent with the goals expressed in the IRS Restructuring and Reform Act of 1998.

Furthermore, the proposed strengthened reasonable cause standard is too high a standard to satisfy and is unclear in its application. The only current standard in the Code that is similar to the "strong chance of sustaining its tax position" is the burden placed on IRS by Sec. 7454(a) and Tax Court Rule 142(b) in a civil fraud case of proving by "clear and convincing evidence" the taxpayer's intent to evade his taxes. To place such a similar burden on a corporate taxpayer to avoid the accuracy penalty attributable to a tax shelter is unwarranted because it places this heavy burden on the taxpayer, not the IRS who is seeking to impose the penalty.

If it were true that taxpayers are either ignoring or circumventing the requirements of regulation section 1.6664-4, codifying the requirements therein would significantly strengthen the reasonable cause standard and should satisfy the administration's stated concerns.

IV. INCREASED CORPORATE DISCLOSURE REQUIREMENTS

Under current law, unlike the rules for non-tax shelter understatement items, disclosure of a corporate tax shelter item does not provide a basis for avoiding the substantial understatement penalty. To increase disclosure, the Administration recommends that the substantial understatement penalty be reduced if the proposed disclosure requirements are met. The Administration would require that transactions meeting certain characteristics be disclosed, whether or not they meet the definition of corporate tax shelter. A $100,000 penalty would be applied to each failure to satisfy the disclosure requirements.

Corporate taxpayers would be required to disclose transactions that result in a significant tax benefit and have some combination of the following characteristics ("filters"): (1) a book/tax difference in excess of a certain amount; (2) a rescission, unwind or provision insuring tax benefits; (3) involvement of tax-indifferent parties; (4) advisor fees in excess of a certain amount or contingent fees; (5) confidentiality agreement; (6) offering of the transaction to multiple corporations (if known); and a difference between the form of the transaction and how it is reported. The disclosure must be filed with the IRS National Office by the unextended due date of the tax return and again with each income tax return that the transaction affects. The disclosure would be a "short form" filed with the National Office and would require taxpayers to provide a description of the filters that apply to the transaction, as well as other information. A $100,000 penalty for each failure to disclose would apply. The disclosure form must be signed by a corporate officer who would be made personally liable for misstatements on the form. The officer could be subject to penalties for fraud or gross negligence and would be accorded due process rights.

While this enhanced notice requirement is intended to keep IRS current on the latest tax planning activities of corporate taxpayers, it is burdensome and a trap for the unwary corporate taxpayer. Although we believe that the Administration proposed the use of the "filters" to limit the number of transactions that must be disclosed, the use of these filters may have the opposite effect because several of the filters can occur with some frequency in routine business transactions. For example, non-deductible goodwill can create a book/tax difference, which is a common occurrence and does not indicate the presence of a tax shelter. Moreover, with the recently enacted 2-year limitation on NOL carrybacks, characterizing a taxpayer with a 3-year NOL carryforward as a tax indifferent party could classify many business combinations as tax shelters subject to disclosure and possible penalties.

The inequity and burden of this requirement is only further compounded with the significant $100,000 monetary penalty. Surely the breadth of the proposed "filters" and the vagueness of the tax shelter definition will cause taxpayers, including unsophisticated small and medium sized businesses, to be subject to this very large penalty. As noted above, the wide scope of business transactions subject to disclosure under this proposal would be astonishing. If filters are to be used to narrow the number of transactions that must be disclosed, a better approach would be to require that a transaction have at least three of the filter characteristics to trigger the disclosure requirements. However, we believe that disclosure made on schedule M-1[13] of the corporate tax return, reconciling discrepancies between how income and losses are reported for tax and book purposes, should provide the IRS with the information they need without imposing an unnecessary additional burden on taxpayers.

Furthermore, the proposal to hold a corporate officer personally liable for the disclosures, with possible penalties, does not serve a logical propose. According to Treasury officials, one of the purposes of having a corporate officer attest to this information is to have the person most in control of the facts sign the disclosure. In most cases, the person most in control of the facts is the tax director. If the tax director is a corporate officer, he generally is already signing the tax return under penalties of perjury that to the best of his knowledge and belief, the return is true, correct and complete. We do not believe it is appropriate or necessary to require the attestation of an additional corporate officer who does not otherwise have control of the facts in the situation.

Even more troublesome is the possibility that a transaction that the taxpayer reasonably believes is not a tax shelter, and therefore does not disclose, is later classified as a corporate tax shelter. Under the proposed regime, that taxpayer would be subject to a significant penalty. First, the tax benefits would be denied. Second, a 40 percent penalty would apply. Finally, a $100,000 failure to disclose penalty would be imposed. Thus, in addition to the substantial power granted to IRS field agents, the higher standards for reasonable cause and the significantly increased monetary penalties create substantial risk for both routine business transactions and legitimate corporate tax planning. Overall, the regime Treasury has proposed is overly burdensome, complicated and vague in its practical application.

V. CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

The Administration's proposal attempts to codify and clarify the judicial economic substance doctrine. Under the proposal, tax benefits would be disallowed from any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the taxpayer from the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of the taxpayer from such transaction. With respect to financing transactions, tax benefits would be disallowed if the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing.

The proposal would not apply to disallow any claimed loss or deduction of a taxpayer that had economically been incurred by the taxpayer before the transaction was entered into. The proposal would apply to any transaction entered into in connection with a trade or business or activity engaged in for profit or for the production of income, whether or not by a corporation.

As noted above, this proposal would provide IRS agents with extraordinary power to classify business transactions as tax shelters. Taxpayers that enter into transactions that have legitimate business purposes, even though under the mathematical test of the proposal no pre-tax profit is quantifiable, would be denied tax benefits and subject to harsh penalties. The judicially applied economic substance doctrine looks to both the economic consequences and an analysis of the intended purposes behind the transaction. This business purpose analysis is an important means of determining whether a transaction has no purpose other than the avoidance of tax or serves a non-tax business purpose. The proposal is clearly lacking this critical element of the doctrine developed over the years by the courts.

VI. ADMINISTRATIVE SAFEGUARDS

Identifying and defining corporate tax shelters is a nearly impossible task. As evidenced by the various iterations of tax shelter definition, all of which are extremely broad and lack a business purpose exception, both taxpayers and IRS agents are bound to disagree about which transactions are or are not tax shelters. Thus, especially in light of the proposed enhanced penalty regimes, taxpayers should be afforded remedies to protect against the potential abuse of power by IRS agents under these stricter yet ambiguous tax shelter definitions.

The budget proposals of the Administration do not provide any safeguards or protections against IRS agents using the new penalties as leverage to extract other concessions or otherwise abusing their power as a result of these new higher and stricter penalties.

In its White Paper, Treasury suggested modifying the Administration's FY2000 budget proposal to allow any corporate tax shelter issue raised by an examining agent to be automatically referred to the National Office of the IRS for further processing or resolution. This review would facilitate consistent treatment among various taxpayers and protect taxpayers from aggressive IRS field agents. It is extremely unfortunate that the revised FY2001 budget proposals provide no such relief.

Treasury's White Paper also suggested allowing a taxpayer to get an expedited ruling on whether a contemplated transaction is a tax shelter. Again, given the ambiguity in the definition of tax shelter and the harsh penalty associated with characterization as a tax shelter, an expedited ruling process could be helpful.

The proposed overly broad definition of corporate tax shelter will give examining agents an unwarranted and unrestrained opportunity to hold corporate taxpayers hostage during the examination process. Revenue agents, who have no downside, can threaten to propose adjustments based on alleged corporate tax shelter transactions to extract unreasonable concessions by the corporate taxpayer on other issues. Incidents of "rogue" revenue agents abusing their authority in efforts to extort unfair concessions and settlements are not limited to individual taxpayers. In fact, the higher rate of corporate tax audits makes this a particularly worrisome proposal.

Under the proposal to codify the economic substance doctrine, revenue agents could disallow any deduction, credit, exclusion, or other allowance obtained by a corporate taxpayer based on the determination that a transaction falls within the vague definition of a "tax avoidance transaction." This authority could be used to deny a corporate taxpayer a tax benefit provided by the Code merely because the IRS believes that the transaction yielded too much tax savings, regardless of a corporate taxpayer's legitimate business purpose for entering into the transaction. Again, this is giving an IRS agent too much discretion and is inconsistent with the IRS Restructuring and Reform Act. At least, the Treasury's White Paper recognized and made accommodations along these lines by proposing National Office review of a tax shelter characterization, as well as an expected ruling process. An additional safeguard might be to allow taxpayers to obtain an early referral to Appeals on an item that is characterized by an agent as a tax shelter.

VII. PROMOTERS, TAX ADVISORS AND STANDARDS OF PRACTICE

In addition to tougher requirements for corporate taxpayers, the proposals increase the penalties and sanctions on third parties associated with corporate tax shelters. Among other reasons, the Administration blames promoters for the recent increase in corporate tax shelter activity. Currently, there are a number of Code provisions that impose promoter penalties. In addition, there are ethical standards to guide tax advisors that practice before the IRS. In general, to curtail the proliferation of tax shelter activity and increase the risk to promoters, the proposals increase and expand current penalties as well as impose additional penalties.

The Administration's FY 2001 Budget proposes to impose additional penalties on other parties involved in corporate tax shelter transactions. The proposal would impose a 25-percent excise tax on fees received in connection with the purchase and implementation of a corporate tax shelter (including underwriting and other fees) and the rendering of certain tax advice related to a corporate tax shelter. Only persons who perform services in furtherance of the corporate tax shelter would be subject to the proposal. The proposal would not apply to expenses incurred with respect to representing the taxpayer before the IRS or a court. For example, an adviser that cautions not to enter into the transaction would not be subject to the penalty excise tax. In addition, due process procedures would be provided for parties subject to the excise tax. Again, we believe the Administration heeded some of the concerns that the Coalition and others expressed with their FY2000 Budget Proposals. It is appropriate that this excise tax be imposed only on the fees associated with furtherance of a corporate tax shelter and that procedures for due process be provided.

Finally, any income received by a tax-indifferent person with respect to a corporate tax shelter would be taxable to such person. To ensure that a tax is paid, all corporate participants would be made jointly and severally liable for the tax. A tax-indifferent person would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, or a domestic corporation with a loss or credit carryforward that is more than three years old.

These proposals rely on the same vague and faulty definition of "tax avoidance transaction" as the previously discussed proposals. The proposal to impose an excise tax on fees received in connection with a tax shelter raises numerous administrative issues. The determination that a transaction falls within the new definition of corporate tax shelters may not be made until years after the payment or the receipt of fees, which raises questions concerning the statute of limitations and IRS' assessment authority against the "shelter provider."

VIII. CONCLUSION

Notwithstanding the attempts to address criticisms of the Administration's budget proposals on corporate tax shelters, the fundamental problem still remains; the proposals are so broad in their application that they will still impact legitimate business transactions. This is primarily because the proposals focus on the tax result and completely ignore business purpose. For example, business restructurings designed to reduce business costs would be characterized as tax shelters if structured in a tax efficient manner.

The disclosure requirements in the proposals are also too burdensome. Given the broad application of the disclosure requirements, taxpayers will have difficulty in identifying transactions that must be disclosed. Even an inadvertent failure to disclose will prevent taxpayers from being able to reduce or eliminate the 40 percent understatement penalty. In addition, attestation should not be required, other than the attestation required by a corporate officer in signing a tax return. Again, because of the breadth of the tax shelter definition in the proposals, attestation would be required for numerous transactions. It would be extremely burdensome to provide a briefing on all of these transactions to a corporate officer who is not the tax director that is sufficient to make this individual comfortable in attesting to the facts of these transactions under penalties of perjury.

A regime that narrowly targets abusive transactions and encourages disclosure without significant burdens would prove more effective in curtailing unwanted activity and promoting voluntary compliance. In addition, administrative safeguards are needed to protect against the potential abuse of power by IRS agents. The Administration's proposal does not strike this essential balance.

We continue to believe that the best way of addressing the corporate tax shelter issue is through the court system because in applying the judicial economic substance doctrine the court will examine whether any business purpose existed.14

ENDNOTES

[1] This testimony was prepared by Arthur Andersen on behalf of the Coalition for the Fair Taxation of Business Transactions.

[2] Department of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals, July 1999.

[3] As the Tax Court stated in the recent decision of Saba Partnership, et. al. v. Commissioner, T.C. Memo 1999-359, "(a)n evaluation of the economic substance of the . . . transactions requires: (1) A subjective inquiry whether the . . . carried out the transaction for a valid business purpose other that to obtain tax benefits; and (2) an objective inquiry whether the . . . transactions had practical economic effects other than the creation of tax benefits." at 111.

[4] See also Compaq Computer Corporation and Subsidiaries v. Commissioner of Internal Revenue, 113 T.C. No. 17 (Sept. 21, 1999); ACM Partnership v. Commissioner, 73 T.C.M. 2189 (1997), aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct 1251 (1999); ASA Investerings v. Commissioner, 76 TCM 325 (1998); Laidlaw Transportation Inc., et al. V. Commissioner, T.C. Memo. 1998-232; The Limited Inc. v. Commissioner 113 T.C. No. 13 (1999); IES Industries Inc. v United States 84 AFTR2d Par. 99-5373 (1999); and United Parcel Service of America v. [illegible]issioner 78 TCM 262 (1999).

[5] Under current law, a tax shelter is any entity, investment, plan, or arrangement with a significant purpose of avoiding or evading Federal income taxes. Section 6662(a)(2)(c)(iii).

[6] For transactions entered into before August 6, 1997, a "tax shelter" is defined as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if the principal purpose of the partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax. The Taxpayer Relief Act of 1997 amended section 6662(d)(2)(C)(ii) to provide a new definition of tax shelter for purposes of the substantial understatement penalty. Under this new definition of tax shelter, the tax avoidance purpose of an entity or arrangement need not be its principal purpose. Now a tax shelter is any entity, investment, plan, or arrangement with a significant purpose of avoiding or evading Federal income taxes. The new definition of tax shelter is effective for transactions entered into after August 5, 1997.

[7] Notice 97-21, 1997-1 C.B. 651 and Prop. Treas. Reg. section 1.7701(l).

[8] ACM Partnership v. Commissioner, 73 T.C.M. 2189 (1997), aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct 1251 (1999).

[9] Compaq Computer Corporation and Subsidiaries v. Commissioner of Internal Revenue, 113 T.C. No. 17 (Sept. 21, 1999).

[10] Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. No. 21 (1999).

[11] ACM at 247.

[12] Generally, Section 6662(a) of the Internal Revenue Code imposes a 20 percent penalty on the portion of an underpayment of tax attributable to a substantial understatement of income tax.

[13] Adequate disclosure must meet the requirements of Rev. Proc. 98-62, 1998-52 I.R.B. 23 (12/28/98).

[14] As noted previously, the IRS has successfully litigated many cases in this area, including most notably Compaq Computer Corporation and Subsidiaries v. Commissioner of Internal Revenue, 113 T.C. No. 17 (Sept. 21, 1999); ACM

Partnership v. Commissioner, 73 T.C.M. 2189 (1997), aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct 1251 (1999) and ASA Investerings v. Commissioner, 76 TCM 325 (1998).

STATEMENT OF THE COALITION OF SERVICE INDUSTRIES [1]

The which represents a broad range of financial institutions, including both large and small institutions, strongly opposes the Administration's proposal to increase penalties for failure to file correct information returns.

The proposed penalties are unwarranted and place an undue burden on already compliant taxpayers. It seems clear that most, if not all, of the revenue estimated to be raised from this proposal would stem from the imposition of higher penalties due to inadvertent errors rather than from enhanced compliance. The financial services community devotes an extraordinary amount of resources to comply with current information reporting and withholding rules and is not compensated by the U.S. government for these resources. The proposed penalties are particularly inappropriate in that (i) there is no evidence of significant current non-compliance and (ii) the proposed penalties would be imposed upon financial institutions while such institutions were acting as integral parts of the U.S. government's system of withholding taxes and obtaining taxpayer information.

THE PROPOSAL

As included in the President's fiscal year 2001 budget, the proposal generally would increase the penalty for failure to file correct information returns on or before August 1 following the prescribed filing date from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported.[2] The increased penalties would not apply if the aggregate amount that is timely and correctly reported for a calendar year is at least 97 percent of the aggregate amount required to be reported for the calendar year. If the safe harbor applies, the present-law penalty of $50 for each return would continue to apply.

CURRENT PENALTIES ARE SUFFICIENT

We believe the current penalty regime already provides ample incentives for filers to comply with information reporting requirements. In addition to penalties for inadvertent errors or omissions,[3] severe sanctions are imposed for intentional reporting failures. 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.[4]
- 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).

There is no evidence that the financial services community has failed to comply with the current information reporting rules and, as noted above, there are ample incentives for compliance already in place.[5] It seems, therefore, that most of the rev-

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[1] The Coalition of Service Industries (CSI) was established in 1982 to create greater awareness of the major role services industries play in our national economy; promote the expansion of business opportunities abroad for US service companies; and encourage US leadership in attaining a fair and competitive global marketplace. CSI represents a broad array of US service industries including the financial, telecommunications, professional, travel, transportation, information and information technology sectors.

[2] A similar proposal was included in President Clinton's fiscal year 1998, 1999 and 2000 budgets.

[3] It is important to note that many of these errors occur as a result of incorrect information provided by the return recipients such as incorrect taxpayer identification numbers (TINS).

[4] The standard penalty for failing to file correct information returns is $50 per failure, subject to a $250,000 cap. Where a failure is due to intentional disregard, the penalty is the greater of $100 or 10 percent of the amount required to be reported, with no cap on the amount of the penalty.

[5] Also note that, in addition to the domestic and foreign information reporting and penalty regimes that are currently in place, for payments to foreign persons, an expanded reporting regime with the concomitant penalties is effective for payments made after December 31, 1999. See TD 8734, published in the Federal Register on October 14, 1997. The payor community is

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enue raised by the proposal would result from higher penalty assessments for inadvertent errors, rather than from increased compliance with information reporting requirements. Thus, as a matter of tax compliance, there appears to be no justifiable policy reason to substantially increase these penalties.

PENALTIES SHOULD NOT BE IMPOSED TO RAISE REVENUE

Any reliance on a penalty provision to raise revenue would represent a significant change in Congress' current 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 raising of revenue.[6] Congress endorsed the IRS Task Force's conclusions by specifically enumerating them in the Conference Report to the Omnibus Budget Reconciliation Act of 1989.[7] There is no justification for Congress to abandon its present policy on penalties, which is based on fairness, particularly in light of the high compliance rate among information return filers.

SAFE HARBOR NOT SUFFICIENT

Under the proposal, utilization of a 97 percent substantial compliance "safe harbor" is not sufficient to ensure that the higher proposed penalties apply only to relatively few filers. Although some information reporting rules are straightforward (e.g., interest paid on deposits), the requirements for certain new financial products, as well as new information reporting requirements,[8] are often unclear, and inadvertent reporting errors for complex transactions may occur. Any reporting "errors" resulting from such ambiguities could easily lead to a filer not satisfying the 97 percent safe harbor.

APPLICATION OF PENALTY CAP TO EACH PAYOR ENTITY INEQUITABLE

We view the proposal as unduly harsh and unnecessary. The current-law $250,000 penalty cap for information returns is intended to protect the filing community from excessive penalties. However, while the $250,000 cap would continue to apply under the proposal, a filer would reach the penalty cap much faster than under current law. For institutions that file information returns for many different payor entities, the protection offered by the proposed penalty cap is substantially limited, as the $250,000 cap applies separately to each payor.

In situations involving affiliated companies, multiple nominees and families of mutual funds, the protection afforded by the penalty cap is largely illusory because it applies separately to each legal entity. At the very least, any further consideration of the proposal should apply the penalty cap provisions on an aggregate basis. The following examples illustrate why aggregation in the application of the penalty cap provisions is critical.

EXAMPLE I—Paying Agents

A bank may act as paying agent for numerous issuers of stocks and bonds. In this capacity, a bank may file information returns as the issuers' agent but the issuers, and not the bank, generally are identified as the payors. Banks may use a limited number of information reporting systems (frequently just one overall system) to generate information returns on behalf of various issuers. If an error in programming the information reporting system causes erroneous amounts to be reported, potentially all of the information returns subsequently generated by that system could be affected. Thus, a single error could, under the proposal, subject each issuer for whom the bank filed information returns, to information reporting penalties because the penalties would be assessed on a taxpayer-by-taxpayer basis. In this instance, the penalty would be imposed on each issuer. However, the bank as paying agent may be required to indemnify the issuers for resulting penalties.

Recommendation: For the purposes of applying the penalty cap, the paying agent (not the issuer) should be treated as the payor.

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being required to dedicate extensive manpower and monetary resources to put these new requirements into practice. Accordingly, these already compliant and overburdened taxpayers should not have to contend with new punitive and unnecessary penalties.

[6] Statement of former IRS Commissioner Gibbs before the House Subcommittee on Oversight (February 21, 1989, page 5).

[7] OBRA 1989 Conference Report at page 661.

[8] For example, Form 1099-C, discharge of indebtedness reporting, or Form 1042-S, reporting for bank deposit interest paid to certain Canadian residents.

EXAMPLE II—Retirement Plans

ABC Corporation, which services retirement plans, approaches the February 28th deadline for filing with the Internal Revenue Service the appropriate information returns (i.e., Forms 1099R). ABC Corporation services 500 retirement plans and each plan must file over 1,000 Forms 1099-R. A systems operator, unaware of the penalties for filing late Forms 1099, attempts to contact the internal Corporate Tax Department to inform them that an extension of time to file is necessary to complete the preparation and filing of the magnetic media for the retirement plans. The systems operator is unable to reach the Corporate Tax Department by the February 28th filing deadline and files the information returns the following week. This failure, under the proposal, could lead to substantial late filing penalties for each retirement plan that ABC Corporation services (in this example, up to $75,000 for each plan).[9]

Recommendation: Retirement plan servicers (not each retirement plan) should be treated as the payor for purposes of applying the penalty cap.

EXAMPLE III—Related Companies

A bank or broker dealer generally is a member of an affiliated group of companies, which offer different products and services. Each company that is a member of the group is treated as a separate payor for information reporting and penalty purposes. Information returns for all or most of the members of the group may be generated from a single information reporting system. One error (e.g., a systems programming error) could cause information returns generated from the system to contain errors on all subsequent information returns generated by the system. Under the proposal, the penalty cap would apply to each affiliated company for which the system(s) produces information returns.

Recommendation: Each affiliated group[10] should be treated as a single payor for purposes of applying the penalty cap.

While these examples highlight the need to apply the type of penalty proposed by the Treasury on an aggregated basis, they also illustrate the indiscriminate and unnecessary nature of the proposal.

CONCLUSION

The Coalition of Service Industries represents the preparers of a significant portion of the information returns that would be impacted by the proposal to increase penalties for failure to file correct information returns. In light of the current reporting burdens imposed on our industries and the significant level of industry compliance, we believe it is highly inappropriate to raise penalties. Congress has considered and rejected this proposal on three previous occasions, and we hope it will continue to reject this unwarranted penalty increase. Thank you for your consideration of our views.

STATEMENT OF THE COMMITTEE OF ANNUITY INSURERS

The Committee of Annuity Insurers is composed of forty-one life insurance companies that issue annuity contracts, representing approximately two-thirds of the annuity business in the United States. The Committee of Annuity Insurers was formed in 1982 to address Federal legislative and regulatory issues affecting the annuity industry and to participate in the development of Federal tax policy regarding annuities. A list of the member companies is attached at the end of this statement. We thank you for the opportunity to submit this statement for the record.

The Administration's proposals relating to the taxation of life insurance companies and their products are largely a rehash of last year's discredited budget proposals, which Congress rejected. All of these proposals remain fundamentally flawed and should be rejected again. The focus of this statement, however, is the Administration's proposal to increase retroactively the so-called "DAC tax" imposed under IRC section 848 and, in particular, the increase proposed with respect to annuity contracts used for retirement savings outside of pension plans ("non-qualified annuities"). Increasing the DAC tax continues to be bad tax policy, and doing so retroactively would make a bad situation far worse.

As was the case last year, the Administration's proposed increase in the DAC would have a substantial, adverse effect on private retirement savings in America.

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[9] If the corrected returns were filed after August 1, the penalties would be capped at $250,000 per plan.

[10] A definition of "affiliated group" which may be used for this purpose may be found in Section 267(f) or, alternatively, Section 1563(a).

The Administration continues to show that it does not understand the important role that annuities and life insurance play in assuring Americans that they will have adequate resources during retirement and adequate protection for their families.

Annuities are widely owned by Americans. At the end of 1997, there were approximately 38 million individual annuity contracts outstanding, nearly three times the approximately 13 million contracts outstanding just 11 years before. The premiums paid into individual annuities—amounts saved by individual Americans for their retirement—grew from approximately $34 billion in 1987 to $90 billion in 1997, an average annual increase of greater than 10 percent.

Owners of non-qualified annuities are predominantly middle-income Americans saving for retirement. The reasons for this are obvious. Annuities have unique characteristics that make them particularly well-suited to accumulate retirement savings and provide retirement income. Annuities allow individuals to protect themselves against the risk of outliving their savings by guaranteeing income payments that will continue as long as the owner lives. Deferred annuities also guarantee a death benefit if the owner dies before annuity payments begin.

The tax rules established for annuities have been successful in increasing retirement savings. Eighty-six percent of owners of non-qualified annuities surveyed by The Gallup Organization in 1999 reported that they have saved more money than they would have if the tax advantages of an annuity contract had not been available. Nearly all (93%) reported that they try not to withdraw any money from their annuity before they retire because they would have to pay tax on the money withdrawn.

As discussed below, the proposal contained in the Administration's FY 2001 budget to increase the DAC tax is in substance a tax on owners of non-qualified annuity contracts and cash value life insurance. It would make these products more expensive and less attractive to retirement savers. It would also lower the benefits payable to savers and families. As discussed below, the DAC tax is already fundamentally flawed and increasing its rate would simply be an expansion of bad tax policy. The fact that the Administration proposes to increase the DAC tax retroactively suggests that the proposal is simply a device to raise a targeted amount of revenue from the insurance industry.

1. THE ADMINISTRATION'S DAC PROPOSAL IS IN SUBSTANCE A TAX ON THE OWNERS OF ANNUITIES AND LIFE INSURANCE

The Administration's proposal to increase the DAC tax is an attempt to increase indirectly the taxes of annuity and life insurance contract owners. Two years ago, the Administration's proposed direct tax increases on such owners were met with massive, bipartisan opposition. Last year and again this year, the Administration seeks to increase indirectly the taxes on annuity and life insurance contract owners. We urge this Committee to reject once again the Administration's back door tax increase on annuity and life insurance contract owners.

IRC section 848 denies life insurance companies a current deduction for a portion of their ordinary and necessary business expenses equal to a percentage of the net premiums paid each year by the owners of certain types of contracts. These amounts instead must be capitalized and then amortized over 120 months. The amounts that currently must be capitalized are 1.75 percent of non-qualified annuity premiums, 2.05 percent of group life insurance premiums, and 7.70 percent of other life insurance premiums (including noncancellable or guaranteed renewable accident and health insurance). Under the Administration's proposal, these categories of contracts would be modified and the percentages would be dramatically increased. Specifically, the rate for annuity contracts would more than double to 4.8 percent, while the rate for individual cash value life insurance would increase by a third to 10.3 percent.

The DAC tax under section 848 is directly based on the amount of premiums paid by the owners of the contracts. Thus, as individuals increase their annuity savings (by paying more premiums), a company's taxes increase—the higher the savings, the higher the tax. It is clear that since the enactment of DAC in 1990, the DAC tax has been passed through to the individual owners of annuities and life insurance. Some contracts impose an express charge for the cost of the DAC tax, for example, while other contracts necessarily pay lower dividends or less interest to the policyholder. Still other contracts impose higher general expense charges to cover the DAC tax. (See The Wall Street Journal, December 10, 1990, "Life Insurers to Pass Along Tax Increase.")

According to the Treasury Department, the increased capitalization percentages proposed in the Administration's FY 2001 budget will result in increased taxes of

$8.29 billion for the period 2001--2005 and $11.82 billion for the period 2001—2010. A large portion of this tax increase will come from middle-income Americans who are purchasing annuities to save for retirement and cash value life insurance to protect their families. According to a Gallup survey conducted in 1999, most owners of non-qualified annuities have moderate annual household incomes. About three-quarters (71%) have total annual household incomes under $75,000. Eight in ten owners of non-qualified annuities state that they plan to use their annuity savings for retirement income (81%) or to avoid being a financial burden on their children (82%).

The Administration's proposal will discourage private retirement savings and the purchase of life insurance. Congress in recent years has become ever more focused on the declining savings rate in America and on ways to encourage savings and retirement savings in particular. As described above, Americans have been saving more and more in annuities, which are the only non-pension retirement investments that can provide the owner with a guarantee of an income that will last as long as the owner lives. Life insurance contracts can uniquely protect families against the risk of loss of income. Increasing the cost of annuities and cash value life insurance and reducing the benefits will inevitably reduce private savings and the purchase of life insurance protection.

2. CONTRARY TO THE ADMINISTRATION'S CLAIMS, AN INCREASE IN THE DAC TAX IS NOT NECESSARY TO REFLECT THE INCOME OF LIFE INSURANCE COMPANIES ACCURATELY

The Administration claims that the proposed increase in the DAC tax is necessary to accurately reflect the economic income of life insurance companies. In particular, the Administration asserts that "life insurance companies generally capitalize only a fraction of their actual policy acquisition costs." The Administration is wrong. As explained below, life insurance companies already more than adequately capitalize the expenses they incur in connection with issuing annuity and life insurance contracts. The Administration's proposal would further distort life insurance company income simply to raise revenue.

The current tax rules applicable to life insurance companies capitalize policy selling expenses not only through the section 848 DAC tax, but also by requiring (in IRC section 807) reserves for life insurance and annuity contracts to be based on a "preliminary term" or equivalent method. It is a matter of historical record that preliminary term reserve methods were developed because of the inter-relationship of policy selling expenses and reserves. Since the early 1900's, when preliminary term reserve methods began to be accepted by state insurance regulators, the relationship between policy reserves and a life insurance company's policy selling expenses has been widely recognized. See, e.g., K. Black, Jr. and H. Skipper, Jr, Life Insurance 565—69(12th ed. 1994); McGill's Life Insurance 401—408 (edited by E. Graves and L. Hayes, 1994).

Under a preliminary term reserve method, the reserve established in the year the policy is issued is reduced (from a higher, "net level" basis) to provide funds to pay the expenses (such as commissions) the life insurer incurs in issuing the contract. The amount of this reduction is known as the "expense allowance," i.e., the amount of the premium that may be used to pay expenses instead of being allocated to the reserve. Of course, the life insurance company's liability for the benefits promised to the policyholder remains the same even if a lower, preliminary term reserve is established. As a result, the amount added to the reserve in subsequent years is increased to take account of the reduction in the first year.

In measuring a life insurance company's income, reducing the first year reserve deduction by the expense allowance is economically equivalent to computing a higher, net level reserve and capitalizing, rather than currently deducting, that portion of policy selling expenses. Likewise, increasing the reserve in subsequent years is equivalent to amortizing those policy selling expenses over the subsequent years. Thus, under the current income tax rules applicable to life insurance companies, policy selling expenses are capitalized both under the section 848 DAC tax and through the required use of preliminary term reserves. The Administration's FY 2001 budget proposal ignores this combined effect.

This relationship between policy selling expenses and preliminary term reserves has been recognized by Congress. In accordance with the treatment mandated by the state regulators for purposes of the NAIC annual statement, life insurance companies have always deducted their policy selling expenses in the year incurred in computing their Federal income taxes. Until 1984, life insurance companies also computed their tax reserves based on the reserve computed and held on the annual statement. However, under the Life Insurance Company Income Tax Act of 1959 (the "1959 Act"), if a company computed its annual statement reserves on a preliminary term method, the reserves could be recomputed on the higher, net level method for tax purposes. Because companies were allowed to compute reserves on the net level method and to deduct policy selling expenses as incurred, life insurance companies under the 1959 Act typically incurred a substantial tax loss in the year a policy was issued.

When Congress was considering revisions to the tax treatment of life insurance companies in 1983, concern was expressed about the losses incurred in the first policy year as a result of the interplay of the net level reserve method and the current deduction of first year expenses. In particular, there was concern that a mismatching of income and deductions was occurring. As a consequence, as those who participated in the development of the Deficit Reduction Act of 1984 (the "1984 Act") know, Congress at that time considered requiring life insurance companies to capitalize and amortize policy selling expenses.

Congress chose not to change directly the tax treatment of policy selling expenses, however. Rather, recognizing that the effect of the use of preliminary term reserve methods is economically identical to capitalizing (and amortizing over the premium paying period) the expense allowance by which the first year reserve is reduced, Congress decided to alter the treatment of selling expenses indirectly by requiring companies to use preliminary term methods, rather than the net level method, in computing life insurance reserves. See, e.g., Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at p. 595 (relating to amendments to section 832(b)(7)) (Under the 1984 Act, life insurance reserves "are calculated . . . in a manner intended to reduce the mismeasurement of income resulting from the mismatching of income and expenses.").

In summary, life insurance companies are already overcapitalizing policy selling expenses for income tax purposes because of the combination of the current DAC tax and the mandated use of preliminary term reserves. In these circumstances, increasing the DAC capitalization percentages will not result in a clearer reflection of the income of life insurance companies. To the contrary, increasing the percentages as the Administration proposes would further distort life insurance company income simply to raise revenue.

3. CONTRARY TO THE ADMINISTRATION'S SUGGESTION, AN INCREASE IN THE DAC TAX IS INCONSISTENT WITH GAAP ACCOUNTING

The Administration's explanation of the DAC proposal suggests that increases in the DAC percentages are consistent with generally accepted accounting principles (GAAP). The Administration states that "[l]ife insurance companies generally capitalize only a fraction of their actual policy acquisition costs. . . . In contrast, when preparing their financial statements using generally accepted accounting principles (GAAP), life companies generally capitalize their actual policy acquisition costs, including but not limited to commissions." See Treasury Department, "General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals 170-71 (February, 2000)." This explanation is disingenuous. The Administration fails to disclose that, while GAAP accounting does require actual acquisition costs to be capitalized, GAAP accounting does not mandate the use of preliminary term reserves. In fact, no system of insurance accounting "doubles up" on capitalization by requiring a combination of capitalization of actual policy acquisition costs combined with the use of preliminary term reserves. Thus, far from promoting consistency with GAAP accounting, the Administration's proposal to increase the DAC tax would exacerbate the distortion that already exists under current law.

Apart from the foregoing, the Administration's reference to GAAP accounting is misplaced. In 1990 when the DAC tax was first enacted, Congress expressly considered and rejected GAAP as a basis for accounting for life insurance company policy selling expenses. Instead, Congress chose a proxy approach of amortizing a percentage of premiums over an arbitrary 10 year period, rather than capitalizing actual selling expenses and amortizing them over the actual life of the contracts. In short, when Congress enacted the DAC tax in 1990, it knew that the proxy percentages did not capitalize the same amount of acquisition expenses as does GAAP accounting. However, as discussed above, the combination of the current DAC percentages with the mandated use of preliminary term reserves already results in two different capitalization mechanisms. If GAAP accounting is the appropriate model for taxing life insurance companies, as the Administration suggests, then the DAC tax should be repealed, not increased.

4. THE ADMINISTRATION'S PROPOSAL TO INCREASE THE DAC TAX RETROACTIVELY IS PUNITIVE AND SUGGESTS THAT THE ADMINISTRATION IS SIMPLY SEEKING TO RAISE A TARGETED AMOUNT REVENUE FROM THE INSURANCE INDUSTRY

Last year, the Administration's proposal to increase the DAC tax was strongly criticized and rejected by Congress. Not only is the Administration resurrecting this discredited proposal, but now it seeks to apply the tax increase retroactively to 1990 under the guise of a "change in accounting method." Retroactive tax increases are bad tax policy and violate basic notions of fairness. Moreover, in this case a retroactive increase in the DAC tax would have a severe punitive effect on insurers, which priced their products based on the law in place when those products were sold.

The Administration offers no explanation for why the proposed increase in the DAC tax should be treated as a change in accounting method. When the DAC tax was first enacted in 1990, Congress specifically stated that the DAC tax was not a change in accounting method. The proposal to treat the proposed increase in the DAC capitalization percentages as a change in accounting method, and thus apply the DAC tax increase retroactively, suggests that the Administration's true motive is simply to raise a targeted amount of revenue from the life insurance industry. The retroactive DAC proposal was contrived to achieve this overriding goal. Singling the insurance industry out for a tax increase of this magnitude ($11.82 billion over 10 years) is entirely inappropriate. The insurance industry has and continues to pay more than its fair share of corporate income taxes.

In conclusion, the Committee of Annuity Insurers urges the Committee to reject the Administration's proposal to increase the section 848 DAC tax. The proposal is a disguised tax on the owners of annuities and life insurance contracts. Furthermore, the proposal lacks any sound policy basis and further distorts the income of life insurance companies.

THE COMMITTEE OF ANNUITY INSURERS
WASHINGTON, D.C.

Aetna Inc., Hartford, CT
Allmerica Financial Company, Worcester, MA
Allstate Life Insurance Company, Northbrook, IL
American General Corporation, Houston, TX
American International Group, Inc., Wilmington, DE
American Investors Life Insurance Company, Inc., Topeka, KS
American Skandia Life Assurance Corporation, Shelton, CT
Conseco, Inc., Carmel, IN
COVA Financial Services Life Insurance Co., Oakbrook Terrace, IL
Equitable Life Assurance Society of the United States, New York, NY
Equitable of Iowa Companies, DesMoines, IA
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
GE Financial Assurance, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Hartford Life Insurance Company, Hartford, CT
IDS Life Insurance Company, Minneapolis, MN
Integrity Life Insurance Company, Louisville, KY
Jackson National Life Insurance Company, Lansing, MI
Keyport Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln Financial Group, Fort Wayne, IN
ManuLife Financial, Boston, MA
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Minnesota Life, St. Paul, MN
Mutual of Omaha Companies, Omaha, NE
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Phoenix Home Mutual Life Insurance Company, Hartford, CT
Principal Financial Group, Des Moines, IA
Protective Life Insurance Company, Birmingham, AL
ReliaStar Financial Corp., Minneapolis, MN

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Security First Group, Los Angeles, CA
SunAmerica, Inc., Los Angeles, CA
Sun Life of Canada, Wellesley Hills, MA
Teachers Insurance & Annuity Association of America—College Retirement Equities Fund (TIAA-CREF), New York, NY
Travelers Insurance Companies, Hartford, CT
Zurich Kemper Life Insurance Companies, Chicago, IL

STATEMENT OF THE EQUIPMENT LEASING ASSOCIATION

INTRODUCTION

The Equipment Leasing Association, (ELA) is submitting this statement for the record to express our concerns regarding the proposed "corporate tax shelter proposals" included in the Clinton Administration's proposed FY 2001 Budget. ELA has over 850 member companies throughout the United States who provide financing for all types of businesses in all types of markets. Large ticket leasing includes the financing of transportation equipment such as aircraft, rail cars and vessels. Middle market lessors finance high-tech equipment including main frame computers and PC networks, telecommunications equipment and medical equipment such as MRIs (magnetic resonance imaging) and CT (computed tomography) systems. Lessors in the small ticket arena provide financing for equipment essential to virtually all businesses such as phone systems, pagers, copiers, scanners and fax machines.

WHAT TYPE OF COMPANY LEASES?

More companies, particularly small businesses, acquire new, state of the art equipment through leasing than through any other type of financing. In a survey of the winners of the Small Business Administration's State Small Business Contest last May, ELA found that 85% of small businesses lease equipment and that 89% of these companies plan to lease again. Companies that lease tend to be smaller, growth-oriented and focused on productivity—these are companies long on ideas, but often, short on capital.

WHY COMPANIES LEASE

Companies choose lease financing for several reasons:

- Leasing permits 100% financing;
- Leasing permits a close matching of rental payments to the revenue produced by the use of the equipment;
- Leasing allows companies to keep their debt lines open for working capital rather than tying it up in capital expenditures;
- Companies that lease know that they make money by using the equipment, not owning it;
- Leasing allows a company to focus on its core business—they don't have to worry about maintenance, upgrading or asset disposition;
- Leasing minimizes concerns about the technological obsolescence of the company's equipment;
- Leasing shifts asset management risk to the lessor, away from the user.

Leasing by commercial enterprises increases productivity and stimulates economic growth. While the federal and state tax codes provide various incentives to invest in new equipment, many companies find they are not in a financial position to utilize the incentives. However, through leasing, the intended incentives to invest can be passed through to the company using the equipment in the form of lower rental payments because the leasing company utilizes the intended investment incentives. The use of leasing in this manner has long been intended by Congress.

LEASING CREATES JOBS

It is estimated that each increase of $1 billion in equipment investment creates approximately 30,000 jobs (Brimmer Report). In 1999 alone, the equipment leasing industry financed over $200 billion in equipment acquisition and it is anticipated that equipment lessors will finance over $230 billion in new equipment acquisition in 2000.

STATE AND LOCAL GOVERNMENTS LEASE TOO

It is not only commercial enterprises that lease equipment. Tax-exempt entities such as states, cities, counties and other subdivisions around the U.S. often lease various types of equipment in an effort to keep taxpayer costs down. Equipment leased by local governments includes 911 emergency phone systems, computers, school buses and police vehicles. Tax-exempt hospitals often lease their emergency vehicles and high-cost, sophisticated diagnostic medical equipment, in an effort to keep health care costs down.

Lessors also lease equipment to other tax-exempt entities such as foreign corporate enterprises or individuals. Examples include automobile fleet leasing, leases of tractors and trailers, and leases of aircraft (both commercial and corporate). Further, many domestic lessees have the right to sublease assets into foreign markets in times when the equipment may be surplus. Very often, these subleases are to entities in foreign markets which have the need for the asset.

THE ADMINISTRATION'S "CORPORATE TAX SHELTER" PROPOSALS REPRESENT A SIGNIFICANT CHANGE IN U.S. TAX POLICY

An analysis of the Administration's sweeping and vague corporate tax shelter proposals raises the concern that leasing transactions which conform to long standing tax policy and Congressional intent could be negatively impacted by the Administration's proposals. If this is the case, these proposals represent a significant change in longstanding U.S. leasing tax policy, overturning longstanding I.R.S ruling polices set forth in Revenue Procedures 75-21 and 75-78, as well as established judicial precedent. Without a clear exclusion of leasing transactions that meet the standards of current law from the sweeping new corporate tax shelter proposals, ELA must oppose these proposals and urges Congress to reject them.

ELA has long supported two fundamental principles of federal tax policy. First, the form of financing chosen to facilitate the acquisition of assets, whether loans or leases, should be respected as long as economically valid. Second, is the principle that the tax treatment of an owner of an asset should not differ whether the asset is used directly by the owner or leased to another end-user. Again, in their current form, the Administration's proposals appear to violate these two principles and have already had a chilling effect on equipment acquisition in certain markets. Therefore, ELA opposes them and urges Congress to reject them.

ADMINISTRATION'S ANTI-LEASING SERVICE CONTRACT PROPOSAL

The service contract rules set forth in Section 7701(e) of the Code were enacted as part of the original Pickle legislation in 1984. These rules set forth explicit statutory standards based on clear economic distinctions for distinguishing leases from so-called service contracts. A lease of equipment is in fact different than a service contract and Congress clearly intended that an agreement that qualifies as a service contract would not be treated as a lease for purposes of the Pickle legislation or for any other tax purpose. The Administration's proposal would repeal this clear distinction and expand the scope of an already discriminatory statute that inhibits U.S. global competitiveness and no longer furthers a legitimate policy objective. Further, the proposed legislation overlooks significant business purposes that give rise to use of service contracts. Service contracts involve a tradeoff between rights and risks. Relative to a lessor, the service provider enjoys more control over the asset used to generate such services, but also assumes additional performance and operational risk with respect to such asset. The parties' preferences as to the division of rights and risks with respect to property determine the form of contractual arrangement they choose. The service contract arrangement has long been commercially recognized, particularly within certain industries including the utilities and shipping industries. Congress should reject the Administration's most recent misguided assault on leasing as it did in both 1998 and 1999. (See the enclosed 1999 letter signed by 26 members of the House Ways and Means Committee to Chairman Archer and Ranking Member Rangel.)

Clearly, the Administration's proposal goes far beyond what is necessary to prevent perceived abusive transactions as it encroaches upon non-abusive transactions that are permitted under current law. In fact, in light of the 1986 depreciation rules providing for straight-line depreciation over the class-life of foreign use property (which were intended to replicate economic depreciation), we believe that the Pickle depreciation rules, insofar as they relate to foreign lessees, are no longer necessary or appropriate and do not reflect sound tax policy. Consequently, we urge Congress to reject this proposal and encourage the Treasury Department to support a depreciation rule which does not discriminate between property owned by a U.S. taxpayer that is used outside the U.S. and property owned by a U.S. taxpayer that is leased to a foreign person. In both cases the income is fully taxable.

In applying the Pickle rules, Treasury regulations adopted in 1996 (Treas. Reg. Section 1.168 (i)-2 (b) (1)) provide that the lease term will be deemed to include certain periods beyond the original duration of the lease. Under these regulations the lease term includes both the actual lease term and any period of time during which the lessee (or a related person) (i) agreed that it would or could be obligated to make a payment of rent or a payment in the nature of rent or (ii) assumed or retained any risk of loss with respect to the property (including, for example, holding a note secured by the property). Clearly, these regulations extend beyond the reach of the statute and should be overturned.

ADMINSTRATION'S PROPOSAL CONFLICTS WITH U.S. TRADE POLICY

If enacted, this proposal will have a devastating impact on U.S. companies currently involved in selling assets to foreign entities where lease financing has been a significant feature of the marketplace, for example, manufacturers of aircraft and aircraft engines. As such, the proposal is contrary to long-established policies of promoting U.S. exports and is in direct conflict with the Congressional objective of developing a U.S. trade policy which will provide U.S. companies with the ability to compete on a level playing field with their foreign competitors. If enacted, this legislation will severely inhibit the ability of U.S. exporters and financial institutions to compete effectively on a global scale. If U.S. companies are not able to compete on cross-border leases, tax revenues currently going to the U.S. Treasury will be lost to foreign Treasuries, as all leases, including cross-border leases, generate more taxable income than deductions over the life of the lease agreement.

HISTORY OF THE "PICKLE" RULES

As part of the Deficit Reduction Act of 1984, Congress amended the Code to limit the depreciation available for property leased to a tax-exempt entity to straight line depreciation over the longer of the property's class life or 125% of the lease term. These provisions, referred to as the Tax-Exempt Entity Leasing Rules or the "Pickle" rules, were enacted in response to a series of leasing and similar transactions which passed a significant portion of the economic benefit of the Accelerated Cost Recovery System (ACRS) depreciation deductions through to various U.S. federal, state and local governmental entities and tax-exempt organizations.

At that time, Congress was concerned that investment incentives, such as depreciation under ACRS, were being turned into unintended benefits for tax-exempt entities. These restrictions were extended to foreign persons not subject to U.S. tax on their operations as Congress concluded that it would be inappropriate to subsidize foreign persons that were not U.S. taxpayers by permitting accelerated depreciation for property leased to them.

However, as part of the Tax Reform Act of 1986, Congress limited depreciation on foreign use property to the straight-line method over an asset's class life. Thus, after 1986, property used predominantly outside the United States by an U.S. taxpayer was not entitled to accelerated depreciation. Consequently, the changes in generally applicable depreciation rules enacted in 1986 rendered the Pickle rules unnecessary in order to achieve the 1984 policy objective of not passing accelerated depreciation through to foreign persons not subject to U.S. income tax. Nevertheless, the Pickle rules were not amended in 1986 or subsequently.

THE PICKLE RULES ARE DISCRIMINATORY AND ANTI-COMPETITIVE AND SHOULD BE CONFORMED TO THE TAX ACT OF 1386 TO MAKE THE U.S. LEASING INDUSTRY GLOBALLY COMPETITIVE

The Pickle rules discriminate against property owned by a U.S. taxpayer which is used in its leasing business outside the United States, as compared to the same property owned by a U.S. taxpayer, and used in a non-leasing business outside the U.S. For example, a U.S. owner of an item of equipment operated outside the U.S. would be entitled to straight-line depreciation over the asset's class life, even though the benefit of that depreciation would be reflected in the price of the goods or services provided to non-U.S. taxpayers. By contrast, a U.S. lessor of the same item of equipment if leased to a foreign entity would be limited by Pickle depreciation to straight-line depreciation over the longer of the property's class life or 125% of the lease term.

If U.S. companies are to compete effectively in a global marketplace, Congress should enact a depreciation rule which does not discriminate between property owned by a U.S. taxpayer which is used outside the United States, and property owned by a U.S. taxpayer and leased to a foreign person. In both cases, the income is fully taxable. This policy can be accomplished by simply conforming the 1984 Pickle rules to the Tax Reform Act of 1986.

PROPOSAL TO "DISALLOW INTEREST ON DEBT ALLOCABLE TO TAX-EXEMPT OBLIGATIONS" WILL INCREASE STATES' AND MUNICIPALITIES' COST OF CAPITAL

ELA also opposes the Administration's proposal to "disallow interest on debt allocable to tax-exempt obligations," as the elimination of the 2% de minimis rule will impair the ability of state and local governments to raise capital. While non-financial corporations may not account for a large percentage of total municipal securities outstanding, these corporate buyers do play a vital role in three important market segments: 1) short term municipal investments, 2) state and local government housing and student loan bonds, and 3) municipal leasing transactions.

CONCLUSION

Congress, the Treasury Department and the courts have long recognized that companies financing the acquisition of equipment through a loan are the recipients of various tax incentives. These same bodies also have long recognized that equipment acquired through leasing involves the transfer of tax benefits from the user of the equipment to the owner-lessor. As a direct result of these sound tax policies, American citizens are the beneficiaries of the most modern and productive economy in the world. While equipment lessors would undoubtedly be negatively impacted by the proposed changes discussed above, the ultimate impact will be to drive up the cost of capital equipment acquisitions for all businesses, particularly small businesses.

For over three decades, ELA members have provided lessees with various financing options within the spirit and intent of U.S. tax policy. In 1999 alone, the equipment leasing industry invested in excess of $200 billion in productive assets. However, the uncertainty caused by the Administration's proposals has already slowed down the market. To minimize further market disruptions and maintain strong economic growth while Congress deliberates the FY 2001 budget, we urge the respective Chairmen of the House Ways and Means and Senate Finance Committees to publicly state that the effective date for any tax code amendments restricting the use of incentives will be the date of enactment.

STATEMENT OF THE HOME CARE COALITION

On behalf of the Home Care Coalition, thank you for the opportunity to provide comments on the President's budget proposal for fiscal year 2001. The Home Care Coalition was founded in 1991 to unite the efforts of home care providers, family caregivers, health care professionals, manufacturers, consumers, and consumer advocacy organizations. The Coalition has become a major voice in support of home health care, which is often patient-preferred and more cost-effective than institutional care. As the only national organization representing providers, consumers and manufacturers of home health services, we urge you to support proposals to help America's caregiving families.

This year, the President has placed more emphasis on providing home and community-based services through Medicaid and making assisted living facilities available to lower income elderly. Once again, he has called for the creation of a program of counseling and supportive services for disabled and chronically ill individuals, and the families that care for them. He has also called for a $3000 tax credit for caregiving families, and increase from the $1000 credit offered last year. The President's proposal also includes a non-subsidized long-term care insurance for federal employees, retirees and their families. In addition, a number of bills have been introduced in this Congress to expand access to long-term care insurance and provide relief to family caregivers.

The Home Care Coalition urges this Committee to act this year to support programs needed to relieve the burdens on family caregivers and to increase access to the home and community-based services so essential to the well being of millions of frail elderly, disabled and chronically ill Americans.

WHO WE ARE

The Home Care Coalition (HCC) is comprised of the following:

Consumers of Home Care: Not all home care beneficiaries are alike. As a result, their at-home needs are wide and varied. Those with chronic conditions such as emphysema require the constant assistance of oxygen systems to make breathing easier. Consumers in the final stages of complications brought about by diseases such as AIDS require extensive levels of care. Active elderly persons who may be recuperating from an injury need products and services for an interim period until they recuperate. Younger persons with disabilities may require fewer products and services, but may need them for a lifetime.

Family Caregivers: People who cannot completely care for themselves because of an illness or disability rely heavily on family members to provide a wide range of services. Typically, family caregivers provide assistance with basic needs such as feeding, toileting, and dressing, as well as transportation, shopping, and cooking. Family caregivers give injections, change dressings, and help with rehabilitative exercises. They teach, advocate, and provide emotional support. Family caregivers provide these services out of feelings of love and a sense of duty. They are not paid for their services. It is estimated that there are over 25 million family caregivers in the United States, providing 80% of all home care services. Family caregivers make the difference between someone being alive and having a life.

Home Health Providers: Home health providers include individuals such as skilled nurses, rehabilitation specialists, therapists, pharmacists, physicians, nutritionists, medical social workers, home health aides, and homemakers. Health care services in the home setting provide a continuum of care for individuals who no longer require hospital or nursing home care, or to avoid an unnecessary hospital or nursing home admission. The range of home care services includes skilled nursing; respiratory, occupational, speech, and physical therapy; intravenous drug therapy; enteral nutrition; hospice care; emotional, physical, and medical care; assistance in the activities of daily living; skilled assessments; teaching; and financial assistance.

Home Medical Equipment (HME) Manufacturers: Manufacturers of home medical equipment (HME) are committed to producing quality products that promote the ability of persons with acute and chronic health conditions and disabilities to lead productive lives in their homes and communities. Products include everything from disposable items such as bandages to high-tech equipment such as power-driven wheelchairs, infusion therapy pumps and home oxygen delivery systems. As HME manufacturers produce advances in medical technology (e.g., telemedicine), home care will become even more cost-effective than it is today.

Home Medical Equipment Providers: Home medical equipment (HME) providers supply the equipment and related services that help consumers meet their therapeutic goals. Pursuant to the physician's prescription, HME providers deliver medical equipment to a consumer's home, set it up, maintain it, and educate and train the consumer and caregiver in its use. HME providers also interact with physicians and other home care providers as the consumer improves and his/her needs evolve. In addition, specialized providers of home infusion manage complex intravenous services, including chemotherapy and nutrition therapies, in the home.

Hospital Discharge Planners: Hospital discharge planners are health care professionals who are involved in the coordination of continuing care services for consumers and their families in all health care settings. The discharge planner is proactive in the health care delivery planning process and will begin an assessment of the consumer's needs either in the ambulatory care setting, at home prior to an admission for elective surgery, or within 24 hours of an acute care admission. This proactive perspective allows discharge planners to develop a plan of care that decreases the length of the hospital stay and reduces unnecessary acute care admissions. The discharge planner facilitates the progress of consumers and their families along the health care continuum whether it be home care, hospice, or inpatient care.

FAMILY CAREGIVERS AND TODAY'S LONG-TERM CARE SYSTEM

Family caregivers are literally underpinning our healthcare system. A recent GAO study reports that approximately 80% of all home care services are provided by family caregivers who are not reimbursed for their time and effort. They are family, friends and neighbors who stand by those they love as they face chronic illness or disability. Their help can take many forms: physical assistance with daily activities from going to the bathroom to going to the drug store; monitoring medical devices from IVs to ventilators; and providing emotional, financial, legal and spiritual support.

The National Alliance for Caregiving conducted a study in 1997 that revealed the human face of caregiving. The study found that 22.4 million households are involved in caring for a loved one over the age of 50. The results highlighted the experiences of today's "sandwich generation" that is increasingly asked to care for their ailing parents at the same time that they are juggling the demands of their own families and careers. The typical caregiver is a 46 year old married woman caring for her 77 year old mother.

The United Hospital Fund of New York estimates that it would cost at least $196 billion a year to replace the vital services provided by family caregivers. The economic value of this "invisible" health care sector dwarfs the costs of both paid home health care ($32 billion) and nursing home care ($83 billion). Without the free and loving care provided by our nation's caregivers, the national health care system would be much sicker than it is today.

THE NEED FOR FAMILY CAREGIVER SUPPORT

The need for caregiving is exploding at the same time that the number of available caregivers is evaporating. The aging of the baby boom generation will only make this situation more dire. People over 85 years of age are the fastest growing segment of the population, and they are also the group most likely to need care. By 2020, there will be 14 million elderly in need of long-term care. It won't be long before every family in America is involved in family caregiving.

Unfortunately, caregiving takes a high economic toll on America's families and businesses. A 1998 survey by the National Family Caregivers Association found that 61% of caregivers who provide 21 hours or more of care a week suffer from depression. 51% of these caregivers suffer from sleeplessness, and 41% suffer from back problems. Three fourths of all caregivers report that they do not receive consistent support from other family members.

A recent study by the Center for Women and Aging and the National Alliance for Caregiving shows that family caregivers can lose over $650,000 in wages, pensions and Social Security because of their caregiving responsibilities. Lost wages, promotions and career opportunities are the normal consequence of family caregiving. In addition, a study conducted by the Alzheimer's Association in 1998 found that Alzheimer's disease alone costs US businesses $26 billion a year in caregiver absenteeism. The Alzheimer's Association reports that increased use of respite care at mild and moderate stages of Alzheimer's has shown to delay nursing home placement significantly, at a net savings of $600 to $1,000 a week.

Clearly, America's caregivers are in need of support. In addition, it is in the best interest of the health care system to help families care for their loved ones in their homes for as long a period as possible. Numerous studies have shown that simple caregiver interventions, such as respite care, counseling education and supportive services can have a major impact on the well being of caregivers and patients.

The President's proposal would provide state governments access to a network that provides respite care and other caregiver support services, information about community-based long-term care services, and counseling and support services. The Administration estimates that this program would assist approximately 250,000 families nationwide. In addition, the President proposes a $3,000 tax credit for individuals or families that care for individuals with three or more limitations in activities of daily living (ADLs) or a comparable cognitive impairment.

The Home Care Coalition believes that these proposals represent a critical first step in acknowledging the vital role that family caregivers play in our nations health care system. We can not assure the future of Medicare and there is no way to control the costs of Medicaid, if we let the family caregiving system collapse. We urge this committee to revisit the issues of family caregiver tax credits and caregiver support programs this year.

ACCESS TO HOME AND COMMUNITY-BASED SERVICES

The Omnibus Budget Reconciliation Act of 1981 established a program that allows states to apply for waivers (known as 1915(c) waivers) to reimburse home and community-based services for beneficiaries who would otherwise be institutionalized. In order to qualify for a waiver, the cost of institutionalization must be explicitly calculated and shown to be greater than the home and community-based services. Therefore, individuals must be shown to be deficient in at least three activities of daily living (e.g., bathing, dressing, toileting, transferring, continence, or eating) to qualify for a waiver. As states search for new and innovative means of controlling Medicaid costs, 1915(c) waivers have become more and more popular. There are currently 240 waiver programs in effect across the nation.

The President's budget includes a proposal to enable states to provide services to nursing-home qualified beneficiaries at 300% of the Supplemental Security Income (SSI) limit without requiring a federal 1915(c) waiver. This proposal would encourage states to implement these popular and cost-saving programs.

~~We are very concerned, however, about funding for the Title XX Social Services~~ Block Grant Program, which funds adult day services, home and community care and adult protective services in many states. Two years ago, the program was funded at a level of $2.38 billion. The program was cut to $1.775 billion and, much to our surprise, President Clinton has proposed freezing spending at this lower level, far below the Administration's request last year of $2.38 billion.

The Home Care Coalition urges the Committee to support the President's proposal to recognize the effectiveness of home and community-based services by eliminating the need for 1915(c) waivers. However, we hope that you will back up this recognition by opposing drastic reductions in funding for the Title XX Social Services Block Grant.

CONCLUSION

The services provided by home health care providers—be they paid direct service providers or informal family caregivers—are vital to America's chronically ill, frail elderly and disabled. These services are also key to securing the financial viability of the Medicare Program. The Home Care Coalition urges this Committee to recognize the importance of family caregivers by enacting long-term care proposals such as those proposed by the President this year. The Coalition looks forward to working with this Committee to address the many issues facing home health care.

STATEMENT OF THE INDEPENDENT SECTOR

Independent Sector (IS) is a coalition of more than 700 national organizations and companies representing the vast diversity of the nonprofit sector and the field of philanthropy. Its members include many of the nation's most prominent and far-reaching nonprofit organizations, leading foundations, and Fortune 500 corporations with strong commitments to community involvement. This network represents millions of volunteers, donors, and people served in communities around the world. is members work globally and locally in human services, education, religion, the arts, research, youth development, health care, advocacy, democracy, and many other areas. is is the only organization to represent a network so broad.

America's "independent sector" is a diverse collection of more than one million charitable, educational, religious, health, and social welfare organizations. It is these groups that create, nurture, and sustain the values that frame American life and strengthen democracy. In 1980, a group of visionary leaders, chaired by the Honorable John W. Gardner, became convinced that if the independent sector was to continue to serve society well, it had to be mobilized for greater cooperation and influence. Thus a new organization, named to celebrate the independent sector's unique role apart from government and business, was formed to preserve and enhance and protect a healthy, vibrant independent sector.

There are a number of initiatives relating to the nonprofit sector in the Administration's FY 2001 budget that we would like to bring to the committee's attention. These include a charitable deduction for nonitemizers, an increased limit for individual donations of appreciated assets, and taxation on the investment income of associations. IS would like to present the following comments to the committee.

NONITEMIZER DEDUCTION

The President's budget would create a charitable deduction for taxpayers who do not itemize their deductions. These individuals would be able to deduct fifty percent of their annual charitable contributions above a $1,000 floor ($2,000 for joint returns) through 2005. That floor will be lowered to $500 ($1,000 for joint returns) beginning in 2006.

IS has long been supportive of any legislative effort to encourage charitable giving, particularly by permitting nonitemizers to deduct their generous gifts. The Charitable Giving Tax Relief Act, H.R. 1310, introduced by Representative Philip Crane (R-IL) and cosponsored by William Coyne (D-PA), Wally Herger (R-CA), and Karen Thurman (D-FL), is a case in point. This legislation is similar to the President's proposal with the exception that the $500 floor would become effective immediately. The bill currently has 122 bipartisan cosponsors, including 18 members of the Ways and Means Committee.

Charitable giving is a transfer of private resources for public purposes. Giving to charities promotes individual choice as well as public responsibility among nonprofit organizations. In a recent study, Giving and Volunteering in the United States, 1999, IS found that the average annual household contribution made by nonitemizers is $619. By creating a deduction for nonitemizers we would be recognizing those taxpayers who give above and beyond average levels.

The nonitemizer deduction is also based on generosity and sacrifice, not personal gain. Individuals are motivated to make charitable contributions primarily by their altruistic nature. However, as with any decision related to the use of limited resources, the amount a person gives to charitable causes will be influenced by the cost to them of giving. The cost of giving can be significantly changed by the tax treatment of the gift.

This deduction would restore fairness to the tax code for nonitemizers who give generously. Currently, nonitemizers represent more than two-thirds of American taxpayers B over 84 million people. Americans who don=t itemize on their returns would have a new opportunity to deduct some of their charitable contributions. In 1986, the tax deduction expired due to a sunset provision in the law. IS believes that it is time our public policies recognize those who give significant portions of their income to the causes they care about.

This is also an example of effective and meaningful tax policy. It recognizes the contributions of individuals and families while it also acknowledges the contributions charitable organizations make to communities.

We are grateful for the Administration's efforts to include incentives for charitable giving in his budget, and we urge you to support HR 1310.

LIMITATION ON INDIVIDUAL GIFTS OF APPRECIATED PROPERTY

The President's budget includes a provision that would increase the limitation on the charitable deduction for gifts of appreciated property to charity. Current law permits taxpayers who itemize to take a deduction for gifts of appreciated property to a public charity or private foundation. However, the deduction is limited to a percentage of the taxpayer's adjusted gross income (AGI). Presently, the charitable deduction is limited to thirty percent of AGI for gifts of appreciated property to charities, and to twenty percent for such gifts to private foundations. The Administration's proposal would increase these limits to fifty and thirty percent, respectively. This would become effective for gifts made after December 31, 2000.

As more Americans are acquiring additional income and assets as a result of the strong performance of the stock market, we hope the government will encourage these individuals to give a portion of their new wealth to charitable causes. For many Americans, donating gifts of appreciated property is a common form of philanthropy. We urge the committee to enhance this incentive by more fully recognizing these generous contributions.

ASSOCIATION INVESTMENT INCOME TAX

The Clinton Administration has proposed once again to place an income tax on the investments made by trade associations (501(c)(6) organizations). Identical to the provision introduced by the President last year, the tax affects all trade associations with income exceeding $10,000 during any tax year. The tax is levied on the interest, dividend, royalty, and rental income of associations and essentially alters section of the tax code that had previously granted such groups exempt from taxation.

IS joins the American Society of Association Executives (ASAE) in opposing this misguided proposal. While the Administration maintains that this provision would close a loophole in the tax code encouraging members of associations to pay higher dues in order to claim a tax deduction, associations are not permitted to pay dividends to their members, and therefore are more likely to keep their dues levels at a minimum. In addition, investment income helps an association enhance the services it provides its members while creating reserve funds for the future. We are also concerned about this proposal since it erodes the principle of exempting from tax passive income earned by nonprofit organizations.

CONCLUSION

Mr. Chairman, we appreciate the opportunity to submit these comments to the committee, and look forward to working with you and your staff on these matters.

STATEMENT OF THE LEASING COALITION

I. INTRODUCTION

On behalf of a group of companies in the leasing industry (hereinafter the "Leasing Coalition"), PricewaterhouseCoopers appreciates the opportunity to present this written statement to the Senate Finance Committee in conjunction with its February 8, 2000, hearing on the Administration's FY 2001 budget proposals.

Our comments center on tax increases proposed by the Administration that would overturn the carefully constructed body of law, built over decades, governing the tax treatment of leasing transactions. These proposals include a leasing-industry specific measure that would further penalize U.S. companies using leasing to finance the export of manufactured goods abroad.[1] The Leasing Coalition also has strong concerns about the impact on leasing transactions of several general Administration proposals relating to "corporate tax shelters," including a proposal empowering IRS agents to deny tax benefits in "tax-avoidance transactions."[2]

In these comments, the Leasing Coalition discusses the rationale underlying the present-law tax treatment of leasing transactions and examines the impact of the Administration's proposals on commonplace leasing arrangements. We also discuss the adverse impact these prop sals would have on the competitiveness of American businesses, on exports, and on the cost of capital.

We conclude by urging Members of the Senate Finance Committee to reject the Administration's tax proposals that would adversely affect the leasing industry. These proposals inappropriately would overturn the longstanding body of tax law governing common leasing transactions, branding these legitimate business transactions as "corporate tax shelters." Instead of considering proposals at this time that would impair the competitiveness of the leasing industry, we respectfully suggest that the Administration and the Congress consider ways to help U.S. companies that use leasing as a form of financing expand in the global marketplace.

II. THE LEASING INDUSTRY

Leasing is an increasingly common means of financing investment in equipment and other property. It is estimated that approximately 30 percent of all domestic equipment investment is financed through leasing rather than outright acquisition.[3] Approximately 80 percent of U.S. companies lease some or all of their equipment.[4] The leasing industry in 1998 financed more than $180 billion in equipment acquisitions, an amount that exceeded $200 billion in 1999.[5]

Lessees, or the users of the property, find leasing an attractive financing mechanism for a number of reasons. Because a lease allows 100-percent financing, the lessee is able to preserve cash that would be necessary to buy or make a downpayment on a piece of equipment. Moreover, lessees generally are able to secure financing under a lease at a lower cost than under a loan. A lessee also may wish to use the asset only for a short period of time, and may not want to risk having the value of the equipment decline more quickly than expected—or become obsolete—during this period of use. For financial statement purposes, leasing can be preferable in that it allows the lessee to secure off-balance sheet reporting with respect to the asset. Finally, the lessee may find rental deductions for lease payments more beneficial, from a timing perspective, than depreciation deductions taken over a certain schedule (e.g., double-declining balance).

Leasing also provides a number of business advantages to lessors. Manufacturing companies (e.g., automobile, computer, aircraft, and rolling stock manufacturers) may act as lessors through subsidiary companies as a means of providing their goods to customers. Financial institutions like banks, thrifts, and insurance companies engage in leasing as a core part of their financial intermediation business. As the owner of the equipment, the lessor is able to take full deductions for depreciation. Currently, more than 2,000 companies act as equipment lessors.[6]

Leasing also promotes exports of U.S. equipment, and thus helps U.S. companies compete in the global economy. Many lease transactions undertaken by U.S. lessors are cross-border leases, i.e., leases of equipment to foreign users. These involve all types of equipment, including tankers, railroad cars, machine tools, computers, copy machines, printing presses, aircraft, mining and oil drilling equipment, and turbines and generators. Many of these leases are supported in one form or another by the Export-Import Bank of the United States, which insures the credit of foreign lessees. Further, U.S. manufacturers demand global leasing solutions in support of their export activities.

III. PRESENT-LAW TREATMENT OF LEASES

A substantial body of law has developed over the last forty years regarding the treatment of leasing transactions for federal income tax purposes. At issue is whether a transaction structured as a lease is respected as a lease for tax purposes or is recharacterized as a conditional sale of the property. If the transaction is respected as a lease for tax purposes, the lessor is treated as the owner of the property and therefore is entitled to depreciation deductions with respect to the property. The lessor also is entitled to interest deductions with respect to any financing of the property, and recognizes income in the form of the rental payments it receives. The lessee is entitled to a business deduction for the rental payments it makes with respect to the property. On the other hand, if the transaction is recharacterized as a conditional sale, the purported lessee is treated as having purchased the property in exchange for a debt instrument. The purported lessee is treated as the owner of the property and is entitled to depreciation deductions with respect to the property. In addition, the purported lessee is entitled to interest deductions for a portion of the amount it pays under the purported lease. The purported lessor recognizes gain or loss on the conditional sale and recognizes interest income with respect to a portion of the amount received under the purported lease. The purported lessor is entitled to interest deductions with respect to any financing of the property.

Guidance regarding the determination whether a transaction is respected as a lease for tax purposes is provided pursuant to an extensive body of case law. There also have been significant IRS pronouncements addressing this determination, which have been maintained for more than 25 years. Finally, statutory provisions provide specific rules regarding the tax consequences of certain leasing transactions.

A. Case law

The determination whether a transaction is respected as a lease for tax purposes generally is made based on the substance of the transaction and not its form.[7] This substantive determination focuses on which party is the owner of the property that is subject to the lease (i.e., which party has the benefits and burdens of ownership with respect to the property).[8] In addition, the transaction must have economic substance or a business purpose in order to be classified as a lease for tax purposes.[9]

The most important attributes of ownership are the upside potential for economic gain and the downside risk of economic loss based on the residual value of the leased property.[10] The presence of a fair market value purchase option in a lease agreement should not impact the determination of tax ownership.[11] Moreover, the fact that such an option is fixed at the estimated fair market value should not by itself cause the lease to be treated as a conditional sale.[12] However, where a lessee is economically or legally compelled to exercise the purchase option because, for example, the option price is nominal in relation to the value of the property, the lease likely would be treated as a conditional sale.[13]

Another important indicia of ownership for tax purposes is the holding of legal title; this factor, however, is not determinative.[14] The right to possess the property throughout its economic useful life also is an attribute of ownership for tax purposes. For example, the entitlement of the lessee to possession of the property for its entire useful life would be a strong indication that the lessee rather than the lessor should be considered the owner of the property for tax purposes.[15]

The economic substance test finds its genesis in the Supreme Court opinion in Frank Lyon Co., supra. There, the United States Supreme Court determined that a sale and leaseback should not be disregarded for federal income tax purposes if the transaction:

> is a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . . Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.[16]

The IRS challenged the sale-leaseback transaction in Frank Lyon on the grounds that it was a sham. However, the Court concluded that, in the absence of specific facts evidencing a sham transaction motivated solely by tax-avoidance purposes, a lessor need only possess "significant and genuine attributes of traditional lessor status," evidenced by the economic realities of the transaction, in order for a lease to be respected for federal income tax purposes. The Court recognized that there can be many business or economic reasons for entering into a lease. Legal, regulatory, and accounting requirements, for example, can serve as motivations to lease an asset. Instead of trying to identify one controlling factor, the Court used the same test as the other leasing cases—that all facts and circumstances must be considered in determining economic substance. Further, the Court noted that "the fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences."[17]

In the wake of Frank Lyon, the Tax Court has refined the analysis of whether a lease should be respected for tax purposes. Under Rice's Toyota World, Inc. v. Commissioner, supra, and its progeny, the Tax Court will disregard a lease transaction for lack of economic substance only if (i) the taxpayer had no business purpose for entering into the transaction other than to reduce taxes, and (ii) the transaction, viewed objectively, offered no realistic profit potential. Further elaborating on this standard, the Tax Court in Mukerji v. Commissioner[18] set forth the test that in subsequent cases has been used to determine whether a lease should be disregarded for tax purposes:

[u]nder such test, the Court must find "that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction, and that the transaction had no economic substance because no reasonable possibility of a profit exists."[19]

Once business purpose is established, a lease transaction should not be classified as a "sham." A finding of no business purpose, however, is not conclusive evidence of a sham transaction. The transaction will still be valid if it possesses some economic substance. The Tax Court has developed an objective test for economic substance. A lease will meet the threshold of economic substance and will be respected when the net "reasonably expected" residual value and the net rentals (both net of debt service) will be sufficient to allow taxpayers to recoup their initial equity investment.[20] Applying this analysis, the Tax Court in several cases has concluded that a purported lease transaction was devoid of business purpose and lacked economic substance because the taxpayers could not reasonably expect to recoup their capital from the projected non-tax cash flows in the lease.[21]

Most recently, outside the context of leasing transactions, the Tax Court in ACM Partnership v. Commissioner[22] had the opportunity to apply a form of economic substance test. There, the Tax Court stated that "the doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of a transaction that serves no economic purpose other than tax savings."[23] The court further found that the taxpayer could not have hoped to recover its initial investment and its costs under any reasonable economic forecast. This proposition that the economic substance test cannot be satisfied if a taxpayer cannot demonstrate a reasonable expectation of pre-tax profit is consistent with the long-standing body of case law regarding lease transactions.

B. Administrative pronouncements

Through revenue rulings and other administrative pronouncements, the IRS has identified certain principles and factors it considers relevant in determining whether a transaction should be treated for tax purposes as a lease or as a conditional sale.

In Rev. Rul. 55-540,[24] the IRS indicated that conditional sale treatment is evidenced where the lessee effectively has the benefits and burdens of ownership for the economic life of the property, as demonstrated by, for example, the application of rentals against the purchase price or otherwise to create an equity interest, the identification of a portion of rentals as interest, the approximate equality of total rentals and the cost of the property plus interest, or the existence of nominal renewal or purchase options. The passage of legal title itself is not determinative.

In addition, the IRS has issued a series of revenue procedures setting forth guidelines that must be satisfied to obtain an advance ruling that a "leveraged lease" (a transaction involving three parties—a lessor, a lessee, and a lender to the lessor) will be respected as a lease for tax purposes.[25] According to Rev. Proc. 75-21, the guidelines set forth therein were published

> to clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued and thus to provide assistance to taxpayers in preparing ruling requests and to assist the Service in issuing advance ruling letters as promptly as practicable. These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes and are not intended to be used for audit purposes. If these guidelines are not satisfied, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances. (Emphasis added.)

Thus, the IRS guidelines are intended only to provide a list of criteria that if satisfied ordinarily will entitle a taxpayer to a favorable ruling that a leveraged lease of equipment will be respected as a lease for tax purposes.

With respect to economic substance, the IRS guidelines set forth a profit test that will be met if:

> the aggregate amount required to be paid by the lessee to or for the lessor over the lease term plus the value of the residual investment [determined without regard to the effect of inflation] exceed an amount equal to the sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property and the lessor's equity investment in the property, including any direct costs to finance the equity investment, and the aggregate amount required to be paid to or for the lessor over the lease term exceeds by a reasonable amount the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property.[26]

The IRS guidelines do not specify any particular amount of profit that a lease must generate.[27]

The IRS itself has not relied exclusively on the criteria set forth in the IRS guidelines when analyzing the true lease status of a lease transaction. Moreover, the courts have not treated the IRS guidelines as determinative when analyzing whether a transaction should be respected as a lease for tax purposes.[28] Rather, the IRS guidelines are viewed as constituting a "safe harbor" of sorts. Accordingly, satisfaction of the conservative rule set forth by the applicable IRS guideline with respect to a particular criterion usually is viewed as an indication that the transaction should not be challenged on such a criterion.

The IRS in March 1999 issued Rev. Rul. 99-14, with respect to a narrow class of relatively recent cross-border leasing transactions commonly referred to as "LILO" transactions. The IRS ruled that a taxpayer may not deduct rent and interest paid or incurred in connection with a LILO transaction that lacks economic substance.

C. Statutory provisions

The party that is treated as the owner of the leased asset is entitled to depreciation deductions in respect of such asset. The Deficit Reduction Act of 1984 enacted the "Pickle" rules (named after one of the sponsors of the provision, Representative J.J. Pickle), which restrict the benefits of accelerated depreciation in the case of property leased to a tax-exempt entity.

The Pickle rules generally provide that, in the case of any "tax-exempt use property" subject to a lease, the lessor shall be entitled to depreciate such property using the straight-line method and a recovery period equal to no less than 125 percent of the lease term.[29] Tax-exempt use property, for this purpose, generally is tangible property leased to a tax-exempt entity, which is defined to include any foreign person or entity.[30]

In applying the Pickle rules, Treasury regulations adopted in 1996 provide that the lease term will be deemed to include certain periods beyond the original duration of the lease. Under these regulations, which extend beyond the reach of the statutory provision, the lease term includes both the actual lease term and any period of time during which the lessee (or a related person) (i) agreed that it would or could be obligated to make a payment of rent or a payment in the nature of rent or (ii) assumed or retained any risk of loss with respect to the property (including, for example, holding a note secured by the property).[31]

IV. ADMINISTRATION'S FY 2001 BUDGET PROPOSALS

The Administration's FY 2001 budget includes several proposals that could have the effect of completely rewriting longstanding tax law on leasing transactions. These proposals, if enacted, would replace the substantial and specific body of law regarding leasing transactions that has developed over the last forty years with broad and largely undefined standards that could be used by IRS revenue agents to challenge traditional leasing transactions undertaken by companies operating in the ordinary course of business in good-faith compliance with the tax laws. Moreover, the proposal that would modify the tax rules applicable to cross-border leasing would penalize U.S. lessors and would further hamper the ability of U.S.-based multinationals to compete in export markets.

A. Proposal to codify the economic substance doctrine

The proposal would authorize the IRS to disallow any deduction, credit, exclusion, or other allowance obtained in a "tax-avoidance transaction." A "tax avoidance transaction" is defined generally as any transaction in which the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits. A financing transaction would be considered a tax-avoidance transaction if the present value of the tax benefits of the taxpayer to whom the financing is provided significantly exceed the present value of the pre-tax profit or return of the person providing the financing.

This proposal creates the entirely new and vague concept of a "tax-avoidance transaction." The inclusion of so many subjective concepts in this definition precludes it from operating as an objective test. As an initial matter, what constitutes the "transaction" for purposes of this test?[32] Next, what are the mechanics for computing pre-tax economic profits and net tax benefits and for determining present values (e.g., what discount rate should be used, particularly where rentals, residuals, and their tax benefits have significantly different risk and reward profiles?)? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits? Moreover, is the determination of "insignificance" transaction-specific; stated otherwise, does the form of the transaction affect the determination of what will be considered "insignificant" for these purposes? The presence of these same vague and undefined elements in the concept of a tax-avoidance financing transaction renders that test equally subjective.

Under this proposal, once the IRS had used its unfettered authority to determine independently that a taxpayer had engaged in a tax-avoidance transaction, the IRS would be entitled to disallow any deduction, credit, exclusion, or other allowance obtained by the taxpayer in such transaction. Thus, even though a taxpayer's transaction has economic substance and legitimate business purpose, the IRS would be empowered to deny the tax savings to the taxpayer if another route to achieving the same end result would have resulted in the remittance of more tax. In other words, if an IRS revenue agent believed for any reason that a taxpayer's transaction was too tax efficient, he or she would have the power to strike it down, even if the actual pre-tax return on the transaction satisfied any objective benchmark for appropriate returns. That power could be invoked without regard to the legitimacy of the taxpayer's business purpose for entering into the transaction or the economic substance underlying the transaction.

In the context of leasing transactions, this proposal effectively could wipe out the entire body of law that has developed over the last forty years. A leasing transaction that is scrutinized and passes muster under the benefits and burdens of ownership, business purpose, and economic substance tests could run afoul of this vague new standard. This proposal would completely disregard the presence of a business purpose, ignoring the business reality that lease transactions often are motivated by criteria that would not be taken into account under this new standard. It would replace the traditional economic analysis of lease transactions with this new and largely undefined standard. The long-standing law regarding the treatment of leasing transactions allows taxpayers to employ prudent tax planning to implement business objectives while giving the IRS the tools it needs to address potentially abusive transactions. The extraordinary power that would be vested both in Treasury and in individual IRS revenue agents is unnecessary and would create substantial uncertainty that would frustrate commerce done through traditional leasing transactions.

B. Proposal to increase depreciation life by service term of tax-exempt use property

The proposal would require lessors of tax-exempt use property to include the term of optional service contracts and other similar arrangements in the lease term for purposes of determining the recovery period under the Pickle rules.

As an initial matter, it should be noted that the reach of the proposal is not clear. The proposal does not define optional service contracts and does not provide any guidance regarding what would fall within the reach of the proposal as an "other similar arrangement."

The proposed legislation overlooks significant business purposes that give rise to use of service contracts. Service contracts involve a tradeoff between rights and risks. Relative to a lessor, the service provider enjoys more control over the asset used to generate such services, but also assumes additional performance and operational risk with respect to such asset. The parties' preferences as to the division of rights and risks with respect to property determine the form of contractual arrangement they choose. The service contract arrangement has long been commercially recognized, particularly within certain industries such as the utility, specified manufacturing, and shipping industries.

This proposal would exacerbate the anti-competitive impact of the Pickle rules by further limiting depreciation deductions for U.S. lessors financing assets being sold or developed in overseas markets. Domestic manufacturers, distributors, and retailers alike avail themselves of export leasing, not only as a pure financing vehicle for major equipment sales, but also as a powerful sales tool to promote equipment sales abroad. The proposal would put these U.S. companies at a further disadvantage compared to foreign-based companies that are able to offer lease financing for their goods on more favorable terms. The proposal similarly would adversely affect the ability of U.S. financial institutions to compete internationally with foreign lenders and financiers.

The service contract issue was addressed explicitly at the time the Pickle rules were enacted in 1984. Code section 7701(e), which was enacted with the Pickle rules, provides rules regarding the distinction between a service contract and a lease, and further specifically provides that certain service contracts will not be subject to potential recharacterization as leases. This proposal would reverse the safe harbor provided in 1984 for service contracts with respect to certain solid waste disposal, energy, and water treatment facilities and would subject these facilities to the penalty of delayed depreciation. Moreover, the proposal would further extend the reach of the Pickle rules to other services contracts and to any arrangement that constitutes an "other similar arrangement," a concept which has not been defined.

When the Pickle rules were enacted in 1984, their reach was limited by the rules of Code section 7701(e). Removing those limitations and expanding the reach of the Pickle rules would further impair the ability of U.S. leasing companies to compete in the global economy. As discussed further below, given the increasingly competitive global environment for leasing, this is not the time to remove those carefully considered limitations and expand the reach of the Pickle rules.

V. ADMINISTRATION'S PROPOSALS ARE ANTI-COMPETITIVE

A. Impact on Common Transactions

Consider a standard domestic leveraged lease under which an airline carrier enters into a "sale-leaseback" transaction in order to finance a newly manufactured aircraft. Under this transaction, the airline carrier purchases the aircraft from the aircraft manufacturer and immediately sells it to an institutional investor. The investor finances the acquisition through an equity investment equal to 25 percent of the $100 million purchase price and a fixed-rate nonrecourse debt instrument from a third-party lender equal to the remaining 75 percent. Immediately after the sale, the investor leases the aircraft to the airline carrier pursuant to a net lease for a term of 24 years. Upon the expiration of the lease term, the aircraft will be returned to the investor (the lessor). During year 18 of the lease, the airline carrier (the lessee) will have an option to purchase the aircraft from the investor for a fixed amount, which will be set at an amount greater than or equal to a current estimate of the then-fair market value of the aircraft. As the tax owner of the aircraft, the lessor is entitled to depreciation deductions in respect of the aircraft and deductions in respect of the interest that accrues on the loan.

The lease in this example complies with applicable case law and with the cash flow and profit tests set forth in Rev. Proc. 75-21. In fact, the sum of the rentals and the expected residual value exceeds the aggregate disbursements of the lessor and the lessor's equity investment, together with applicable costs, by approximately $18 million (or 18 percent of the asset purchase price).

Even though this transaction complies with the established body of leasing law, it appears that it potentially could be characterized as a "tax-avoidance transaction" under the Administration's proposal, discussed above. As noted above, the manner in which the proposal would test whether a transaction is or is not a "tax-avoidance transaction" is capable of numerous different interpretations and appears to be highly subjective. Under a range of potential applications of the proposal to this transaction, it might be determined that the lessor would reasonably expect an annual pre-tax return anywhere in the range of 2.5 percent to 5.5 percent. On an after-tax basis, the lessor might be determined to reasonably expect an annual return anywhere in the range of 6.5 percent to 8.5 percent. Depending on the particular manner in which the proposed test might be applied, the differential between the pre-tax and the after-tax returns could be large enough to suggest that an IRS agent-might take the position that the discounted value of the reasonably expected pre-tax profit is not sufficient under the proposed test when compared to the discounted value of the reasonably expected net tax benefits.

Regardless of how the test is applied, however, the tax advantages received by the lessor in this example are identical to the tax benefits that would be received by any owner of the property financing the property in a similar manner and in the same tax bracket. If the tax benefits are disallowed only for lessors, leasing will be put at a disadvantage relative to direct ownership. There is no sensible policy that would declare a leasing transaction to lack economic substance where the same cash flows and tax benefits would occur for any similarly situated direct owner of such an asset.

B. Impact on Global Competitiveness and U.S. Exports

The ability of U.S. equipment manufacturers to compete in global markets depends in part on their ability to arrange financing terms for their potential customers that are competitive with those that can be arranged by foreign producers. The Administration's budget proposals would make it much more difficult and potentially impossible to arrange financing on competitive terms.

For example, consider the case of a U.S. aircraft manufacturer seeking to expand into the European market.[33] A European airline may find cost to be a final determining factor in comparing an aircraft manufactured by a U.S. company with one produced by a European manufacturer. Financing provisions, such as lease terms, directly influence the cost. The U.S. manufacturer's ability to sell its aircraft to the European airline may be contingent on its ability to assist the airline with arranging a suitable lease that is competitive with the lease terms that can be offered with respect to the European aircraft.

A U.S. aircraft manufacturer would have to take into account the current U.S. tax law in determining the rate at which it could offer a European airline a short-term operating lease or a long-term financial lease. In contrast, a European aircraft manufacturer, if it worked through a German investor, for example, might be able to offer financing to the airline at a much lower rate. A chief reason for this disparity is the favorable tax treatment of leased property under German law, including significantly accelerated depreciation for the lessor even when the lessee is a tax-exempt entity under German tax law. Under the present Pickle rules, a U.S. export lease on U.S. equipment cannot compete with a German lease on similar German equipment. The availability of favorable lease rules in foreign jurisdictions, such as the German rules, already hinders the ability of U.S. companies to compete in the global market. Changes to the rules further impairing the tax treatment of export leasing will further disadvantage U.S. leasing companies and U.S. manufacturers vis-a-vis their foreign counterparts.

If enacted, the Administration's budget proposals would tilt the balance in these competitive financing situations even further against the U.S. manufacturer. For leasing-intensive industries, the proposals could make it prohibitive to expand in existing markets or to enter emerging markets on a competitive basis. Because the Administration's proposals effectively would make U.S.-manufactured goods in leasing-intensive industries more expensive in foreign markets, these measures could be expected to have an adverse effect on American exports.

A significant percentage of American exports is attributable to leasing. While no exact data regarding this percentage is available, consider that data discussed in section II, above, indicated that nearly one third of all equipment investment, at least on a domestic basis, is financed through leasing. Further, consider that exports of equipment in 1998 represented 44 percent of all goods exported by the United States.[34] Moreover, the share of exported goods accounted for by equipment has been rising steadily since 1980. Despite the strong showing of U.S. exported equipment, we live in a highly competitive world and face worldwide competition in our export markets and at home for these products.

In certain sectors most likely to be leasing-intensive, exports are accountable for a substantial share of domestic production. For example, in 1996 exports accounted for 50 percent of U.S. production of aircraft, aircraft engines, and other aircraft parts; 28 percent of U.S. production of construction equipment; 31 percent of U.S. production of farm machinery; 40 percent of U.S. production of machine tools; and 56 percent of U.S. production of mining machinery.[35] In the absence of these exports, domestic employment in these equipment-producing industries would be substantially reduced.

The Administration's proposals also would impede the ability of U.S.-based financial institutions to compete in the worldwide leasing market. If enacted, the Administration's proposals would give foreign-based financial institutions a leg up in providing financing. The impact of these proposals on the U.S. financial sector, an important part the U.S. economy, should not be overlooked.

C. Impact on Start-Ups and Companies in Economic Downturn

Some companies that directly own their assets may find that they have a higher cost of capital than their competitors due to special tax circumstances. For example, companies in a loss position (as is the case for many businesses in the start-up phase) and companies paying AMT (which often hits companies experiencing economic downturns) often have a higher cost of capital because they cannot immediately claim all of the depreciation allowances provided under the tax law. These companies may be at a competitive disadvantage relative to other firms. Some regard it as unfair that a company in the start-up phase or recovering from an economic downturn faces higher costs for new investment than its competitors.

Through leasing, a company in these circumstances often can achieve a cost of capital comparable to that of its competitors. Leasing helps to "level the playing field" between companies in an adverse tax situation and their competitors by equalizing the cost of capital. For certain assets, leasing can lower the cost of capital for a firm in this tax situation by as much as one percentage point. This can mean the difference between successfully competing and bankruptcy. Rehabilitation or liquidation in bankruptcy can be more detrimental to U.S. revenues than the granting of ordinary depreciation and interest deductions.

By denying the benefits of leasing, the Administration's proposals would further increase the cost of capital for companies in such circumstances. As a result, the economy suffers real losses. Investment may be allocated not on the basis of who is the most efficient or productive producer, but who is in the most favorable tax situation. In the absence of leasing, a company in a loss position—facing a higher cost of capital than its competitors—might not be able to undertake new investment even if, in the absence of taxes, it would be the most efficient firm.

VI. REFORMS NEEDED TO STRENGTHEN COMPETITIVENESS OF U.S. LEASING INDUSTRY

As discussed above, the leasing industry is important to the American economy. U.S. manufacturers use leasing as a means to finance exports of their goods in overseas markets, and many have leasing subsidiaries that arrange for such financing. Many U.S. financial companies also arrange for lease financing as one of their core financial intermediation services. Ultimately, the activities of these companies support U.S. jobs and investment.

The present-law Pickle rules place the American leasing industry at a competitive disadvantage in overseas markets. Because of the Pickle rules and their adverse impact on cost recovery, U.S. lessors are unable in many cases to offer U.S.-manufactured equipment to overseas customers on terms that are competitive with those offered by foreign counterparts. Many European countries, for example, provide favorable lease rules for home-country lessors leasing equipment manufactured in the home country. The 1996 Treasury regulations regarding replacement leases compound this competitive disadvantage faced by the U.S. leasing industry. It is unclear why the Administration, through the proposals in its FY 2001 budget submission, would choose to further increase these competitive disadvantages.

Rather than follow the Administration's lead, the Leasing Coalition respectfully submits that Congress should consider reversing course. Specifically, we would ask that Congress explore whether, in light of the globalization of the economy, there is any tax policy or economic rationale for the present-law Pickle rules. The Leasing Coalition knows of no such legitimate rationale, and urges repeal of the Pickle rules applicable to export leases, which serve only to penalize the U.S. leasing industry. As an immediate step, we also would call on Congress to overturn the 1996 Treasury regulations that treat the lease term, for purposes of the Pickle rules, as including periods beyond the actual lease term. These regulations have no basis in the legislative history underlying enactment of the Pickle rules and have no policy justification. These changes would greatly strengthen the competitiveness of the U.S. leasing industry.

VII. CONCLUSION

The Leasing Coalition urges Members of the Senate Finance Committee to reject the Administration's tax proposals that would adversely affect the leasing industry. As discussed above, we believe these proposals inappropriately would overturn the longstanding and carefully crafted body of tax law governing common leasing transactions and would have a deleterious impact on the U.S. economy. Moreover, we find it highly objectionable that these common and legitimate business transactions effectively are being cast by the Administration as "corporate tax shelters."

Instead of considering proposals at this time that would impair the competitiveness of the leasing industry and industries that manufacture goods commonly acquired through lease arrangements, we respectfully would suggest that the Administration and Congress consider ways to help U.S. companies that use leasing as a form of financing expand in the global marketplace. The Congress should act to reverse the overreaching 1996 Treasury regulations regarding replacement leases and, further, should consider repeal of the Pickle rules themselves.

ENDNOTES

[1] General Explanations of the Administration's Fiscal 2001 Revenue Proposals, Department of the Treasury, February 2000, at 137-8.
[2] Id. at 124.
[3] U.S. Department of Commerce.
[4] Equipment Leasing Association.
[5] U.S. Department of Commerce.
[6] Equipment Leasing Association.
[7] Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939).
[8] Estate of Thomas v. Commissioner, 84 T.C. 412 (1985).
[9] See Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in part and rev'd in part, 752 F.2d 89 (4th Cir. 1985); Frank Lyon Co. v. United States, 435 U.S. 561 (1978).
[10] Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), rev'g, 76 T.C. 547 (1981).
[11] Lockhart Leasing Co. v. Commissioner, 54 T.C. 301, 314-15 (1970), aff'd 446 F.2d 269 (10th Cir. 1971).
[12] See Frank Lyon Co. v. United States, supra.

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[13] Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955), rev'g, 12 T.C.M. 277 (1953).
[14] Coleman v. Commissioner, 87 T.C. 178, 201 (1986), aff'd 833 F.2d 303 (3d Cir. 1987).
[15] Pacific Gamble Robinson v. Commissioner, 54 T.C.M. 915 (1987).
[16] Id. at 583.
[17] Id. at 561.
[18] 87 T.C. 926 (1986).
[19] Id. at 959 (quoting Rice's Toyota World, supra, at 91).
[20] See Mukerji, supra.
[21] See Goldwasser v. Commissioner, 56 T.C.M. 606 (1988); Casebeer v. Commissioner, 54 T.C.M. 1432 (1987); and James v. Commissioner, 87 T.C. 905 (1986).
[22] 73 T.C.M. (1997), aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 1999 U.S. LEXIS 1399 (Mar. 22, 1999).
[23] Id. at 130.
[24] 1955-2 C.B. 39. See also Rev. Rul. 55-541, 1955-2 C.B. 19.
[25] See Rev. Proc. 75-21, 1975-1 C.B. 715 (setting forth several requirements that must be satisfied for the Service to rule that a transaction is a lease for tax purposes); Rev. Proc. 75-28, 1975-1 C.B. 752 (specifying information that must be submitted pursuant to Rev. Proc. 75-21); Rev. Proc. 76-30, 1976-2 C.B. 647 (providing that the Service will not issue an advance ruling if the property subject to the "lease" is limited use property); Rev. Proc. 79-48, 1979-2 C.B. 529 (modifying Rev. Proc. 75-21 to allow the lessee to pay for certain improvements).
[26] Rev. Proc. 75-21, supra.
[27] The IRS guidelines understate the actual profit earned over the lease term by failing to adjust the residual value of the investment for inflation. The advance ruling practice of the IRS from 1975 has been to require a pre-tax profit, cash on cash return, that approximates the inflation rate projected for the leased asset.
[28] In a footnote in Frank Lyon, supra at n. 14, the Supreme Court specifically recognized that the IRS guidelines "are not intended to be definitive." Moreover, in Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n. 15 (1985), the Tax Court viewed the failure to satisfy all the IRS guidelines as not determinative because the facts and circumstances demonstrated that the transaction satisfied the "spirit" of the guidelines.
[29] I.R.C. section 168(g).
[30] I.R.C. section 168(h).
[31] Treas. Reg. Section 1.168(i)-2(b)(1).
[32] By itself, the determination of the scope of the transaction is both extremely complex and vitally important to the application of this test. Some of the questions to be resolved include: Do the qualified nonrecourse indebtedness rules control the determination of whether debt is considered part of a transaction? If recourse debt is taken into account in defining the transaction, how is the appropriately allocable amount of such debt to be determined? In addition, in defining the transaction, will an implicit charge for the use of capital be taken into account? Will allocations of internal expenses and corporate overhead to the transactions be required? Moreover, will a lease of multiple assets or multiple classes of assets be treated as a single transaction or multiple transactions? All of these questions and more must be answered in order to determine the scope of the transaction, which would be only the starting point in applying this test.
[33] About half of the aircraft flown in Europe are leased rather than owned by airlines.
[34] U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, January 2000.
[35] U.S. Department of Commerce, International Trade Administration.

Statement of the National Association of Real Estate Investment Trusts®

As requested in Press Release No. 106-289 (January 31, 2000), the National Association of Real Estate Investment Trusts ("NAREIT") respectfully submits these comments in connection with the Committee on Ways and Means' hearing on the President's Fiscal Year 2001 Budget ("Budget"). NAREIT thanks the Chairman and the Committee for the opportunity to share its views on several important issues affecting REITs and publicly traded real estate companies.

NAREIT's comments address (1) the Budget's proposal to increase a real estate investment trust's ("REIT") distribution requirement to avoid the 4% excise tax; (2) the Budget's proposal to modify the treatment of closely held REITs; and (3) the

Budget's proposal to made permanent the ability to deduct remediation expenses for Brownfields sites. We appreciate the opportunity to present these comments.

NAREIT is the national trade association for REITs and publicly traded real estate companies. Members are REITs and publicly traded businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. REITs are companies whose income and assets are mainly connected to income-producing real estate. By law, REITs regularly distribute most of their taxable income to shareholders as dividends. NAREIT represents over 200 REITs and publicly traded real estate companies that own over $250 billion of real estate assets, as well as over 2,000 industry professionals who provide a range of legal, investment, financial and accounting-related services to these companies.

EXECUTIVE SUMMARY

Excise Tax. The Budget's proposal to increase the distribution requirement to avoid the 4% excise tax ignores the capital intensive nature of REITs, as well as the practical differences between REITs and mutual funds in timely calculating the required distribution amounts. Further, this proposal would effectively nullify Congress' decision reached only a few months ago to restore the general distribution requirement from 95% to 90%, effective in 2001.

Closely Held REITs. The Budget proposes to prevent any entity from owning 50% or more of the vote or value of a REIT's stock. NAREIT does not oppose the Administration's intention to craft a new ownership test intended to correspond to a REIT's primary mission: to make investment in income-producing real estate accessible to ordinary investors. However, we believe that the Administration's proposal is too broad, and therefore should be narrowed to prevent only non-REIT C corporations from owning 50% or more of a REIT's stock (by vote or value). In addition, the new rules should not apply to so-called "incubator REITs" that have proven to be a viable method by which small investors can access publicly traded real estate investments. Last, the proposal should not apply to publicly traded REITs when one person owns less than 80% of the vote or value of a REIT's stock because it would deter legitimate business transactions.

Brownfields Expenses. The Budget proposes to make permanent the provision contained in the Tax Relief Extension Act of 1999 that allows a taxpayer to deduct remediation expenses for Brownfields sites. NAREIT strongly supports this proposal, but also recommends that Congress extend the expensing treatment to properties that do not currently fit within the definition of a "qualified contaminated site."

BACKGROUND ON REITS

A REIT is a corporation or business trust combining the capital of many investors to own, operate or finance income-producing real estate, such as apartments, shopping centers, offices and warehouses. REITs must comply with a number of requirements, some of which are discussed in detail in this statement, but the most fundamental of these are as follows: (1) REITs must pay at least 95% of their taxable income to shareholders (90% after 2000); (2) most of a REIT's assets must be real estate; (3) REITs must derive most of their income from real estate held for the long term; and (4) REITs must be widely held.

In exchange for satisfying these requirements, REITs (like mutual funds) benefit from a dividends paid deduction so that most, if not all, of a REIT's earnings are taxed only at the shareholder level. On the other hand, REITs pay the price of not having retained earnings available to meet their business needs. Instead, capital for growth and significant capital expenditures largely comes from new money raised in the investment marketplace from investors who have confidence in the REIT's future prospects and business plan.

Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to investors from all walks of life. Based in part on the rationale for mutual funds, Congress decided that the only way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements.

In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals. REITs are owned primarily by individuals, with 49% of REIT shares owned directly by individual investors and 37% owned by mutual funds, which are mostly owned by individuals.

I. REIT DISTRIBUTION REQUIREMENTS

Background. Under current law, to maintain their tax status, REITs are required to distribute 95% of their taxable income while mutual funds are required to distribute 90% of taxable income. The Tax Relief Extension Act of 1999 (the "1999 Act") reduced the distribution requirement for REITs from 95% of taxable income to 90% of taxable income for years beginning after December 31, 2000.

In addition to the distribution requirement necessary to maintain their tax status, both REITs and mutual funds are subject to a 4% excise tax on the difference between their "required distribution" for a calendar year and their "distributed amount" for that year. For REITs, the required distribution under current law equals the sum of 85% of "ordinary income" for the calendar year (essentially, REIT taxable income for the year without reduction for the dividends paid deduction and without reference to capital gain or loss) plus 95% capital gain net income for that calendar year. For mutual funds, the required distribution equals 98% of a its "ordinary income" plus 98% of its capital gain net income.

For example, a REIT that generates $100x in ordinary income in 1999 must distribute at least $95x to its shareholders to receive a dividends paid deduction for 1999. However, if a REIT makes an election under I.R.C. § 858, the Code treats as paid in 1999 any dividend declared before it files its tax return (due, with extensions, on September 15, 2000) and paid in 2000 before its first regular dividend payment date after such declaration. To avoid the 4% excise tax for 1999, the REIT must distribute at least $85x during 1999 or, under the "look back" rule of I.R.C. § 857(b)(8), in January of 2000 if the dividend is declared in the last quarter of 1999.

Budget Proposal. The Administration proposes that in order to a REIT not to be assessed the 4% excise tax, its required distribution would be increased to the sum of 98% of its ordinary income and 98% of its capital gain net income. The Administration believes that this provision is necessary in order to conform the REIT excise tax to the mutual fund excise tax rules.

NAREIT Analysis and Position. While REITs were modeled after mutual funds, REITs have evolved separately as investment vehicles. The Budget would ignore Congress' recognition last year of the special capital needs of REITs and the increased difficulties a REIT faces in accurately calculating its taxable income during a taxable year.

Congress has mandated that REITs concentrate on owning and operating real estate. Unlike mutual funds that have relatively low overhead because they own the securities of other companies, REITs must continually invest capital into its projects for both upkeep and to prevent them from becoming obsolete. Reinvestment needs span the gamut of ordinary upkeep such as painting to capital expenditures (such as a installing new roof or repaving a parking lot) to renovations needed to meet customer demand (such as installing fiber optic lines for telecommunications). Thus, REITs have clear reasons why they need to retain more capital than mutual funds.

In addition, it takes considerable more time for a REIT to compute its taxable income than does a mutual fund. A mutual fund only needs to tabulate the dividends or capital gains from its portfolio, and the sources of this public information are manifold in this Age of the Internet. Conversely, a REIT must rely on non-public sources of information for which it does not control.

A REIT that owns shopping malls illustrates this lag time of information. A significant source of a typical retail REIT's annual taxable income is "percentage rents," under which the REIT landlord receives base rent throughout the year and then additional rent if the tenant generates sales at the REIT's property above an agreed threshold. The Christmas Holiday Season is by far the biggest sales period for most shopping malls, and a retail REIT cannot compute its taxable income until its tenants have informed it of their sales and the consequent percentage rents. Since the Code does not compel the tenants to provide this information by any deadline, often a retail REIT does not receive the necessary breakdown of percentage rents until February or March. Accordingly, the REIT can approximate by year-end how much it needs to distribute to satisfy the current 85% requirement, but would be hard pressed to reach the precision required by a 98% requirement, as proposed in the Budget.

The increased distribution proposal would vitiate much of the benefits of Congress' decision in the 1999 Act to lower the 95% distribution requirement to 90%. To avoid the 4% excise tax, REITs very well could be compelled to distribute more than necessary during a taxable year because they would not have the necessary information to estimate 98% of their taxable income. This would be the opposite of what Congress authorized by restoring the 90% distribution requirement.[1] Accordingly, NAREIT strongly opposes this provision.

II. CLOSELY HELD REITS

Background and Current Law. As discussed above, Congress created REITs to make real estate investments easily and economically accessible to the small investor. To carry out this purpose, Congress mandated two rules to ensure that REITs are widely held. First, five or fewer individuals cannot own more than 50% of a REIT's stock.[2] In applying this test, most entities owning REIT stock are "looked through" to determine the ultimate ownership of the stock by individuals. Second, at least 100 persons (including corporations and partnerships) must be REIT shareholders. Neither test apply during a REIT's first taxable year, and the "five or fewer" test only applies in the last half of each subsequent taxable year of the REIT.

Budget Proposal. The Administration appears to be concerned about non-REITs establishing "captive REITs" and REITs engaging in transactions which the Administration finds abusive, such as the "liquidating REIT" structure curtailed by the 1998 budget legislation.[3] The Budget proposes changing the "five or fewer" test by imposing an additional requirement. The proposed new rule would prevent any "person" (i.e., a corporation, partnership or trust, including a pension or profit sharing trust) from owning stock of a REIT possessing 50% or more of the total combined voting power of all classes of voting stock or 50% or more of the total value of shares of all classes of stock. Certain existing REIT attribution rules would apply in determining such ownership, and the proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action.

NAREIT Analysis and Position. NAREIT agrees that the REIT structure is meant to be widely held and that it should not be used for abusive tax avoidance purposes. Therefore, NAREIT supports the intent of the proposal. Nevertheless, we are concerned that the Budget proposal casts too broad a net. A limited number of exceptions are needed to allow certain "entities" to own a majority of a REIT's stock. For instance, NAREIT certainly agrees with the Administration's decision to exclude a REIT's ownership of another REIT's stock from the proposed new ownership limit.[4] NAREIT would like to work with Congress and the Administration to ensure that any action to curb abuses does not disallow transactions necessary to foster the future REIT marketplace and to recognize the widely held nature of certain non-REIT entities.

First, an exception should be allowed to enable a REIT's organizers to have a single large investor for a temporary period, such as in preparation for a public offering of the REIT's shares. Such an "incubator REIT" sometimes is majority owned by its sponsor to allow the REIT to accumulate a track record that will facilitate its going public. The Budget proposal is silent on this important approach which, in turn, could curb the emergence of new publicly traded REITs in which small investors may invest. NAREIT supports the incubator REIT exception that was included as part of the Taxpayer Refund and Relief Act of 1999.[5]

Second, there is no reason why a partnership, mutual fund, pension or profit-sharing trust or other pass-through entity should be counted as one entity in determining whether any "person" owns 50% of the vote or value of a REIT. A partnership, mutual fund or other pass-through entity usually is ignored for federal tax purposes. The partners in a partnership and the shareholders of a mutual fund or other pass-through entity should be considered the "persons" owning a REIT for purposes of any limits on investor ownership. Similarly, the Code already has rules preventing a "pension held" REIT from being used to avoid the unrelated business income tax rules, and therefore the new ownership test should not apply to pension or profit-sharing plans.[6] Instead, NAREIT suggests that the new ownership test apply only to non-REIT C corporations that own more than 50% of a REIT's stock.[7] NAREIT is encouraged by the Budget's proposal for a "limited look-through rule" for partnerships, and suggests that any such rule be flexible enough to provide for the typical allocations used by real estate partnerships, such as preferred returns.

Third, none of the transactions identified by the Administration have involved publicly traded REITs. Such REITs must divulge information to the Securities and Exchange Commission that is then available to all. This "Sunshine" exposure typically is antithetical to tax shelters, and there is no reason to expect that such public attention should not work in this case. In fact, there does not appear to be a single example of a publicly-traded REIT serving as a tax avoidance vehicle. Therefore, NAREIT recommends that any closely held REIT legislation contain an exception for a REIT the stock of which is regularly traded on an established securities market, so long as no entity owns 80% or more of the vote or value of its common stock. NAREIT would support certain limits on this exception that would ensure that it would not be used for tax avoidance purposes. This exception would allow one entity to acquire a majority of the common stock of a public traded REIT for business purposes, such as forcing a change in strategy or certain types of takeover transactions.

III. BROWNFIELDS EXPENSING

Background. Under the Taxpayer Relief Act of 1997, certain remediation costs are currently deductible if incurred with respect to a "qualified contaminated site" (a "Brownfields" site). As part of the 1999 Act, this provision was extended for one year to allow deductions for expenditures paid or incurred on or before December 31, 2001.

Budget Proposal. The Budget would extend permanently the ability to deduct remediation expenses for Brownfields sites.

NAREIT Position. NAREIT applauds the Administration for proposing a permanent extension of current deductions for Brownfields remediation expenses. In addition, NAREIT encourages the Administration and other policymakers to consider the tremendous potential remediation that could occur at contaminated sites if the extension were expanded to properties that do not currently fit within the exact definition of a "qualified contaminated site," but are nevertheless in need of significant environmental remediation. NAREIT supports the Brownfields expansion contained in S. 1792, the Senate version of the Taxpayer Refund and Relief Act of 1999, and urges Congress to enact such provision this year.

NAREIT thanks the Committee for the opportunity to comment on these important proposals.

ENDNOTES

[1] Since REITs likely would distribute extra amounts during a taxable year so the excise tax would not be imposed, it is unclear how this provision would raise any revenues. We note that the 90% rule was scored in the 1999 Act as a revenue raiser, so that any proposal such as that contained in the Budget that would deter a REIT from paying corporate taxes on its undistributed amounts would appear to be a revenue loser.

[2] I.R.C. § 856(h)(1). There is no apparent reason why the proposed ownership test similarly should not be aimed at limiting more than 50% stock ownership, rather than 50% or more as now proposed.

[3] NAREIT supported the Administration's and Congress' move to limit the tax benefits of liquidating REITs.

[4] If the proposed test remains applicable to all persons owning more than 50% of a REIT's stock, then Congress should apply the exception for a REIT owning another REIT's stock by examining both direct and indirect ownership so as not to preclude an UPREIT owning more than 50% of another REIT's stock. NAREIT supports the rule providing such clarification that was contained in the Taxpayer Refund and Relief Act of 1999.

[5] NAREIT recommends that the 10% annual growth requirement contained in the Taxpayer Refund and Relief Act of 1999 as proposed section 856(l)(4)(v) be replaced with a requirement that the REIT not lease more than half of its properties to the principal owner of the REIT's stock.

[6] NAREIT supports the pension plan look-through rule contained in the Taxpayer Refund and Relief Act of 1999.

[7] As under the current "five or fewer" test, any new ownership test should not apply to a REIT's first taxable year or the first half of subsequent taxable years. See I.R.C. §§ 542(a)(2) and 856(h)(2).

STATEMENT OF PRICEWATERHOUSECOOPERS

I. INTRODUCTION

PricewaterhouseCoopers appreciates the opportunity to submit this statement to the Committee on Finance for the record of its February 9, 2000, hearing on the proposals in the Administration's FY 2001 budget. This statement specifically addresses the Administration's general proposals regarding "corporate tax shelters."

PricewaterhouseCoopers, the world's largest professional services organization, provides a full range of business advisory services to corporations and other clients, including audit, accounting, and tax consulting. The firm, which has more than 6,500 tax professionals in the United States and Canada, works closely with thousands of corporate clients worldwide, including most of the companies comprising the Fortune 500. These comments reflect the collective experiences of many of our corporate clients.

We respectfully urge the Committee to reject the Administration's general "corporate tax shelter" proposals. We believe no justification has been presented that would support enactment of such sweeping changes. Economic data does not suggest any systemic erosion of the corporate income tax base attributable to tax shelters. Current-law administrative tools, if used properly, are more than adequate to detect and penalize abuses. Further, the Administration's proposals are at odds with sound tax policy principles and efficient tax administration, would threaten legitimate tax-planning activities undertaken by corporate tax professionals, and would exacerbate the complexity of the tax code.

II. THE ADMINISTRATION'S "CORPORATE TAX SHELTER" PROPOSALS

The Administration's latest general proposals regarding "corporate tax shelters," included in its FY 2001 budget, reflect a number of modifications to the proposals originally advanced in the Administration's FY 2000 budget. These modifications, which were discussed in the Treasury Department's "White Paper"[1] released in July, generally narrowed the scope of the original proposals. For example, the Administration dropped proposals to eliminate the reasonable cause exception to the accuracy-related penalty and to disallow deductions for fees paid to tax shelter promoters and advisors.

Surprisingly, Treasury estimates that its FY 2001 corporate tax shelter proposals, even though narrower in scope, would raise significantly more revenue than its previous proposals. The prior proposals were estimated by Treasury to raise $1.5 billion over five years. The new proposals are estimated to raise nearly five times as much—$7.3 over five years and $14.5 over ten years. It is difficult to understand this upward re-estimate, especially given the significant victories (discussed further below) won by the Internal Revenue Service (IRS) in the courts over the past year, which have strengthened the hand of the government in challenging aggressive tax positions taken by corporations. These court decisions presumably would operate to reduce the revenues that could be generated by further legislative changes.

Before turning to specific concerns over the Administration's proposals, we want to restate a general observation. Like individual taxpayers, corporations have the right to seek legitimate minimization of tax liabilities, i.e., to pay no more in taxes than the tax law demands.[2] Indeed, corporate executives have a fiduciary duty to preserve and increase the value of a corporation for its shareholders. Some commentators decry this responsibility, termed "profit center activity" in current management parlance. We disagree. Responsible minimization of taxes in conjunction with the business activity of a corporation is an important function of corporate executives and one that long has been viewed as consistent with sound policy objectives.[3]

The following are our specific comments on the Administration's proposals.

A. Increase Disclosure with Respect to Certain Reportable Transactions

Summary

The proposal would require a corporation to disclose a transaction that has "significant tax benefits" if it has some combination of the following "filters": (1) a book/tax difference in excess of a certain amount; (2) a rescission clause, unwind clause, insurance, or similar arrangement; (3) involvement with a tax-indifferent party; (4) contingent advisor fees in excess of a certain amount; (5) the offering of the transaction to multiple taxpayers; and (6) a difference between the form of the transaction and how it is reported. Disclosure would be made on a short form or statement filed with the return; the form or statement would have to be signed by a corporate officer who has, or should have, knowledge of the transaction. Failure to disclose would subject the taxpayer to a penalty of $100,000 per failure.

Comment

This proposal would create considerable uncertainties for taxpayers seeking to determine whether disclosure is required. Consider, for example, the proposed requirement to disclose transactions that are reported differently from their form. Does "form" refer to the label given to the transaction or instrument, or does it refer to the rights and liabilities set forth in the documentation? For example, if an instrument is labeled debt, but has features in the documentation typically associated with an equity interest, is the form debt or equity? What if the taxpayer reasonably believed that it was reporting the transaction in accordance with its "form," but later interpretations of "form" suggested that it had not so reported the transaction? Furthermore, it is unclear how a company would know whether the tax consequences of a transaction constitute a "significant tax benefit," a term that is not defined by Treasury.

The disclosure requirement would be redundant in a number of respects. First, companies already are required to account for book/tax differences on Schedule M of the corporate income tax return. Treasury has not indicated why a second level of reporting of these differences is necessary. Second, the disclosure requirements would overlap with tax shelter reporting requirements enacted by Congress in 1997.[4] More than two years later, the Treasury Department has yet to take the steps necessary to implement the new tax shelter reporting rules.

The proposed disclosure requirement would add significantly and unnecessarily to the burdens already shouldered by corporate tax officials.[5] Companies would be forced to report thousands of transactions and arrangements in order to guard against the $100,000 penalty for failure to report. Remarkably, this penalty would be imposed on the taxpayer regardless of whether the the taxpayer's treatment of the unreported transaction is sustained. Examples of commonplace transactions that presumably would have to be reported would include purchases of equipment that qualifies for accelerated depreciation, thus creating a book-tax difference, and transactions with foreign companies—hardly a rarity in today's global economy—and other "tax-indifferent parties." It would be patently unfair to assess a tax shelter penalty for nondisclosure of legitimate transactions.

The utility to the IRS of this flood of information is questionable. By point of reference, the United Kingdom last year dropped a proposal made by the Labor Party in 1997 that would have imposed a "general anti-avoidance rule" to counter perceived tax avoidance in the corporate sector. The proposal was dropped, in part, because of concerns that arose over Inland Revenue's ability to process reports that UK corporate taxpayers would have been forced to file with respect to transactions in order to have any certainty that the tax treatment would be respected. Similar difficulties surely would arise for the IRS if the Administration's proposals were enacted.

B. Modify Substantial Understatement Penalty for Corporate Tax Shelters

Summary

The substantial understatement penalty imposed on corporate tax shelter items generally would be increased to 40 percent (reduced to 20 percent if the taxpayer discloses). The reasonable cause exception would be retained, but narrowed with respect to transactions deemed to constitute a corporate tax shelter—for these transactions, taxpayers would have to have a "strong" probability of success on the merits and to make disclosure.

For this purpose, a "corporate tax shelter" would be defined as any entity, plan, or arrangement in which a corporate participant attempts to obtain a tax benefit (other than those clearly contemplated in the Tax Code) in a "tax avoidance transaction." A "tax avoidance transaction" would be defined generally as any transaction in which the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits. A financing transaction would be considered a tax avoidance transaction if the present value of the tax benefits of the taxpayer to whom the financing is provided significantly exceed the present value of the pre-tax profit or return of the person providing the financing.

Comment

This proposal is inconsistent with the goals of rationalizing penalty administration. If the proposal were enacted, an IRS agent proposing a different treatment of a tax shelter item than on the taxpayer's return would feel compelled to impose a penalty even if the agent determines that (1) there is substantial authority supporting the return position taken by the taxpayer, and (2) the taxpayer reasonably believed (based, for example, on the opinion or advice of a qualified tax professional) that its tax treatment of the item was more likely than not the proper treatment. It is doubtful that the agent would decline to impose the penalty based on the taxpayer's arguing that its position had had a "strong probability of success," an undefined term setting an unrealistically high threshold. Indeed, one might question how a return position that was challenged successfully could ever be shown to have had a strong probability of success.

The near-automatic nature of the proposed increased penalty would alter substantially the dynamics of the current process by which the vast majority of disputes between the IRS and corporate taxpayers are resolved administratively. Today, even where a corporation and the IRS agree that there is a substantial understatement of tax attributable to a tax shelter item, the determination as to whether the substantial understatement penalty should be waived for reasonable cause continues to focus on the merits of the transaction and the reasonableness of the taxpayer's beliefs regarding those merits. If, however, the reasonable cause exception no longer were effectively available, the parties necessarily would have to focus on whether the transaction in question was a "tax avoidance transaction" and other definitional issues unrelated to the underlying merits of the transaction.

The proposal also runs directly counter to the goal of maintaining transparency (i.e., the ability for a taxpayer to determine the tax rules applicable to transactions) in our tax system. The inclusion of so many subjective concepts in the definition of "tax-avoidance transaction" precludes it from being an objective test. As an initial matter, what constitutes the "transaction" for purposes of this test? Next, what are the parameters for "reasonable expectation" in terms of both pre-tax economic profit and tax benefits? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits? Given these ambiguities, this definition would threaten to sweep in legitimate transactions undertaken in the ordinary course of business, such as financing transactions, capital restructuring transactions, and corporate reorganizations. It also could sweep in many start-up ventures—how many "dot coms" can be said to have a reasonable expectation of profit? It is safe to say that it is highly unlikely that this definition would be applied uniformly by IRS agents.

The difficulty of defining "corporate tax shelter" is highlighted when one compares Treasury's FY 2000 and FY 2001 "Green Book" descriptions of the Administration's revenue proposals. Some proposals (e.g., a proposal to modify the treatment of "built-in losses") that were characterized as targeting "corporate tax shelter" transactions in Treasury's FY 2000 Green Book no longer are characterized as such in Treasury's FY 2001 Green Book. Conversely, some proposals (e.g., a proposal to amend the "80/20" company rules) that were not characterized as targeting "corporate tax shelter" transactions in the FY 2000 Green Book are now characterized as such in the FY 2001 Green Book. This inconsistency illustrates the inherent difficulties in the Administration's proposed definition.

Finally, it should be noted that the proposed 40-percent penalty rate is out of line with other penalty rates in the tax code.

C. Codify the Economic Substance Doctrine

Summary

The proposal would disallow tax benefits from any "tax avoidance transaction," as defined in B., above.

Comment

While couched as merely codifying an existing common-law doctrine, the proposal would have the plain effect of encouraging IRS agents to challenge taxpayer positions that meet the objective rules provided by Congress and set forth in the tax code. Given the loose definition of "tax avoidance transaction," the proposal essentially would grant IRS agents unfettered authority to disallow deductions, credits, exclusions, or other allowances where they see fit. This power could be invoked without regard to the legitimacy of the taxpayer's business purposes for entering into the transaction. If a transaction is viewed as too tax efficient, it could be challenged on those grounds alone. As a result, audits would become more protracted, and corporate tax officials would find it impossible to rely on the statute in planning transactions.

The proposed disallowance rule strongly resembles a test that was included in the new U.S.-Italy Income Tax Treaty and the new U.S.-Slovenia Income Tax Treaty that drew strong criticism last year from the staff of the Joint Committee on Taxation ("JCT"). "Main purpose" tests in the treaties as proposed would have denied treaty benefits (e.g., reduced withholding rates on dividends) if the main purpose of a taxpayer's transaction is to take advantage of treaty benefits. The JCT staff correctly raised policy objections to this proposed test:

> The new main purpose tests in the proposed treaty present several issues. The tests are subjective, vague and add uncertainty to the treaty. It is unclear how the provisions are to be applied. — This uncertainty can create planning difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty. — This is a subjective standard, dependent on the intent of the taxpayer, that is difficult to evaluate. — It is also unclear how the rule would be administered. — In any event, it may be difficult for a U.S. company to evaluate whether its transaction may be subject to Italian main purpose standards.[6]

These very same objections—"vague," "subjective," "difficulties for legitimate business transactions"—apply equally to Treasury's proposed definition of "tax-avoidance transaction." In light of concerns raised by the JCT staff and the Senate Foreign Relations Committee, the Senate last year approved the treaties subject to a "reservation" that has the effect of eliminating the "main purpose" test.

It would be inappropriate for the Congress to hand the IRS this authority to deny tax benefits at this time, less than two years after Congress enacted significant new limitations[7] on the authority of IRS agents in audit situations. Congress also should note that Treasury and the IRS could use the authority that would be provided under this proposal to make changes administratively that Congress has not seen fit to make legislatively. For example, Treasury in its FY 1999 budget proposals asked for expansive authority to "set forth the appropriate tax results" and "deny tax benefits" in hybrid transactions.[8] Congress dismissed this proposal. The FY 2001 budget proposals now ask for authority of the same type but significantly broader than the authorization that Congress rejected. The Treasury's new proposals thus can be seen as an attempted end run around earlier failed initiatives—this time accompanied by the shibboleth of "stopping tax shelters."

D. Impose a Penalty Excise Tax on Certain Fees Received from Corporate Tax Shelters

Summary

The proposal would impose a 25-percent excise tax on fees received in connection with promoting or rendering tax advice related to corporate tax shelters.

Comment

The imprecise definition of a corporate tax shelter transaction would make it difficult for professional tax advisers to determine the circumstances under which this provision would apply. The substantive burdens of interpreting and complying with the statute and the administrative problems that taxpayers and the IRS would face cannot be overstated.

Further aggravating the complexity and burdens that are imbedded in this proposal is the fact that the ultimate determination that a particular transaction was a corporate tax shelter may not be made until several years after the fees are paid. In that situation, issues arise as to when the excise tax is due, whether the applicable statute of limitations has expired, and whether and upon what date interest would be owed on the liability.

More fundamentally, the creation of the proposed excise tax subjects tax advisors to an entirely new and burdensome tax regime, a regime that again shifts the focus away from the substantive tax aspects of the transaction to unrelated definitional and computational issues. It is also unclear who would administer or enforce this new tax regime. For instance, if the existence of a tax shelter is determined as a result of an income tax examination of a corporation, would the revenue agents conducting that examination have jurisdiction over a resulting excise tax examination of the taxpayer's tax adviser? Would the income tax and excise tax examinations be conducted concurrently? How would conflicts of interest between the taxpayer and the adviser be identified and handled? These are only a few of the serious real-world issues that would have to be resolved to administer an inherently vague and cumbersome proposal.

Finally, the real possibility exists that the effect of the proposal may be to deter certain taxpayers from seeking and obtaining necessary advice and guidance from a qualified tax professional in many transactions where the broad and vague scope of the prohibition calls into question the ultimate deductibility of fees. In many such cases, it is likely that qualified tax advice would have either convinced the taxpayer that it would be unwise or improper to enter into the transaction, or resulted in the restructuring of the transaction so as to bring it within full compliance with the letter and spirit of the internal revenue laws.

E. Tax Income from Corporate Tax Shelters Involving Tax-Indifferent Parties

Summary

Any income allocable to a "tax-indifferent party" (e.g., a foreign person; a foreign, State, or local government; a Native American tribal organization; a tax-exempt organization) with respect to a corporate tax shelter would be taxable to that party. The corporate participants in the transaction would be jointly and severally liable for the tax.

Comment

Treasury itself has conceded that this proposal "may be difficult to administer."[9]

This overreaching Treasury proposal cannot be justified on any tax policy grounds. The proposal ignores the fact that many businesses operating in the global economy are not U.S. taxpayers, and that in the global economy it is increasingly necessary and common for U.S. companies to enter into transactions with such entities. The fact that a tax-exempt person earns income that would be taxable if instead it had been earned by a taxable entity surely cannot in and of itself be viewed as objectionable.

Moreover, as it applies to foreign persons in particular, the proposal is overbroad in two significant respects. First, treating foreign persons as tax-indifferent ignores the fact that in many circumstances they may be subject to significant U.S. tax, either because they are subject to the withholding tax rules, because they are engaged in a U.S. trade or business, or because their income is taxable currently to their U.S. shareholders. Second, limiting the collection of the tax to parties other than treaty-protected foreign persons does not hide the fact that the tax-indifferent party tax would constitute a significant treaty override.

III. ARGUMENTS AGAINST SWEEPING CHANGES

A. The Myth of the Eroding Corporate Income Tax Base

The Treasury Department has cited as justification for its proposals a possible erosion of corporate income tax revenues attributable to "corporate tax shelters," but has not presented any evidence to support this concern. Rather, Treasury has cited statements made Joseph Bankman of Stanford University that "corporate tax shelters" are responsible for $10 billion in lost corporate income tax revenues each year. Bankman essentially admits he has no data supporting his $10 billion figure in his Internet tax policy chatroom,[10] where he answers a question from a reader as to the references for his $10 billion figure as follows: "The $10 billion figure that I am quoted on is obviously just an estimate." This unsubstantiated claim hardly represents the type of serious economic analysis that should be undertaken before adopting sweeping tax policy changes of the scope envisioned by Treasury.

An analysis of actual data shows no evidence of a loss of corporate income tax revenues attributable to shelter activities. Since 1992, corporate federal income tax payments have grown by more than 80 percent, from $100.3 billion in fiscal 1992 to $184.7 billion in fiscal 1999 (see Appendix 1). By point of comparison, GDP has grown by 44 percent over this period. Over the fiscal 1993-1999 period, corporate tax payments averaged 2.1 percent of GDP; only once in the preceding 1980-1992 period were corporate income tax payments higher in percentage terms (in 1980).

Despite the high level of tax payments in the post-1992 period, some commentators have pointed to a two-percent drop in federal corporate tax payments in fiscal 1999, as compared to the prior year, as possibly indicating corporate tax shelter activity.[11] This claim has been made despite the fact that corporate tax payments as a percentage of GDP in fiscal 1999 were higher than the average for the 1980-1999 period.

A possible explanation for this drop is a relative decline in corporate profits attributable to depreciation deductions associated with increased equipment investment and the increase in employee compensation relative to corporate profits.[12] The Congressional Budget Office in its January 2000 budget outlook noted depreciation as among the factors putting downward pressure on corporate profits.[13] It also should be noted that the slight falloff in corporate profits was not unforeseen—the Office of Management and Budget (OMB) last year projected that corporate income tax payments would fall in FY 1999, before rising again in FY 2000.[14] It should be further noted that actual corporate income tax payments for FY 1999 ultimately exceeded the OMB forecast by more than $2 billion.

In this section, we examine whether the recent dip in corporate income tax payments provides any evidence that "corporate tax shelter" activity is proliferating. After a thorough review of the data, including data from the IRS, the Bureau of Economic Analysis (BEA), and corporate financial statements, we find no basis for assertions that increased shelter activity has caused corporate tax burdens to fall.

1. Corporate tax liability and the timing of tax payments

Corporate tax payments received by the IRS during a given year fail to reflect that year's tax liability for several reasons. First, large corporate taxpayers frequently have five to ten "open" years for which final tax liability has not been determined. Thus, current corporate tax payments may include deficiencies (plus interest and penalties) for a number of prior tax years. Similarly, current corporate tax payments may be reduced by refunds arising from overpayments of corporate tax in a number of prior tax years. In addition, current tax payments may be reduced by previously unused net operating losses and tax credits that are carried forward from prior years. Thus, current data on corporate income tax payments received by the IRS are not a reliable indicator of current year tax liability; rather, current year tax receipts reflect a blend of current and past year tax liabilities, and are reduced by carryforwards of unused losses and credits from prior years.

Corporate tax payments

Monthly information on receipts of corporate income taxes by the U.S. Government is published by the Financial Management Service of the U.S. Treasury Department.[15]

The Treasury defines net corporate tax receipts in any month as gross receipts less refunds. Net corporate tax receipts were $185.0 billion in calendar year 1998 and $185.9 billion in 1999. Gross corporate tax receipts were $213.5 billion in 1998 and $217.0 billion in 1999. Net corporate tax receipts increased by a smaller amount than gross corporate tax receipts due to an increase in corporate tax refunds, from $28.5 billion in 1998 to $31.1 billion in 1999. Refunds can increase as a result of overpayments of estimated tax (which may occur when profits turn out to be lower than expected) or as a result of amendments to prior year tax returns (for example, when current year losses or credits are carried back to a prior tax year). Until the IRS tabulates tax return data for 1998 and 1999, it is not possible to determine the reason for the recent increase in refunds.

Corporate tax liability

For purposes of the National Income and Product Accounts, BEA makes current estimates of corporate tax liability based on IRS and other data. The IRS calculates annual corporate income tax liability by tabulating corporate tax returns (before audit). The most recent publicly available corporate income tax return information is for IRS years 1996 (i.e., tax years ending after June 1996 and before July 1997).[16]

In summary, it is important to distinguish between corporate tax liability and corporate tax receipts. Because corporate tax receipts are a mix of estimated tax payments for the current year as well as adjustments (both up and down) to taxes paid with respect to prior years, a drop in corporate tax receipts does not imply a drop in corporate tax liability. For example, in 1985, corporate tax receipts increased over the prior year at the same time that corporate tax liability decreased (see Appendix 2).

2. Effective tax rates: Commerce Department data

Corporate tax liability can be broken down into two components: (1) a reference measure of profits arising in the corporate sector; multiplied by (2) the effective tax rate (which is equal to corporate tax divided by reference profits). A decline in corporate tax liability can occur as a result of lower profits or, alternatively, as a result of a lower effective tax rate. A decline in corporate tax liability due to a fall in real corporate income is not, of course, evidence of tax shelter activity. By contrast, a decline in the effective tax rate may warrant investigation to determine if there is tax avoidance not intended by lawmakers.

Calculation of the effective corporate tax rate requires a measure of corporate income tax liability as well as a reference measure of corporate profits. Two data sources are used in this analysis: (1) the National Income and Product Accounts (NIPA) published by the U.S. Commerce Department; and (2) data from audited financial statements of public companies filed with the Securities and Exchange Commission (SEC) on Form 10K. Effective tax rate calculations based on NIPA data are described in this section; calculations based on SEC data are described in the following section.

One of the items used by BEA to calculate GDP is "corporate profits before tax."[17] This concept of profits includes income earned in the United States (whether by U.S. or foreign corporations) and excludes income earned outside the United States. For purposes of calculating an effective tax rate, several adjustments are made to "corporate profits before tax": (1) profits of the Federal Reserve Banks are subtracted; (2) profits of subchapter S corporations are subtracted; (3) payments of State and local income tax are subtracted; and (4) corporate capital gains are added. These adjustments follow the methodology developed by CBO to estimate "taxable corporate profits."[18] BEA estimates that corporate profits before tax, as adjusted, increased from $587 billion in calendar 1998 to $603 billion in 1999 (see Appendix 3).[19] As a percent of GDP, pre-tax corporate profits are estimated to have reached a post-1980 high of 7.0 percent in 1996, with a dip to 6.9 percent in 1997-1998, and a further dip to 6.8 percent in the first half of calendar 1999 on an annualized basis.

Based on adjusted NIPA data, the effective corporate tax rate, measured as federal corporate tax liability divided by corporate profits before federal income tax, is projected to be 32.7 percent in 1999, higher than the 31.2 percent rate in 1998 and higher than the 32.6 percent average for the 1993-1999 period (see Appendix 3). Thus, based on the National Income and Product Accounts, there is no evidence of a decline in the effective rate of corporate income tax.

3. Effective tax rates: SEC data

Corporate effective tax rates also can be estimated from the audited financial statements that publicly traded companies are required to file with the SEC. This method was used by the General Accounting Office in its 1992 study of corporate effective tax rates.[20] Following the GAO methodology, the effective corporate tax rate is measured by dividing the current provision for federal income tax into reported U.S. operating income, reduced by the current provision for State and local income tax. U.S. operating income is determined by subtracting foreign operating income from total operating income net of depreciation, based on geographic segment reporting.

Standard & Poors publishes SEC 10K data in its Compustat database, which is updated monthly.[21] Based on the August 1999 Compustat data release, effective corporate tax rates were calculated for the 1988-1998 period using information from every corporation in the database that supplied all of the necessary data items. Recognizing that the results for 1998 might not be comparable to prior years due to the limited sample size, the effective tax rates for 1996 and 1997 were recomputed using information from the same companies as in the 1998 sample.

For purposes of this analysis we excluded publicly traded corporations and partnerships that are not generally taxable at the corporate level (i.e., mutual funds and real estate investment trusts). Separate calculations were made for companies that reported foreign activity (multinationals) and for companies that reported no foreign activity (domestics). A multinational's current provision for U.S. tax may include U.S. tax on foreign source income; consequently, measured relative to domestic income, the effective tax rate of U.S. multinationals may be higher than for comparable domestic firms. In theory, U.S. tax on foreign source income should be removed from the numerator of a domestic effective tax rate calculation; however, this adjustment cannot accurately be made with financial statement data.

The results of this analysis are shown in Appendix 4. For 1997, the most recent year for which annual reporting is complete, companies included in the Compustat sample report $78 billion of current federal income tax liability, accounting for over 40 percent of federal corporate tax liability in the National Income and Product Accounts. The Compustat sample of firms excludes private companies and public companies that do not report all of the items necessary to calculate the effective tax rate. While the average firm in Compustat is much larger than the average corporate taxpayer, the main purpose of our analysis is to examine the trend in effective corporate tax rates over time. We have no reason to believe that there is a systematic difference in trend effective tax rates between companies in Compustat and other corporate taxpayers. Indeed, if there were a proliferation of corporate tax shelter activity, we might expect to see indications of this first among the largest and most sophisticated corporations, of the type included in the Compustat sample.

In general, we find that the effective tax rates calculated from financial statement data are lower than those calculated from the National Income and Product Accounts. One reason for this is that the profit definition used for the NIPA calculations is based on tax depreciation, while the profit definition used for the financial statement calculations is based on book depreciation. Another reason is that the income element of nonqualified stock options is deductible for tax purposes when the option is excercised (and included in the employee's income), but is not treated as an expense against income for financial statement purposes. We also find that, on average, over the 1988-1998 period, effective federal tax rates are higher for multinational corporation than for domestic corporations.

Based on financial statement data, the corporate effective tax rate for all corporations (domestic and multinational) was higher in 1997 (19.9 percent) than the average over the ten-year period 1988-1997 (18.5) percent, and for the sample of companies reporting financial results for 1998, the effective tax rate increased between 1997 (19.4 percent) and 1998 (20.7 percent).[22]

In summary, based on audited financial statements, there is no evidence for a decline in the effective corporate tax rate. This is consistent with our findings using National Income and Product Account data.

4. Corporate capital gains

One category of corporate "tax shelter" that has received recent attention is the use of transactions designed to avoid tax on capital gains. Indeed, one commentator believes these transactions are so prevalent that the tax on corporate capital gains has essentially been rendered "elective."[23] If this assessment of the corporate income tax system were accurate, we would expect to see a marked decline in corporate capital gain realizations in recent years.

The IRS data, however, do not support the view that corporations easily can avoid tax on capital gains. Excluding mutual funds, net corporate gain on capital assets increased by 54 percent from $53 billion in 1992 to $82 billion in 1996 (the most recent year for which IRS data is available)-an average annual increase of 11.5 percent per year (see Appendix 5). In short, notices of the death of the corporate capital gains tax are premature.

5. Conclusion

If unusually high levels of corporate tax shelter activity have been occurring over the last few years, we would expect to see a drop in corporate tax liability relative to normative measures of pre-tax corporate income. To test this hypothesis, we measure corporate effective tax rates using data from the National Income and Product Accounts and audited financial statements. Neither measure shows a suspicious drop in tax liabilities relative to corporate income; to the contrary, both measures show flat or rising corporate effective tax rates over the last five years. Moreover, if corporate capital gains tax was easily avoidable using tax shelter techniques, we would expect to see little or no growth in net capital gains reported on corporate tax returns. Again, the data disprove this hypothesis, showing instead a robust rate of increase over the most recent four-year period for which data are available.

B. Efficacy of Current-Law Tools

Proponents of extensive new legislation to address "corporate tax shelters" overlook the formidable array of tools currently available to the government to deter and attack transactions considered as abusive. In our view, the tools described below are more than sufficient to achieve compliance with the corporate income tax. That is, these tools enable the IRS and courts to ensure that corporations pay the corporate income tax liability that results from application of the Internal Revenue Code.

1. Threat of penalties

As an initial matter, the tax Code includes significant disincentives to engage in potentially abusive behavior. Present law imposes 20-percent accuracy-related penalties under section 6662 in the case of negligence, substantial understatements of tax liability, and certain other cases. In considering a proposed transaction that may turn on a debatable reading of the tax law, a corporate tax executive must weigh the potential for imposition of these penalties, which could have a negative impact on shareholder value and on the corporation.

Furthermore, it should be noted that Congress, in the 1997 Taxpayer Relief Act, strengthened the substantial understatement penalty as it applies to "tax shelters." Under this change, which was supported and encouraged by the Treasury Department, an entity, plan, or arrangement is treated as a tax shelter if it has tax avoidance or evasion as just one of its significant purposes.[24] The Congress believed that this change, coupled with new reporting requirements that Treasury has failed to activate, would "improve compliance by discouraging taxpayers from entering into questionable transactions."[25] Although this change is effective for current transactions, the IRS and Treasury have not yet issued regulations providing guidance on the term "significant purpose."

The 1997 Act changes have made it even more important for chief tax executives to weigh carefully the risks of penalties and even more difficult to determine which transactions might trigger penalties. At this time, there is no demonstrated justification for making these penalties even harsher.

2. Anti-abuse rules

The Code includes numerous provisions that arm Treasury and the IRS with broad authority to prevent tax avoidance, to reallocate income and deductions, to deny tax benefits, and to ensure taxpayers clearly report income.

These rules long have provided powerful ammunition for challenging tax avoidance transactions. For example, section 482 authorizes the IRS to reallocate income, deductions, credits, or allowances between controlled taxpayers to prevent evasion of taxes or to clearly reflect income. While much attention has been focused in recent years on the application of section 482 in the international context, section 482 also applies broadly in purely domestic situations. Further, the IRS also has the authority to disregard a taxpayer's method of accounting if it does not clearly reflect income under section 446(b).

In the partnership context, the IRS has issued regulations under subchapter K aimed at arrangements the IRS considers as abusive.[26] The IRS states that these rules authorize it to disregard the existence of a partnership, to adjust a partnership's methods of accounting, to reallocate items of income, gain, loss, deduction, or credit, or otherwise to adjust a partnership's or partner's tax treatment in situations where a transaction meets the literal requirements of a statutory or regulatory provision, but where the IRS believes the results are inconsistent with the intent of the Code's partnership tax rules.

The IRS also has issued a series of far-reaching anti-abuse rules under its legislative grant of regulatory authority in the consolidated return area. For example, under Treas. Reg. Sec. 1.1502-20, a parent corporation is severely limited in its ability to deduct any loss on the sale of a consolidated subsidiary's stock. The consolidated return investment basis adjustment rules also contain an anti-avoidance rule.[27] The rule provides that the IRS may make adjustments "as necessary" if a person acts with "a principal purpose" of avoiding the requirements of the consolidated return rules. The consolidated return rules feature several other anti-abuse rules as well.[28]

3. Common-law doctrines

Pursuant to several "common-law" tax doctrines, Treasury and the IRS can challenge a taxpayer's treatment of a transaction if they believe the treatment is inconsistent with statutory rules and the underlying Congressional intent. For example, these doctrines may be invoked where the IRS believes that (1) the taxpayer has sought to circumvent statutory requirements by casting the transaction in a form designed to disguise its substance, (2) the taxpayer has divided the transaction into separate steps that have little or no independent life or rationale, (3) the taxpayer has engaged in "trafficking" in tax attributes, or (4) the taxpayer improperly has accelerated deductions or deferred income recognition.

These broadly applicable doctrines—known as the business purpose doctrine, the substance over form doctrine, the step transaction doctrine, and the sham transaction and economic substance doctrine—give the IRS considerable leeway to recast transactions based on economic substance, to treat apparently separate steps as one transaction, and to disregard transactions that lack business purpose or economic substance. Recent applications of those doctrines have demonstrated their effectiveness and cast doubt on Treasury's asserted need for additional tools.

The recent decisions in ACM v. Commissioner[29] and ASA Investerings v. Commissioner[30] illustrate the continuing force of these long-standing judicial doctrines. In ACM, the Third Circuit, affirming the Tax Court, relied on the sham transaction and economic substance doctrines to disallow losses generated by a partnership's purchase and resale of notes. The Tax Court similarly invoked those doctrines in ASA Investerings to disallow losses on the purchase and resale of private placement notes. Both cases involved complex, highly sophisticated transactions, yet the IRS successfully used common-law principles to prevent the taxpayers from realizing tax benefits from the transactions.

More recent examples of use of common-law doctrines by the IRS are the Tax Court's decisions in United Parcel Service v. Commissioner[31] (8/9/99), Compaq Computer Corp. v. Commissioner[32] (9/21/99), and Winn-Dixie v. Commissioner[33] (10/19/99). In United Parcel Service, the court agreed with the IRS's position that the arrangement at issue—involving the taxpayer, a third-party U.S. insurance company acting as an intermediary, and an offshore company acting as a reinsurer—lacked business purpose and economic substance. In Compaq, the court agreed with the IRS's contention that the taxpayer's purchase and resale of certain financial instruments lacked economic substance and imposed accuracy-related penalties under section 6662(a). In Winn-Dixie, the court held that an employer's leveraged corporate-owned life insurance program lacked business purpose and economic substance.

This recent line of cases and the IRS's increasingly successful use of common-law doctrines in these cases argue against any need for expanding the IRS's tools at this time or (as the Treasury Department has suggested) for codifying the doctrines.

4. Treasury action

Treasury on numerous occasions has issued IRS Notices stating an intention to publish regulations that would preclude favorable tax treatment for certain transactions. Thus, a Notice allows the government (assuming that the particular action is within Treasury's rulemaking authority) to move quickly, without having to await development of the regulations themselves—often a time-consuming process—that provide more detailed rules concerning a particular transaction.

Examples of the use of this authority include Notice 97-21, in which the IRS addressed multiple-party financing transactions that used a special type of preferred stock; Notice 95-53, in which the IRS addressed the tax consequences of "lease strip" or "stripping transactions" separating income from deductions; and Notices 94-46 and 94-93, addressing so-called "corporate inversion" transactions viewed as avoiding the 1986 Act's repeal of the General Utilities doctrine.[34]

Moreover, section 7805(b) of the Code expressly gives the IRS authority to issue regulations that have retroactive effect "to prevent abuse." Although many Notices have set the date of Notice issuance as the effective date for forthcoming regulations,[35] Treasury has used its authority to announce regulations that would be effective for periods prior to the date the Notice was issued.[36] Alternatively, Treasury in Notices has announced that it will rely on existing law to challenge abusive transactions that already have occurred.[37]

5. Targeted legislation

To the extent that Treasury and the IRS may lack rulemaking or administrative authority to challenge a particular type of transaction, one other highly effective avenue remain open—that is, enactment of legislation. In this regard, over the past 30 years dozens upon dozens of changes to the tax code have been enacted to address perceived abuses. For example, Congress last year enacted legislation (H.R. 435) addressing "basis-shifting" transactions involving transfers of assets subject to liabilities under section 357(c).

These targeted legislative changes often have immediate, or even retroactive, application. The section 357(c) provision, for example, was made effective for transfers on or after October 19, 1998—the date House Ways and Means Committee Chairman Bill Archer introduced the proposal in the form of legislation. Chairman Archer took this action, in part, to stop these transactions earlier than would have been accomplished under the effective date originally proposed by Treasury (the date of enactment).

C. IRS National Office Activities Regarding "Corporate Tax Shelters"

The question whether broad legislative action regarding "corporate tax shelters" is warranted at this time should be considered in view of current administrative initiatives now being undertaken at the IRS. Larry Langdon, Commissioner of the IRS's new Large and Mid-Size Business Division, has announced that the IRS is establishing a special office to coordinate IRS efforts to address corporate tax shelter issues.[38] The new office will allow for quick communication between IRS examiners, the IRS Chief Counsel, and the Treasury Department in identifying and addressing abuses. These IRS efforts will serve as a strong deterrent to abusive transactions and further call into question the need for legislative action at this time.

IV. CONCLUSION

Congress should reject the broad legislative proposals regarding "corporate tax shelters" that have been advanced by the Treasury Department. The revenue and economic data indicate no need for these radical changes. Further, the proposals are completely unnecessary in light of the array of legislative, regulatory, administrative, and judicial tools available to curtail perceived abuses. Finally, these proposals would create an unacceptably high level of uncertainty and burdens for corporate tax officials while potentially imposing penalties on legitimate transactions undertaken in the ordinary course of business.

ENDNOTES

[1] The Problem of Corporate Tax Shelters, Department of the Treasury, July 1999.

[2] Individual taxpayers often undertake actions to obtain favorable tax treatment, but this alone is not considered a reason simply to disallow the benefits. For example, an individual holding an appreciated security may decide to hold it for sale until a particular date solely to obtain long-term capital gain treatment. Also, an individual may take out a home-equity loan to pay off credit-card debt because interest on the home loan can be tax deductible. As another example, an individual renting a home may decide to purchase it, viewing the tax benefits as a principal purpose for entering into the transaction. In such cases, Congress has not been concerned that the taxpayer acted out of tax motivations; the tax benefits still are allowed.

[3] Judge Learned Hand wrote: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions." Comm'r v. Newman, 159 F.2d 848, 850-851 (2d Cir. 1946) (dissenting opinion).

[4] Taxpayer Relief Act of 1997, P.L. 105-34.

[5] Of the $1.7 trillion in tax revenue collected by the federal government in FY 1998, corporate tax officials were responsible for remitting more than 50 percent.

[6] "Explanation of Proposed Income Tax Treaty and Proposed Protocol between the United States and the Italian Republic," October 8, 1999 (JCS-9-99); see also, "Testimony of the Staff of the Joint Committee on Taxation before the Senate Committee on Foreign Relations Hearing on Tax Treaties and Protocols with Eight Countries," October 27, 1999 (JCX-76-99).
[7] Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-208.
[8] General Explanation of the Administration's Revenue Proposals, Department of the Treasury, February 1998, p. 144.
[9] The Problem of Corporate Tax Shelters, supra n.1, at 114.
[10] http://www.law.nyu.edu/bankmanj/federalincometax
[11] See, Martin A Sullivan, "Despite September Surge, Corporate Tax Receipts Fall Short," 85 Tax Notes 565 (Nov. 1, 1999).
[12] See, New York Times, September 21, 1999, "When an Expense is Not an Expense." This article points to rising compensation paid in the form of stock options as a possible explanation. An increase in employee compensation increases personal income tax (at the employee level) at the expense of corporate income tax, because employee compensation generally is deductible in computing corporate income tax and includable in computing personal income tax.
[13] Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2001-2010, January 2000, p. 60.
[14] The Administration's FY 2000 budget projected that corporate income revenues would total $182.2 billion in FY 1999, or $2.5 billion less than actual.
[15] U.S. Dept. of the Treasury, Monthly Treasury Statement of Receipts and Outlays of the United States Government.
[16] See, IRS, Statistics of Income Bulletin, Winter 1998/1999.
[17] BEA makes two adjustments to this measure of corporate profits in determining GDP: (1) BEA uses an "economic" measure of depreciation rather than tax depreciation (i.e., the "capital consumption adjustment"); and (2) BEA removes inventory profits attributable to changes in price (i.e., the "inventory valuation adjustment"). Note that the BEA data uses in this report are based on information available as of October 1999 and do not reflect the subsequently released comprehensive revision of the National Income and Product Accounts (NIPA).
[18] See, Congressional Budget Office, The Shortfall in Corporate Tax Receipts Since the Tax Reform Act of 1986, CBO Papers, May 1992. The first adjustment reflects the fact that the Federal Reserve system is not subject to corporate income tax; the second adjustment is made because S corporations generally do not pay corporate level tax (rather the income is flowed through to the shareholders); the third adjustment is made because state and local income taxes are deductible in computing federal income tax; and the fourth adjustment is necessary because corporations are taxed on capital gains while GDP excludes capital gains.
[19] 1999 data are annualized based on the first six months of the year, seasonally adjusted.
[20] See, General Accounting Office, "1988 and 1989 Company Effective Tax Rates Higher Than in Prior Years," GAO/GGD-92-11, August 1992.
[21] Financial statements for companies with fiscal years ending after May of 1998, and before June of 1999, are classified as 1998 statements in Compustat. Because there is a lag between the end of a company's fiscal year and the time it files Form 10K, and another lag between the time the form is filed and the time it is processed by Standard & Poors, information for Compustat's 1998 year was incomplete as of August 1999.
[22] These results also generally hold up when effective tax rates are measured relative to U.S. assets or U.S. revenues. Among domestic-only firms, however, income has grown more slowly than either assets or revenues since 1995, with the result that the ratio of tax liability to either assets or revenues has declined slightly for companies without foreign operations.
[23] Michael Schler, as quoted in the September 1, 1999, Wall Street Journal "Tax Report," A1.
[24] Section 6662(d)(2)(C)(iii). Prior law defined tax shelter activity as an entity, plan, or arrangement only if it had tax avoidance or evasion as the principal purpose.
[25] General Explanation of Tax Legislation Enacted in 1997, Staff of the Joint Committee on Taxation, December 17, 1997 (JCS 23-97).
[26] Treas. Reg. § 1.701-2.
[27] Treas. Reg. § 1.1502-32(e).
[28] See, e.g., Treas. Reg. § 1.1502-13(h) (anti-avoidance rules with respect to the intercompany transaction provisions) and Treas. Reg. § 1.1502-17(c) (anti-avoidance rules with respect to the consolidated return accounting methods).

[29] 157 F.3d 231 (3d Cir. 1998). See also Saba Partnership, T.C.M. 1999-359 (10/27/99).
[30] T.C.M. 1998-305.
[31] T.C.M. 1999-268.
[32] 113. T.C. No. 17.
[33] 113. T.C. No. 21.
[34] The General Utilities doctrine generally provided for nonrecognition of gain or loss on a corporation's distribution of property to its shareholders with respect to their stock. See, General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). The General Utilities doctrine was repealed in 1986 out of concern that the doctrine tended to undermine the application of the corporate-level income tax. H.R. Rep. No. 426, 99th Cong., 1st Sess. 282 (1985).
[35] See, e.g., Notice 95-53, 1995-2 CB 334, and Notice 89-37, 1989-1 CB 679.
[36] See, e.g., Notice 97-21, 1997-1 CB 407.
[37] Notice 96-39, I.R.B. 1996-32.
[38] BNA Daily Tax Report, January 18, 2000, G-4.

APPENDIX 1

Corporate Income Tax Receipts, FY 1980-1999
[Billions of current dollars]

Fiscal year	GDP	Federal corporate income tax receipts	Corporate tax receipts as a percent of GDP
1980	$2,719	$64.6	2.4%
1981	$3,048	$61.1	2.0%
1982	$3,214	$49.2	1.5%
1983	$3,423	$37.0	1.1%
1984	$3,819	$56.9	1.5%
1985	$4,109	$61.3	1.5%
1986	$4,368	$63.1	1.4%
1987	$4,609	$83.9	1.8%
1988	$4,957	$94.5	1.9%
1989	$5,356	$103.3	1.9%
1990	$5,683	$93.5	1.6%
1991	$5,862	$98.1	1.7%
1992	$6,149	$100.3	1.6%
1993	$6,478	$117.5	1.8%
1994	$6,849	$140.4	2.1%
1995	$7,194	$157.0	2.2%
1996	$7,533	$171.8	2.3%
1997	$7,972	$182.3	2.3%
1998	$8,404	$188.7	2.2%
1999	$8,851	$184.7	2.1%
Period averages:			
1980-99	***$5,529.9***	***$105.5***	***1.9%***
1980-82	$2,993.7	$58.3	1.9%
1983-85	$3,783.7	$51.7	1.4%
1986-89	$4,822.5	$86.2	1.8%
1990-92	$5,898.0	$97.3	1.6%
1993-99	$7,611.6	$163.2	2.1%

Sources:

1. Congressional Budget Office, Historical Budget Data, The Economic and Budget Outlook: Fiscal Years 2000-2009, released January 1999.
2. Congressional Budget Office, The Economic and Budget Outlook: An Update, July 1999.
3. US Treasury Department, Monthly Treasury Statement, October 1999 and earlier issues.

APPENDIX 2

Federal Corporate Tax Liability and Receipts, 1980-1999
[Billions of dollars]

Calendar year	Federal corp. tax liability[1]	Federal corp. income tax receipts		
		Gross	Refunds	Net
1980	$58.6	$72.0	$8.6	$63.4
1981	$51.7	$75.1	$13.4	$61.7
1982	$33.9	$63.5	$19.5	$44.0
1983	$47.1	$64.6	$22.7	$41.9
1984	$59.1	$75.5	$16.9	$58.6
1985	$58.5	$78.7	$16.1	$62.6
1986	$66.0	$84.1	$17.8	$66.3
1987	$85.5	$105.2	$18.0	$87.2
1988	$93.6	$114.4	$16.0	$98.5
1989	$95.5	$113.9	$14.1	$99.8
1990	$94.4	$112.9	$15.9	$96.9
1991	$89.0	$112.9	$16.6	$96.4
1992	$101.8	$119.7	$16.6	$103.1
1993	$122.3	$137.3	$13.7	$123.6
1994	$136.2	$158.9	$14.7	$144.2
1995	$155.9	$180.4	$17.9	$162.5
1996	$172.9	$191.8	$19.8	$172.1
1997	$189.5	$211.1	$19.8	$191.3
1998	$183.2	$213.5	$28.5	$185.0
1999	$197.5[2]	$217.0	$31.1	$185.9

[1] Determined from the National Income and Product Accounts as profits before tax (domestic basis) minus profits of the Federal Reserve Banks minus state and local income taxes. See text for details.

[2] Federal corp. tax liability is seasonally adjusted at an annual rate based on first six months of the year.

Sources:

1. U.S. Commerce Department, Bureau of Economic Analysis, *Survey of Current Business*, October 1999. Note that the data do not reflect changes in the most recent comprehensive revision of the National Income and Product Accounts (NIPA), which came out after our study was completed.
2. U.S. Treasury Department, Monthly Treasury Summary, January 2000 and earlier issues.
3. PwC calculations.

APPENDIX 3

Effective Corporate Tax Rate, NIPA, 1980-1999
(Billions of dollars)

Calendar year	GDP	Corp. profits before tax (BEA adj.)[1]	Federal corp. tax liability (BEA adj.)	Federal corp. tax liability (BEA adj.) as a percent of corp. profits before tax	Corp. profits before tax (BEA adj.) as a percent of GDP
1980	$2,784.2	$200.8	$58.6	29.2%	7.2%
1981	$3,115.9	$193.6	$51.7	26.7%	6.2%
1982	$3,242.1	$142.9	$33.9	23.7%	4.4%
1983	$3,514.5	$181.1	$47.1	26.0%	5.2%
1984	$3,902.4	$212.3	$59.1	27.8%	5.4%
1985	$4,180.7	$215.4	$58.5	27.2%	5.2%
1986	$4,422.2	$238.0	$66.0	27.7%	5.4%
1987	$4,692.3	$255.9	$85.5	33.4%	5.5%
1988	$5,049.6	$305.2	$93.6	30.7%	6.0%
1989	$5,438.7	$290.0	$95.5	32.9%	5.3%
1990	$5,743.8	$281.1	$94.4	33.6%	4.9%
1991	$5,916.7	$287.3	$89.0	31.0%	4.9%
1992	$6,244.4	$317.8	$101.8	32.0%	5.1%
1993	$6,558.1	$369.5	$122.3	33.1%	5.6%
1994	$6,947.0	$399.5	$136.2	34.1%	5.8%
1995	$7,269.6	$499.9	$155.9	31.2%	6.9%
1996	$7,661.6	$537.6	$172.9	32.2%	7.0%
1997	$8,110.9	$559.7	$189.5	33.9%	6.9%
1998	$8,511.0	$587.3	$183.2	31.2%	6.9%
1999[2]	$8,873.4	$603.4	$197.5	32.7%	6.8%
		Period averages:			
1980-99	***$5,609.0***	***$333.9***	***$104.6***	***31.3%***	***6.0%***
1980-82	$3,047.4	$179.1	$48.1	26.8%	5.9%
1983-85	$3,865.9	$203.0	$54.9	27.1%	5.2%
1986-89	$4,900.7	$272.3	$85.1	31.3%	5.6%
1990-92	$5,968.3	$295.4	$95.1	32.2%	4.9%
1993-99	$7,704.5	$508.1	$165.4	32.5%	6.6%

[1]Figures for 1997-1999 are based on CBO fiscal year projections. Because actual corporate capital gains data were not available for 1980-82, imputations were used.
[2]Figures for 1999 are annualized based on first six months, seasonally adjusted.

Sources:

1. U.S. Commerce Department, Bureau of Economic Analysis, *Survey of Current Business*, October 1999. Note that the data are based on information available as of October 1999 and do not reflect the subsequently released comprehensive revision of the National Income and Product Accounts (NIPA).
2. U.S. Treasury Department, Monthly Treasury Summary, October 1999.
3. PwC Calculations

APPENDIX 4

U.S. Corporate Income Tax Liability per Audited Financial Statements, 1988-1998

[Dollar amounts in billions; Tax years ending after May of indicated year, and before July of following year]

Item	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	96Aug	97Aug	98Aug	Avg '88-97
A. Companies with foreign operations														
U.S. fed. inc. tax liability[1]	$25	$24	$25	$23	$23	$27	$34	$41	$42	$48	$19	$22	$24	$31
U.S. oper. inc. after state inc. tax	$127	$144	$138	$123	$128	$149	$181	$222	$231	$234	$89	$103	$105	$168
U.S. assets	$1,408	$1,587	$1,753	$1,904	$1,996	$1,988	$2,310	$2,433	$2,595	$2,494	$905	$1,050	$1,071	$2,047
U.S. revenues	$1,063	$1,212	$1,313	$1,371	$1,423	$1,373	$1,529	$1,745	$1,794	$1,770	$736	$817	$841	$1,459
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	19.9%	16.6%	18.2%	19.1%	18.3%	18.2%	19.0%	18.3%	18.4%	20.7%	21.7%	21.4%	22.6%	18.7%
U.S. assets	1.8%	1.5%	1.4%	1.2%	1.2%	1.4%	1.5%	1.7%	1.6%	1.9%	2.1%	2.1%	2.2%	1.5%
U.S. revenues	2.4%	2.0%	1.9%	1.7%	1.6%	2.0%	2.2%	2.3%	2.4%	2.7%	2.6%	2.7%	2.8%	2.2%
Number of corps.	700	746	806	886	963	820	934	1,057	1,159	1,178	633	633	633	925
B. Companies without foreign operations														
U.S. fed. inc. tax liability[1]	$17	$19	$20	$23	$24	$22	$25	$27	$29	$29	$24	$26	$29	$24
U.S. oper. inc. after state inc. tax	$106	$116	$118	$123	$136	$115	$130	$149	$157	$157	$131	$144	$150	$131
U.S. assets	$1,332	$1,488	$1,570	$1,658	$1,825	$1,627	$2,061	$2,295	$2,526	$2,676	$2,124	$2,493	$2,907	$1,906
U.S. revenues	$913	$1,016	$1,117	$1,182	$1,286	$1,079	$1,252	$1,398	$1,509	$1,564	$1,214	$1,403	$1,593	$1,232
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	15.7%	16.3%	17.3%	18.4%	18.0%	19.2%	19.6%	18.2%	18.7%	18.6%	18.1%	18.0%	19.4%	18.1%
U.S. assets	1.2%	1.3%	1.3%	1.4%	1.3%	1.4%	1.2%	1.2%	1.2%	1.1%	1.1%	1.0%	1.0%	1.2%
U.S. revenues	1.8%	1.9%	1.8%	1.9%	1.9%	2.1%	2.0%	1.9%	1.9%	1.9%	2.0%	1.9%	1.8%	1.9%
Number of corps.	3,681	3,573	3,646	3,731	3,945	3,696	3,847	4,209	4,249	4,052	3,357	3,357	3,357	3,863
C. Companies with and without foreign operations														
U.S. fed. inc. tax liability[1]	$42	$43	$45	$46	$48	$49	$60	$68	$72	$78	$43	$48	$53	$55
U.S. oper. inc. after state inc. tax	$233	$261	$256	$246	$264	$264	$310	$372	$387	$391	$220	$247	$256	$298
U.S. assets	$2,740	$3,075	$3,323	$3,562	$3,821	$3,615	$4,371	$4,727	$5,120	$5,171	$3,030	$3,543	$3,978	$3,952
U.S. revenues	$1,976	$2,228	$2,430	$2,553	$2,709	$2,452	$2,781	$3,143	$3,302	$3,333	$1,950	$2,220	$2,434	$2,691
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	18.0%	16.5%	17.6%	18.8%	18.2%	18.7%	19.2%	18.3%	18.5%	19.9%	19.6%	19.4%	20.7%	18.5%
U.S. assets	1.5%	1.4%	1.4%	1.3%	1.3%	1.4%	1.4%	1.4%	1.4%	1.5%	1.4%	1.4%	1.3%	1.4%
U.S. revenues	2.1%	1.9%	1.9%	1.8%	1.8%	2.0%	2.1%	2.2%	2.2%	2.3%	2.2%	2.2%	2.2%	2.0%
Number of corps.	4,381	4,319	4,452	4,617	4,908	4,516	4,781	5,266	5,408	5,230	3,990	3,990	3,990	4,788

[1] Current provision for tax.

Source: Standard and Poors, Compustat, September 1999; PwC calculations.

APPENDIX 5

Net Capital Gains for All Active Corporations, 1980-1996

(Excluding RICs in Billions of dollars)

Year	Net gain on capital assets		
	Net short-term gain less net long-term loss	Net long-term gain less net short-term loss	Subtotal
1980	1.4	22.1	23.5
1981	1.7	25.6	27.3
1982	1.9	24.1	26.0
1983	2.7	28.4	31.1
1984	2.4	35.1	37.6
1985	4.3	45.9	50.2
1986	8.2	74.2	82.4
1987	4.4	54.5	58.9
1988	4.0	56.7	60.7
1989	6.0	62.5	68.5
1990	2.9	43.4	46.3
1991	7.1	41.1	48.2
1992	7.9	45.1	53.0
1993	10.8	53.3	64.1
1994	2.4	47.9	50.3
1995	10.0	60.9	70.8
1996	6.6	75.2	81.8

Source: IRS. *Corporate Source Book*, various issues.

STATEMENT OF THE SECURITY CAPITAL GROUP INC.

(SUBMITTED BY DONALD V. MOOREHEAD AND DARRYL D. NIRENBERG, PATTON BOGGS LLP)

This statement is submitted on behalf of Security Capital Group Incorporated of Santa Fe, New Mexico and its subsidiary, SC Group Incorporated of El Paso, Texas (collectively "Security Capital") for inclusion in the record of the hearings held by the Committee on Finance on February 8, 2000 concerning the Administration's budget and tax legislative proposals for fiscal year 2001.

In its budget, the Administration renews it's prior request for legislation to prohibit the use of closely-held REITs. As described in Treasury's General Explanation of the Administration's Revenue Proposals, a new requirement would be established for REIT status such ". . . that no person can own stock of a REIT possessing more than 50 percent of the total combined voting power of all classes of voting stock or more than 50 percent of the total value of shares of all classes of stock." In support of this change, the General Explanation states that "[a] number of tax avoidance transactions involve the use of closely-held REITs." (General Explanation at 156). In particular, the Administration cites transactions where:

> "in order to meet the 100 or more shareholder requirement, the REIT generally issues common stock and a separate class of non-voting preferred stock. The common stock, which reflects virtually all of the REIT's economic value, is acquired by a single shareholder, and the preferred stock is acquired by 99 other "friendly" shareholders (generally, employees of the majority shareholder.)

aware of a number of tax avoidance transactions involving the use of closely held REIT's." (Id.)

Security Capital agrees with the view that Congress should address situations involving the inappropriate use of provisions of the Internal Revenue Code for unintended purposes. Security Capital also believes that the current Administration proposal is overly broad and will also have the effect of prohibiting various bona fide transactions which, for the policy and commercial reasons described below, should in fact be encouraged. In addressing past abuses of the REIT structure, both the Administration (in the case of step-down preferred transactions) and Congress (liquidating REIT transaction) have taken a very focused and targeted approach. In Security Capital's view this is the most appropriate way to proceed with respect to closely-held REITs.

If Congress does adopt the Administration's proposed prohibition on closely-held REITs, it should structure the legislation with certain limitations so that not only will it prevent abuses but it will also meet the Administration's objective of not "frustrating the intended viability of REITs." (General Explanation at p. 156). As discussed more fully below, this requires that (i) there be an exclusion for entities that are publicly traded on an established securities market; and, (ii) a specific exception should be provided for so-called "incubator" REITs which meet certain criteria.

PUBLICLY TRADED REITS

Real Estate Investment Trusts ("REITs") provide investors with a vehicle through which they may invest in professionally managed real estate while maintaining liquidity. At the same time, REITs provide critically needed capital and the discipline of the public markets to the real estate industry. To encourage the use of REITs, Congress exempted REITs from the federal income tax, but required them to distribute 95 percent of their taxable income to their shareholders who in turn pay tax on these dividends.[1]

To qualify for this "single tax" treatment, a REIT must satisfy several criteria, including requirements that it have at least 100 shareholders and that no more than 50 percent of its stock be held by five or fewer individuals during the last half of any taxable year. As stated above, the Clinton Administration's tax legislative proposals for fiscal year 2001 renew a prior proposal to impose a further limitation so that ". . . no person [including a corporation] can own stock of a REIT possessing more than 50 percent of the total combined voting power of all classes of voting stock or more than 50 percent of the total value of shares of all classes of stock." The proposal was included, with certain modifications, in H.R. 2488, which was vetoed by the President last year.

This closely-held REIT prohibition was originally proposed in 1998 to prevent unspecified abuses of the REIT structure. Within the private sector the proposal was widely perceived to be aimed at transactions involving REITs whose stock was not publicly-traded. Indeed, neither the Administration's formal proposal nor the relevant Congressional reports on H.R. 2488 cited specific examples of abuses involving publicly-traded REITs. However, H.R. 2488 did not distinguish between REITs whose stock is publicly-traded and REITs whose stock is not.

The prohibition on closely-held REITs should extend only to private REITs. The inclusion of publicly-traded REITs will have a number of presumably unintended consequences. First, it will provide a tax shield discouraging many acquisitions of a REIT by a fully taxable "C" corporation and thus at least partially insulate incumbent REIT managers from the discipline of the marketplace. Second, it may prevent the corporate sponsor of a REIT from making open market purchases to support share prices and from investing new capital in the REIT. Third, it may preclude share repurchase programs even though these often may be of significant benefit to the REIT's public shareholders. In all these bona fide situations, the prohibition as currently proposed would cause a REIT disqualification event where the effect of the transaction/strategy increased a shareholder's ownership above the 50% threshold.

In addition to effectively prohibiting certain legitimate transactions (such as those cited above) involving public companies, the proposal would be erroneously targeting a general situation that is not abusive. Since taxable "C" corporations must pay tax on earnings they receive from a REIT in the form of dividends, and REITs must pay out almost all of their earnings in the form of dividends, there is limited potential for tax avoidance as a result of a "C" corporation owning more than 50% of a publicly traded REIT. Moreover, the federal securities laws and stock exchange listing rules already impose substantial restrictions on the permissible actions of controlling shareholders of publicly-traded REITs regardless of whether such shareholders are "C" corporations or other REITs.

We therefore urge the Committee to limit the application of the prohibition on closely-held REITs to private REITs, and not subject to the ban any publicly-traded REIT, the shares of which are actively traded on an established securities market. In so limiting the reach of the proposal, the discipline of the marketplace, the interests of minority shareholders, and the goals for which Congress designed REITs would all be preserved.

INCUBATOR REITS

As Congress itself recognized, the proposed restriction on closely-held REITs would effectively prohibit the use of the REIT structure as the vehicle to enter a new market or new line of real estate and build the business from the ground up, culminating in a "going public" transaction. Congress in 1999 excluded "incubator" REITs from the prohibition on closely-held REITs and it should do so again if it opts for such a prohibition.

There are numerous examples of publicly-held REITs that were, when first formed, closely-held REITs. Among the REITs which started as so-called "incubator" REITs are Security Capital's industrial distribution REIT (the nation's largest), and a portion of its multi-family housing REIT (the nation's second largest). "Incubator" REITs that have developed into widely-held REITs have created jobs and opportunities for thousands of Americans, and through the taxes paid on the dividends they pay to shareholders, have resulted in additional revenues to the Treasury. For example, the development of "incubator" REITs has been a major factor in the growth at our client's El Paso facility from 12 to 536 employees. None of this would have been possible under the current Administration proposal.

"Incubator" REITs are formed with the specific expectation that they will become public after an appropriate "incubation" period. In most cases, the specific intent to "go public" has been evident from the outset in, for example, the REIT's financing documents. This period normally takes at least three years (perhaps a year or two longer in some cases depending on market conditions). During this incubation period, the REIT assembles a staff, raises initial interim capital to finance the acquisition of a portfolio of properties, operates the acquired properties and otherwise develops the type of "track record" necessary for a successful "going public" transaction.

Security Capital believes that "incubator" REITs have been an important component in the industry's ability to fulfill the goals set forth by Congress when it created the REIT structure. They are the building blocks upon which successful, widely-held REITs have been based, enabling small investors to participate in large scale, income producing real estate and allowing the capital of many to be united into a single economic enterprise. All of this leads to increased jobs and increased overall tax revenues to the U.S. Treasury.

WHY "INCUBATION" REQUIRES USE OF A REIT VEHICLE

Use of a closely-held REIT (as opposed to a "C" corporation or partnership) during the incubation period is necessary if the new REIT is to develop into a widely-held public REIT. Some have questioned whether this is only important because of the intangible benefit of increasing the likelihood of favorable reviews from one or more investment analysts at the time of the "going public" transaction. Security Capital believes the market perceptions about the desirability of use of the REIT structure from the outset cannot be ignored by those who seek access to the public capital markets. Even absent such perceptions, there would remain other important and substantive considerations that, in Security Capital's view, make use of a closely-held REIT during the incubation period critical.

Use of a "C" corporation during the incubation period would place the entity at a competitive disadvantage. A key activity during the incubation period is the solicitation of initial capital from third parties in order to finance the acquisition of the portfolio of properties that will form the basis for the "going public" transaction. The third party providers of such initial capital demand returns that are commensurate with those obtainable from other similar investments in real estate (i.e., significant current dividends such as those paid by REITs in exchange for no corporate level tax). In those limited instances where "C" corporations are used with respect to real estate, investors typically receive far more modest dividends and the emphasis is on long term appreciation in value. The incremental cost (in the form of double taxation) of providing REIT-level current returns through dividends from a "C" corporation structure obviously would be quite significant and this added cost would in turn limit the ability of the entity to compete for properties during the incubation period. We estimate that this disadvantage is equal to approximately 160 basis points on property yields.

Use of a partnership during the incubation period would likewise be detrimental from a business point of view. First and foremost, there are some investors who simply will not invest in partnerships due to illiquidity concerns and historical abuses. Additionally, a partnership creates significant administrative burdens and builds in conflicts of interest. Following the "going public" transaction, the REIT would be required to use a carryover basis for any properties carried on the partnership's books at historic cost. Where, as is often the case, historic cost differs from current value, there could undoubtedly be conflicts of interest between the initial providers of capital and the new public investors on matters such as the selection of properties to hold or to sell. In addition, in some cases, public shareholders could experience an immediate dilution attributable to the combination of carryover basis and the fixed minority ownership percentage of the original partners. Finally, a significant administrative burden is created by the multiple sets of records that would be required to account for the entity as a partnership for tax purposes.

Security Capital believes that the "incubator" REIT exception included in H.R. 2488, as vetoed by the President, will allow for continued use of the REIT vehicle for the legitimate purposes discussed in this letter. At the same time, the exception will provide sufficient safeguards to prevent use of qualifying "incubator" REITs for the type of tax avoidance transactions that prompted the Treasury to propose the closely-held REIT prohibition in the first instance. Security Capital urges the Committee that it include this exception again in any legislation providing for a prohibition on closely-held REITs.

Security Capital looks forward to continuing to work constructively with the Administration and Congress in connection with the development of legislation to enable REITs to continue effectively to serve their important economic functions.

ENDNOTES

[1] In accordance with legislation enacted last year, the general distribution requirement will be 90%, effective in 2001.

February 9, 2000

Honorable William V. Roth
Chairman
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

The major associations involved in the federal student loan programs wrote to members of the Finance Committee earlier this week to recommend a technical change in the formula used for calculating the interest deduction on student loans. We are hopeful this change can be considered part of any tax legislation considered by the Committee this year.

Through this letter, I am requesting that our letter to you be included as part of the official hearing record for the Committee's hearing on tax and budget proposals that took place on February 8th.

Thank you for your consideration of this request.

Sincerely,

Paul Tone
Unipac Service Corporation

ATTACHMENT

cc: Joe Belew, Consumer Bankers Association
William D. Hansen, Education Finance Council
Brett Lief, National Council of Higher Education Loan Programs
Dan Yost, Student Loan Servicing Alliance

February 9, 2000

Honorable William Roth
Chairman
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

This letter is to urge your support of an amendment expanding the student loan interest tax deduction passed in the Taxpayer Relief Act of 1997, Public Law 105-34. The proposal, which has wide support, would expand the tax deduction provision by eliminating the limitation that interest is only deductible during the first 60 months of repayment, raise the income ceilings, and allow for full deduction of interest paid for qualified student loans.

Our amendment would also implement these changes in a manner that would simplify the reporting burden on providers of education loan capital. That burden is caused by conflicting definitions of interest as provided for under the Higher Education Act (HEA) – which governs the student loan programs – and IRS policy. Internal Revenue Service's policy expands the definition of interest from that reflected in the HEA to include an amortized portion of any capitalized interest, origination fees, and guarantee fees. This new IRS policy also differs from IRS practice used before the student loan interest deduction was eliminated by the 1986 Tax Reform Act. Capitalized interest, origination fees and guarantee fees on student loans are treated as principal rather than as interest under the HEA. As a result, the historical data that would otherwise be necessary to report under Internal Revenue policy is not available.

Our proposal would accomplish a simplified reporting by allowing a deduction to the taxpayer indexed to the total amount of interest payments made (as defined under the Higher Education Act). Simply stated, the deduction would be calculated by multiplying the amount of traditional interest paid by a factor producing a deduction approximately equal to that produced by the IRS methodology now in use. The indexing would approximate the amortization of previously capitalized interest, origination fees, and guarantee fees for an average borrower, the result being a marriage of the provisions under the Higher Education Act and IRS policy.

We will be forwarding specific legislative language to you in the immediate future and hope to work closely with you and other members of the Finance Committee to encourage inclusion of this important change in any tax legislation considered this year relating to the student loan interest deduction.

If you have any questions regarding this proposal, please call Dan Yost, President of the Student Loan Servicing Alliance, at 317-576-6495 or Paul Tone on behalf of the Consumer Bankers Association at 303-696-5403.

Sincerely,

Joe Belew
President
Consumer Bankers Association

Brett Lief
President
Na'ional Council for Higher
Education Loan Programs

Bill Hansen
President
Education Finance Council

Dan Yost
President
Student Loan Servicing Alliance

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