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OUR BUSINESS TAX SYSTEM: OBJECTIVES, DEFICIENCIES, AND OPTIONS FOR REFORM

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BEFORE THE

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UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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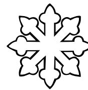

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COMMUNICATION

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OUR BUSINESS TAX SYSTEM: OBJECTIVES, DEFICIENCIES, AND OPTIONS FOR REFORM

WEDNESDAY, SEPTEMBER 20, 2006

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

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Present: Senators Hatch, Lott, Baucus, Bingaman, and Wyden.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Thank you all for being patient. We are here to talk about business tax reform. We start out with the impact on the economy. I think the U.S. economy obviously is fueled by U.S. businesses, whether it is small business or whether it is our largest corporations.

President Bush has called our economy the envy of the world, and I will bet a lot of people have besides the President. But I happen to think that that is true, particularly when you relate our GDP growth, our productivity, our low inflation, our low unemployment, they are really unmatched among developed economies.

But I have not heard anyone claim to be envious of our business tax system. The primary objective of our business tax system is to promote sensible tax policy. By that I mean it should equitably raise an appropriate level of revenue, minimize tax-induced distortions to legitimate business decisions, and, of course, be as simple as possible.

Some hard-core economists might disagree, but another objective of our business tax system should be to promote sensible, non-tax policies. The system should provide effective, transparent, easy-to-administer incentives for appropriate business activities, but we have to keep in mind that targeted incentives increase the tax burden on everyone else.

So we had the President's Tax Reform Panel saying this: "A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers." I suspect many business tax expenditures in the code would fail to meet that test if the realities of politics were set aside.

Another non-tax policy that we hear much talk about is competitiveness. We have heard about how we need to change our business

tax system because of competitiveness, but it is not clear what is meant by that.

A large, multinational may think that it is being competitive with foreign businesses in foreign markets. A family business may think of it as being competitive with a large multinational corporation in the local domestic market. American workers may think of it in terms of ability to compete for, and keep, a job. A policy maker may think of it in terms of making the U.S. more competitive with other countries, attracting business leading to new jobs.

A cynic might say that competitiveness is just a more palatable word for cutting taxes. Taxes, by definition, represent the transaction cost of doing business, so that person might be right. From a business person's perspective, it is, of course, a sunk cost with no expected rate of return.

But it is a fact of life that we must fund our government, and taxing business activities is one of the ways we do that. Our goal, therefore, is to minimize as much as possible the tax system's interference with rational business behavior.

Our system is complex, but it is equally indisputable that businesses operate in a complex world. There is a wide variation in businesses in terms of size and complexity, and addressing this variation is one of those challenges facing us.

Many businesses engage in complex transactions, relationships, and legal structures because of the global marketplace. Globalization creates challenges for our business tax system as well. U.S. businesses operate in that global market for capital, customers, suppliers, competitors, and business partners.

A related challenge is the global integration of our multinational corporations. Our tax system needs to fairly and efficiently address the realities of business complexity.

We had a hearing on that in August, where we invited in the President's Advisory Panel on Tax Reform, as a first step towards tackling the issue. It is important that we examine business tax reform as a whole before focusing on a single aspect of reform.*

Before introducing the panel, I will invite comment from Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

Susan B. Anthony once said, "Cautious, careful people always casting about to preserve their reputations can never effect reform." That is true, Mr. Chairman. Many, including the administration, seem to be afraid to address true tax reform.

In contrast, you have taken it on, and I thank you very much for calling this hearing on how tax reform would affect business and trying to search out, find, and implement good, new, big ideas.

The President's Tax Reform Advisory Panel spent almost a year hearing from taxpayers and interest groups. The panel studied the issue, and the panel issued a very detailed report.

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*For additional information on this subject, *see also,* "Present Law and Background Relating to Selected Business Tax Issues," Joint Committee on Taxation staff report, September 19, 2006 (JCX–41–06).

But down at Treasury, they seem to have just put that report on the shelf. Treasury seems to have ignored the report, along with its recommendations. The exception to that rule, however, is our Treasury Department witness today, Robert Carroll, who produced a fairly glowing analysis of the report.

I look forward to asking him a series of questions. First, how would the loss of depreciation deductions on existing assets under these proposals affect American businesses like Ford and GM? What about the loss of interest deductions?

How would that affect American business? What about the costs of transitioning to the new regime? Will tax reform help to reduce the budget deficit? These are all questions for which we need answers as we consider tax reform.

I am also glad to see that Comptroller General David Walker is here with us. He admonishes us that we cannot consider these issues in a vacuum. He warns that long-term budget issues must also play a real role and be a part of any tax reform debate, and he is right.

We welcome back to the committee former IRS Commissioner Charles Rossotti. His participation on the Tax Reform Advisory Panel was greatly appreciated.

I look forward to the testimony of Dr. Neubig, Mr. Bernard, and Mr. Johannesen, who will give us a real-life perspective from the private sector.

Cautious, careful ideas, ideas designed to preserve reputations, cannot bring about true reform. True reform does require big ideas, and I appreciate the willingness of our witnesses to come forward with them and discuss them. I will be listening for big ideas that we need to accomplish reform, along with practical, realistic ways to accomplish them.

I might also add, this is an opportunity to address American competitiveness. It is a real issue. It is a major challenge facing us in the world. Some of it is coming from the developed world, some from the under-developed world—China, India.

Many countries are hungry. They want to have what we have. They want to have our standard of living, and they are going to work as hard as they can to get there. We have to be ready. We have to meet that challenge. It is an opportunity, as well as a challenge.

As we examine tax reform, we clearly have to have an eye on the globe, on other countries' tax regimes, and not do anything that harms American competitiveness and hopefully will try to find ways to enhance American competitiveness.

That is, help American companies compete in the world. That means jobs in the U.S. as much as possible. Not jobs overseas, but jobs in the U.S. as much as possible.

A lot of that comes down to education, to having the highest, best-educated workforce in America. That will mean that more higher paying jobs will be in America. But without belaboring the issue, we clearly have to spend a lot of time as we think through tax reform to keep a very strong eye on the world.

Too many tax reform proposals, Mr. Chairman, in my judgment, just look at the four corners of the United States. They just look at the American system. They pay personally no attention to what

has happened with the rest of the world. We cannot do that any more.

Frankly, I am a bit surprised at the President's reform proposals, as his panel virtually looked at just the United States' system, looking only at the United States and not really paying much attention to what has happened in the rest of the world, but as we proceed, we have to do that.

Thank you.

[The prepared statement of Senator Baucus appears in the appendix.]

The CHAIRMAN. Of course, what you asked will obviously be a subject of discussion if we pursue this next year together.

Senator BAUCUS. I assume we will.

The CHAIRMAN. Yes. Thank you. I appreciate that. I hope that is true, whoever controls Congress.

Senator BAUCUS. I do, too, Mr. Chairman. [Laughter.]

The CHAIRMAN. I just got a commitment out of him. [Laughter.]

Senator BAUCUS. That follows our mutual teamwork approach.

The CHAIRMAN. That is right.

I am going to make a very short introduction, because all of our people, except my constituent, are very well-known. He may be very well-known in his profession, but I want to take some time to introduce him.

But we have David Walker, Comptroller General of the Government Accountability Office; Robert Carroll, Deputy Assistant Secretary for Tax Analysis, Treasury; the Honorable Charles Rossotti, a member at The Carlyle Group, but we all know him on this committee as former IRS Commissioner. He was also on the President's panel for reform. Dr. Neubig is the national director for quantitative economics and statistics at Ernst & Young. David Bernard is the international president of the Tax Executives Institute, and vice president of tax and real Estate for Kimberly-Clark.

My constituent, Jeff Johannesen, is the managing director of RSM McGladrey in Des Moines, IA, but they are a national firm. He is going to give views on tax reform from the perspective of something that firm specializes in, things for small- and mid-sized businesses. That firm has been around since 1926, when it was originally called McGladrey. They have 7,000 people in 130 countries, and I thank my constituent for coming in.

Would you start in the order that I gave you, General Walker? Then from my left to right, ending with Mr. Johannesen.

STATEMENT OF HON. DAVID WALKER, COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

General WALKER. Thank you, Chairman Grassley, Senator Baucus, and other members of the Senate Finance Committee. It is a pleasure to be before you to speak on business tax reform.

I assume, Mr. Chairman, that my statement and the others' will be included in the record, and therefore I will move to summarize them.

The CHAIRMAN. Yes. Let me affirm that, without your having to ask. Each witness summarize, and then your entire statement is in the record.

General WALKER. Thank you, Mr. Chairman.

[The prepared statement of General Walker appears in the appendix.]

General WALKER. Businesses, both corporate and non-corporate, are a crucial pillar of our tax system. Corporate businesses paid $278 billion in Federal corporate income taxes in fiscal year 2005. But as we all know, businesses play important roles with regard to other aspects of our tax system, including dealing with individual taxes.

Beyond raising revenue, taxes affect business decision-making, thereby affecting the performance of our economy. Making business decisions based on tax considerations rather than on underlying economic benefits results in the channeling of some investments into less-productive activities. This, in turn, reduces economic growth and ultimately has an impact on the standard of living of all Americans.

Complexity in business tax laws imposes costs on its own, facilitates tax shelters, and provides cover for those who do not want to pay their fair share. Although the precise amount of the business tax avoidance is unknown, IRS's latest estimates show a business tap gap of at least $141 billion for 2001.

Not surprisingly, there is a growing debate about reforming the tax system, including business taxes. My full statement reviews our Nation's large and growing long-term fiscal imbalance, describes some of the challenges with our current system of business taxation, lists some of the major strategic choices that we must make as a Nation about how to tax businesses in the future, and then provides some principles that ought to guide the debate, in our view, about business tax reform.

These principles are based on three longstanding criteria typically used to evaluate tax policy, namely: equity, economic efficiency, and the combination of simplicity, transparency, and administrability, which are discussed more fully in my testimony.

The principles include such concepts as: the proposed tax system should raise sufficient revenue in the aggregate over time to fund our current bills and deliver on our future promises. The tax base should be as broad as possible. The proposed system should have attributes associated with high compliance rates.

To the extent that other objectives such as equity and simplicity allow, the tax system should aim for increased economic efficiency by remaining as neutral as possible in connection with various structural forms.

The more neutral the tax policy is, the greater potential for enhanced economic growth, the less the compliance costs, the greater potential for increased productivity and competitiveness of the U.S. economy, and ultimately the standard of living of Americans.

Finally, the consideration of transition rules needs to be carefully considered as an integral part of the new design. This document, Senators, I would commend to you—I think all of you have received a copy of it—which GAO published in September of 2005 and includes a very comprehensive, plain-English summary of some of the key elements of our current tax system and a potential way forward on tax reform.

In summarizing, the problems outlined in my statement relating to compliance costs, efficiency costs, equity, and tax gaps associated with the current business tax system, combined with our Nation's large and growing long-term fiscal imbalance, would seem to make a clear and compelling case for comprehensive review and reform of our existing tax policy.

Further, American businesses operate in a world that is profoundly different than when many of these provisions were put into place. It is much more competitive, much more global, and, quite frankly, geopolitical boundaries have less and less significance every day. Many of these tax provisions were enacted years ago and have not been reviewed, revised, and updated to reflect the realities of the 21st century.

Despite numerous and repeated calls for reform, progress has been slow. The recent report of the President's Advisory Panel on Federal Tax Reform recommended two different tax reform plans.

Although each plan is intended to improve economic efficiency and simplify the tax system, neither of them addresses the large and growing fiscal imbalance facing our Nation which serves to threaten the future of our country, our children, and our grandchildren.

I would be happy to answer any questions after my colleagues have the opportunity to make their statements, Mr. Chairman. That summarizes my full statement. Thank you.

The CHAIRMAN. Thank you.

Dr. Carroll?

STATEMENT OF DR. ROBERT CARROLL, DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Dr. CARROLL. Mr. Chairman, Senator Baucus, and distinguished members of the committee, I thank you for the opportunity to appear before you today to discuss business tax reform.

Tax reform is, without question, one of the most important issues facing our economy today. Reform of the Federal individual and business tax systems offers a significant opportunity for improving job and wage gains for American workers.

The key consideration in evaluating approaches for reform in the business area is the relative efficiency of different policies to encourage investment, or more accurately to reduce the extent to which the tax system discourages investment. Also, in today's global economy, the competitiveness of the United States is essential for our economy to continue to attract investment and create jobs.

Before focusing on business tax reform, I would first like to discuss the problems with our tax system more broadly, then focus on how the tax system affects investment and the importance of business taxation to the tax burden on investment.

Our tax system imposes very large costs on our economy. First, our tax system is extremely complex, difficult to comply with, and hard to understand. Individuals, small businesses, and corporate taxpayers spend literally billions of hours and billions of dollars each year to comply with the tax system. Compliance costs total some $140 billion each year.

The tax system also imposes large economic costs on our economy. It interferes with and distorts decision making by individuals and businesses in a number of different ways. These economic costs hinder economic growth and reduce living standards. Some estimates suggest that tax reform can ultimately increase the size of the economy by 2 to 10 percent.

At the core of tax reform are the three pillars of simplicity, growth, and fairness. These are, of course, the objectives the President set forth when creating the Advisory Panel on Federal Tax Reform.

It is useful to consider general principles that can be applied for our tax system with these core objectives in mind.

First, the tax system should raise revenue with the least possible interference with business and household decision making. Second, the tax system should have a broad base with low tax rates. Third, the tax system should promote a strong economy by promoting savings and investment. Fourth, the tax system should be appropriately progressive and provide equal tax treatment to similarly situated taxpayers. Fifth, the tax system needs to adapt and change with the increasingly global economy to maintain the competitiveness of the United States and to continue to attract investment in highly skilled labor. Finally, the tax system should be stable and avoid frequent changes that create uncertainty and make it difficult for taxpayers to plan for the future.

Business tax reform, the subject of today's hearing, is an issue that can be considered in the broader context of how the tax system taxes investment. Investment adds to the productive capacity of the economy directly by increasing the capital stock, as well as indirectly by integrating new technologies and production processes.

Higher investment raises labor productivity by giving labor more capital with which to work. Policies that encourage investment by virtue of additional capital formation and higher labor productivity are the key to increasing living standards.

Business taxation generally reflects only one aspect of the tax on investment. The return on an investment may be subject to three layers of tax under our tax system: business level taxes, investor level taxes, and the estate tax.

Our tax system also treats investment unevenly across asset types, sectors, and sources of financing, which reduces the productivity of a given stock of capital. Business tax reform can increase the productive capacity of the economy by reducing these distortions.

There are a number of different policy avenues for influencing the tax on capital and treating different types of investment more uniformly, each with its own set of inherent trade-offs.

The corporate tax rate, the individual tax rate, how quickly investment is written off, the tax on investment returns received by individuals in the form of dividends and capital gains, and the tax treatment of interest all influence the incentive to invest.

Not all policy levers are created equal, however. Some policies are more focused on encouraging new investment, while others may more broadly benefit new investment as well as the return from old capital. Each policy approach involves significant and difficult

trade-offs among the sometimes competing objectives of simplicity, growth, and fairness.

A key consideration in business tax reform is also to ensure that the United States remains competitive as a leader in the global marketplace. The United States is increasingly linked to the world economy through trade and investment, and the benefits of domestically based multinational businesses and their foreign investment are becoming clearer each day.

The tax system can have profound effects on multinational corporations' choices of how much, and where, to invest. The United States has a statutory corporate tax rate that is high relative to the G–7, as most of the other G–7 countries have reduced corporate tax rates over the past several years, but the U.S. corporate tax rate is close to the effective and average tax rates of the G–7.

Importantly, the integrated effect of tax rates in the United States would be considerably higher than the G–7 without the lower tax rates on investor-level income—dividends and capital gains—enacted in 2001 and 2003, and now in effect through 2010. That is, the tax relief enacted in 2001 and 2003 has helped make the United States a more attractive place to invest relative to other G–7 countries.

I thank you again for the opportunity to appear before you today, and I look forward to working together with this committee and others in the Congress on this important issue. I would be pleased to answer questions from the committee after my colleagues have their opportunity.

The CHAIRMAN. Thank you, Dr. Carroll.

[The prepared statement of Dr. Carroll appears in the appendix.]

The CHAIRMAN. Mr. Rossotti?

STATEMENT OF HON. CHARLES ROSSOTTI, SENIOR ADVISOR, THE CARLYLE GROUP, WASHINGTON, DC

Mr. ROSSOTTI. Thank you, Mr. Chairman. It is good to be back to appear for the first time since I left as IRS Commissioner.

Senator BAUCUS. Welcome back.

Mr. ROSSOTTI. Thank you. I am particularly happy to be talking about how we can simplify taxation of business in America. My involvement in the tax world has actually been a bit strange, because for more than 30 years I was a businessman and a taxpayer, but definitely not a tax expert.

Then by an unexpected turn of events, I ended up as IRS Commissioner for 5 years. Last year, another unexpected turn of events led me to be on the Tax Reform Panel. But despite these occasional forays into the tax world, I remain a person whose main life experience has been that of a businessman.

After traveling on this unexpected path through tax territory, I have one observation that trumps all others about the U.S. tax system. That is, it is astoundingly inefficient, mainly as a result of mind-numbing and unnecessary complexity.

I find it truly remarkable that the time and money the taxpayers in this country spend trying to comply with the tax code costs $140 billion a year. That complexity gets worse every year. In the 20 years since adoption of the 1986 Tax Reform Act, Congress has

passed 14,400 amendments to the tax code. That is an average of about 2.9 changes for every single working day in the last 19 years.

When you add in approximately $300 billion per year in taxes that should be paid but are not paid, in part because of the complexity of the code, you arrive at a total overhead burden on honest taxpayers in the neighborhood of $450 billion a year. That is about what we spend on Social Security, and it is more than one-third of what we actually pay in income taxes.

While all taxpayers suffer from this inefficiency, it is a fact that the majority of this cost is borne by businesses, especially small businesses. Of the $140 billion per year in tax compliance costs, about 75 percent of that is shouldered by businesses, including self-employed individuals.

But beyond that staggering compliance cost, businesses suffer from inefficiency in another way. That is because the actual tax burden on individual businesses is capriciously uneven and often unpredictable.

Many businesses do, in fact, pay the full statutory tax rates on their income, but many other businesses, sometimes even in the same competitive industries, pay far less.

That is for two reasons. One is that they just simply may fail to report what they should report and they simply get away with it because of lack of resources in the IRS.

The other reason is that they just may happen to be in a better position to take advantage of special provisions and complexities of the code to reduce their actual tax rate well below the statutory rate.

This situation is not only unfair, it creates great inefficiency by distorting the business playing field and diverting scarce attention away from improving efficiency of operations into planning how to minimize taxes.

There may be, and probably are, political factors at work that tend to lock in this level of inefficiency. I cannot judge that question because I am not a politician. But I do know that there is a better way available if our political leaders want to adopt it, and that is to adopt a much, much simpler system that would even the playing field among businesses and would at the same time enable us to lower the statutory rates while raising the same amount of revenue.

Now, the Tax Panel laid out in detail some options about how this could be done, and I will not repeat them here. I will only list four principles that I think are essential to making the system of business taxation simpler, fairer, and more efficient. I have, in my written testimony, provided more detail on each of these four points.

Number one, lower rates are better than special preferences. Number two, rules for small businesses should be, and can be, far simpler than for larger businesses. Number three, double taxation of businesses should be reduced or eliminated, but all business income should be taxed once at approximately the same rates. And finally, as many here have said, the tax system badly needs to be updated to reflect the reality that a large fraction of business is now routinely done on a global basis, not just a local basis.

So the conclusion that I hope you will come to, Mr. Chairman and members of the committee, is that the U.S. tax system does not have to be as complex and inefficient as it is. While it would take considerable political leadership to make a major reform, I believe the benefits to the taxpayers of the U.S. would make it worth it.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Rossotti.

[The prepared statement of Mr. Rossotti appears in the appendix.]

The CHAIRMAN. Now, Dr. Neubig?

STATEMENT OF DR. THOMAS NEUBIG, NATIONAL DIRECTOR FOR QUANTITATIVE ECONOMICS AND STATISTICS, ERNST & YOUNG LLP, WASHINGTON, DC

Dr. NEUBIG. Thank you, Mr. Chairman. I appreciate the invitation to testify before the committee on the issue of business taxation, and in particular options for reform.

The breadth of the hearing is quite large, so I will restrict my comments to reasons why many corporations prefer a lower corporate tax rate to more targeted tax reductions, and specifically prefer lower marginal tax rates to expensing of capital investments.

The President's Advisory Panel outlined a growth and investment tax plan for a business cash flow tax as one of their alternatives, and that included a proposal for expensing, which is, first year, 100 percent write-off of capital equipment, structures and inventory.

One might have expected that this plan would receive a standing ovation from the business community, since many economists, my academic friends, claim it would result in a zero effective tax rate for new capital investment.

Instead, the idea of a business cash flow tax and expensing was largely greeted with silence. So why was there this tepid response from the corporate community? Why is there this disconnect between the corporate community and what academic economists are saying?

If we look at the Tax Council Policy Institute's survey of multinational corporations where they were asked to rank a range of alternative tax reform options, the clear favorite was lowering the corporate tax rate to 25 percent or below, compared to other, both incremental or fundamental tax reforms.

I would like to highlight four reasons why many corporations prefer a lower corporate tax rate to the proposed option of expensing capital equipment. The first reason is expensing offers only a timing benefit and it does not reduce, for book reporting, the book effective tax rate.

The book effective tax rate remains at 35 percent, even though they are getting significant deductions. If you lower the corporate marginal tax rate, that would lower corporations' book effective tax rates and it would also increase their reported book profits.

Expensing accelerates deductions from future years into the first year when the investment is made. It provides only a timing tax difference. With expensing, public corporations would continue to

have high effective tax rates on their current income, plus they would build up very large, deferred book-tax liabilities.

In contrast, reducing the corporate marginal tax rate would immediately lower corporations' book effective tax rates, increase their reported after-tax profits, and would reduce their deferred book-tax liabilities and assets.

This is important, because two-thirds of the largest companies, the top 50 companies that we looked at, reported large deferred tax liabilities, and a lower marginal tax rate would be welcome in reducing those deferred tax liabilities.

The second reason is that corporations already expense a large fraction of their capital investments. A lower tax rate would benefit both their tangible investments, as well as their intangible investments.

A recent study found that business investment in intangible capital is now as large as their spending on tangible capital. Intangible investments include research and development, copyrights, computerized databases, and brand equity.

Most investments in self-constructed intangible assets are already deducted in the year that the wages and salaries are incurred, and a lower corporate marginal tax rate would benefit income from both those intangible investments on their future income, as well as lowering the cost of capital on tangible investments.

The third reason is, expensing is unlikely to occur without a counterbalancing loss of interest deductibility. Combining expensing with repeal of interest deductibility is necessary to prevent negative effective tax rates, as the Advisory Panel concluded. A lower corporate marginal tax rate could occur with continued interest deductibility.

The fourth reason is, expensing reduces the tax wedge at only one margin of corporate decision making, the decision to invest in tangible property. A lower tax rate would reduce the tax wedge on all corporate decisions, including location of investments in the U.S. versus foreign countries, debt equity financing, and transfer pricing planning.

The U.S. has one of the highest statutory corporate tax rates. A combined Federal/State corporate rate of 39 percent is one of the highest compared to the OECD average of 31 percent, and that average is falling as more countries are going to phase in future tax rate reductions.

While there are a wide range of views among the corporate tax community, many of them would prefer to see the U.S. join other countries in lowering the corporate marginal tax rate rather than moving to a business cash flow tax or reducing the corporate tax base further with expensing.

Thanks.

The CHAIRMAN. Thank you, Dr. Neubig.

[The prepared statement of Dr. Neubig appears in the appendix.]

The CHAIRMAN. Now, Mr. Bernard?

STATEMENT OF DAVID BERNARD, INTERNATIONAL PRESIDENT, TAX EXECUTIVES INSTITUTE, INC., WASHINGTON, DC; AND VICE PRESIDENT OF TAX AND REAL ESTATE, KIMBERLY-CLARK CORPORATION, NEENAH, WI

Mr. BERNARD. Thank you, Mr. Chairman, for inviting me to testify on behalf of the Tax Executives Institute in order to provide the perspective of a business tax executive on fundamental tax reform.

TEI is the preeminent association of in-house tax professionals, with more than 6,000 members. They represent 2,800 of the largest companies in the United States, Canada, Europe, and Asia.

I am not only TEI's volunteer president this year, but I am also vice president of tax and real estate at Kimberly-Clark Corporation, a 130-year old company that has grown from an initial capitalization of $30,000 to a market cap of $30 billion. Today the company is a global leader in health and hygiene products, with manufacturing facilities in 18 States, 39 countries, and products being sold in over 150 countries.

Our tax code, like the world around us, has grown increasingly complex in the 3 decades since I joined Kimberly-Clark. The growth has spawned a universe of statutory and regulatory pronouncements that are profoundly difficult for taxpayers to understand and to comply with. Part of the reason for this is society's increasing reliance on the Internal Revenue Code not merely to raise revenue, but also to advance social and economic policies. In a very real sense, the code has lost its way, and we all must accept a measure of responsibility.

The challenge is to refocus and reform our Internal Revenue laws. TEI believes there are four principles that should guide our collective efforts. First, U.S. businesses do not operate in a closed system. The current system places American companies at a competitive disadvantage. Let me offer two brief examples: our system for taxing foreign income under Subpart F and our foreign tax credit regime.

Specifically, Subpart F makes it difficult to operate in the same manner as our foreign competitors since our competitors generally are not taxed in the home country on foreign operating income, while U.S. businesses may be taxed in both the United States and abroad. To be sure, the code provides a foreign tax credit, but it does not always eliminate double taxation. In the case of my own company, tax is not an after-thought on location decisions.

U.S. companies are increasingly forced to build facilities overseas, not merely because that is where our customers are, but because the economic and tax environments are often friendlier there.

Congress should strive to create a tax environment that allows U.S. companies to compete around the world while retaining research, manufacturing, and jobs at home. America's foreign trading partners are not shy in vying for new plants, research facilities, and distribution centers. If the United States is to remain competitive, our rules must change.

Second, the U.S. tax rate must be competitive. In the mid-1980s, the United States recognized this and reduced the corporate tax rate to a then global-leading 34 percent. Now our rate comes in at near the top of the list. While we were running in place, our Euro-

pean trading partners made rate reductions the rule of the day. From 1986 to 1996, the average corporate tax rate of the 25 countries of the European Union dropped more than 10 percentage points.

Lower rates, however, do not mean lower revenue. Indeed, Tax Notes magazine recently confirmed that, despite significant reductions in tax rates in European countries, corporate tax revenue, as a percentage of GDP, is rising there. As part of fundamental tax reform, Congress should level the rate playing field and thereby make America's tax system and American business more competitive.

Third, the tax system should not pick winners and losers. While some incentives such as those for research and education have widespread support, a growing consensus favors lower rates and a broader base to reduce complexity, ease tax administration, and minimize the government's role in picking winners and losers.

It can be argued, of course, that tax reform itself will produce winners and losers, just a different group than under the current system. While this may be true, especially on a transition basis, it should not staunch the debate. TEI submits that sound tax policy should take precedence over a patchwork of tax incentives and inducements.

Fourth, the tax system must be simpler. Achieving and maintaining an effective balance between fairness and simplicity is not easy. At one extreme, fairness—this is to say, treating similarly situated taxpayers in the same way—demands tax rules to be complex. At the other, simplicity calls out for rough justice.

American society is complex and the tax rules must reflect that, but they need not be consumed by it. Simple is good not only on its own account, but because complexity represents a daunting, hidden tax on American business.

Estimates of this cost vary, but the Tax Foundation estimates that in 2005, taxpayers incurred costs in excess of $265 billion to comply with the Federal income tax laws, with business's share being a staggering 55 percent. For example, Kimberly-Clark electronically filed its 3,300-page U.S. tax return for 2005 just last week after 8 months and 19,000 staff hours of effort.

Equally important, a simpler tax system will also be easier for the IRS, which currently spends a disproportionate amount of its resources plugging so-called loopholes, often creating unintended and expensive consequences. Simply stated, the more complex the code, the greater the likelihood for taxpayers to confront interpretative issues and questions that, if not addressed, will spawn opportunities for lawful tax avoidance. Simplifying the code will also reduce the heavy proxy tax of record keeping that can impede day-to-day business decisions.

Mr. Chairman, one final point, if I may. Recently, attention has focused on the so-called tax gap. While definitional and measurement issues exist, TEI firmly believes that the tax gap can be significantly reduced by meaningful reform and simplification. This is because some portion of the gap is undeniably attributable to the complexity of the code itself. If taxpayers do not understand its provisions, they may not be able to comply.

Similarly, some portion of the tax gap may be attributable to taxpayers exploiting the complexity. It may not be possible to quantify how much of the gap is attributable to this complexity but, beyond question, making the code less complex will help narrow that gap.

In conclusion, TEI applauds the committee's efforts to advance the debate on tax reform. We stand ready to be active participants in the discussion of how to make the system of taxation more competitive and less complex, while preserving fairness for all taxpayers.

I would be pleased to answer any questions that you or my colleagues have.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Bernard appears in the appendix.]

The CHAIRMAN. Mr. Johannesen?

STATEMENT OF JEFF JOHANNESEN, MANAGING DIRECTOR, RSM McGLADREY, INC., DES MOINES, IA

Mr. JOHANNESEN. Well, Mr. Chairman, first, I want to thank you for that nice introduction you gave a few minutes ago.

I also want to thank you and the entire committee for inviting us to be here. We certainly appreciate that. We are honored. We are excited about this process. Probably just as much as you have, I have enjoyed listening to this panel give their opinions in this area.

My testimony is probably from a slightly different perspective. I do not necessarily disagree, but, because of the people I work for and the type of clients we have, our perspective is different. We have a significant number of clients that are what we call mid-sized businesses.

Mid-sized businesses obviously have all sorts of industries that they participate in. They conduct their affairs in every conceivable business entity structure that we have in the tax law. They operate domestically, they operate internationally. Some are owned, honestly, by international interests. Overall, it is just a very interesting group.

I have a couple of observations that I want to share with the committee about this group. I think you will find them interesting.

One is that, unlike large companies and publicly traded companies, many mid-sized businesses do not have tax departments. They do not have internal professional staff that can deal with the complexities that we face. Some of the consequences of that are that they do not take advantage of the incentives, the deductions, the credits that are built into the tax law.

Oftentimes they miss those, either because they are unaware of the existence of those rules, or, quite frankly, they are just too costly for them to implement for the benefit they will receive.

An example of that would be the recently-enacted 199 deduction. It is a great piece of well-intentioned legislation, but it is very hard for the middle market to successfully take advantage of it.

I know this is true because I have seen it from my own personal experience. Oftentimes when we have a new client relationship where we view prior returns, it is disturbing how many deductions,

credits, and incentives that these companies do not take advantage of.

It is also confirmed by a survey that our firm participated in this summer, where we surveyed almost 1,000 CEOs and CFOs of small- and mid-sized businesses. What that confirmed was that almost 40 percent of that group did not take advantage of every deduction, credit, and incentive that is in the tax law that they were entitled to.

One other observation about this group that I want to make. I think there is a lot of anxiety about tax reform in mid-sized businesses. I think that manifests itself in the fact that they do not have tax departments to deal with changes.

They probably do not quite understand how major tax reform will affect them in the long term. Maybe more importantly, and this has been mentioned earlier, they just do not know how to get from the system we have to the system that we are going to have. Assuming that that will be a much-improved system, that transition is going to be very difficult for this group to deal with.

I want to briefly outline some of the things that we would like to see included in the tax system for mid-sized businesses. Some of the things have been mentioned previously, and I think we are going to have some consistency in that.

We do need a tax system that promotes growth and vitality for this business segment. If we can get the simplicity/lack of complexity worked into there, that would certainly be important. Stability and predictability is also a key factor of what we would like to see present.

If we can eliminate provisions that inhibit these businesses from conducting normal business operations, I think we will have gained quite a bit right there. That is doable, and I have a couple of examples for you here that I would like to talk about, especially in the S corporation arena.

Also consistent with the panel, we think that lower tax rates on business makes sense. I also feel, and our firm agrees, that either the elimination or significant simplification of the Alternative Minimum Tax would be a big plus.

I talked about transition rules. I just want to say one more time that I really appreciate the committee's interest in how this affects mid-sized businesses that do not necessarily have the tax resources that other companies do.

I have to tell a story. I think sometimes stories are very meaningful, and this will highlight, I think, some of the things—not everything, but some of the things—that I have been trying to stress here.

We had a client that, a few years ago, went from a C corporation environment to an S corporation election. It as absolutely the right thing for them to do. It made sense. We helped them with that analysis. A few years after that, because of the growth in their business, they decided that rather than continue as a family business, they were going to need to access the capital markets.

When they came to us as a team, and we helped them try to work through this, they then remembered, as we had talked about earlier, a couple of things about S corporations that were very difficult.

One was that, for the most part, you could only have individual investors. It is hard to go to the capital markets when you can only get individual investors. Two, they found out that you could not have a second class of stock, and this is what they were proposing to bring in for equity investment.

So we did help them work through an appropriate structure as part of a team of professionals that did that. The end result was very positive. They were a very successful company. Unfortunately, it was costly, it was confusing, and, quite frankly, it was unnecessary.

At the end of the day, there was no effect to the revenue for the government in this. We just had a lot of hurdles in place for this business. They cleared those hurdles, but it would have been nice, in our system, if we had not had to jump over them.

So I have many more examples. I know I do not have time to discuss those now, but I would be happy to do that later. Again, thanks for the opportunity to be here.

The CHAIRMAN. Yes. Thank you.

[The prepared statement of Mr. Johannesen appears in the appendix.]

The CHAIRMAN. We will take 5-minute rounds of questioning. The order is: Grassley, Baucus, Hatch, Bingaman, Wyden, and Lott, in the first-come, first-serve. Also, I think we are expecting a vote at 11.

Senator BAUCUS. It is at 11:15.

The CHAIRMAN. Oh. It is 11:15. It will still come in the middle of our questioning. I would like to keep the session going, so whatever members have voted, keep the meeting going in my absence.

I am going to start with an issue that was brought up by the President's Commission that came forth with what they called the Simplified Income Tax Plan. Mr. Rossotti talked about it in his testimony, about moving, as we did from our present system, to the territorial international tax regime.

I am going to ask Mr. Rossotti, and then at least Mr. Bernard, to respond to this. If other people want to respond, it is up to you, but at least those two. I am going to start with Mr. Rossotti and ask you two questions.

First, why should this committee consider moving to a tax system that intensifies the pressure placed on transfer pricing enforcement? Second, given the difficulty the IRS faces under our current deferral regime, is it realistic to expect enhanced enforcement to adequately address the increased importance of transfer pricing issues in the territorial regime?

Mr. ROSSOTTI. Thank you, Mr. Chairman. Yes. I do not believe that the system proposed by the Tax Panel, which was built on something proposed by the Joint Committee on Taxation, would materially increase the pressure on transfer pricing.

There is plenty of pressure on it, but I think today, as it is already, with the deferral of income and with the availability of foreign tax credit planning, there is ample opportunity—or ample incentive, I should say—for multinational corporations to do what they can in the transfer pricing arena and move income away from U.S. reporting to other places. That would continue to be the case, but would, I do not think, be materially different.

I think what would be different is another element of tax planning that would be eliminated, or mostly eliminated, which is the interaction between foreign tax credits, as well as transfer prices.

The CHAIRMAN. All right.

Mr. Bernard?

Mr. BERNARD. Mr. Chairman, I would like to add to the Commissioner's comments by saying that I believe that a lower tax rate as part of the tax reform initiative would greatly reduce the pressure that exists presently on transfer pricing.

If you look at transfer pricing, there is no right or wrong answer. There is usually a range of right answers when you come to transfer pricing questions. And if the U.S. rate were more competitive, we would generally end up with more of the profit through transfer pricing ending up in the United States on the front end of the transaction.

The CHAIRMAN. All right.

I am going to go on to another question, again, to Mr. Rossotti, but if Mr. Bernard and Mr. Neubig would follow up, I would appreciate it.

This is in regard to the Generally Accepted Accounting Principles. Proponents cite the tension between competing incentives to report high accounting income but low taxable income. And dealing with that issue, I want to quote Dr. Douglas Shackelford, who testified as a Professor from the University of North Carolina before the Subcommittee of the House Ways and Means Committee.

He said, "Book-tax conformity would adversely affect both financial reporting and the tax system for at least two reasons. First, shareholders and the taxing authorities need different information. Second, even if Congress mandates conformity, it will not be sustainable. In time, the policy will revert to the current system. In the meantime, conformity will damage our capital markets."

So, Mr. Rossotti, Mr. Bernard, and Dr. Neubig, your reactions to those criticisms.

Mr. ROSSOTTI. Well, first, let me say that my own personal opinion here was not part of the Tax Panel's report. This is something that I have thought of beyond that that would be a far-reaching change.

But I do believe, and Dr. Neubig here made some very good comments about how this works, that the divergence has gotten so great between the financial reporting—and I am talking for large corporations here, not for small businesses—between the tax code reporting and the financial reporting, that it has created a very substantial amount of burden in trying to explain these differences and track these differences, even a burden on businesses. As a matter of fact, the second-largest cause of financial restatements because of Sarbanes-Oxley had to do with tax accounting.

I think one proposal that would be worth consideration would be to simply separate the issue of measurement of corporate income—which already has an elaborate process through the Financial Accounting Standards Board, through the Public Corporation Accounting Oversight Board, and the SEC—to separate that process from the decision of how much of it to tax.

So you could use the well-established process to measure corporate income on a before-tax basis to measure income. The Con-

gress then would be limited to focusing on how much tax and how many tax credits should be applied to that.

Should that be done? I have done my own calculations on this. I believe just by taking that approach you could reduce the corporate tax rate to no more than 25 percent and still raise the same amount of revenue.

I think that would be a far-reaching proposal. It would require a lot of study. It would require Congress to be willing to, in effect, delegate one part of the question on business tax income to an independent technical process, the measurement of income.

It would not, of course, give up the right to decide how much tax it can impose, but it would give up, in a sense, a delegation of that technical issue to an independent body.

My own personal view as a business person, although many issues would have to be thought through about this, is this would be a far-reaching change that could dramatically not only improve the simplicity of the system, the reliability of the system, the equalness of the system, since everybody would be reporting the same, but would also enable you to, in a revenue-neutral way, dramatically reduce our tax rates in order to make them actually lower than what they would be in most of the other countries in the world.

So this was not a proposal that was adopted by the Tax Panel, but as just my own personal opinion, I think if we are going for corporate tax reform it would be something that would be worth considering.

Senator LOTT. Mr. Chairman?

The CHAIRMAN. Yes?

Senator LOTT. Would you yield just for a brief comment?

The CHAIRMAN. Yes.

Senator LOTT. I ask my colleagues to allow me to do this. I will be very brief. Just to thank you all for being here. I found the panel very interesting. Thank you, Mr. Chairman and Senator Baucus, for having the hearing.

I do want to say to you, Mr. Rossotti, that you certainly look more prosperous and seem to be more articulate than you were when you were at IRS. [Laughter.] I do not know what happened.

Mr. ROSSOTTI. Well, I think I have actually grown a couple of inches.

Senator LOTT. Well, maybe so. But you have given us a lot to think about today. Thank you all.

The CHAIRMAN. For the other two people, would you please give a short answer, because I have run way over on my time?

Mr. BERNARD. I would be glad to, Mr. Chairman. I am not sure we can entirely conform book and tax, but we can learn from many of our major trading partners.

We have substantial operations in Germany, France, the U.K., Australia, and Canada, where there is much greater conformity and the tax return preparation process is much simpler to comply with. Rather than hundreds of book-to-tax differences, I think you could follow GAAP in many respects and greatly reduce the complexity that exists today.

The CHAIRMAN. Dr. Neubig?

Dr. NEUBIG. I testified with Professor Shackelford in May on the House side, and I guess I share Dr. Shackelford's concern that relying on book-tax conformity as a meaningful tax reform raises a whole host of issues that would need to be explored in depth.

I'll give two quick observations. In the 1986 Tax Reform Act, we actually did try to tax the difference between book and tax, and it had an ugly acronym of Business Untaxed Reported Profits, BURP. Trying to tax BURP raised many issues, and Congress eventually repealed the BURP preference after a few years.

Second, the IRS has instituted a new Schedule M–3 that will really give policy makers a lot more detailed information about differences between book and tax reporting. And the IRS and Treasury staff recently released a report last month that I think will really help you understand some of these issues.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Let me just kind of change subjects a little bit, just going to the present.

You all are concerned, and I think everybody in this room is concerned, everybody who is watching this is concerned, about unnecessary complexity in the American tax code.

Would Congress not be adding still another complexity to the tax code unnecessarily, clearly, if Congress does not pass these extenders in the next couple of weeks, that is, before the election?

I say that because the IRS has testified that if we do not, that is if the extenders come up after the election in November, then the IRS will have to reprint forms, have to go back and re-do all kinds of items. One hundred and forty million Americans file 1040s, and a lot of these provisions and extenders are the subject of that Form 1040. Tax software developers will have to go back and rewrite software, new code.

If we are going to obviously pass the extenders, the Work Opportunity Tax Credit, State sales tax deduction, research and development tax credit, tuition and classroom deduction for teachers, if we are going to do it—and we are going to do it, there is no doubt about that, we are going to do it—would it not make more sense to get all these passed before the election so that we would not cause more paperwork, more complexity, more cost to the IRS, more cost to companies?

That is, do it before the election rather than after the election? Because the IRS has said their drop-dead date is October 15. Many companies have told us their drop-dead date is October 15. Many companies have said they are going to have to restate their financials if it is not done now.

Mr. Rossotti?

The CHAIRMAN. The answer is obviously "yes."

I appreciate Senator Baucus's points on the tax extenders. As should be clear, this is a matter that is extremely frustrating for me.

As far as I'm concerned, there was an agreement to deal with these provisions as part of the pension conference. That agreement was a key premise to reaching agreement on the reconciliation conference report. Members, businesses, and taxpayers relied on that agreement.

In June, shortly after the cloture vote on the motion to proceed to the death tax repeal, I indicated I thought the political season had arrived and Republicans were going to be denied an accomplishment on the death tax.

Several subsequent efforts were made by the Leadership to try to force a vote on the death tax by adding sweeteners. An attempt was made on the pension conference. An attempt was made on the so-called Trifecta. I counseled against each of those courses of action. My counsel was ignored in each instance. And the action involved legislation that I had developed in this committee on the floor in a bipartisan manner. In each case, as predicted, the efforts failed.

When we came back early this month, the Leadership suggested they would take another shot at the Trifecta. I said, do it early. If it succeeds, then fine, we've finally delivered on extenders. If it doesn't succeed, then let's do the trailer bill by itself.

Well, that was several weeks ago. Once again, it appears my counsel will be ignored on legislation I've shepherded through the process. It is extremely frustrating. There never was an early decision and action on Trifecta, and now leadership members and staff have slow-walked us into a probable nullity on these time-sensitive matters.

Now, some members have backed up the slow-walk by threatening to shoot the trailer bill "hostage." In other words, they are using all their powers as Senators to block action on a matter that has overwhelming bipartisan support. Unlike those members, who again have not had the role I've had in bringing the legislation through the process, I have refrained from using my full power to force the issue on the floor.

What is sad about this is that these members ignore the impact on millions of middle-income taxpayers and hundreds of thousands of businesses who relied on a decent process. These constituents of ours who are trying to do the right thing are secondary to a gambit that is probably going to fail. The concerns, track record, and integrity of the Finance Committee are simply discarded by concerns about the "credibility" of threats to shoot these popular tax provision "hostages."

Senator Baucus, we will get this done, but I'm very disappointed in this process. It is not right.

Senator BAUCUS. All right. But I want to hear it from them.

Mr. ROSSOTTI. Well, I think Dr. Carroll is probably a lot better able to answer this, because I am not involved any more in knowing exactly which provisions——

Senator BAUCUS. I am telling you what the current Commissioner said.

Mr. ROSSOTTI. Yes. But, I mean, in general, certainly any provisions that affect the actual individual tax forms get to be a problem if they are not passed. If those decisions are delayed into the fourth quarter, I would certainly agree with that. But I honestly am not up to date on the details.

Senator BAUCUS. All right. Well, just generally. In principle. If the facts are as I presented them, and they are the facts that were presented by Commissioner Everson.

Mr. ROSSOTTI. Without question, it becomes more of a problem, for all of the reasons you cited, as those issues are in suspense.

Senator BAUCUS. Yes. Do you have any thoughts on that, General Walker?

General WALKER. If the facts are as you presented, I think the answer is, clearly, yes. That does not mean you should or should not do what you said.

Senator BAUCUS. Right. Right.

General WALKER. But that is, clearly, yes. If I can come back really quickly to what Senator Grassley mentioned a second ago. As a certified public accountant who has spent most of my career in the private sector before coming into the government, I can tell you that, clearly, the complexity with regard to book and tax differences is shown in Schedule M–3.

You ought to do what is right from an economic standpoint, from a public policy standpoint, with regard to the tax code. Namely, you need to streamline it, simplify it, lower the rates, broaden the base, and deal with a number of these other issues. Do not worry about the accounting. Let the accountants worry about the accounting. Focus on the public policy and the economic aspects.

Senator BAUCUS. Now, is it not true, and I asked Dr. Carroll this point, that if we adopt one of the main recommendations of the panel, which is to basically work toward a consumption tax, does that not favor new business, new capital at the expense of old capital?

Will there not be a huge transition cost to bail out those folks that will not be able to take advantage of current provisions where they get to depreciate their capital expense, but rather businesses can only expense?

Dr. CARROLL. I think one of the very important decisions that we face in thinking about business tax reform, and tax reform more generally, is putting in place a set of incentives and a new tax system that will encourage growth, but also——

Senator BAUCUS. What do we do about old capital? I have limited time here. Ford, GM. What are we going to do about their depreciation? That is gone? Transition costs?

Dr. CARROLL. I think, in just a couple of sentences, a policy that promotes growth will be focused more on encouraging new investment as opposed to benefitting past decisions. That would encourage growth more than other policies.

That said, I think as we approach business tax reform or tax reform more generally, we have to be very careful that we are sensitive to changes in market valuations, changes in asset values, and the adjustment costs that could occur with fairly large changes in the tax system. That might cause a set of descriptions and——

Senator BAUCUS. One more question. That is, how do we get from here to there? This is obviously a hugely complex question. We are in a massive country. I mean, it is all kinds of people, different interests, and so forth. This is the U.S. Congress. We represent the people. Congress does not lead very much. Congress follows.

Congress basically follows what the people of the country want us to do: mortgage interest deductions, bail out New York City, 9/11 issues, Katrina, health care questions. I mean, we follow what the people want us to do. Congress meets annually and there is al-

ways a new Congress every year. So, how do we deal with this? I am asking a process question.

I firmly believe, and I liked your response to it, there is only one way to deal with this, only one, and that is something similar to what we did in the early 1980s with Social Security, with the Greenspan Commission.

When President Reagan nominated Alan Greenspan to head the Commission on Social Security, he appointed a lot of high-profile people to the panel. Both ends of Pennsylvania Avenue shook hands on the deal.

Jim Baker basically called Tip O'Neill and said, hey, what are we going to do here? Baker said, all right, are you Democrats willing to reduce benefits if we Republicans are willing to raise taxes? Yes. They shook on it. They all joined hands and that is how we got it done. Politically, it is very, very, very difficult, if not impossible, in my judgment, for this Congress alone to meet and solve this problem.

I will just make another quick point here. We—and Mr. Chairman, you know this very well—a couple, 3 years ago, Senator Voinovich and I had this idea of a Tax Reform Commission, basically set up along the lines I suggested. What happened? We had it in the bill.

The White House called and said, no, they did not want it. They were opposed to it. They wanted to have their commission. Right away, it was a dead duck. It was gone. Why? Because it was cooked. It was a cooked deal, with ulterior motives. That is why it was dead on arrival. That is why, I hate to tell you guys, this tax reform proposal is basically dead on arrival. But it is a good springboard from which we can talk about these questions.

Now, that is why I think you have to do something that is perceived as objective, that does not have ulterior motives, where people come together, both political parties. I would just like your idea on process. How are we going to get from here to there, General Walker?

General WALKER. Senator Baucus, process is of critical importance because we have not made much progress. Washington has proven over the years to be a lag indicator, and I believe it is going to be critically important that you do something along the lines of what Senator Voinovich and Congressman Wolf have recommended.

They have legislation that is pending right now and are trying to get bipartisan support for, that would have a capable, credible, high-level, bipartisan entitlement and tax reform commission with a defined scope that could look at all the great work that has already been done by the many commissions before. It is based on the lessons from which commissions worked and which did not in the past, such as the 1983 Greenspan Commission, and others. The Commission could, I think, report within 6 to 9 months if it was comprised the right way so that Congress would be able to——

Senator BAUCUS. I know I am taking time here, but two points. You are going to have to put revenues on the table, as well as taxes. Everything is going to have to be on the table for it to work, otherwise it is dead.

General WALKER. And their bill has that.

Senator BAUCUS. All right. Good.

Second, the composition of the commission has to totally pass the smell test.

General WALKER. It does.

Senator BAUCUS. It cannot in any way be perceived as political.

General WALKER. And their bill is designed to do that.

Senator BAUCUS. That may be. I am not sure about that point. But I am just saying, general principle. You and I both agree on the approach and the principle. Other thoughts?

Mr. JOHANNESEN. May I comment on that?

Senator BAUCUS. Yes.

Mr. JOHANNESEN. It is a monumental task. As I study what is out there, there are so many interests, as you have mentioned, and there are so many things to accomplish, that I think trying to do them all—it would be nice to have something done in 2 years, I just do not know if it is realistic.

I think you see a lot of things in process that you could accomplish when you focus in certain areas. I think possibly we may have to bite off what we can chew as we move forward in a very deliberate pace. It would be great if we could get it done 2 years from now. I am not sure we can.

I am very concerned about the transition, as you have mentioned. One thing that we maybe need to consider a little bit as we go through here is, we have a lot of history on what works and what does not work in tax policy.

I am not sure we have ever studied it very well. I do not know if we have ever really done a return on investment of the type of things that we suggest for investments or incentives. If we were to take that approach and maybe study that a little bit first, we might learn something.

I know we spend a lot of time revenue projecting before we put laws in place. I just do not know if we spend much time evaluating our return, as a government investor in our economy, what we get back on that.

So as much as I would like to have it done quickly, I am not sure it is workable. We do have a complex country. I think we expose ourselves to risk in what we might do if we are wrong in some of our decisions.

Senator BAUCUS. I agree.

Mr. JOHANNESEN. So I think a little bit more deliberate, intentional approach, but not a slow approach. That is not what I am trying to say.

Senator BAUCUS. That was my last point. I very much agree with that. We are too ad hoc around here in this town. Way too ad hoc. We need to think much less tactically ad hoc and much more strategically, kind of start thinking about planning a little bit, thinking ahead a little bit, addressing what other countries are doing, and so forth. We need a process that helps make that happen and encourages it.

General WALKER. Senator, we spend $700 to $800 billion a year in foregone revenues through tax preferences, whether they be corporate or individual. They are not subject to the budget process. They are not subject to the appropriations process. They are not part of the normal financial reporting process. They are not part

of the President's Program Assessment and Rating Tool (PART) review.

We need to start analyzing which of these tax preferences work and which ones do not, whether they are generating a return on investment, and who is benefitting from them. Even the R&E credit, which clearly has strong conceptual merit, was designed many years ago, and we really have not analyzed how much of this R&E credit is based upon basic research and therefore can fuel our competitive posture in long-term economic growth, versus applied research. You are right on. We need to do this and we need to do it beginning now, and forever.

Senator BAUCUS. Yes. I lied. I said that was my last point. It was not my last point. Now this one really is. [Laughter.]

The CHAIRMAN. So none of you guys follow on.

Senator BAUCUS. That is right.

In my experience since I have been in the Congress, basically in the last 15 years or so, most decisions made in this committee are not policy-driven, they are budget-driven. We have forgotten policy. We are not paying any attention any more to what is the policy consequence of this. Rather, we are trying to split the difference on the budget.

The Budget Committee gives us the orders, we have to cut so much here, do so much there, and so we tend to want to spread the pain as widely as we can and not to hurt people very much, or hurt them less, and it is not policy-driven, it is all budget-driven. It is a huge, huge problem.

I just very much hope, Mr. Chairman, that we could find some way to get out of that trap, because the timer is ticking. I have gone way over my time, and I apologize.

The CHAIRMAN. Senator Hatch?

Senator HATCH. Well, I am very interested in what Senator Baucus has said. It sounds to me like he is talking simplification like all of you seem to be talking.

If that is so, I hope we can get some leadership on both sides to be able to make some of the changes that really need to be made in our tax code, because it is a god-awful, pathetic thing when you stop and think about it. We have made it that way, and I think it is time for us to straighten it out.

I have questions for all of you, and I will have to submit them because there will not be enough time.

[The questions appear in the appendix.]

Senator HATCH. But Mr. Bernard, you mentioned the importance of reforming our tax system to improve the competitiveness of U.S.-based multinational corporations.

Now, I have long worked to improve our international tax rules to try to accomplish this. How specifically should our tax system be changed to make the U.S. a more attractive destination for new business operations? One other question. Do you favor moving to a territorial system of taxation or to completely reform Subpart F and the foreign tax credit to make them work as they should?

Mr. BERNARD. First of all, let me respond in my individual capacity, because I am not sure we have consensus among TEI's 6,200 members on these questions.

I personally think that two things that would significantly improve U.S. competitiveness are, number one, a major rate reduction on the corporate side, putting us more in line with our major trading partners. The second thing is that I personally do believe that a territorial system ought to be our target at some point in the future. The transition may not be easy, but other countries have done it. Canada, as an example, went to a territorial system not that long ago. We can learn from some of the other countries' experiences on how to do it right.

So I think those two things, in and of themselves, would get rid of many of the problems inherent in the system because of Subpart F, including the foreign tax credit abuses that might be perceived to be in the system. Those two things I, think, in tandem would greatly improve American competitiveness.

Senator HATCH. I want to compliment each of your for your statements. I read them all. I have to say that I think you have added a lot to our understanding here on the committee.

Let me just conclude with you, Dr. Neubig. I thought your testimony on why businesses generally prefer a lower tax rate to immediate expensing was extremely interesting to me. However, it seems to me your remarks focus on the viewpoint of the business community, as probably they should.

But as an economist, do you believe that expensing is superior to lowering tax rates? For purposes of maximizing economic growth, are we limited to one or the other? Is there a feasible way we could adopt immediate expensing and also lower the corporate tax rate at the same time?

Dr. NEUBIG. I think it would be very difficult to lower marginal tax rates and have 100 percent write-off in the first year. I guess I do have some disagreement with a number of my academic colleagues in terms of what really is the power of expensing versus lower marginal tax rates.

Maybe a simple example would be helpful. If I am a small business and I am doing some R&D, and I have a great idea, I am trying to hit the home run, and I invest $1 million in this new copyright and I am going to be able to sell that idea to another corporation a year from now for $100 million because it is a great idea, would I want to write off that $1 million in the first year or would I like to have a lower tax rate on that $99 million of gain?

That first-year write-off does have some benefit in terms of the time value of money which is the equivalent of a zero interest rate loan. But having that $99 million of gain taxed at 25 percent versus 35 percent marginal tax rates would matter more.

You oftentimes will hear academic economists say that expensing is the equivalent of a zero tax rate. I do not agree with that. It is a zero tax rate if you read the fine print on the risk-free return on that new investment. It is still a high marginal tax rate on the efforts from entrepreneurship, innovation, and effort.

So I think oftentimes the benefits of expensing are greatly overstated. The benefits of marginal tax rates for R&D, innovation, international competitiveness are oftentimes not fully recognized.

Senator HATCH. All right.

One last question, if I could. It is my understanding that the U.S. corporate tax rate is one of the highest in the world. However,

deductions and credits lower the effective tax rate below the marginal rate.

Now, if our effective tax rate is considered, how does the U.S. rate compare with that of other nations?

Dr. NEUBIG. I think there are some studies done by Michael Devereux. I am not intimately familiar with them. I think, clearly, there are lots of accelerated deductions and lots of credits that lower average tax rates below the statutory marginal tax rate. Now, I guess I am not sure that the average tax rate is as meaningful as the statutory marginal tax rate.

Senator HATCH. Yes. Or the effective tax rate.

Yes, General Walker?

General WALKER. Based on work that we have done, Senator, the effective tax rate, corporate tax rate, in the U.S. is roughly the same and competitive with the G–7 countries. We have done some work with regard to the G–7.

But again, it is true that that might be accurate. On the other hand, what is the compliance cost of getting there and what is the economic opportunity cost associated with getting there? These points are important, too.

Senator HATCH. That is good. Anybody else care to comment on that?

Mr. JOHANNESEN. I would like to briefly comment. I do not disagree with the lower rate theory at all. I think it is right on. One thing I would like to mention, though, with respect to mid-sized businesses, is that access to capital is a big deal to them. Whereas, a public company has access to the capital markets from that route, closely held businesses generally do not have that.

So, while I understand the theory on the timing position, I also think there is some advantage to that because of the fact that, if you can create cash in a closely held business without access to other marketable capital, that is valuable, short-term. It does give them the ability to stay in existence, to continue to operate, and be successful.

So there is a place, I think, for some expensing that is valuable, but I certainly would not disagree at all with anything Dr. Neubig said in terms of the long-term benefits of lower rates.

Senator HATCH. Thank you.

Senator Wyden?

Senator WYDEN. Thank you all. I think this has been an excellent panel. I would just start by saying, gentlemen, my sense is that, 20 years ago, Ronald Reagan, Bill Bradley, and a bipartisan group really got it right.

I have introduced legislation, the Fair Flat Tax Act, which essentially tries to update that work. It is different. Clearly, the issue we are examining today, the question of corporate taxes and our role in the global economy, has to be handled differently.

But a little over a month ago, Senators Mack and Breaux sat where you all are, and I asked them both whether they agreed that, philosophically—not in terms of all the rates and the like, but philosophically—did they think what happened in 1986, where the focus was on driving down rates and getting rid of preferences, was still sound today and would be the makings of another bipartisan effort? Both of them, a Republican and a Democrat, said yes.

They have differences of opinion in terms of a rate, and certainly many are concerned about the corporate rate, and I understand that. But philosophically, they said if Congress, in 2006, does what was done in 1986, Congress would be on target.

I would like to go down the row and just ask you whether you think that the philosophy of what Ronald Reagan, Bill Bradley, Dan Rostenkowski, Bob Packwood, that bipartisan group did is still sound.

My question is not about maybe altering the rates in various areas, because I think that clearly is something that will have to be debated. But do you think, philosophically, what was done in 1986, which is what I am trying to do in my bill, is still sound? Let us just go down the row.

Mr. JOHANNESEN. I would agree with that, very much. I think the business community would as well. Nobody wants to give anything up. That is hard, right? I mean, when you have something in your pocket, it is hard to let it go. But I think if a simpler tax structure with less preferences went into place and the business community understood it, I think they would support it.

Senator WYDEN. Mr. Bernard?

Mr. BERNARD. I agree that imposing a lower rate of tax on a braoder base—with fewer preferences—is still sound policy. The one thing that we have to do then is be disciplined and not go back every year and tinker with the system and add to the complexity.

Senator WYDEN. Well, three cheers for you! In fact, that is one of the changes a number of people have suggested. Mr. Rossotti has made a very compelling case.

I am looking at it in terms of modifying my original bill to try to see if we can get in this room a bipartisan agreement, try to find some procedures that could be put in place to keep us from sliding back, which I think is the single biggest problem we have had since 1986.

Dr. Neubig, when I listened to you, I think you and I were singing out of the same hymnal. But can we get you on the record on this 1986 philosophical issue?

Dr. NEUBIG. Well, Senator Wyden, I was serving for President Reagan in the Department of the Treasury during development of Treasury–1, the President's proposal, and the 1986 Tax Reform Act. Absolutely. We have seen the benefits of the 1986 tax reform. I'm philosophically in complete agreement.

Senator WYDEN. Mr. Rossotti?

Mr. ROSSOTTI. Yes. I can be very simple. The first principle, as I said, is lower rates are better than preferences.

One of the things I have said to people that sort of gets attention on this is, when you stop to think about it, the entire income tax system, corporate and individual, raises somewhere between a little more than 9 and 10 percent of GDP. Yet, we have a top rate of 35 percent. Why do you need 35 percent to raise 9 percent? The answer is, that is because you have a complex tax code and it makes no sense.

Senator WYDEN. Dr. Carroll?

Dr. CARROLL. Generally speaking, having broad-based low rates is a very good principle. I think a number of witnesses here, in

their opening remarks, mentioned that as a principle for reform in the business area, or more broadly.

I think it does depend on the starting point as well. Back in the early 1980s, the top individual rate was much higher than it is today. It is also important to focus on the effective marginal tax rates on labor and capital.

Just as an observation, I think starting from where we are today, one of the key drivers for improving living standards is lowering the tax, not only for all taxpayers, the marginal tax rate on all taxpayers, but also focusing on savings and investment has very beneficial effects to promoting growth.

Senator WYDEN. I think those are fair comments, coming from the administration. What I was interested in was trying to focus on what I think was the heart of 1986, which was to give everybody the chance to accumulate wealth. I think that somehow we have managed to move away from that, and I think this is an area, again, that we could work on in a bipartisan kind of fashion.

General Walker?

General WALKER. The answer, Senator, is the same as I said last time. Yes, lower rates, broader base, with a big, big footnote: if you want stability, then we need to make sure that it is fiscally prudent and sustainable.

We are far out of balance today, and our long-range fiscal situation is getting worse day by day. So if you want to be able to achieve it, then you need to consider not just 1 year, not just 5 years, not just 10 years, but how we're likely to look over the longer term, or else by definition you will not be able to sustain it.

Senator WYDEN. Fair comment. This is one you all might want to get back to us on the record about, but it was something that came up repeatedly in 1986. Senator Bradley, I know, was interested in it, Senator Packwood was interested in it.

That is, I would be interested in your judgments. For example, it is clear, Mr. Johannesen, in Des Moines you have a lot of clients, medium-sized businesses, who would have views about this question.

What would be your sense of, how low does the rate have to be before businesses do not fight like crazy to come on in here and add preferences? In other words, people come to the Senate Finance Committee constantly because they feel they have to get rates down.

But I heard Senator Bradley, Senator Packwood, and others ask repeatedly in 1986, how low do rates have to go before preferences become a bit less important to your clients? Mr. Johannesen?

Mr. JOHANNESEN. Well, I can say with absolute certainty that if it is zero, no one will come.

Senator WYDEN. Right.

Mr. JOHANNESEN. So we are safe there. [Laughter.]

Senator WYDEN. There will not be any protest rallies if the rate is zero. I got you.

Mr. JOHANNESEN. Probably a little more realistic, I think at 30 percent you would still get visits. That is pretty low, though. At 25, which I think is what a lot of the panel members are suggesting——

Senator WYDEN. Is that what you said, Dr. Neubig?

Mr. JOHANNESEN. Twenty-five, to me, just seems like the right number. I cannot cite a study, but at 25 percent I have talked to various business owners. When you were discussing the estate tax revisions that did not get through, their whole perspective changed when the rates became more reasonable.

Then all of a sudden, they would not have been very happy with that. But I think 25 percent on the business tax would be something that would reduce your time spent with visits. But I think you do not even have a chance unless you get at least down to 30.

Senator WYDEN. I think I am right on the clock in terms of being able to vote. Could the others of you get back to us on that—this is as much because you are practitioners in the field—as to your sense of what it would take to get preferences to be less important?

My understanding is that now, because the Chairman, Senator Baucus, and I all want to ask you some additional questions, we are going to have a brief committee recess of the Finance Committee, and then we will all come back and ask you additional questions. But you have been an excellent panel, and I know we are going to have a lot of things to ask you about in the days ahead.

[Whereupon, at 11:33 a.m., the meeting was recessed, reconvening at 11:36 a.m.]

The CHAIRMAN. We have heard it said over and over again that the U.S. tax rates on business income need to be lowered. We have heard that again today from several of you. We have heard knowledgeable people say that the tax system will be more equitable, efficient, simpler, with lower rates to a broader base.

Most people can agree on lowering the rate, but when it comes to broadening the base, then that is where it gets very tricky. How should Congress go about picking the winners and losers in relationship to the current system?

One way would be to start with a blank slate and the lowest possible rate, then see how much a particular tax expenditure raises the tax rate and then decide if it is worth it. I am going to ask Mr. Bernard and Mr. Johannesen, what tax benefits would businesses be willing to give up in order to get a lower rate?

Mr. BERNARD. Thank you, Mr. Chairman. I can say on behalf of the TEI group, that this is going to be the most difficult part of this process. Everybody has their favorite incentives, obviously.

But I think that any incentive that is targeted for specific industries or for specific activities should be open to fair and open discussion on whether it should be continued. Whether that means a clean slate or not, I am not sure.

But TEI is certainly open to debate on each and every incentive. The section 199 deduction is very well-intentioned, but it is very difficult to comply with. There is a high level of compliance costs on that.

Even the research tax credit, in my personal experience, has been unbelievably heavy in the compliance burden that it creates for Kimberly-Clark. It also creates a lot of controversy on the back end with the IRS.

As a result, it is not an example of an incentive that we can rely on because we always have questions about what qualifies and what does not. Then on the back end, we have debates with the

IRS about what qualified and if our decision on the front end was correct.

So that is just one example of an incentive that many members of TEI love because it creates great value for them, but it is one of those situations where there are winners and there are some that just are not able to take much advantage of it.

The CHAIRMAN. All right.

Mr. Johannesen?

Mr. JOHANNESEN. Thank you, Mr. Chairman.

Mr. Bernard, I agree with you. I think it is going to be difficult because people do not want to give up what they have. However, I would probably pose the question a little differently in that, back to what I mentioned earlier, what type of return is the government getting on its investment and incentives?

That is where I would probably start, because it will be difficult to expect people to step forward and volunteer. Yet, business people understand return on investment. They understand that something has to give in order to reap the rewards of the lower rates.

So volunteering, it would be tough to find people stepping forward, but a rational basis of evaluation of what has been working, what has not, and where we are getting a good return on our investment, I think, is the appropriate approach to take.

General WALKER. Mr. Chairman, can I jump in there, if possible?

The CHAIRMAN. Yes.

General WALKER. I would like to add to that. I think it is very, very important that the Congress start analyzing these different tax preferences, which ones are working, which ones are not, what return on investment are we getting, in what form, and who is benefitting from them.

Then I would specifically suggest that you want to minimize the rate and broaden the base, and that means, if in doubt, leave the preference out. I do not think it is realistic to expect that a business is going to come up here and say, well, get rid of this, get rid of this, and get rid of this. But I do think you could probably gain agreement that you want to try to minimize the rate.

And if you are going to minimize the rate, by definition, it means you are going to have to limit the number of tax preferences. Now, you are going to have transition issues that have to be dealt with, as Senator Baucus talked about. Those are real, and they have to be dealt with.

That is why you may need some type of commission, informed with analyses from GAO, CBO, JCT, and others, to try to help make a more evidence-based decisions with regard to these matters.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. On that last point, this gets pretty complicated. Let us take the employer-provided deduction for health insurance. That is big. That is extremely big.

That plays right into health care policy because today in America, the more you work for a big company, the wealthier you are and the better your health care, basically.

The more you do not work for a big company, the more you are not wealthy. Your health care is not as good, except for emergency care, and Medicaid helps a little bit. So, if we were to eliminate

that preference, that would radically change our health care system, maybe for the better. But it has huge consequences apart from tax theory.

General WALKER. Senator, I agree. I have testified before that there are two aspects of the tax preferences for health care. One aspect is the employer deduction. The other aspect is the individual income tax exclusion and the exclusion from the payroll tax base.

I would respectfully suggest that you need to limit the exclusion. You need to limit, both for income taxes for the individual, as well as for the payroll tax base, and you may want to target it.

In other words, you may want to allow some exclusion to some level of coverage, but not what we have right now, which is very unaffordable, unsustainable, disassociates people from the cost of health care, and creates huge winners and losers under our current system. So you are right. It is not just looking at the tax, it is looking at social policy and other areas that would have to be looked at.

Senator BAUCUS. Which raises another question. Let us say we have the pure result here that is good: broaden the base, lower the rates, et cetera. Much more simple. Well, Congress meets every day. So what limitations do you have on it? Are you suggesting what Congress could and should not do that will then complicate the code again? We are back in the soup again.

Or are you saying that, well, this is cyclical, it ebbs and flows. Let us get a real efficient system here. Then gradually, as happened after 1986 when we started reacting to the people, the people we work for, we started to change the code and complicate it further.

General WALKER. I come back to what you said, Senator Baucus. Washington is a lag indicator. It is reactive. Human beings will always come and ask for more. That is a normal human condition. It will always happen.

We need a more disciplined process. We need to start with understanding what already exists, what is working, what is not working. You are going to need some type of commission.

And even if the commission cannot get you to the point where you can make decisions in the next Congress, at least it would help to set the table for the next presidential election. This would increase the likelihood that whoever is elected President will end up having to take this issue more seriously than otherwise might be the case.

Senator BAUCUS. Any other thoughts on the questions that General Walker and I have been discussing from anybody else on the panel? That is, the health care exclusion, for example.

Mr. ROSSOTTI. Well, one comment on the general question of preferences versus rates on the business side, is that I actually do not think that you could ever get there by trying to analyze each one and seeing which one is working or not, because I do not think you could ever come to a conclusion on that. It is very difficult.

I think the conclusion that we, all nine of us on the Tax Panel, came to is that the only real way to do this is to do it with a clean slate and, on the business side, eliminate all the preferences and get the lowest possible rates.

Let me give you an example of why I say that. Take the R&E credit. Mr. Bernard made some comments about how it is difficult to rely on that. For most of my career, 36 years, except for 5 years in the IRS, I was in the technology business. Even now, on the investment side, I am in the technology business. We had the R&E credit for most of that time.

I cannot remember a single time, not only in my company but anywhere in the technology business, that anybody ever made a decision on whether to undertake an R&E project on whether it was going to be eligible for the R&E credit or not, because nobody even knew whether it would apply.

It was something that the tax department did at the end of the year. I see him shaking his head. We were very glad to get the tax credit, do not get me wrong, in my company. We loved it. We loved to get it.

Senator BAUCUS. And what if you did not have it?

Mr. ROSSOTTI. We never made any decisions based on it.

Senator BAUCUS. What if you did not have it? What if it was not there?

Mr. ROSSOTTI. If we had not had it, we would have had a higher—if you came to us and said, would you give up the R&E credit for no reason, we would have said, oh, no.

Senator BAUCUS. No, no. That is not my question. What if it were not there?

Mr. ROSSOTTI. If it were not there, it would not have affected any decisions we ever made because we did not know in advance whether we were going to get it, first of all, and second of all, if we were going to get it, it was such a small factor relative to the return that you would expect on an R&E project that it was not going to make a difference.

So, really, the best thing to do—I think the only thing to do if you really want to get the tax reform—would be to start with a clean slate. What we really want is to treat everybody equally, to get the lowest possible rates, get rid of all the preferences, and give everybody the benefit, as Dr. Neubig said.

The one thing that you do know is that, in any business decision to make an investment, the tax rate is going to play into that decision. The statutory tax rate is going to play into the decision. All the other stuff may or may not play, and most of the time does not play.

Senator BAUCUS. So you are basically saying none of these preferences matter at all to business. That is what you are saying.

Mr. ROSSOTTI. I am saying, if you were going to go through tax reform, the only way to do it, I believe, is to go to a clean slate and get the lowest rate possible.

Senator BAUCUS. Does anybody here think any of these preferences help business at all, current preferences?

Dr. NEUBIG. Senator Baucus, I think there are definitely some provisions in the tax code that definitely are worth the costs.

Senator BAUCUS. What are some?

Dr. NEUBIG. Well, I think what we are missing is the systematic approach that Mr. Walker suggested in terms of systematically looking at the benefit-cost analysis of each of the tax provisions. That really is completely lacking in our tax policy discussion.

I think one of my experiences with the 1986 Tax Reform Act, and also the Advisory Panel, is by just saying, these are gone, they do not have any reason to be in the tax code, misses the point that some of them are probably worthwhile, some of them probably not, and we need some systematic way to evaluate whether or not they are benefitting.

Senator BAUCUS. Well, that is a nice, high-sounding principle. I tend to agree with Mr. Rossotti, despite what General Walker said. I do not know how the heck you are going to determine what the real effect of these preferences really is.

Dr. NEUBIG. Both the Treasury Department and the Joint Committee on Taxation are spending resources looking at the dynamic analysis of tax changes. I would suggest that, in addition to looking at dynamic analysis, they should be having the capability of doing benefit-cost analysis on specific tax provisions.

General WALKER. Senator Baucus, these are not irreconcilable points. You could, for example, do what Charles Rossotti suggested, and that is, start with a clean slate: there are no tax preferences.

Then you could take it the other way to be able to say the only way that you would consider anything is if there is some type of ROI cost-benefit analysis to demonstrate that it makes sense.

So either way we need to be able to make more evidence-based decision making. The ultimate goal should be, minimize rates, minimize preferences, and maximize the level playing field that we have on a global basis.

Mr. BERNARD. Senator, if I may on that point, I would answer your question by saying the preferences that we need to keep in the code, perhaps, are those that allow us to be competitive.

Senator BAUCUS. Name some, please.

Mr. BERNARD. An example would be a capital cost recovery system. Perhaps the one we have is fine relative to our trading partners and our competition overseas, but many countries offer not only lower tax rates, but also accelerated depreciation. So that is an example of an incentive that I think would have to be kept, even if rates were dramatically lowered.

Senator BAUCUS. What do other countries do with respect to R&D? Do any other countries have any tax incentives at all to help their companies spend more on research, et cetera?

Mr. BERNARD. Yes, Senator, some countries do have incentives. For example, in the U.K. you are allowed to deduct 125 percent of the R&D expenditure. In Australia, there is a similar beneficial incentive on R&D.

Senator BAUCUS. That is a high percentage.

Mr. BERNARD. Pardon?

Senator BAUCUS. That is a high percentage.

Mr. BERNARD. Well, 125 percent of the amount of the R&D expenditure. So the U.K. tax rate is 30 percent, so it is the equivalent of a 7.5 percent credit. It is 30 percent of the 25 percent incremental deduction.

Senator BAUCUS. Mr. Rossotti, besides the tax code, what are some of the reasons why some companies go offshore and do their research in other countries?

Mr. ROSSOTTI. Well, I mean, there are a lot of reasons besides taxes. For example, in India today there is a tremendous wealth of

technology talent that is not only lower cost in some cases, but actually is very, very high quality, to the level where it is hard to match in the U.S. So people would be doing that for reasons that are not driven by tax.

I think the best that you could do, really, is to make sure that the tax is not the main influence, or a significant influence, or to keep it neutral, and then you could compete on the economic factors as opposed to the tax factors.

What I think, honestly, is happening is that people are moving some of their intellectual property assets and some of their income reporting assets to certain low-tax countries for reasons that are really primarily tax-driven as opposed to because of any other reason.

I think that is the kind of issue that, ideally, would be resolved through tax reform. It is not easy to do, but that would be the kind of thing that you would want. You do not want to stop the international competition to find the best quality technology talent.

Senator BAUCUS. I was over in India not long ago in Bangalore, visiting the Jack Welch Technology Center. GE has this huge research center there in Bangalore. I talked to the head guy there. I said, why are you here? Why are you in Bangalore? His answer was, well, this is where the best talent pool is, here in India, for all the work that we are doing.

I am not a big technology expert, but going through the many buildings, I was very impressed. They are doing, seemingly, a lot of good stuff there. I said, where is the next greatest technology pool, next after India? China. I said, where are we in the United States? He said, you are kind of down there. You are a way down there.

I said, what do we need to do to get up there? He had two answers: one is education, the other is health care costs. For him, health care costs are a major reason why it is difficult for American companies to do business and to compete. Second, you have to spend a lot more time on education. You have to get math and science. You have to get your people up there.

General WALKER. On that, Senator, I think we have to keep in mind that companies do not have duties of loyalty to countries.

Senator BAUCUS. That is clear.

General WALKER. Companies have duties of loyalty to their shareholders and investors.

Senator BAUCUS. Right.

General WALKER. That means, by definition, they want to maximize revenue, minimize expenses, maximize net income, maximize ROI, and maximize free cash flow. So that is a lot of what is going on.

Plus, the talent pools are different around the world. We are not even top 20 in science and math scores at the junior high and high school level. And health care costs are arguably the number-one competitiveness challenge for American business, in addition to a huge fiscal challenge for not just the Federal Government, but also for State governments because of employee and retiree costs.

Senator BAUCUS. And maybe you are correct that the tax code should not get all involved in that debate on what to do about health care costs.

General WALKER. I am suggesting that the tax code is part of the problem with our health care system. It is fueling the problem.

Senator BAUCUS. But you are suggesting, if you take away the fuel, after the fuel is removed, as a general rule we should not use tax policy as a tool to address American health care policy.

General WALKER. Not anywhere near the extent that we do today. I am suggesting that you have to have three things for a system to work: incentives for people to do the right thing, transparency to provide reasonable assurance they will, and accountability if they do not.

We do not have any of the three in health care. In fact, our tax incentives are part of the problem because we are reducing the transparency of the cost of health care to individuals.

Senator BAUCUS. Right.

General WALKER. We are significantly subsidizing some, and others not at all. Clearly, we are going to have to look at the tax provisions as part of comprehensive health care reform.

Senator BAUCUS. All right. Thank you.

Senator Wyden?

Senator WYDEN. Thank you, Senator Baucus. I think Senator Baucus's points about the tax code as it relates to competitiveness are extraordinarily important. One of the reasons that I want to clear out a lot of the clutter in the code is that, if you are going to be in a position to make some of the structural changes that Senator Baucus has talked about in order to look at our competitiveness for the long term, you do not have any resources if you throw 14,000 tax breaks at it, as Mr. Rossotti is talking about.

So I want to build on the earlier discussion and incorporate some of Senator Baucus's thinking on this. I mean, Senator Breaux and Senator Mack both said that 1986 could be a solid principle for bipartisan tax reform in the days ahead. All of you, to a person, have said that as well.

My question then is, what might be done to prevent the creep that really did so much to unravel what was done in 1986? In other words, basically as soon as the ink was dry on this 1986 bill that all of you have said is a solid philosophical basis for going from here, and Senators Breaux and Mack said was a good, solid philosophical basis for going from here, we started adding to the whole thing and started unraveling it.

Now you basically see resources go to these 14,000 tax breaks that might go for the kinds of things Senator Baucus is talking about that could really deal with the global economy in a structural kind of way.

I would be interested in your thoughts, because I am actively looking at this as part of my Fair Flat Tax Act, about what can be done to keep all the clutter from just creeping back in and unraveling something that all of you have said is structurally sound: low rates, emphasis on getting low marginal rates, and getting rid of preferences.

General Walker?

General WALKER. In addition to making sure that you consider the fiscal implications at the outset, I think that you need to think about how you might be able to require an independent professional analysis of proposed changes that would have a material ef-

fect on the budget and on our fiscal position as an integral part of Congressional consideration before any changes to the code, after you rationalize the system.

Senator WYDEN. That is probably too logical at this point, but I think those are exactly the kinds of ideas we are looking at.

Dr. Carroll?

Dr. CARROLL. I think for the tax system you have to set out clear goals and objectives. You want a tax system that interferes with individual and household decision-making as little as possible.

In areas where particular preferences and incentives are considered, a very, very high standard needs to be applied, and the analytical tools need to be developed to do the cost-benefit analysis to support or not support consideration of a particular incentive or provision.

Senator WYDEN. Mr. Rossotti, since I only quote you about four or five times a day on your 14,000 breaks, three for every working day, what do we do to prevent the creep that basically brings all this stuff back?

Mr. ROSSOTTI. During this Tax Panel, I personally enjoyed working on it because the nine people that were members were really trying their best to come up with the best answers.

That was one of the questions we talked about, and we thought about whether we should put a recommendation in the report to address exactly that question. You will notice there is not any recommendation in the report because we really could not come up with an answer.

I think the reason that we could not is that this is inherently something that is part of a political process here in Congress. It is not a technical issue, it is a political process issue. That is not my field of expertise.

I think what others have said, I would generalize this way. If you really want to do that, you have to impose something on the process here in Congress that makes it more difficult to pass these things than it would be as it is now, whatever that may be.

Senator WYDEN. Right.

Mr. ROSSOTTI. And it is probably difficult enough. But it is a political question in terms of how Congress legislates, which is why we did not address it here. Beyond just simply saying something that would have to make it more difficult, I do not know.

There is one other idea I could throw out to you—and I know this is controversial—which is, to some extent, there are parts of this that could be, in effect, taken outside the legislative process by delegating it to another group. This is where the use, potentially, of Generally Accepted Accounting Principles might come in.

I will take the example of Social Security, which is very political. Congress makes the decision or has a process to determine how much it wants to adjust Social Security, through legislation, through cost of living, and so forth, but it does not legislate precisely how cost of living is measured.

It has some technical experts in the Department of Labor and other places that have been established as independent technical experts to simply measure how much the cost of living goes up every year. That is a little bit controversial, but still it is done in a professional way.

Then the legislative process makes the next step, which is, all right, based on that, how do we adjust what people get? I would suggest that, with respect to business income, the issue of measurement of what a corporation is actually earning in a year is a question where there is a very elaborate process already in place that is overseen by the government that comes up with that number.

I think it might be very worthwhile to consider separating out how you measure that income from how much tax you want to impose on it. By doing that, if you could ever make that separation, one of the elements, at least, of leading to this creep and this complexity would be perhaps eliminated.

It would still leave the question to what extent Congress wanted to provide subsidies through credits, for example, for energy or something like that, but at least it would separate out the measurement issue from the subsidy issue, which I think is one of the things that leads to a lot of lack of clarity in today's system, because you do not even know, for example, what exactly you are subsidizing.

So that is another thought that I would throw out to you that would be very far-reaching, I understand, and probably is not going to get any further than 5 minutes of discussion in this hearing, but at least it is a thought.

Dr. NEUBIG. Mr. Rossotti has raised something that I found very helpful in terms of the Advisory Panel report. Also, it is something that the State and local governments are very concerned about in terms of maintaining their corporate income tax systems.

I think you can really separate out the income tax base from various incentives. One of the things that the Advisory Panel report did was to propose, in most cases where there was going to be a tax incentive, that it be done in the form of a credit. It should also be a refundable credit. So, measure the income tax base comprehensively, and then apply, hopefully, a low rate. Then to the extent that you want to provide incentives to meet the cost-benefit test, do it through refundable credits.

Mr. ROSSOTTI. If I could just interrupt. I think one of the reasons for doing that—and by the way, I would still be against all the credits. But if you were at least to do it that way, you would go a step towards two things.

One is avoiding having to make complex the measurement of income, but also towards David Walker's point that you would know what the cost was because you would know exactly what that credit was, and it would be at least measurable and knowable. Then you could try to analyze that against the cost-benefit side.

Personally, I am a little skeptical you would get too far in that measurement, but at least that would be a step forward over where we are now.

General WALKER. If I could interject really quickly, Senator. You can go back to something you used to do and you do not do any more, and that is, go back to pay-go on both sides of the ledger, namely, both the tax and spending sides of the ledger. So if somebody comes in and says, gee, we want this new tax preference, you have to pay for it.

Second, in addition to that, be able to calculate the discounted present-value dollar cost of major tax and spending proposals, in addition to a 10-year pay-go rule. That will put some discipline on really quickly. You have already done one of those before.

Senator WYDEN. I am very attracted to that idea as well. Gentlemen, I have had a lot of time. Maybe you could answer, quickly. My Chairman is back.

Mr. BERNARD. Senator, you asked earlier, how low would the rate have to go before the lobbyists come back in. I do not know exactly what that is, but we will certainly get back to you on that. Personally, I like Dr. Neubig's idea of about a 10-percent rate reduction. It would be perfect in my mind because that would bring you down among the lower corporate rates in the world and there would be much less reason for the business community to be coming in, looking for special incentives for targeted activities and industries.

Mr. JOHANNESEN. Quickly, maybe a little bit on the other side of the ledger or the thought process here. But if it is very difficult to raise that rate that you want, I think it is hard to spend money—I know we have done it—that we do not have. But rather than trying to stop the incentives as much, maybe take a shot at trying to make it very difficult to change the tax rate, accomplish it from the other side and make that.

Then I think you are going to need some flexibility in this system. Try to avoid the special interest preferences. But this is a complex country and you are going to need some flexibility, because there may be a time that the tax policy is important to try to make a statement or make a change from what you have going on. I would maybe lock up the rate.

Senator WYDEN. Mr. Chairman, you have been very gracious in giving me all this time. I think this has been an extremely good panel. Under your leadership, both from the standpoint of what we heard earlier in August with Senators Breaux and Mack, I still have the conclusion that folks, working in good faith on a bipartisan basis under the Chairman's leadership, with Senator Baucus, we could duplicate what was done in 1986. Of course there would be changes. It is, as Mr. Johannesen said, a very dynamic economy. We have structural changes today that we did not face in 1986.

But the basic proposition, which is what I am trying to address in the Fair Flat Tax Act—and I am not wedded to the numbers and the rates—is to drive down the rates, particularly the marginal rates, do it by getting rid of clutter, and having good people like our Chairman and Senator Baucus lead the effort the way Ronald Reagan and Bill Bradley did, with the executive branch and the Congress working together.

Mr. Chairman, I look forward to our next hearing as well, and would just thank you very much for being willing to prosecute this case when you have a lot of other stuff on your plate.

The CHAIRMAN. I have just a couple of more questions, and then I think probably nobody else is coming and the hearing will be over.

I wanted to go to Mr. Johannesen. He testified about how a large part of American business is conducted through entities that are taxed at the individual level. We have 2 million C corporations, 3.3

million S corporations, 2.4 million partnerships, 19 or more million non-farm sole proprietorships.

People select, for various reasons, which ones they are going to use. So Mr. Johannesen, you highlighted a lot of tax burden that business entities have to deal with as they grow and need to change the business forms that have originally been chosen.

In order to simplify the tax code, do you think that there are too many choices? Do you think that all the tax benefits should be blended so that the burdens you have pointed out would not be so obvious between business types?

Mr. JOHANNESEN. Simplicity would be good there. If you and I could go off in a corner and create a new country and start out with all new business structures, that might be a panacea. Although I really like this country, so I think I will just plan on staying here.

I think the number of entities is fine, the alternatives. If we were to harmonize these rules so that, for instance, when we talked about limited liability companies and S corporations earlier and some of the differences there, I think with not much effect on the revenue for the government—and I know that would be studied—we could bring these rules into much more conformity on the flow-through side, and businesses would really appreciate that.

It would make their daily life much easier to raise capital, to go to the market, to get bank financing, all the types of things they need to do. I think it would be difficult to reduce the number of entities because of where we are, Senator Grassley, but I think we can align more of the rules with these significant entities and that would help a lot.

The CHAIRMAN. Yes.

Dr. Carroll, one of the issues that has been raised is who actually pays these taxes that business has. You spoke about this. The President's Reform Panel noted the burden of corporate taxes is likely to be shifted to workers and consumers.

CBO staff concluded in a preliminary report, so this may be modified, that domestic labor bears about 70 percent of the burden. Shareholders would bear about 30 percent.

As we think about business tax reform, especially corporate tax reform, to make our Nation competitive in the global economy, it is important that we understand better who actually shoulders this burden.

So, Dr. Carroll, how do you view who bears the burden of corporate income tax?

Dr. CARROLL. Well, I think it is a very difficult issue. The economics profession, generally, does not have a settled view on the issue. It is, nevertheless, very important to recognize, in considering business tax reform or tax reform more generally, that businesses do not ultimately pay taxes, people do.

When one thinks about the objectives of having a fair tax system and having a system that promotes growth, this is a very important point, to recognize that people ultimately pay corporate income taxes in their role as investors, in their role as workers, or in their role as consumers.

Although I said that there is no established or settled view in the economics literature, I think there has been an evolution over time.

If you go back to the early 1960s, when that paper was written in 1962, there was a consensus view that emerged, that owners of capital bear the burden of the corporate income tax.

I think since then a number of things have happened, particularly in the 1970s and 1980s. In the numerical models that were developed, which focused on the inter-temporal dimensions of saving and investment, the conclusion was that at least a portion of the tax is borne by labor.

Theoretical papers were written in the 1980s that indicated that a substantial portion of the corporate income tax is borne by labor. You mentioned the more recent work at CBO by a staff economist who formerly was at Treasury. The CBO report is kind of interesting, although I have not gone through it in detail.

But just 10 years ago, just as an illustration of the evolution and thinking in this area, CBO released a report entitled, "The Incidence of the Corporate Income Tax," where they concluded that the corporate income tax fell on owners of capital. Now there is this more recent work emerging from that organization, which is reaching a very different conclusion.

So over time, I think more and more economists, more and more researchers who have looked at this issue very seriously are concluding that perhaps a more significant portion of the tax is borne by labor than previously thought.

The staff at Treasury are also focused on this issue. We are engaged in a study of the incidence of the corporate income tax. It is very important to tax reform. It is very important to reconcile these competing objectives of fairness and pro-growth policies.

The CHAIRMAN. Yes.

I have two questions I am going to submit for answer in writing, and maybe other members will as well, so we would appreciate your cooperation on that.

[The questions appear in the appendix.]

The CHAIRMAN. I have a closing statement that I am just going to put in the record.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. I thank you all very much for your cooperation.

[Whereupon, at 12:13 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Committee On Finance

Max Baucus, Ranking Member

Opening Statement of U.S. Senator Max Baucus (D-Mont.)

Susan B. Anthony once said: "Cautious, careful people, always casting about to preserve their reputations, can never effect a reform."

That's true, Mr. Chairman. Many, including the administration, seem to be afraid to address true tax reform. In contrast, you, Mr. Chairman, have taken it on. Thank you for calling this hearing on how tax reform would affect business.

The President's Tax Reform Advisory Panel spent almost a year hearing from taxpayers and interest groups. The panel studied the issue. And the panel issued a very detailed report.

Down at Treasury, they seem to have just put that report on the shelf. Treasury seems to have ignored that report, along with its recommendations. The exception to that rule is our Treasury Department witness today, Robert Carroll. He produced a fairly glowing analysis of the report.

I look forward to asking him a number of questions about it. How would the loss of depreciation deductions on existing assets under these proposals affect American businesses like Ford and GM? What about the loss of interest deductions? What about the costs of transitioning to the new regime? And will tax reform help to reduce the budget deficit? These are all questions for which we need answers, as we consider tax reform.

I am also glad that the Comptroller General, David Walker, is here with us today. He admonishes us that we cannot consider these issues in a vacuum. He warns that long-term budget issues must play a part of any tax reform debate. And he's right.

I welcome back to the Committee former IRS Commissioner Charles Rossotti. His participation on the tax reform panel was surely greatly appreciated.

And I look forward to the testimony of Dr. Neubig, Mr. Bernard, and Mr. Johannesen, who will give us the real-life perspective from the private sector.

"Cautious, careful" ideas, ideas designed "to preserve . . . reputations," cannot bring about true reform. True reform requires big ideas. I appreciate the willingness of our witnesses to come forward today. And I'll be listening for the big ideas that we will need to reform our tax code.

Statement

of

David L. Bernard
International President
Tax Executives Institute, Inc.

before

Senate Committee on Finance

on

Our Business Tax System: Objectives, Deficiencies, and Options for Reform

September 20, 2006

Chairman Grassley, Ranking Member Baucus, and Members of the Committee: Thank you for inviting me to testify on behalf of Tax Executives Institute, where I currently serve as International President, to provide the perspective of business tax professionals on fundamental tax reform. Tax Executives Institute is the preeminent association of in-house tax professionals. Our 6,000-plus members represent more than 2,800 companies in the United States, Canada, Europe, and Asia. Our members deal with the tax laws — in the United States and throughout the world — on a day-to-day basis, and we are proud of our record of working with Congress, the Treasury Department and Internal Revenue Service, and their counterparts around the globe to improve both tax policy and tax administration.

In addition to my volunteer service to TEI, I am Vice President–Tax and Real Estate for Kimberly-Clark Corporation, where I have been employed for my entire 32-year career. Kimberly-Clark is a 130-year old company founded in Neenah, Wisconsin, by four young businessmen to manufacture and sell paper, pulp, and bathroom tissue. We have grown from an initial capitalization of $30,000 to a market capitalization of almost $30 billion, and today the company is a global leader in health and hygiene products, with products manufactured in 18 states and 39 countries and sold in more than 150 countries.

Mr. Chairman, not to date either us, but the tax world has changed considerably since I joined Kimberly-Clark and you were first elected to Congress. Back then, you could easily carry the Internal Revenue Code (1 volume) and regulations (2 volumes) in your briefcase with room to spare. Since those times, our tax code — like the world around us — has grown significantly and become increasingly more complex. This exponential growth of our tax law, in terms of size, scope and

complexity, has spawned a universe of statutory law and regulatory pronouncements that is profoundly difficult for taxpayers to understand and comply with and for tax administrators to examine, interpret, and enforce. Part of the reason for this is society's increasing reliance on the Internal Revenue Code, not merely to raise revenue from individuals and entities to fund governmental operations, foster economic growth, and enable prosperity, but also to advance social and economic policies that, while perhaps laudable, impose heavy costs on the tax system and its participants. Thus, in a very real sense, the Code has lost its way, and all of us must accept a measure of responsibility for that having taken place.

The challenge to both government and business is to refocus our internal revenue laws. To TEI, that is what fundamental tax reform is all about.

We are not naïve about the challenge. We recognize that whatever the *need* for tax reform, the *prospects* for it remain uncertain, both because certain groups, industries, and advocates are heavily invested in the current system (or one or more of the competing alternatives) — not without reason — and because transitioning to a new system will never be easy.

But we must begin. Thus, we recommend that the following four principles (or themes) guide our collective efforts.

1. U.S. Business Does Not Operate in a Closed System

Mr. Chairman, American companies operate under a tax system that places us at competitive disadvantages in the world marketplace. Let me offer two brief examples — our regime for taxing foreign base company income under Subpart F and our foreign tax credit regime, both of which impede our ability to compete.

Specifically, Subpart F makes it difficult to operate in the same manner as foreign competitors since our competitors are generally *not* taxed in their home country on foreign operating income while U.S. businesses may be taxed in both the United States and the foreign country. To be sure, the Code provides a foreign tax credit in such cases, but that mechanism does not always eliminate double taxation.

In the case of my own company, tax is no longer an afterthought in deciding the location of a new manufacturing plant or a distribution center. Put simply, tax costs matter (as do labor and other costs), and the choice between a domestic and foreign location for a new plant can be significantly affected by the tax costs associated with each venue. Kimberly-Clark is a U.S. company, but we are increasingly forced — for competitive reasons — to build facilities overseas, not merely because that is where our customers are, but because the economic and tax environments are often friendlier. We are fiercely patriotic, Mr. Chairman, but in a global marketplace, we owe it to our shareholders to be equally profit-oriented.

As Congress moves forward on the important issue of tax reform, it must strive to create a tax environment that allows U.S. companies to compete around the world while retaining research, manufacturing, and jobs at home. Some economists bemoan tax competition as a "race to the bottom," but the competition America faces is real, persistent, and effective. Our foreign trading partners are not shy in vying for new plants, research facilities, and distribution centers, and — if the United States is to remain competitive — our rules must change.

Mr. Chairman, one final comment on the need for us to build a competitive tax system. A comprehensive debate on tax reform without consideration of some form of generally applicable consumption tax would ignore global trends. Accordingly, we recommend that Congress address the efficacy of enacting some form of national tax here, especially given the desire to reduce the income

tax rate, the special concerns of federalism (and how a federal tax might be integrated with current state tax systems), and the importance of restoring fiscal discipline to the budget process. To date, Tax Executives Institute has not adopted a position on the question of a consumption tax, in part because of the diversity of views among our members, but we remain ready to assist the Committee in evaluating the merits and, equally important, the administrability of various proposals.

2. The U.S. Tax Rate Must Be Competitive

Mr. Chairman, how do you compete in a marketplace for the production and sale of goods and services when the price of operating here is higher than it is abroad? A critical aspect of tax competition is the tax rate. In the mid-1980s, the United States recognized this, and acted to reduce the top corporate tax rate from 46 percent to a then global-leading 34 percent. That was then. Now, our top rate (which was increased to 35 percent in 1995) comes in near the top of the list. Thus, while we essentially were "running in place" on the issue of corporate tax rates, our European trading partners followed our lead and for the past decade have made rate reductions the rule of the day. In fact, from 1986 to 1996, the average top statutory corporate tax rate for the 25 countries of the European Union dropped more than 10 percentage points (from 43.2 to 32.6 percent).

One example will suffice: Ireland. In 1999, the Irish Republic passed legislation that over time reduced its overall corporate rate to 12.5 percent (slightly more than a third of the U.S. rate), which has helped spur strong economic growth. The Celtic Tiger is not a myth — it is a reality, and the results (including job, economic development, and tax revenues) have prompted Ireland's neighbors to follow suit, with Germany and Spain being the most recent countries to announce significant reductions and The Netherlands signaling the intention to follow suit.

Lower rates, however, do not necessarily mean lower revenue. Indeed, economist Martin Sullivan of the independent publication *Tax Notes* has confirmed that despite significant reductions in the tax rate in European countries, corporate tax revenue as a percentage of GDP is rising. This is not only due to changes in the tax base in the affected countries (which I discuss below), but also because lower rates (and, more generally, lower taxes) have spurred significant economic activity and job growth. The dynamic effect of tax cuts may not always be easy to measure, but it proves too much to say, for example, that the sharp increase in tax revenues in the United States has no causal link to recent tax rate reductions.

As part of fundamental tax reform, therefore, Congress should act to level the "rate" playing field and thereby make America's tax system — and American business — more competitive.

Mr. Chairman, there should be no doubt that American business wants to build technology centers here, manufacturing plants here, and testing facilities here, all of which engage local labor that, in turn, contribute to our local, state and national economies. Absent fundamental change, doing so will become increasingly difficult.

3. The Tax System Should Not Pick "Winners" and "Losers" — The Tax Base Should Be Broadened

The amount of revenue raised by a tax system is the product of the tax rate and the tax base. While some incentives such as those for research and education have widespread support, a growing consensus favors lower rates and a broader tax base to reduce complexity, ease tax administration, and minimize the government's role in picking "winners" and "losers."

Mr. Chairman, we recognize the challenge here is striking the appropriate balance between the need to fund the government with the goal of encouraging (or discouraging) certain behavior. For example, the Nation has long placed a premium on education and, as a result, Congress has enacted numerous incentives to advance that goal. Similarly, the strategic importance of having research conducted in the United States prompted the enactment of the research tax credit that, at the margin, has kept research facilities in this country.

It can be argued, of course, that tax reform itself will produce "winners" and "losers," just a different group than under the current Code. While this may be true, especially on a transition basis, it cannot be permitted to stanch the debate. TEI contends that a broader tax base coupled with a simpler, more administrable code will generate a system of taxation in which sound tax policy takes precedence over a patchwork of tax incentives and inducements.

4. The Tax System Must Be Simpler

Achieving and maintaining an effective balance between fairness and simplicity — in the tax system or society generally — is not easy. At one extreme, fairness, *i.e.*, treating similarly situated taxpayers in the same way, demands tax rules to be complex. At the other, simplicity (or a lesser level of complexity) calls out for "rough justice."

American society is complex, and the tax rules that govern our conduct must, of necessity, reflect that complexity — but they need not be consumed by it. Simple is good, not only on its own account, but because complexity represents a daunting, hidden tax on American business. The Tax Foundation estimated that in 2005 taxpayers incurred total costs in excess of $265 billion to comply with federal income tax laws, with business's share being a staggering 55 percent.

As a broad proposition, a simpler tax system will also be easier for the Internal Revenue Service to enforce. The IRS currently seems to spend a disproportionate amount of its resources plugging so-called loopholes, often creating unintended (and expensive) consequences. Stated simply, the more complex the Code, the greater the likelihood for taxpayers to confront interpretative issues and questions that, if not addressed, will spawn opportunities for *lawful* tax avoidance. Simplifying the Code will also eliminate the need for Band-Aid-like compliance measures that can impede routine, day-to-day business transactions and force law-abiding businesses to absorb the heavy proxy tax of additional recordkeeping.

* * *

Mr. Chairman, recently attention has focused on the so-called tax gap and what connection, if any, the tax gap may have to fundamental tax reform. Key to this question, of course, is the definition of the term as well as the validity of the data that undergird any estimates of the gap. Indeed, these issues are connected, because it is impossible to measure something that you cannot define. The Comptroller General recently put it this way: ". . . [I]n large part because of the complexity and uncertainty in the application of tax laws, the actual level of corporation income tax non-compliance (illegal tax avoidance) is poorly understood. IRS estimates a corporate tax gap in the tens of billions of dollars, but also acknowledges that this estimate is not based on robust, recent and reliable research."[1] The tax gap estimate is itself an aggregation of estimates for three types of

[1] *A Tune-Up On Corporate Tax Issues: What's Going On Under The Hood?, Hearing Before the Senate Committee on Finance*, 109th Cong., 2d Sess. (June 13, 2006) ("Tax Compliance: Challenges to Corporate

noncompliance, underreporting of tax liabilities on tax returns, underpayment of taxes due from filed returns and underpayment of taxes due to the failure to file a required return altogether or on time. Published estimates of the size and composition of the tax gap vary dramatically. The most recent tax gap estimate published in the *Washington Post*, citing a variety of government sources, totals $345 billion, of which about 10 percent is attributable to corporate tax sources.[2]

TEI firmly believes that the tax gaps can be significantly reduced by meaningful reform and simplification. This is because some portion of the tax gap is undeniably attributable to the complexity of the Code itself. If taxpayers do not understand its provisions, they may not be able to comply. Similarly, some portion of the tax gap may be attributable to taxpayers exploiting the complexity in a manner that is ultimately determined to be inappropriate. It may not be possible to quantify how much of the gap is attributable to the complexity of the Code, but beyond question making the code less complex will help narrow that gap.

Conclusion

Mr. Chairman, Tax Executives Institute applauds the Senate Finance Committee's efforts to advance the dialogue and debate on tax reform. We stand ready to be actively participants in this ongoing discussion about how best to make the American system of taxation, more competitive and less complex, while at the same time preserving fairness for all taxpayers. I would be pleased to answer any questions that you or your colleagues may have.

Tax Enforcement and Options to Improve Securities Basis Reporting," statement of David M. Walker, Comptroller General of the United States at 13).

[2] *See* Christopher Lee, *Falling in to the Tax Gap*, WASH. POST, Sept. 4, 2006, at A17.

Tax Executives Institute, Inc.

1200 G Street, N.W., Suite 300
Washington, D.C. 20005-3814
Telephone: 202.638.5601
Fax: 202.638.5607
Web: www.tei.org

Supplemental Responses of
Tax Executive Institute

From Senator Grassley:

I found Dr. Neubig's discussion of permanent versus temporary tax benefits interesting. Because temporary tax benefits do not reduce a corporation's effective tax rate that it reports to shareholders, they are generally not valued by corporate tax and financial officers as highly as permanent tax benefits. Of course, this ignores the time value of money, which is itself a permanent benefit.

Mr. Bernard, do you agree with Dr. Neubig's analysis? Do you think this point of view applies only to public traded corporations, or does it translate to privately held businesses and pass through entities as well?

Mr. Bernard's Response:

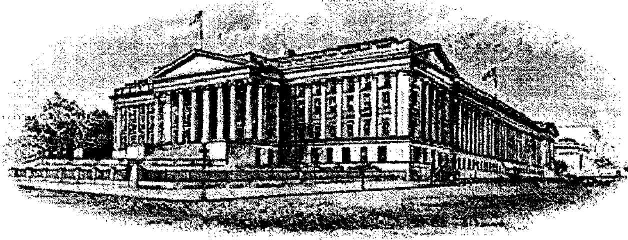
I generally agree with Dr. Neubig's observations with respect to public companies. Privately held companies, of course, are more concerned with cash flow than the company's effective tax rate (and earnings), so I do not believe the comments could apply with equal force there.

From Senator Baucus:

Mr. Bernard, your testimony states that TEI believes Congress should consider tax reform in the form of a consumption tax. Dr. Neubig testified that the second plan recommend by the panel was disguised consumption tax – a "Red Riding Hood" proposal. He cites a survey that most corporations do not favor the main element of the consumption tax and would simply prefer a lower corporate rate, and for this reason, the business community has not embraced the consumption tax proposal. Do you agree with Dr. Neubig's assessment? Does your company or TEI have an opinion on this proposal? Was this the type of consumption tax your testimony referred to or are there others you believe Congress should consider?

Mr. Bernard's Response:

As my written statement explains, a comprehensive debate on tax reform should not ignore global trends and, therefore, must at least consider generally applicable consumption tax proposals. From TEI's perspective, the merits and implications of a generally applicable consumption tax should be debated in conjunction with tax reform proposals that address corporate rate reduction, base broadening and simplification. To be sure, certain segments of the business community feel strongly that such a consumption tax should not be part of a reformed tax system. While that view may ultimately carry the day, TEI believes that limiting our discussion to the income tax system, without evaluating other aspects of our tax system (including possible effects on state tax systems) is short sighted. Thus, the Institute endorses a comprehensive debate.



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

TESTIMONY OF ROBERT J. CARROLL
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman, Senator Baucus, and Distinguished Members of the Committee.

Thank you for the opportunity to appear before you today to discuss business tax reform. Tax reform is, without question, one of the most important issues facing our economy today. Reform of the federal tax on businesses offers significant opportunities for improving job and wage gains for American workers. A key consideration in evaluating approaches for reform in the business area is the relative efficiency of different policies to encourage investment, or, more accurately, to reduce the extent to which the tax system discourages investment. Also, in today's global economy, tax reform can play an important role in sustaining and improving the competitiveness of U.S. workers and businesses, as well as our ability to continue to attract capital investment from abroad.

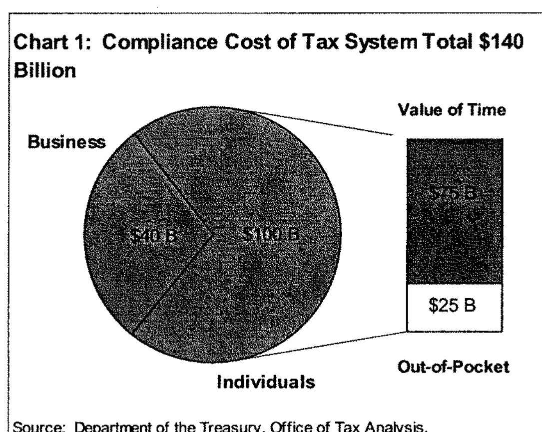
Before focusing on business tax reform, I would first like to discuss the problems with our tax system more broadly. Then, I will focus on how the tax system affects investment and the importance of business taxation to the tax burden on investment.

The Costs of Our Tax System

Our tax system imposes very large costs on our economy. First, our tax system is extremely complex, difficult to comply with, and hard to understand. Individual taxpayers spend over 3.5 billion hours each year to comply with the tax system. To put this into perspective, this is equivalent to hiring another 2 million IRS employees. They

spend so much time despite the fact that about 60 percent of taxpayers rely on paid preparers to fill out their tax returns and 25 percent rely on computer software.

The IRS estimates the compliance burden of our tax system to be $140 billion annually, reflecting both the direct out-of-pocket costs – return preparation, tax software, fees for tax professionals, etc. – and the opportunity cost of taxpayers' time to understand the tax system, maintain records, pay their taxes, and otherwise comply with the tax system. About $100 billion of the compliance costs are borne directly by individuals with the remaining $40 billion borne by businesses (Chart 1).



The tax system also imposes a particularly significant burden on the 31 million small business taxpayers who, because of their limited size, are unable to spread the costs broadly over their business operations. While an individual taxpayer spends on average 26 hours each year to comply with the tax system, taxpayers who report self-employment income spend an average of 45 hours each year to comply with the tax system – more than a full work week away from their business endeavors.

One of the best examples of complexity in our tax system – and, in many respects, the poster child for tax reform – is the individual alternative minimum tax (AMT). The minimum tax, enacted in 1969, was initially intended to affect a very small group of higher income taxpayers who paid no income tax by making extraordinary use of a small set of narrowly defined tax provisions. Several major and many minor changes since 1969 have transformed the original minimum tax into the current alternative minimum tax which, for too many taxpayers, is now a second income tax that runs parallel to the regular individual income tax. Today, the AMT affects 4 million taxpayers and, by 2016, without any change in the law, is projected to affect 56 million taxpayers – nearly one-half of all those who owe income tax.

The broad reach and design flaws of the AMT result in a tax system that is unfair and complex. The likelihood of being subject to the AMT rises with family size – creating a penalty for having children. Additional millions of taxpayers must comply with two parallel tax systems – even if they ultimately have no AMT liability.

Complexity also arises from the numerous duplicative and overlapping tax provisions that involve eligibility rules that are difficult-to-understand and are more often than not phased-in or out by income or other taxpayer characteristics. The vast array of provisions available to taxpayers to encourage education spending, retirement savings, and health care, to name but a few, and the associated forms, schedules, and worksheets, present taxpayers with a complex and staggering web of choices.

The complexity of our tax system has also led to the perception by many that the tax system is unfair because it creates opportunities for manipulation to evade paying taxes. Clearly, a tax code that is simpler and more transparent would instill greater confidence in our voluntary tax system.

In addition to these compliance costs, the tax system also imposes large economic costs on our economy. It interferes with and distorts numerous decisions made by individuals and businesses such as whether to participate in the labor force, how much labor to supply, what type of job to take, how much to save and invest, whether to start a small business. These distortions can lead to an inefficient allocation of resources and hinder economic growth.

Some estimates suggest that by reducing these and other economic distortions, reform has the potential ultimately to increase the size of the economy by between 2 percent and 10 percent, depending on the reform. Similarly, the capital stock, which reflects the wealth of the nation, could rise by upwards of 20 percent. This higher capital stock can be thought of as producing an annual annuity, which in today's $13 trillion economy, would translate into an additional $260 billion to $1.3 trillion in output or Gross Domestic Product (GDP). A larger economy means higher real incomes and living standards for Americans – and a larger tax base.

Criteria for a Well Functioning Tax System

In creating the Advisory Panel on Federal Tax Reform, the President outlined three goals: simplicity, growth, and fairness. While there is general agreement on these three broad objectives, there is considerable controversy about the extent to which the details of any reform plan advance these goals. It is useful to consider general principles that can be applied for our tax system.

First, the tax system should raise a given amount of revenue with the least interference in business and household decisions. This requires a tax system that is as simple, transparent and understandable as possible, and has low cost and non-intrusive tax administration.

Second, as a general rule the tax system should have a broad tax base, with low tax rates. Business and household decisions should be based on the tax code as little as possible.

This means that there should be a high standard for special tax treatment that is provided only where there is clear and convincing evidence of its benefits. In general, the returns from all activities should be taxed uniformly because this leads to a more efficient allocation of resources within the economy and less economic waste.

Third, the tax system should promote a strong economy. Encouraging saving and investment is essential to promoting economic growth. A tax system that penalizes saving and investment will generally result in lower standards of living.

Fourth, the tax system should be appropriately progressive. It should provide equal tax treatment of similarly situated taxpayers (horizontal equity) and a reasonable degree of progressivity, imposing higher taxes on those with a greater ability to pay (vertical equity).

Fifth, the tax system exists in a world where capital and labor are increasingly mobile and where nations compete for investment and workers. The tax system needs to adapt and change with the increasingly global economy to maintain the competitiveness of the United States and continue to attract investment and highly skilled labor.

Finally, the tax system should be as stable as possible. Frequent changes create uncertainty and make it difficult for taxpayers to plan, while wasting economic resources and increasing compliance burdens.

Tax reform that recognizes and builds upon these principles will also meet the broader goals of simplicity, growth, and fairness as identified by the President and will help serve as a guide as we work to improve our tax system.

Investment and Business Taxes

One key tenet of public economics is that businesses do not pay taxes, people do. Businesses organize capital and labor in the production of goods and services used throughout the economy and consumed by households. Businesses, however, are owned by individual investors, hire individual workers, and sell to individual consumers. While corporations may remit tax to the federal government, it is individuals who bear the burden of business taxes. Investors "pay" business taxes through lower after-tax returns to their investments, workers "pay" business taxes through lower wages, and consumers "pay" business taxes through higher prices.

Business tax reform, the subject of today's hearing, is an issue that can be considered in the broader context of how the tax system taxes investment. Investment adds to the productive capacity of the economy directly by adding to the capital stock, as well as indirectly by integrating new technologies and production processes. Higher investment also raises labor productivity by giving labor more capital with which to work. Policies that encourage investment, increase capital formation, and raise labor productivity are the key to higher living standards.

Business taxation generally reflects only one aspect of the tax on investment. The return to an investment may be subject to several layers of tax under our tax system: business level taxes, investor level taxes, and the estate tax.

Consider, for example, a newly equity-financed investment in the corporate sector. First, corporate tax is paid on the earnings from the investment at the firm level at a top corporate tax rate of 35 percent. Second, for income paid out as dividends, another layer of tax is paid by individual shareholders at a maximum rate of 15 percent. Alternatively, shareholders pay tax at a maximum statutory rate of 15 percent on the realization of appreciation in stock value that arises from corporate earnings that are retained and reinvested in the firm. For corporate income paid out as dividends, the combined corporate and investor level tax rate can be nearly 45 percent (excluding state and local taxes). For corporate income that is retained and reinvested, the combined corporate and investor level tax rate depends on how long the investor holds his stock, but is, on average, upwards of 40 percent.

Such an investment may also be taxed yet again under the estate tax upon the death of the investor. The estate tax can also discourage individuals from saving and investing. To provide some perspective on the estate tax's economic effects, it is useful to translate the estate tax into an equivalent accrual-based income tax for individuals saving for the benefit of their heirs (i.e., bequest motivated saving). This "accrual-based tax rate" on the return to saving is the income tax rate that would leave an individual at death with a net worth exactly equal to the after-tax value of his or her estate under the current estate tax. According to Treasury Department estimates, across all taxpayers the estate tax translates into an additional accrual-based tax on the return to investment of between 5 percent and 10 percent. That is, when the third layer of tax from the estate tax is added, the combined federal tax rate on corporate profits can be over 50 percent.

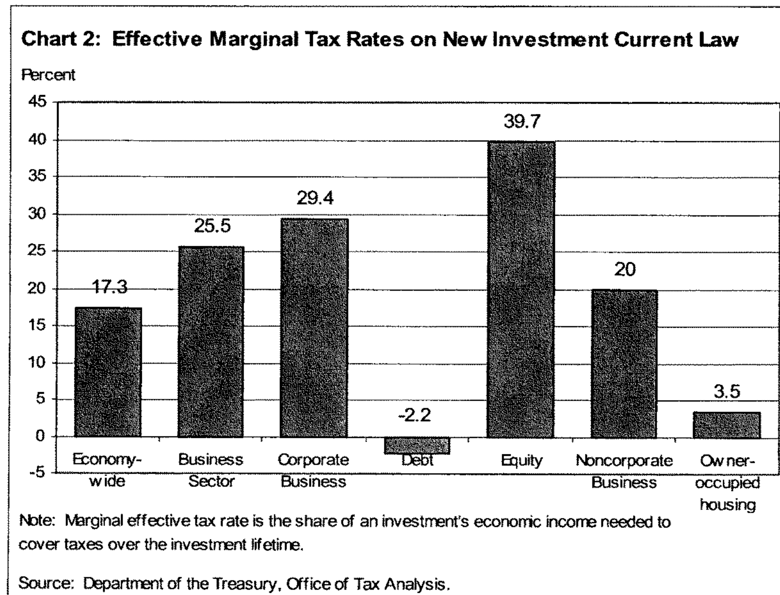
Of course, there are many other dimensions to business taxation. Not all business investment is subject to the statutory tax rate. Tax rules generally allow faster write-off of investment in equipment than economic depreciation, which has the effect of lowering the *effective* tax rate below the *statutory* tax rate. Also, a substantial fraction of business income is not subject to the corporate income tax, but is instead taxed when passed through to owners of S corporations, partnerships and sole proprietorships, many of which are small businesses. According to Treasury Department estimates, roughly one-third of the tax on business income is remitted by owners of such pass-through entities, often at the top individual income tax rate.

Marginal effective tax rates (METR) measure the impact of taxes on investment decisions and summarize how various provisions of the tax code – the statutory tax rate, depreciation deductions, interest deductions, deferral of tax, and both the individual and corporate levels of tax – interact with and affect the after-tax rate of return to a new investment. The METR is the extra share of an investment's economic income that is needed to cover taxes over its lifetime. Because of the double tax on corporate profits, accelerated deprecation on certain investments, and many other provisions taxes can vary sharply from one investment to another. The METR is useful to highlight the effect of these differences, and for focusing attention on the level of tax on investment.

Chart 2 shows the METR on different types of investment by the type of financing and sector under the current tax system. Currently, the estimated overall effective tax rate on all investment in the economy is 17.3 percent, while the marginal effective tax rate on business investment (corporate and non-corporate) is 25.5 percent. Lower tax rates on capital income – the reward to saving and investment – encourage more of these activities. Investment increases the amount of capital available for each worker and also increases the rate at which new technology embodied in capital can be put to use throughout the economy. More productive capital translates into higher labor productivity, and, ultimately, higher real wages and living standards.

The chart illustrates another key feature of our tax system: Investment can face very disparate tax treatment depending on the sector and financing. Investment in the business sector faces an effective marginal tax rate of 25.5 percent, but because of the double tax on corporate profits the effective marginal tax rate for investment in the corporate sector is 29.4 percent, nearly ten percentage points higher than in the non-corporate sector. Moreover, equity-financed investment in the corporate sector faces an effective tax rate of 39.7 percent, while debt-financed investment is effectively subsidized at a rate of -2.2 percent (which together provide the weighted average METR in the corporate sector).

Chart 2: Effective Marginal Tax Rates on New Investment Current Law



Note: Marginal effective tax rate is the share of an investment's economic income needed to cover taxes over the investment lifetime.

Source: Department of the Treasury, Office of Tax Analysis.

This uneven treatment of investment across sectors and sources of financing leads to an inefficient allocation of capital within the economy, which wastes economic resources, and, ultimately, reduces living standards. The high level of tax on investment in the

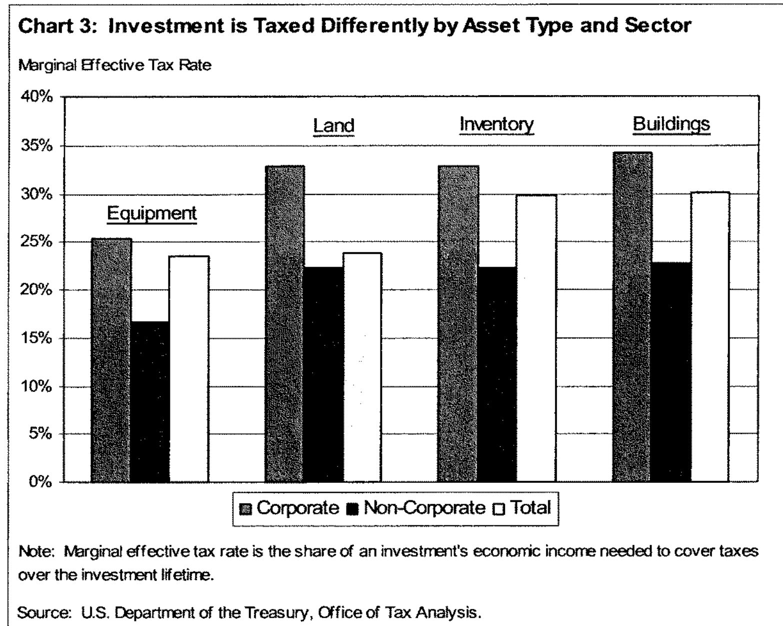
corporate sector, for example, discourages investment in this sector. This greater tax burden on corporations encourages business owners to choose organizational forms, such as partnerships and other pass-through entities, that face only a single level of taxation, but often at the cost of giving up the benefits of limited liability or centralized management found in the corporate structure.

The greater taxation of equity investments leads to an over-reliance on debt finance for corporate investment. A higher debt burden increases a firm's risk of bankruptcy during temporary industry or economy-wide downturns. Business failures generate losses to both shareholders and employees, and the heightened bankruptcy risk can make the entire economy more volatile.

The tax system also discourages corporations from paying out earnings through dividends because dividends are more heavily taxed than capital gains generated through share repurchases or retained earnings. The payment of dividends may improve corporate governance by providing a signal to investors of a company's underlying financial health and profitability. Regular dividend payments also may be one way for shareholders to ensure that managers reinvest only in projects that raise shareholder value.

Also, without the reduction in the double tax on corporate profits enacted in the Jobs and Growth Act of 2003 – the top 15 percent tax rate on dividends and capital gains now in effect through 2010 – the uneven treatment of investment reflected in Chart 2 would be even more pronounced. Lower taxes on dividends and capital gains have moved the tax system to more equal treatment of debt and equity, of dividends and capital gains, and of corporate and non-corporate capital. This move increases economic efficiency because it promotes an allocation of capital based on business fundamentals, rather than tax considerations.

The current tax system also taxes the return on investment of some assets much more heavily than the return earned on other assets. This uneven treatment discourages investment in high-taxed activities. As shown in Chart 3, investment in buildings, land and inventories is discouraged relative to investment in equipment. Also, as noted above, business investment, particularly in the corporate sector, is generally taxed more heavily relative to other investment. This uneven tax treatment reduces productivity because tax considerations compete with market fundamentals in guiding investment decisions.



A clear theme emerges: The tax on investment income discourages capital formation. Furthermore, the disparate treatment of investment income by the tax system means capital is inefficiently allocated throughout the economy. Business tax reform that focuses on reducing these tax distortions could increase the productive capacity of the economy and increase living standards.

Towards a More Rational Taxation of Investment

There are a number of different policy avenues for influencing the tax on capital and treating different types of investment more uniformly, each with its own set of inherent tradeoffs. The corporate tax rate, the individual tax rate, how quickly investment is written off, the tax on investment returns received by individuals, and the tax treatment of interest all influence the cost of capital. One consideration in evaluating these policy levers is to what extent a particular change provides windfalls to taxpayers because it rewards past decisions. Another consideration is to what extent a change will have large impacts on the market value of assets if new investment is treated differently than existing capital.

Consider, for example, the choice between allowing faster write-off of investment versus lowering the corporate tax rate. Both policies can have a profound effect on effective marginal tax rates and encourage investment. Faster write-off of business investment reduces the role taxes play in investment decisions by reducing the tax on the investment

return at the margin. Full expensing of investment (e.g., immediate write-off) completely removes taxes from investment decisions. The value of the deduction in the year the investment is placed in service will exactly offset (in present value) the tax on the expected return to the investment over its life. Consequently, any tax paid on returns above the expected return will have no effect on the decision to make the initial investment. In this way, taxes are removed from the investment decision. One important aspect of expensing is that tax may be paid on higher than expected investment returns, but these taxes will have no effect on the initial decision to make the investment. Another important aspect of expensing is that it is inherently prospective, thus benefiting new investment, but not investment that has already been placed in service.

One difficulty with faster write-off of investment or expensing is the disparate treatment between old and new investment. Because new investment receives more favorable treatment, the market value of existing capital may in some instances fall relative to new investment. This gives rise to the potential need for transition relief to address changes in asset values that result from the disparate treatment of existing capital and new investment. Corporate rate reduction, in contrast, avoids this difficulty because it applies to the return from both existing capital and new investment.

In contrast to faster write-off of business investment or expensing, reducing the corporate tax rate lowers the tax on the full return to investment, regardless of whether it exceeds the expected return. Also, corporate rate reduction benefits old and new investment alike. Thus, prior investments also benefit.

The various policy levers listed above can be contrasted by comparing how much they would encourage investment per dollar of revenue cost. This "bang-for-the-buck" calculation takes into account the extent to which the various policies focus on encouraging new investment, or instead also reward investments that would have been made absent the policy change. Table 1 ranks the policies by their relative "bang-for the-buck". The "bang-for-the-buck" depends on the degree to which investment is responsive to tax changes. But the focus here is on the relative effectiveness of various policies. Thus, the table shows the "bang-for-the-buck" of each policy relative to expensing.

Table 1: Comparison of "Bang for the Buck" of Alternative Investment Incentives

	Effective Marginal Tax Rate on Investment	"Bang for the Buck" Relative to Expensing 1/
Current Law	17%	
Policy Change:		
30% expensing of all investment	13%	100%
Expand tax free savings accounts 2/	12%	65%
Corporate tax rate lowered to 25%	15%	60%
Tax rate on dividends and capital gains lowered to 10%	16%	60%

Source: Department of the Treasury, Office of Tax Analysis.

1/ Reflects the change in the investment incentive divided by the revenue cost of each policy assuming a constant growth rate of investment over time. Estimates presented relative to expensing for ease of presentation.

2/ Replaces existing tax-free savings acounts with the President's Advisory Panel on Federal Tax Reform's proposal for Save for Families and Save for Retirement Accounts (each with a $10,000 contribution limit).

Not surprisingly, expensing of investment provides the largest "bang-for-the-buck" because it focuses the tax benefit on new investment. By contrast, lowering the corporate tax rate has a smaller "bang-for-the-buck" because it reduces taxes on the return from existing or old capital as well as on that from new investment. The expansion of tax preferred savings accounts has a relatively high "bang-for-the-buck" because it also focuses the tax reduction on new savings.[1]

[1]The "bang-for-the-buck" estimates depend importantly on a variety of assumptions. Two assumptions are highlighted here. First, the calculation for the lower tax rate on dividends assumes that dividend taxes reduce the incentive to undertake corporate investment. Under some theories of the firm, dividend taxes reduce share values rather than discourage investment. Calculations based on this alternative view of the firm would generate a smaller "bang-for-the-buck."

Second, the "bang-for-the-buck" calculation for the expansion of the contribution limit for retirement accounts assumes that increases in these accounts represent marginal increases in funds available for investment. But contributions to these accounts are capped, so that for some taxpayers the expansion of the contribution limit might have little effect on the incentive to undertake an additional, marginal investment. Once the tax free saving account is fully used, additional, or marginal, saving would be taxable and the "bang-for-the-buck" would be smaller.

Of course, there are a host of other considerations at play in evaluating these various policies. As discussed above, changes in the market value of existing assets and the possible need for transition relief is one important consideration. Some of the policies also address multiple distortions. As discussed above, the lower tax rate on dividends and capital gains, for example, results in more equal treatment of corporate and non-corporate capital, but can also help improve corporate governance and reduce the economy's exposure to bankruptcy and financial risk during periods of economic weakness.

International Competitiveness

The United States is increasingly linked to the world economy through trade and investment. Domestically based multinational businesses and their foreign investment help bring the benefits of global markets back to the United States by providing jobs and income. Like all firms, multinational corporations choose how much and where to invest. Multinationals also decide where to locate their headquarters, intangible assets, and research and development, and their decisions often affect which countries reap the majority of benefits from the multinational's operations. The tax system can have profound effects on these decisions.

Table 2: Comparison of Statutory Corporate Tax Rates Among G-7 Countries

	Statutory Corporate Tax Rate		
Country	**2000**	**2006**	**% Change**
Canada	45%	36%	-20%
France	38%	35%	-6%
Germany	52%	39%	-25%
Italy	37%	33%	-11%
Japan	42%	42%	0%
United Kingdom	30%	30%	0%
United States	39%	39%	0%
G7 Average	40%	36%	-10%

Source: Department of the Treasury, Office of Tax Analysis.

Ensuring that our tax system is competitive in the world economy is crucial for the United States to continue to attract capital, create jobs, and further increase living standards. To provide some perspective on how the United States compares to its major trading partners, Tables 2 and 3 compare statutory, average and effective tax rates for the United States with other G-7 countries. The comparison to the G-7 countries is particularly relevant for investment that requires higher skilled labor. A comparison to China, India, and other developing economies might be more relevant for investment that is more closely related to low-skilled labor. However, the data for these comparisons is not widely available and, moreover, differentials in the cost of labor, not the tax system, are likely to be more important.

As shown in Table 2, the United States has a high statutory corporate tax rate relative to the G-7 – 39 percent in the United States (including state level taxes) versus 36 percent, on average, among G-7 countries. Also shown in the table are the reductions in corporate tax rates among G-7 countries over the past several years, with the average statutory corporate tax rate falling from 40 percent to 36 percent. Three countries enacted sharp reductions in corporate tax rates during this period Germany lowered its top rate from 40 percent to 25 percent, Italy lowered its top rate from 37 to 33 percent, and Canada lowered its top central rate for service industries from 28 to 21 percent (thereby equalizing it with the manufacturing and production sectors). The corporate tax rates in Japan, the United Kingdom[2], and the United States were largely unchanged, while France's reduction in corporate tax surcharges somewhat lowered their rate somewhat.

While the statutory corporate income tax rate is the headline measure for a country, it does not indicate the breadth of the corporate income tax base, nor does it reflect how heavily corporate income is taxed at the investor level. A country's statutory tax rate, however, is important for determining the incentive for multinational corporations to allocate income and expenses across their subsidiaries for purposes of complying with the U.S. tax system.

Table 3 also shows the effective marginal tax rates, similar in concept to the effective tax rates described earlier, and average tax rates, which show the ratio of corporate-source tax receipts to total corporate income. Both of these measures provide a more complete picture of the tax burden on investment by capturing in different ways the breadth of the tax base. The effective tax rates are more focused on the effect of the tax system on marginal investment decisions, whereas the average tax rates reflect the overall burden of the tax system on the corporate sector in each country.

[2] The United Kingdom enacted successive tax reforms during the 1990s, which brought its corporate rate down from 34 percent in 1990 to 30 percent by 1999.

Table 3: Comparison of US Corporate Tax Rates to G7 Rates

Country	Statutory CIT	Corporate METR	Integrated METR	Corporate ATR	Integrated ATR
Canada	36%	14%	56%	18%	25%
France	35%	11%	40%	20%	26%
Germany	39%	24%	60%	7%	16%
Italy	33%	-1%	14%	14%	27%
Japan	42%	33%	49%	16%	18%
United Kingdom	30%	15%	47%	27%	38%
United States:					
Current Law	39%	14%	44%	13%	24%
Without the '01/'03 Tax Relief	39%	14%	56%	13%	NA
G7 Average	36%	16%	44%	17%	25%

Source: Department of the Treasury, Office of Tax Analysis.

Notes: CIT = corporate income tax rate, METR = marginal effective tax rate; ATR = average tax rate.

The effective and average tax rates for the United States tend to be close to the average for the G-7 countries whether at the corporate level or "integrated" to reflect both corporate and investor level taxes. Importantly, the "integrated" effective tax rates in the United States would be considerably higher – 56 percent – than the G-7 countries without the lower tax rates on investor level taxes enacted in 2001 and 2003 now in effect through 2010; that is, without the tax relief enacted in 2001 and 2003 the United States would be a relatively less attractive place to invest relative to other G-7 countries.

Thank you again, Mr. Chairman, Senator Baucus, and Members of the Committee for the opportunity to appear before you today. We look forward to working together with this Committee and others in the Congress on this important issue. I would be pleased to answer questions from the Committee.

Senate Finance Committee Hearing:
"Our Business Tax System: Objectives, Deficiencies, and Options for Reform"
Wednesday, September 20, 2006

Questions for the Record for
Dr. Robert J. Carroll
Deputy Assistant Secretary (Tax Analysis)
United States Department of the Treasury

From Senator Hatch:

Question 1

Dr. Carroll it seems to me that the potential gains to our economy from simplifying the tax system are very large, given the numbers you have presented today. However, in my view, the potential for economic growth by ensuring that our tax system has no barriers to growth and includes the right kinds of incentives can dwarf the savings from simplifying the code. Do you agree with this?

Answer

The benefits tax reform that arise from greater economic efficiency and growth may be considerably larger than the benefits from simplification. In my written testimony I discuss the potential for gains in both of these areas in broad terms.

The IRS estimates that the compliance costs of the federal tax system total about $140 billion annually – about $100 billion annually related to individual taxpayers and about $40 billion annually related to business taxpayers. While the size of these burdens could be diminished as the result of a tax reform, they will still remain positive and the upper bound for the gains from simplification are well below $140 billion per year.

The greater economic efficiency and growth effects through the more productive use of resources and greater capital formation and labor supply may well lead to an increase in the overall size of the economy of between 2 percent and 10 percent, depending on the reform. This translates into an annual increase in output (Gross Domestic Product) of between $260 billion to $1.3 trillion in today's $13 trillion economy.

Question 2

Dr. Carroll, what are the three most significant changes Congress could make to the tax laws affecting businesses that would increase overall economic growth? Similarly, what are the three changes we could make to simplify the tax code for businesses?

Answer

There are several changes to the tax laws affecting businesses that would encourage greater economic output. The important factor in each of these changes in encouraging greater economic activity would be to reduce the distortions the tax system imposes on economic decisions of businesses. First, the effective tax rate on business investment could be greatly reduced by allowing immediate expensing of all business investment in place of the current system of depreciation allowances. Second, the double taxation of corporate profits could be reduced either through a lower corporate tax rate or lower tax rates on dividends and capital gains, as was done in 2003. Third, the effective tax paid on different types of business investment could be made more uniform by reforming the cost recovery rules across different types of investment (e.g. equipment and structures) and across different sectors of the economy.

As for simplification, immediate expensing of all business investment would again provide benefits as firms would no longer need to track the tax basis of assets. Allowing cash accounting for small businesses also would bring much simplification to taxpayers with the highest relative burden of complying with the tax system. Finally, broadening the base of the corporate income tax by removing provisions that provide special treatment for narrowly defined business activities would make it easier for taxpayers to comply with and for the IRS to administer the tax system.

From Senator Baucus:

Question 1

Your testimony states that the tax system must be stable and that "frequent changes create uncertainty and make it difficult for taxpayers to plan, while wasting economic resources and increasing compliance burdens." I strongly agree with you but wonder why Treasury has not been more forceful in pressuring this Congress to pass the 2005 expired tax provisions. Surely, this will be one of the most complicating factors for the 2006 tax season if we are not able to enact them by the IRS deadline of October 15. Can you elaborate on the stability and complexity of the tax system when the tax law is changed long after deadlines have passed for the IRS and private vendors in the tax preparation service? How can businesses or individuals plan on utilizing certain tax incentives when such incentives are enacted in the last few months of the tax year?

Answer

Expiring provisions typically vary widely in intent and purpose from the higher expensing limits for small businesses and the research and experimentation credit to the work opportunity and welfare-to-work tax credits to the higher exemption for AMT taxpayers. The choices made with respect to expiring provisions inevitably reflect a balancing of the various and sometimes competing goals of fiscal discipline, providing a stable tax code on which households and businesses can make clear and well-informed decisions, and reevaluation of the effectiveness of special tax provisions.

As a general rule, timely passage of extenders by the Congress is essential to taxpayers for their planning, and also to IRS for administration of the tax law. This year, consideration of many of the expiring provisions was delayed until late in the year. The Tax Relief and Health Care Act of 2006, which extended a number of expiring tax provisions, was signed into law on December 21, 2006. The IRS will work steadfastly to minimize the difficulty associated with late passage of these provisions for business and individual taxpayers.

Many expiring provisions are extended for only a few years at a time. The goal of a more stable tax code and the need to ease of taxpayer planning would suggest that these proposals be extended for a longer duration. However, there is also the need for the effectiveness of many of these provisions to be reevaluated and monitored on a periodic basis by the Congress and the Administration. Nevertheless, it is important the Administration and the Congress to continue to work together to minimize the disruptions that late consideration of expiring provisions can have on taxpayers and the Internal Revenue Service.

Question 2

Your testimony highlights the Alternative Minimum Tax as one of the best examples of complexity in our tax system. I could not agree with you more. I wonder why, though, the Treasury budget has never advocated anything more than a one- or two-year patch for the AMT?

Answer

We are very concerned about the impact of the AMT, especially on an ever-growing number of middle-income earners. In addition to the increased taxes on middle-income taxpayers, the AMT has become a major source of complexity, and creates significant frustration among taxpayers who have to calculate their taxes twice under two parallel tax systems and pay the higher amount.

There is no easy solution to the AMT problem. Because of the complexity of our income tax system, the interrelationships between many of its provisions, and budgetary considerations, the long-term AMT problem cannot be dealt with in isolation. Rather, solutions to the problem associated with the AMT over the long-term should be developed in the context of broader reform of the tax system.

Question 3

You state that the cost to taxpayers to comply with the tax system is $140 billion each year, including return preparation, tax software, professional fees and effort spent by taxpayers to figure out what they need to do. To what extent would free and direct electronic filing with the IRS reduce the burden on taxpayers to meet their tax obligations? Should American taxpayers have the ability to directly file their tax returns electronically with the IRS, for free, without having to pay a middleman?

Answer

The IRS Restructuring and Reform Act of 1998 established the goal of having 80 percent of returns filed electronically in 2007 (that is, returns filed for tax year 2006). The Restructuring Act also directed IRS not to compete unnecessarily with private vendors of tax preparation products.

While over 85 percent of individual income tax returns for 2005 were prepared by computer (either by the taxpayer or by a third-party preparer), only about 55 percent were filed electronically. The percentage of returns filed electronically has been rising steadily, but not rapidly, over the past few years. IRS-supported surveys have indicated that the costs of electronic submission and concerns about disclosure of tax return information to non-IRS electronic return processors are major reasons for taxpayers not filing electronically. Providing electronic filing with IRS directly rather than through a third-party processor would remove these two barriers to electronic filing and could increase electronic filing and reduce taxpayer burden. It would, however, increase IRS costs over the current system.

Question 4

Just this week, TIGTA posted two reports demonstrating that millions of taxpayers cannot get through to the IRS to resolve their tax matters or to get answers to their tax questions. To what extent does inadequate funding for taxpayer service contribute to the burden on taxpayers?

Answer

Within its budget, the IRS must allocate its resources strategically to best meet all of the responsibilities associated with its mission, including taxpayer service. The IRS strives to provide the best customer service possible, given its resources. The IRS currently provides a balanced array of customer service programs, including telephone and walk-in assistance, forms and publications, internet, volunteers, and various e-file options, among others.

Of course, the IRS must continue to strive to improve customer service. In concert with the IRS Oversight Board and the National Taxpayer Advocate, the IRS is currently conducting a comprehensive assessment of customer service needs and preferences, and cost-effective options for meeting those needs. The IRS delivered a report on the first phase of this effort, the Taxpayer Assistance Blueprint (TAB) Phase I, to Congress in April 2006. TAB Phase II, which will include the results of extensive IRS research and external stakeholder input, is expected to be completed by the end of January 2007.

Question 5

Earlier this summer we heard testimony from noted CRS expert Dr. Jane Gravelle, who analyzed your paper regarding the positive growth effects of a consumption tax. She highlighted the extensive transition costs necessary to make this consumption tax work that you favor, resulting in a one-time, lump-sum tax on "old capital." This means that a taxpayer with existing inventory would lose all the deductions for purchasing the goods for resale or purchasing materials for

processing. Would you agree that with inventories valued in the billions, any transition relief could be extremely costly?

Answer

My testimony highlight the economic benefits for reducing the tax on capital income and various ways this might be accomplished – faster write-off of business investment, lowering the corporate tax rate, lowering the tax rates imposed on investor-related incomes. All of these policies would help, to varying degrees, to promote long-term economic growth by leading to greater investment and enhancing the productive capacity of the U.S. economy. Greater capital formation increases labor productivity, which is one of the keys to rising living standards in the long-run.

Ensuring the any major changes in the tax code are made in a way that is fair and sensitive to the potential economic disruptions that could be caused as we move from our current tax system to a new tax system is paramount. The adjustments during this transition carry with them their own economic costs and can reduce the gains from a reform.

The Department of the Treasury has not yet made a decision on how best to proceed with tax reform. But, regardless of the direction, an important objective is to ensure that the transition from our current tax system to a different tax system is fair and not disruptive to the economy.

Question 6

Dr. Gravelle also analyzed the limited transition relief provided for in the consumption tax you favor, and found that a small business owner could lose up to 95% of the depreciation deductions on a building, and 65% of the deduction for equipment. She finds these impacts a significant barrier to adoption of the proposal. Do you agree that any long-term or significant transition relief may hamper the expected growth effects of the consumption tax plan that you favor?

Answer

As indicated above, the Department of the Treasury has not yet decided how best to proceed on tax reform. But, in response to the substance of your question, providing transition could, under some circumstances, dampen the economic benefits from a consumption tax reform (as compared to such a reform without transition relief). The point that is often made is that providing transition relief requires higher tax rates that carry with them economic costs that could dampen economic growth. However, if transition relief were financed by base broadening, the provision of transition relief might have little effect on economic growth.

Moreover, if transition relief is provided over a fixed number of years, for example, as the President's Advisory Panel of Federal Tax Reform had proposed in its Growth and Investment Tax, the eventual growth effects of the reform would be unaffected by the provision of transition relief. An important caveat is that the period of time it takes for the economy to realize the full benefits of the reform would take somewhat longer and this longer adjustment period for the economy carries with it some additional economic costs.

Question 7

Your paper describes this one-time, lump-sum tax on capital and states that tax rates would be adjusted to keep the plan revenue neutral, including an increase in taxes on labor income. It sounds as if this consumption tax would result in higher tax burdens for workers and businesses with "old capital." Since you have publicly touted the benefits of this plan should we presume that this is the plan Treasury will recommend to the President?

Answer

The Department of the Treasury has not yet decided on the best way to proceed on tax reform. The economic effects of any tax plan would, of course, depend on all of the elements of the plan.

Question 8

The National Retail Federation recently wrote the President about the modified consumption tax proposal recommended by the panel and deemed it, "one of the largest tax increases on American consumers in recent memory, and devastating for our nation's economy." They argued that disallowing the deduction for imports results in a 30% additional tax, passed onto consumers. The panel apparently thought that floating exchange rates would compensate, but the Retailers argue that most of these imports come from countries without floating exchange rates. Since Treasury assisted the panel with its recommendations, do you know if these issues were considered? Do you agree with the concerns as outlined by the Retailers, and if not, please explain why?

Answer

The two tax options recommended by the President's Tax Panel – the Growth and Investment Tax and the Simplified Income Tax – were both designed to be revenue neutral. The Growth and Investment Tax, can be viewed as a progressive consumption tax coupled with a small single rate tax on capital income. The consumption tax component of this option is intended to tax domestic consumption, rather than production as under an income tax. Border adjustability ensures that foreign consumption of U.S. production (i.e., exports) is excluded from the tax base and that domestic consumption of foreign production (i.e., imports) is included in the tax base.

The issue of border adjustability was carefully considered in Treasury's work in support of the President's Tax Panel. The issue of how border adjustments affect the relative prices across countries is central to your question. Most economists are of the view that border adjustments under a value added tax – taxes imposed on imports and rebated on exports – would tend to have little effect on the relative purchasing power across countries and on real economic activity. The intuition is that relative prices across countries would adjust in a manner that exactly offsets the direct effect of the border adjustments. In countries where the relative values of currencies are determined by flexible exchange rates, the change in relative prices manifests itself through exchange rates. But for countries where the relative values of currencies are not determined by open and flexible currency markets, the change in relative prices would manifest itself through

changes in the price and/or factor incomes in each country. These changes are likely to occur more gradually over time due to the slower adjustment of prices and wages to changing economic conditions as compared to the rapid adjustment of exchange rates.

Question 9

Some have argued this proposal would violate The General Agreement on Tariffs and Trade (GATT) as imports would be subject to higher taxes than domestically produced goods. Did the Treasury staff who assisted the panel consult with experts at the US Trade Representative's office regarding this proposal, and if so, was this argument refuted?

Answer

The President's Tax Panel indicated that one of its options – the Growth and Investment Tax (GIT) – ought to be border adjustable because the GIT was, in effect, equivalent to a credit-invoice method VAT (at a 30 percent tax rate) coupled with a progressive system of wage subsidies and a separate single rate tax on capital income. In the Tax Panel's view, this structure was reasonably similar to border-adjustable VATs and other tax structures in a number of developed countries.

A key issue in determining the consistency of border tax adjustments with WTO rules is whether the tax subject to border adjustment can be characterized as a "direct" (income-type) or "indirect" (sales-type) tax. While there may be no meaningful economic distinction between direct and indirect taxes, USTR advised that refunds of direct taxes attributable to exported products can run afoul of WTO prohibitions on export subsidies and that the determination of whether a particular VAT would be viewed as a direct or indirect tax for WTO purposes would turn on the specific features of the tax under consideration.

Prepared Statement of Senator Chuck Grassley
Senate Finance Committee Hearing:
"Our Business Tax System: Objectives, Deficiencies, and Options for Reform"
Wednesday, September 20, 2006

The U.S. economy is fueled by U.S. businesses, from the smallest family business to the largest multinational corporation. President Bush has called our economy the envy of the world, and I think he's right. Our GDP growth, productivity, low inflation and unemployment are unmatched among developed economies. But I haven't heard anyone claim to be envious of our business tax system.

The primary objective of our business tax system is to promote sensible tax policy. By that I mean it should equitably raise an appropriate level of revenues, minimize tax-induced distortions to legitimate business decision making, and be as simple as possible.

Some hard-core economists may disagree, but another objective of our business tax system should be to promote sensible non-tax policies. The system should provide effective, transparent, and easy-to-administer incentives for appropriate business activities. But we should keep in mind that targeted incentives increase the tax burden on everybody else. The President's Tax Reform Panel got it right, when it said, quote, that "a rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers," end quote. I suspect many of the business tax expenditures in the Code today would fail that test if the realities of politics were set aside.

Another non-tax policy that we hear much talk of is competitiveness. We have heard about how we need to change our business tax system because of competitiveness. But it is not always clear what is meant by the term competitiveness. For example, a large multi-national may think of it as being competitive with foreign businesses in foreign markets. A family business may think of it being competitive with a large multi-national corporation in a local domestic market. American workers may think of it in terms of being able to compete for a job. A policy maker may think of it in terms of making the U.S. more competitive with other countries in attracting investment that leads to new jobs and better jobs.

A cynic might say that competitiveness is just a more palatable code word for cutting taxes. In a sense, that's right. Taxes, by definition, represent a transaction cost of doing business. From a business person's perspective, it's a sunk cost, with no expected rate of return. But it's a fact of life that we must fund our government, and taxing business activity, in some form, is necessary. Our goal, therefore, is to minimize as much as possible the tax system's interference with rational business behavior.

Our current business tax system is indisputably complex. But it is equally indisputable that businesses operate in a complex world. There is wide variation in

businesses, in terms of size and complexity, and addressing this variation is one challenge our business tax system faces.

Many businesses engage in complex transactions, relationships, and legal structures in a global marketplace. Globalization creates challenges to our business tax system. U.S. businesses operate in global markets for capital, customers, suppliers, competitors, and business partners. A related challenge is the global integration of multinational corporations and the increasing prominence of intangible assets in driving economic profit.

Our tax system needs to fairly and efficiently address the realities of business complexity and globalization.

In August, we had a hearing to kick off this committee's look at tax reform. We heard testimony from members of the President's Advisory Panel on Federal Tax Reform, who took the first step at tackling the problems of our overall tax system. Today, we'll focus on our business tax system, which covers large publicly traded corporations and family businesses that are taxed at the individual level.

It is important that we examine business tax reform as a whole before focusing on a single aspect of reform. We need to get the big picture first. I expect this hearing to serve as a platform on which to base future hearings that will examine specific aspects of business tax reform in greater depth as we work toward reforming the tax code.

In this hearing, we will examine the objectives of our business tax system, challenges to our business tax system, deficiencies of our business tax system, and reform options to address some of those deficiencies.

The Honorable David Walker, Comptroller General of the Government Accountability Office, will put business taxes in the context of our overall budget situation and offer guidelines for policymakers to follow in pursuing business tax reform.

Dr. Robert Carroll, Deputy Assistant Secretary for Tax Analysis at Treasury, will discuss the Treasury's views on the need for business tax reform, characteristics of an optimal business tax system, and trade-offs that need to be considered in the context of business tax reform. Treasury has not yet made its tax reform recommendations to the President, and I don't expect Dr. Carroll to discuss any Treasury-endorsed tax reform plan.

The Honorable Charles Rossotti, Senior Advisor at the Carlyle Group, former IRS Commissioner, and a member of the President's Advisory Panel on Federal Tax Reform, will discuss inefficiencies of our current business tax system and the principles he thinks are essential to making the system simpler, fairer, and more efficient.

Dr. Thomas Neubig, National Director, Quantitative Economics and Statistics at Ernst and Young, will discuss reasons why corporations should prefer a lower tax rate to targeted tax reductions.

Mr. David Bernard, International President of Tax Executives Institute and Vice President of Tax and Real Estate for Kimberly-Clark Corporation, will give views on tax reform from the perspective of large, multinational business enterprises.

Mr. Jeff Johannesen, Managing Director at RSM McGladrey in Des Moines, Iowa, will give views on tax reform from the perspective of small and mid-size businesses. I'd like to offer a warm welcome to Mr. Johannesen, who is also a constituent. His firm was started in 1926 as a seven-person office in Cedar Rapids, Iowa. Today, RSM McGladrey employs more than 7,000 people in over 130 offices in 25 states.

In closing, I'd like to thank each of the witnesses for taking the time to educate members of this committee on a broad range of business tax issues. As I said at the beginning, it is important that we examine business tax reform as a whole before focusing on a single aspect of reform. We need to get the big picture first.

Tax reform will take a bipartisan, national consensus. I think the consensus is there that the business tax system is in desperate need of reform. But we need to start building consensus on how to do it. The theme of lowering rates and broadening the base is easy to agree with in theory. The tough part will be figuring out how low and how broad.

This committee will continue down the path of tax reform. This hearing sets the stage for future hearings that will examine specific aspects of business tax reform in greater depth as we work toward reforming the tax code.

TESTIMONY OF
JEFF JOHANNESEN
RSM McGLADREY

Before

THE COMMITTEE ON FINANCE
UNITED STATES SENATE
SEPTEMBER 20, 2006

I. Introduction

Chairman Grassley, Ranking Member Baucus, members of the Committee, thank you for inviting me to testify at today's hearing on the vital issue of tax policy and reform.

II. RSM McGladrey

RSM McGladrey is a leading professional services firm providing accounting, tax and business consulting to midsized companies. With combined annual revenues of $1.2 billion, RSM McGladrey and McGladrey & Pullen LLP (a partner-owned CPA firm) together rank as the fifth largest U.S. provider of accounting tax and business consulting services (source: *Public Accounting Report*, Aug. 31, 2006).

RSM McGladrey's client list represents some of the top names in manufacturing and distribution, construction, real estate, health care, financial services and the public sector. RSM McGladrey focuses on the middle market because it represents the heart of U.S. commerce and industry, with more than 500,000 businesses contributing more than 30 percent of the nation's gross domestic production and representing one third of all American workers.

Companies in the middle market are a vital sector of our economy, and we continue to dedicate resources to learn about their needs, issues and concerns.

- In February 2006 we commissioned and participated in the development of the first post-9/11 study of the present and future challenges to America's small to midsized manufacturers. Among other things, that comprehensive study identified the best practices observed by these manufacturers, presented case studies from companies following those practices and catalogued government programs that can help businesses thrive.

- This summer, we surveyed more than 1,000 CEOs and CFOs from small to midsized manufacturers across the nation to gauge their perceptions on a wide range of subjects from operations to labor to exports. The survey participants expressed an unexpectedly upbeat feeling about the health of the economy in general and their respective companies. *But the survey also identified serious concerns, one of which is the small number of these manufacturers that are taking advantage of government enterprise assistance programs and the fact that nearly 40 percent aren't taking advantage of key tax credits and deductions.*

The committee staff asked us to testify because of our unique experience working with midsized companies.

III. Clientele

Each year numerous Congressional committees listen to witnesses explain that midsized organizations are the productivity, employment and innovation engines of the U.S. economy. We think there are two important characteristics of midsized, growing companies that are infrequently mentioned. Growing organizations:

- Organize their corporate structure in a different way than larger companies; and,
- Direct their resources to managing and developing their businesses and competing with larger more well capitalized corporations. They don't invest in increasing internal administrative resources to comply with complex public policies that really are not appropriate for them, but nevertheless cover them.

These two points are important because midsized firms are often forgotten in the formulation of public policy. Large businesses actively participate in the development of tax policy. Congress often creates small business exemptions to protect the smallest firms. Unfortunately, middle market firms may not participate in policy development and are often left attempting to implement policies that don't fit their structure.

In our experience, the presumption that companies with revenues of $25 million, $100 million or even $500 million can deal with laws and regulations with the same ease as companies with $25 billion or $100 billion in revenues is flawed. An organization with $500 million of annual revenue with little or no internal tax department simply cannot cope with the numerous federal, state and local filing requirements on a routine and regular basis. Here are a couple of examples:

- Earlier this year, the Senate passed legislation that would limit the ability of integrated oil companies to use the last-in/first-out (LIFO) method of inventory accounting. As the debate continued, there was serious discussion about extending restrictions on or repealing LIFO for all companies. This would have increased tax bills on thousands of U.S. companies, many of them midsized businesses. Our study that was referenced earlier startled many with its revelation that 42 percent of midsized manufacturers use LIFO and would be hurt significantly by its repeal.
- Our survey found that less than two-thirds of midsized manufacturers are taking advantage of key tax credits and deductions that could benefit them. For example, it would be a safe bet that nearly all Fortune 500 corporations take advantage of R&D tax credits . . . but only about 60 percent of midsized manufacturers responding to our survey do so. This statistic is particularly disturbing when you consider that 1) midsized manufacturers produce more innovations per employee than their large counterparts and 2) survey respondents overwhelmingly named business process improvements as most effective means of improving operational effectiveness.

IV. Testimony Summary

We direct our resources toward serving our clients and identifying ways we can assist them. We have not attempted to comprehensively analyze the impact of the various tax reform proposals from their perspective. However, we do have a few observations about the ability of our clients to adapt to a sweeping new tax system.

Specifically, our testimony today will address:

- Tax issues facing growing firms that are organized as pass-through entities.
- Some simplification suggestions to ease a few of the complexities in the current tax system
- The preparedness of growing companies to implement tax reform.

V. Tax Issues Affecting Businesses Organized as Pass-through Entities

To select the optimal business form, each growing firm must look into the future.

In the United States, there are five distinct business structures that are available, Sole Proprietorship, Partnership, Limited Liability Company (LLC), S Corporation and C Corporation. Each has its strengths and weaknesses, and most of the differences between them are prescribed by law. The initial entity decision may produce significant repercussions for the company as it grows. Many provisions of the tax law make changing the form of a business entity infeasible, impractical or extremely costly.

Today more owners organize their businesses as LLCs electing to be taxed as a partnership rather than as S Corporations. There are also many who don't want to choose the LLC structure because they want the company to have the option to change in the future. These business owners are concerned that LLC transition rules will increase the cost of returning to corporate form.

LLCs are a relatively new form of business organization. Many of our existing clients are organized as S corporations. Contrary to common perceptions, S Corporations are not just small businesses. In fact, we have S Corporation clients with hundreds of millions of dollars of annual revenue.

An S Corporation structure is extremely efficient for a growing midsized business. We believe more businesses would benefit from and be able to use the S Corporation structure if the rules governing them were simplified. We think there is a strong argument that the tax rules that distinguish the activities of both S Corporations and LLCs may benefit from a more standard approach. Specifically, we believe Congress should:

1) Lift restrictions that limit access to the equity markets for pass-through entities.

a) Currently, S corporations cannot accept capital and admit owners who are corporations, private equity groups, foreign investors and most retirement plans. The shareholder eligibility requirements limit an S Corporation's ownership structure to individuals who are U.S. citizens, a narrow class of trusts and certain tax exempt

organizations These restrictions on access to capital severely inhibit economic growth for dynamic, midsized businesses.

b) LLCs are generally the favored form of business organization; however, they face significant tax consequences if they intend to issue stock on a publicly traded exchange. To go public, these entities must generally reorganize as C Corporations after triggering a deemed liquidation of the LLC. The tax barrier to access the public markets is a concern for the owners of smaller firms.

These rules raise some legitimate questions:

i) If LLCs and S Corporations both flow their income and loss through to their owners, why do the tax rules treat their access to equity markets differently? As a policy matter, should LLCs have greater access to investment from private equity groups and venture capitalists than S Corporations?

ii) An S Corporation that plans to become publicly traded can easily revoke their S election to become a C Corporation. An LLC electing to be taxed as a partnership that desires the same access to the public markets must liquidate the LLC and expose their owners to tax on the deemed liquidation. Then, the owners can form a C Corporation with their net proceeds. Is it reasonable for these organizations to anticipate what type of equity they might need in the future to choose the appropriate form of business?

To mitigate the impact of these rules, growing organizations adopt more complicated structures. For example, a domestic S Corporation desiring foreign capital could create an LLC owned by the S Corporation and allow the foreign investor to purchase a preferred interest in the LLC.

A simpler approach to the issue would be to make the S shareholder eligibility rules broader. It certainly would reduce the cost of raising capital and eliminate the expense and need for creating and maintaining the entities to achieve the same goal of increased capital.

c) Allow S Corps to offer preferred classes of stock to attract equity investors.

The ability of a corporation to offer preferred stock attracts equity investors. Under the single class of stock rules, S corporations cannot offer preferred shares. For many equity investors, having the option of holding preferred stock offsets some of the risk associated with investing in new and growing businesses.

LLCs can offer preferred member interests: S corporations could attract additional capital if they had the ability to offer preferred shares.

2) Limit the tax burden for switching from C to S status.

For companies with LIFO inventory, electing S status requires the corporation to recapture their LIFO reserve over a four-year period.

Also, C corporations electing S status must recognize built-in-gain items that are realized in the first 10-years after S Corporation status is elected. The uncertainty and audit risk of

selecting an appropriate value for unrealized appreciation on property, and other intangible assets is a significant impediment to electing S status.

Finally, C corporations with January through August fiscal year ends may not retain these year ends if they elect S status. They are precluded from keeping their current tax years and paying an enhanced deposit under Sec. 444(e). Additionally, a calendar year C Corporation that plans to elect S status cannot select a September, October, November or December year end even if the corporation is willing to pay the enhanced deposit required under Sec. 444(e).

Older entities face these restrictions. Newer firms organized as LLCs will not encounter these impediments.

3) **The costly rules and restrictions associated with "related parties" erect yet another barrier to midsized growing businesses and should be eliminated.**

The many sanctions imposed on transactions among related parties are difficult for family owned firms. It is our experience that 50-year old siblings may have less in common than related subsidiaries in a consolidated group. Do these siblings reasonably have the same asset ownership interests compelling them to navigate so many related party restrictions?

Family members must consider the rules in Sec. 1239, 267, 318, 302 and 197. Sections 267 and 318 are particularly egregious in some instances and are widely incorporated by reference throughout the entire Internal Revenue Code (IRC) to impose in some cases a tax exceeding 200 percent of the tax that would be imposed on the same transaction if it were between unrelated parties.

For example, the related party rules prevent a related party from offsetting their gain against their basis in a Sec. 302 redemption that is not a complete termination of interest.

The related party rules can work in surprising ways. New owners could purchase 75 percent of a business and be ineligible for the tax benefits of amortizing the intangibles they have purchased. This "anti-churning" rule quells new investment needed to provide capital for growth.

Numerous related party rules are in place that treat family members as one when they *restrict* family transactions, but won't allow family members to be treated as one for provisions that *benefit* them. Such relationships do not operate in all circumstances where they would cause an ownership interest to be treated as owned by another and thereby receive tax-deferred treatment, such as transfers of property to "controlled" corporations under Sec. 351.

These impediments block the access of midsized companies to more sophisticated business structures.

4) **Increase an S corporation shareholder's tax basis in their S stock for debt guarantees**

S corporation shareholders may increase their tax basis in their S stock by the amount of a loan from the shareholder to the S corporation. A shareholder guarantee of an S corporation loan will not increase the shareholder's basis in their S stock even though the risk associated with the entrepreneur/owner's commitment is virtually identical.

Commercial lending practice requires the personal guarantee of significant shareholders for corporate debt. We are often asked by our clients to explain to the bank the need for the financial institution to lend the money separately to the shareholder so they can then contribute the loan proceeds to the S corporation. We suggest the rule be changed to permit S corporation shareholder guarantees to increase S stock basis.

VI. General Recommendations to Ease Complexity

The Internal Revenue Code is filled with duplicative, insignificant and unnecessary requirements that impose incalculable burdens on the midsized companies we represent.

Simply stated, some code requirements wouldn't meet an objective cost-benefit test. Some tax provisions are sufficiently complex that an IRS examining agent will ignore certain tax return line items after a cost/benefit analysis. Regrettably, our clients must still accumulate this information to make the computation required by the law although it may have a minor impact on their ultimate tax liability.

There are hundreds and hundreds of examples of penalties, reporting requirements and other burdens that prove onerous for midsized companies, but aren't significant or meaningful for the government. Here are a handful of examples:

- Under Sec. 9100, the IRS grants relief to taxpayers that have missed non-statutory deadlines for statutory rules that are too complex. The IRS is authorized to assess relatively hefty user fees to grant this relief. Why should a taxpayer be punished for missing a deadline for rules that the IRS admits are extremely complex? These user fees should be eliminated.

- It makes sense to require information reporting for hedge fund transactions that shelter taxes, but we should revisit reporting requirements for transactions that don't have a tax sheltering impact.

- The uniform capitalization rules add complexity for midsized firms with limited revenue enhancement for the federal government. We believe Congress shouldn't force a firm to use the unicap rules unless they have $100 million in inventory or $500 million of sales.

VII. Broad Tax Reform Issues

We applaud any and all efforts to reduce business tax rates. Lower income tax rates help growing organizations. Entrepreneurial businesses often lack the full-time tax staff with the expertise to analyze the law and collect the data to take advantage of complex incentives.

We strongly support the repeal of the Alternative Minimum Tax (AMT). Our current AMT structure causes unpredictable tax results and undermines Congressional incentives. For individuals who report income or loss from a pass-through entity on their individual returns, the general disallowance of regular tax credits against individual AMT may negate a desirable business activity. For example, the benefit of jobs credits and rehabilitation credits are lost to a pass-through entity whose owners are in the individual alternative minimum tax.

We believe that companies benefit from a generous Sec. 179 expensing allowance. The current phase-out range limits the utility of the benefit. A larger Sec. 179 expensing allowance to $10 million with a higher phase out range from $15 million to $20 million of asset additions would simplify the asset planning activities for many of our clients and, more importantly, provide a meaningful capital resource incentive for midsized organizations to expand their U.S. based manufacturing capacity.

We also believe that tax incentives should be permanent to give midsized organizations the confidence they need to make the relatively sizeable investments necessary to take advantage of them. Research and development activities are inherently long-term undertakings. A permanent research credit will have a disproportionately greater effect on midsized firms who are more reluctant to devote scarce resources to an activity with a temporary incentive.

***Generally,* we support efforts to reform our nation's tax laws.** The President's Task Force on Tax Reform identified growth approaches and simplification approaches to tax reform. We would prefer a growth approach undertaken with an attempt to consider the administrative burden associated with this alternative. Congress will need to strike the best balance between equity and fairness, while considering the administration of the future system and the compliance burden it places on businesses.

However, from the perspective of America's midsized organizations, there are some caveats to our support for tax reforms:

- Transition rules accompanying any significant tax reforms need to be carefully crafted and gradually implemented to allow midsized companies time to adjust.

- We suggest you seek advice from the information technology community about the type of financial information that midsized organizations currently gather and the feasibility of gathering different data that might be needed for a new tax system.

We strongly support the need for clarification and simplification of the tax code. It is right for our clients and will result in a more vibrant economy. After a two-hour discussion on tax complexities and compliance, an exasperated client told me "I wish we had the time to discuss how to run and grow my business!"

We believe that complexity makes many tax incentives more beneficial to big business than to small and midsized organizations. Consequently, the law can unintentionally favor big business over small. The domestic manufacturer's deduction was designed as an incentive for one of the largest and most important drivers of our economy – domestic manufacturers. Incredibly over one third of the 1000+ CEOs and CFOs who responded to our survey aren't taking advantage of this important growth incentive. Although we didn't ask, we suspect that they don't think the benefit of the phased in 3 percent deduction is worth the aggravation of the myriad calculations required by the regulations to claim the deduction.

Many of our clients are attempting to comply with anti abuse provisions enacted during the Enron era. Ironically, these reporting requirements and complexities were put in place to control abuses by the largest businesses, but the resulting administrative burden puts midsized businesses at a competitive disadvantage.

VIII. Conclusion

RSM McGladrey believes that any tax reform plan should consider the ability of growing companies to comply and thrive under the new regime. We applaud your effort to identify tax impediments under current law that impedes the growth of midsized organizations. Any new system will need a workable transition schedule to allow administratively lean businesses to understand and administer the new system. We hope that the system you select will reduce the economic cost of tax administration and restore the faith of taxpayers in the fairness of the system.

Responses to Questions for the Record for
Mr. Jeff Johannesen
October 12, 2006

From Senator Grassley:

I found Dr. Neubig's discussion of permanent versus temporary tax benefit interesting. Because temporary tax benefits do not reduce a corporation's effective tax rate that it reports to shareholders, they are generally not valued by corporate tax and financial officers as highly as permanent tax benefits. Of course, this ignores the time value of money, which is itself a permanent benefit.

Mr. Johannesen, do you agree with Dr. Neubig's analysis? Do you think this point of view applies only to publicly traded corporations, or does it translate to privately held businesses and pass-through entities as well?

Response:

Financial statement income is generally more important to publicly traded companies than taxable income because it affects earning per share computations. This metric affects stock price and executive compensation packages of key executives. Strong financial statement performance also attracts equity investors and attracts more capital for each share of stock sold in public markets.

Financial statement income is generally less important to private family firms. Non-publicly traded firms rely upon financial statements to assure creditors about their financial situation. Some businesses use financial statements to improve business management. For private firms, taxes depress the available cash flow, financial statement income, value of a business and have an effect on loan covenants with financial institutions.

Expensing depreciable assets allows private firms to quickly recover the income tax attributable to the capital expenditure. From the perspective of a private organization, expensing reduces the cost of a capital asset acquisition.

Dr. Neubig's comments also address the impact of expensing assets on an organization's decision to purchase depreciable plant and equipment as opposed to investing in less incented business activities. This comment applies equally to both private and public businesses.

From Senator Hatch:

1. Mr. Johannesen, I appreciate your focus on smaller and emerging businesses and the tax problems they face. Some have suggested that tax reform should include a complete reworking of the tax code so that we create a new regime that combines the best of the features of the way we tax partnerships, limited liability companies and S corporations and make it much simpler. What is your reaction to this idea?

2. Could you discuss some of the barriers that small firms face in regard to raising capital? How could our tax laws help overcome these barriers?

3. As you may know, I recently introduced a bill that would simplify and clarify some of the tax rules governing S corporations in order to allow companies to better take advantage of this structure. While you touched on a few of the problems inherent in choosing to be organized as an S corporation, perhaps you can tell us what are the biggest hindrances for S corporations that legislation can fix at a relatively low cost in term of foregone revenues.

Response:

1. In theory, a tax system that combined the best features of S corporation, partnership and LLC structures would represent true simplification. Many of these forms of organization and their attendant tax rules have evolved over the years. For example, many firms preferred to organize as C corporations before the Tax Reform Act of 1986 because liquidating distributions were subject to a single layer of tax, distributions in partial liquidation qualified for capital gain treatment and corporations could subject their income to less tax using multiple surtax exemptions and the graduated corporate rate structure. Changes to these tax rules left these businesses with a less advantageous tax structure. In creating a new system, transition relief for existing LLCs, S corporations and C corporations to a new regime will remain a significant concern for many growing midsized firms.

2. As businesses grow, they move from reliance on their owner's capital and bank financing to more sophisticated ways to attract capital. Many of our clients look to private equity groups, venture capitalists and international investors before becoming large enough to seek capital in publicly traded markets. They reward their employees with stock and use ESOPs and other incentive compensation arrangements to retain and motivate their employees. Our current tax rules can impede these financial arrangements.

   If a company is organized as an S corporation, the single-class-of-stock rules prevent the business from issuing venture capitalists and private equity groups a preferred form of equity. Venture capital firms and private equity groups generally seek an annual or preferred return on their investment. The S

corporation tax rules do not allow stock to have preferred investment returns that are attractive to private equity investors.

The eligible shareholder rules also restrict foreign individuals and corporations from owning S corporation shares. These investors seeking an equity stake in an S corporation are not eligible shareholders.

Another S corporation impediment to accessing capital is the requirement that a shareholder's basis is increased only if the shareholder borrows funds and contributes them to the S corporation. Financial institutions would prefer that the S corporation borrow the funds needed for business investment with a personal guarantee from the shareholders. In economic terms, the shareholders are responsible to repay the loan in either scenario. The current rule adds paperwork, professional fees and does not alter the substance of the transaction. The current rule should be altered to conform to traditional banking practice and to permit non-abusive financing structures.

Businesses organized as LLCs electing to be taxed as partnerships face some significant tax problems if they try to access public markets or become acquired by a publicly traded company, because generally these companies must organize as C corporations. Restructuring to transition from partnership form to C corporation form may result in a tax recognition event on the conversion transaction on the entire value of the business rather than the tax free treatment normally afforded these types of transactions.

3. Ironically, the tax provisions with the harshest impact on business owners raise the most revenue for the federal government. Advisors have the greatest difficulty planning for these events. These punitive tax rules significantly impede economic choices because of their large tax penalties. In some cases, the rules may have such a large tax impact that a business does not elect to pursue an otherwise beneficial economic activity, so the revenue gain to the government is never realized. Rules in this category are often the toll charges for changing the form of a business entity (for example, the built-in-gain tax on C to S conversions, recapture of LIFO inventory reserves on C to S conversions, and the partnership liquidation rules).

   Other rules around which we can appropriately plan are financially burdensome to businesses because they generally require employing professionals to create different entities and administrative cost associated with tax filings for these entities. For those rules (obstacles) that can be overcome with restructuring and planning, there is limited revenue loss associated with these activities from the perspective of the government.

   In many cases, we can plan around the many S corporation shareholder restrictions by creating additional entities; therefore, permitting S corporations to have international individuals and C corporations as shareholders. Changing these

rules to allow corporate and international shareholders should be relatively inexpensive from the perspective of the federal government. These changes would simplify the tax rules for these businesses by allowing them to avoid creating LLCs to participate in the S corporation's ownership structure.

Another S corporation rule we can plan around is the requirement that shareholders personally borrow money to increase their basis in their S corporation stock.

Frequently, clients are thinking about their business from an economic perspective and they may fail to consider the eligible shareholder rules before adding a shareholder. Admitting an ineligible shareholder into an S corporation is a termination event with significant tax ramifications. In many cases, the IRS grants relief to S corporations who have admitted ineligible shareholders. The IRS also grants 9100 relief to S corporations that have submitted faulty S elections. Simplification of these rules will generally not affect federal revenue because of IRS grace and the associated deductible professional fees expended to correct these problems.

We also suggest you revisit the related party rules referenced in our written testimony. The operation of these rules can cause family firms to avoid transactions that unrelated parties would normally undertake in the ordinary course of business.

Another inexpensive provision to fix is the requirement that health insurance premiums are added to the W-2's of 2% shareholders of S corporations and then deducted on the individual shareholder's return. When health insurance premiums were not fully deductible by partners or self-employed individuals, this rule conformed the tax treatment of S shareholders to other owners of passthrough entities. With the full deductibility of health insurance premiums, this requirement adds complexity. It also disadvantages S corporation shareholders whose employee business expenses must exceed 2% of modified adjusted gross income to be deductible.

We respectfully suggest that S corporations should be permitted to elect any year end if they agree to pay the enhanced deposits required under §444. These deposit rules were designed to prevent any federal revenue loss, but are currently limited to S corporations electing a September, October or November year-end.

Many of our recommendations are included in S. 3838 authored by Senator Hatch and Senator Lincoln. Their legislation also adds many other helpful improvements to Subchapter S.

From Senator Baucus:

1. Your testimony states that probably all Fortune 500 companies take the R&D credit, but only 60% of the midsized manufacturers that responded to your 2006 survey take advantage of the credit. You indicate that this is the case even though midsized manufacturers produce more innovations per employee than larger corporations. What are the reasons midsized businesses do not claim this credit? What would change this trend or improve utilization of the credit?

2. There have been discussions on restricting the use of the LIFO method of accounting. Some even want to repeal the provision. According to your testimony, 42% of midsized manufacturers use LIFO. Could you give us a detailed outlook on how the repeal of LIFO would affect midsized businesses?

3. You may have seen some of the earlier testimony at the Finance committee regarding the Tax Reform Panel recommendations. The non-partisan Congressional Research Service (CRS) highlighted the extensive transition costs necessary to make the consumption tax proposal work, resulting in a one-time, lump-sum tax on "old capital." This means that a taxpayer with existing inventory would lose all the deductions for purchasing the goods for resale or purchasing materials for processing. CRS also analyzed the limited transition relief provided for in the consumption tax, and found that a small business owner could lose up to 95% of the depreciation deductions on a building, and 65% of the deduction for equipment. CRS said these impacts could pose a significant barrier to adoption of the proposal. Your testimony mentions that transition costs in any fundamental tax reform plan can be extremely important to small businesses. What are the factors that Congress should consider in designing transition benefits? What are the greatest concerns for small and midsized businesses in any transition relief?

Response:

1. Our survey of manufacturers found that many midsized businesses fail to claim the R&D credit. Our survey did not ask manufacturers why they fail to claim the R&D credit. Based on our experience, resource constraints limit the ability of midsized manufacturers to compile a full and accurate calculation of their research expenses. Larger companies are better positioned to absorb the cost of documenting the research credit.

   You also requested our suggestions on changes that might improve the utilization of the R&D credit. We respectfully submit these ideas for your consideration:

   a. The IRS expects taxpayers to accumulate costs for each research project. Many businesses do not have project and time reporting systems in place to accumulate this information. A more flexible approach on how a

business accumulates costs associated with research will help midsized firms.

b. There is still a great deal of disagreement between taxpayers and the IRS about what does and does not qualify as research. Additional clarity in the Code and regulations on eligible research expenses is desirable.

c. Current law requires taxpayers to rely on a 1984-1988 base period to discern eligible incremental research allowed for the credit. We believe that 1984-1988 is no longer a relevant base period for recent research expenditures. For clients who have never claimed the credit, exhuming 1984-1988 data may be impossible with record keeping constraints and employee turnover. A rolling base period may make more sense.

d. Many clients and prospects have not heard of the credit and they are skeptical about its existence. Congressional education efforts and publicity will assure midsized firms that Congress endorses this provision.

2. If LIFO were immediately repealed, midsized firms would face taxation on the difference between their FIFO and LIFO reserve computed at the beginning of the year of this change. This income would be included in the manufacturer's income years under Sec. 481.

   Many of our clients experience large fluctuations in their costs of inputs. The most recent purchases of raw materials are matched with the profit realized from the sale of that inventory under LIFO. This computation of profit parallels the profit realized by firms who have just entered the market and are purchasing inputs and manufacturing goods.

   Many of our clients are facing significant price inflation on their costs of inputs. Industries affected include:
   - heating and electronic wholesalers due to the dramatic price increases in commodity prices for copper and steel;
   - wholesale food manufacturers due to increases in wheat prices and petro-chemical inputs in packaging;
   - residential home builders due to increased costs for lumber, steel and copper pipe; and
   - convenience stores due to the increased gasoline prices.

   In addition, current tax rules require taxpayers terminating their LIFO elections to return to their original FIFO methodologies. For many midsized taxpayers this requirement presents a significant burden in identifying and implementing old methodologies as well as potentially incurring the risk of returning to an accounting method that is no longer acceptable.

If LIFO were repealed, midsized firms would pay a large income tax liability. This payment would reduce the amount of cash available to finance expansion. If the Committee decides to repeal LIFO, a longer §481 period would soften the cash flow problem associated with the repeal. A 20-year §481 adjustment period would minimize the cash flow impact of repealing LIFO, but it would not address the policy issues that initially motivated Congress to enact the LIFO method.

One reason publicly traded firms are less concerned with the repeal of LIFO is the LIFO conformity rule. LIFO conformity requires the LIFO method be used for book and tax purposes. If the price of inventory inputs is increasing, LIFO will cause a firm to recognize a smaller profit on the sale of inventory. This effect is undesirable for a public company, but very desirable for a private company that will use the tax savings to finance expansion.

3. Midsized business will face a significant education and administrative burden if Congress enacts a consumption tax. Typically, employers with $200-$500 million of annual revenue do not have an internal tax staff. Employers at the high end of this range may employ a professional to assist with tax compliance. In many cases, these businesses operate in multiple states and localities, as well as internationally, so compliance with existing rules is a full time job for this individual.

   To transition to a new tax system, a financial person within the company will need to learn enough about the new tax rules to determine whether the company is currently gathering the right information to compute its tax obligation. Then, the financial officer will need to assess their current financial software to see if it collects the appropriate information for each taxing jurisdiction, weighing the prospect of state conformity as the federal system is implemented. If the software can accommodate data collection for the new tax system, the individuals who input financial information will need training on the new tax system.

   If the software cannot accommodate the changes, the business must endure an expensive and disruptive software conversion. Depending upon the design of the consumption tax, many businesses may have a responsibility to accumulate information and remit tax associated with the value added from their business activity and claim future credits once the item is sold to an end user. The tracing features of this type of accounting system could create additional administrative costs and burdens for midsized employers.

   In addition to the administrative challenges posed by a consumption tax, the impact of the new system can change the economics of prior business decisions. The CRS statistics you supplied in your question seem accurate to us in light of our experience. If the repeal of LIFO is a significant hardship to midsized firms, the changes unleashed by the migration to a new tax system are more dramatic. As you note, the impact of losing the tax benefit for inventory inputs and the lost

depreciation or amortization deductions for acquired assets will have serious economic effects on midsized businesses. Generally, midsized companies can adjust to new administrative requirements with long transition periods. For example, could the increase in tax associated with the loss of basis in unsold inventory be phased in over a 20-year period? Could Congress shorten the depreciable period on assets already placed in service to provide some transition relief?

We also see some significant issues beyond inventory and depreciation for midsized firms who made economic decisions after considering the current tax rules. A manufacturer may have hired more employees rather than purchase a robot for an assembly line. Employment expenses might not be deductible under a new tax system, but a midsized employer has a legal, moral and economic duty to the existing employees irrespective of the tax system. This employer's international competitors may not have the same constraints. A long transition period helps to minimize the disruptive economic effects of any comprehensive change to the tax system.

Statement of Dr. Thomas S. Neubig
Principal, Ernst & Young LLP

Testimony before the
Senate Finance Committee
Our Business Tax System: Objectives, Deficiencies and Options for Reform
September 20, 2006

Mr. Chairman, Ranking Member Baucus and Members of the Committee:

I am the National Director of Ernst & Young LLP's Quantitative Economics and Statistics practice.[*] I was previously the Director and Chief Economist of the U.S. Treasury Department's Office of Tax Analysis between 1986 and 1990.

I appreciate the invitation to testify before the Committee on the issue of our business tax system, and particularly options for reform.[1] Given the breadth of the topic of business tax reform, I will restrict my comments to the issue of reasons why many corporations prefer a lower corporate tax rate to more targeted tax reductions. My testimony is based on a recent Tax Notes article, entitled "Where's the Applause? Why Most Corporations Prefer a Lower Tax Rate."[2]

The President's Advisory Panel on Federal Tax Reform outlined a Growth and Investment Tax Plan for a business cash-flow tax—essentially an expensing option that allows for a first-year 100% write-off of capital investment. One might have expected that this plan—which many economists claim would result in a zero effective tax rate for new capital investment—would have inspired a collective standing ovation from corporate finance and tax officers. Instead, the response has been similar to the proverbial sound of "one hand clapping."

Why the tepid response from the corporate community? The Tax Council Policy Institute recently asked multinational corporations to rank a range of alternative tax reform options—and, according to the survey, the clear favorite was lowering the corporate tax rate to 25 percent compared to other incremental or fundamental tax reforms.[3]

With economists and the business community differing so widely in their response to the Advisory Panel's expensing option, many observers wonder why the disconnect. Here are seven reasons why many corporations prefer a lower corporate tax rate to the proposed option of expensing capital investments.

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[*] Thomas S. Neubig, Ernst & Young LLP, 1225 Connecticut Avenue, N.W., Washington, DC 20036. E-mail Tom.Neubig@ey.com

[1] The views expressed in this testimony are my own, and don't necessarily reflect the views of my firm or clients.

[2] Tom Neubig, "Where's the Applause? Why Most Corporations Prefer a Lower Tax Rate," Tax Notes, April 24, 2006, p. 483-6.

[3] Tax Council Policy Institute, The U.S. International Tax Regime: Confronting the Challenge of the Evolving Global Marketplace, February 10-11, 2005, Final Report, p. 90.

1) *Expensing offers only a timing benefit, and doesn't reduce corporations' book effective tax rate. A lower corporate marginal tax rate would lower corporations' book effective tax rate and increase book net income for most corporations.*

Most economists don't think book taxes matter. Most corporate tax and financial officers value permanent, rather than temporary, book tax differences. From the perspective of the corporate officer, expensing accelerates tax deductions into the first year, providing only a timing tax difference rather than a permanent tax difference for book purposes.

With expensing, public corporations would have large deferred book tax liabilities, yet would still have a high book effective tax rate on current income. While most economists believe that book corporate tax rates shouldn't matter (because investors should pierce the corporate veil), many corporate tax directors and officers do believe that book corporate tax rates matter to their investors—and also affect their own performance criteria.

In contrast, reducing the corporate marginal tax rate would immediately lower corporations' book effective tax rates, thereby increasing their reported after-tax book profits. A lower corporate marginal tax rate would also immediately reduce corporations' deferred book tax liabilities and assets—a welcome development in an environment where most of the largest companies report deferred tax liabilities.

A lower corporate tax rate would necessitate re-measuring existing deferred tax liabilities and assets, and also result in an increase or charge to earnings in the period the legislation is enacted. Companies in a net deferred tax liability position would have an increase in reported after-tax income from the tax benefit associated with a lower tax rate on their deferred tax liabilities. Of the 50 largest companies within the Fortune 500, 32 have a net deferred tax liability and 18 have a net deferred tax asset. When the State of Ohio enacted legislation phasing down its corporate income tax rate on June 30, 2005, a number of public corporations reported higher profits due to the future tax rate reductions in their second quarter financial results.

2) *Corporations already expense a large fraction of their capital investment. A lower tax rate would benefit both their tangible and their intangible investments—a benefit not offered by the business cash-flow tax.*

Undeniably, proposals for expensing would lower the economic effective tax rate for depreciable property, land and inventories. But, a recent study found that business investment in intangibles—research and development, copyrights, computerized databases, development of improved organization structures, and brand equity—is now as large as the spending on tangible capital. And, through the deduction for wages associated with the creation of the self-constructed intangible assets, a large portion of investments in intangible assets are already expensed under the current system.

Expensing would benefit depreciable and capitalized investments, but would provide no incremental benefit to intangible assets that are currently expensed. A lower corporate marginal tax rate, on the other hand, would benefit income from all tangible and intangible investments. A lower corporate marginal tax rate would also benefit existing intangible investment, since the tax rate at which it expensed the investment would be higher than the tax rate at which the future income would be taxed.

3) *Expensing is unlikely to occur without a counterbalancing loss of interest deductibility. A lower corporate marginal tax rate could occur with continued interest deductibility.*

The Advisory Panel's report emphasizes the necessity of combining expensing with repeal of interest deductibility to prevent negative economic effective tax rates. "Eliminating the business interest deduction for non-financial firms is an essential component of the Growth and Investment Tax Plan. Allowing both expensing of new investments and an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity." (Advisory Panel, p. 164)

As a result, the valid comparison isn't just expensing versus a lower corporate tax rate, it is expensing combined with loss of interest deductions versus a lower corporate tax rate with interest deductions.

It should be noted that debt-financed capital investment is already calculated as having an economic effective corporate tax rate of zero with economic depreciation, and a negative economic effective tax rate with the current accelerated depreciation. "By contrast, the average tax rate on debt-financed investment is negative (-15%), as deductions for interest, together with deductions of items such as accelerated depreciation, more than offset the income generated from debt-financed investment." (Advisory Panel, p. 100)

So, expensing would really only help a small fraction of corporate investment: equity-financed tangible investments. Because of the loss of the interest deduction, debt-financed tangible and intangible investment would be worse off under the business cash-flow tax. For this reason, a lower corporate marginal tax rate on top of the current interest deduction and accelerated depreciation for tangible capital would be more advantageous for many corporations compared to expensing or a business cash-flow tax.

4) *Corporations invest to earn above-normal returns, not just the "normal" or risk-free return. While expensing reduces the tax rate on only the risk-free return, a lower marginal tax rate applies to the entire return to capital,*

Economists distinguish between four different returns to investors: 1) a "normal" or risk-free return for deferring consumption, or a "return to waiting"; 2) an expected risk premium; 3) a return due to entrepreneurial skill, a unique idea, a patent or other specific factors; and 4) an unexpected return from good or bad luck where the actual return differs

from the expected return. The Advisory Panel report (p. 150) states "Removing the tax on the first component, the return to waiting, is the key to removing taxes from influencing savings and investment decisions." The Panel report stresses that both an income tax and a "post-paid" consumption tax (expensing) fall on the other three components, which they say has "important implications for the distributional effects" of reform.

Academic economists argue that in competitive markets businesses can only earn the "normal" or risk-free return to capital on their last (marginal) dollar of investment. By this reasoning, expensing will provide an incentive for additional investment. However, the Growth and Investment Tax Plan with expensing but without an interest deduction would impose a tax on returns in excess of the "normal" or risk-free return arising from risk-taking, entrepreneurial effort or innovation. Consequently, the academic economists' zero tax rate argument only applies to a very small fraction of a company's total investment—just to that last dollar of investment, and only to the portion equivalent to a risk-free return. But, the reality is that companies don't invest just to earn a risk-free return; they expect to earn returns to justify their risk-taking, specialized factors and competitive positioning.

Economic proponents of expensing like to point out that under a business cash flow tax profits above the risk-free return would be taxed. They argue that taxing "rents" is equivalent to a lump-sum tax, causing no economic distortions. Again, we are reminded that the economists and the corporate tax officers are two very different audiences.

While most economists are focused at the "margin", businesses make investments that are large, discrete, finite, risky and also include substantial entrepreneurial and innovative efforts. When entering a market with a sizeable investment, a company looks at its total after-tax return. While a company might earn a risk-free return from the time-value of money from accelerating depreciation deductions, companies invest to earn a significantly higher return on their total investment. On the other hand, a lower corporate tax rate would reduce the tax on all corporate income—both the normal risk-free return income as well as the return to risk-taking, entrepreneurial skill and innovation.

5) *Many companies would not receive the full benefit of expensing without also being able to receive immediate refunds.*

Many companies, especially while transitioning to the business cash flow tax model, would not benefit from the full effect of expensing, because expensing would eliminate all taxable business cash flow for many companies. Unless the government provided immediate cash refunds, they would only realize a fraction of the potential benefits that expensing might offer. Many more companies would find themselves in a net operating loss (NOL) carry forward position with expensing.

The Advisory Panel did propose that the business cash flow tax with expensing would also include NOL deductions with interest. And, economists' present value calculations would show that corporations are made whole with an interest adjustment to NOLs.

However, corporations don't normally choose to invest in Treasury securities earning a risk-free return. Deferring the tax benefits of expensing beyond the initial year, even with a risk-free interest rate, is not the equivalent of a zero economic effective tax rate when a corporation considers the other, more potentially rewarding, opportunities available for its investments or payments to shareholders.

6) *Expensing reduces the tax wedge on one margin, but a lower tax rate would reduce the tax wedge on all margins.*

The Advisory Panel notes that its Simplified Income Tax proposal for a territorial system of international taxation would put increased pressure on transfer pricing. (Advisory Panel, p. 242) Indeed, transfer pricing issues are important when marginal tax rates differ across countries, and currently the U.S. has one of the highest statutory corporate tax rates. The Organization for Economic Cooperation and Development (OECD) calculates the U.S. combined federal/state corporate tax rate to be 39.3% compared to an OECD average of 31.2 %. Other marginal decisions, such as debt versus equity financing, are influenced by the statutory marginal tax rate. Marginal and average tax rates also influence location decisions.

While some economists argue that expensing would eliminate the differential tax treatment of tangible and intangible investments, a lower corporate marginal tax rate would reduce the tax wedge for all corporate decisions, including location decisions, the corporate non-corporate decision, debt equity financing decisions, transfer pricing, etc.

7) *Corporate tax rates could increase in the future. Expensing leaves large deferred tax liabilities that could be subject to significant future tax increases.*

The economists' assertion that expensing creates a zero effective tax rate on the risk-free return only holds if tax rates remain unchanged over the life of the investment. If tax rates increase in the future, then the effective tax rate would be higher. Of course, if tax rates were to decrease in the future, then the economists' effective tax rate could fall below zero.

If tax rates increase in the future, then public corporations' large deferred tax liability from expensing would become even larger on prior investments. In addition, a higher tax rate and increased deferred tax liability would reduce reported book income in the year of the change. Academic economists might think that corporations would be indifferent to the possibility of future tax changes, or at least treat the possibility of a tax rate increase as offsetting the possibility of a tax rate decrease. In reality, though, many corporate officers and tax directors would see a much larger downside from a tax rate increase than benefit from a tax rate decrease. Negative surprises seem to have a larger adverse effect than the positive effect from positive surprises. In today's business environment, jobs and options can be lost with negative surprises; a positive surprise, on the other hand, might elicit a one-time bonus.

Expensing would create large deferred tax liabilities. And, many theoretical economists might argue that these could later be taxed at higher rates without adverse economic effects since the investments had already been made. This is the same argument that many economists use for estimating the future economic benefits of moving to a consumption tax (either a value-added tax or business cash flow tax), since the shift can be financed by imposing taxes on old capital (existing investments). This is another reason why corporate officers are skeptical of expensing and also economic arguments of efficiency.

Conclusion

Given the very different perspectives and day-to-day challenges of the academic economists and the business community, it is unlikely that the Growth and Investment Tax Plan—or any tax reform proposal that resembles a consumption tax—will draw raves from both audiences. And, while the Advisory Panel's business cash-flow tax proposal retains the appearance of the current corporate income tax—with expensing and a repeal of interest deductibility added to the mix—it is still, at its core, a variant of a consumption tax. Part of the explanation for the disconnect between academic economists and the business community is what might be called the "Red Riding Hood disguise" – hiding a consumption tax in income tax clothing.

Expensing capital investment would provide significant tax benefit to many corporations. But still, most corporations—even many of those who would benefit from expensing—are likely to favor lower marginal rates as part of any incremental tax reform. And, while expensing would significantly reduce the taxation of equity-financed depreciable property, the business cash-flow tax (with repeal of interest deductibility) would increase the tax burden on debt-financed tangible and all intangible assets. Plus, expensing would not lower book effective tax rates.

Academic economists are correct when they say that expensing can result in a zero effective tax rate on the risk-free return to marginal investment. However, the underlying assumptions and limited focus of their analysis (marginal investment, equity-financed tangible investments, no financial statement effects, no principal-agent incentive effects) neglect the fact that businesses are seeking high total after-tax returns to their investments, including the return to risk-taking, innovation, and entrepreneurship.

These seven reasons seem to be why many corporate tax directors and officers have not stood up with many economists to applaud expensing and the proposed business cash-flow tax. Most of the corporate tax community would prefer to see the U.S. join other countries in lowering the corporate marginal income tax rate.

Thank you for inviting me to make this statement. I would be happy to answer any questions.

Responses to Questions for the Record From Dr. Thomas Neubig
Senate Finance Committee Hearing of September 20, 2006

Senator Grassley: Do you think this point of view applies only to publicly traded corporations, or does it translate to privately held business and pass-through entities as well?

Answer: Mr. Chairman, You are correct that publicly traded companies have additional considerations weighing in favor of preferring permanent, rather than temporary, tax benefits, but privately held businesses and pass-through entities would have similar reasons for favoring lower marginal tax rates over expensing.

Temporary tax benefits, such as expensing, have a time value of money benefit, which is the equivalent of a zero interest rate loan from the federal government. This cash flow effect is positive for business, but most businesses including privately held businesses and pass-through entities would find a lower marginal tax rate more beneficial. The interest-free loan from expensing only applies to the tax effect of the investment's accelerated depreciation. Eventually the interest-free loan must be repaid. If there is the possibility of an increase in future tax rates, the amount of the loan repayment could be greater than the amount borrowed.

A lower statutory marginal tax rate would reduce the tax distortion on all economic decisions, while expensing only applies to investment in tangible investments, such as equipment, structures and inventories. Recent studies have shown the growing importance of intangible investments, which are important for both C corporations and non-C corporation businesses. In fact, many sole proprietorships and partnerships have significant intangible investments from managerial expertise, innovation and entrepreneurship that would benefit significantly from a lower marginal tax rate, yet only modestly from expensing.

Senator Baucus: Do you agree that Treasury's paper also favors a consumption tax, and if so, why do you think Treasury and the business community seem to have a "disconnect" on this issue? Rather than the rate reduction, if such a consumption tax was enacted – with immediate expensing and the loss of the interest deduction – how do you believe U.S. companies with substantial existing investments in capital and interest deductions would adjust? What kind of transition relief would you expect?

Answer: My reading of Dr. Carroll's testimony is that Treasury is concerned with the many distortions in the current tax code, relative to not only a uniform consumption tax but also a uniform income tax. The testimony highlights non-uniform taxation of business investment. Although favoring lower marginal tax rates on capital investment, the Treasury testimony stops short of calling for a consumption tax that would repeal the interest expense deduction.

It is interesting that the testimony states "Full expensing of investment (e.g., immediate write-off) completely removes taxes from investment decisions.", without the caveat highlighted by the recent Advisory Panel that expensing in combination with debt finance results in a significant negative effective tax rate. Negative effective tax rates distort investment decisions. Even without that caveat, I disagree with the Treasury statement that full expensing is equivalent to removing taxes from the investment decision, since expensing is essentially an interest-free loan of the tax effect from the investment expenditure's accelerated deduction while statutory marginal tax rates apply to the investment's future revenue stream.

My testimony cites several reasons why many in the business community favor lower marginal tax rates over expensing, including the likelihood of repeal of interest deductions, the "retroactive" nature of repeal of interest deductions without adequate transition rules, and the growing importance of intangible investments. These issues are important reasons why most of the business community was not applauding the Advisory Panel's Growth and Investment (consumption) Tax. If the scenario you pose of the corporate income tax replaced with expensing and loss of interest deductions without transition rules, the business community would be very concerned in the future about the stability and predictability of the U.S. tax system. They would likely increase the risk premium associated with tax risk associated from their U.S. investments.

Transition relief is highly political, and will require trade-offs between lost revenue, additional complexity, minimizing distortions and perceived fairness. One of the benefits of a lower corporate marginal tax rate is that it works with the current tax rules and applies to all existing investments, not just future investments, thus not requiring transition rules.

Testimony Before The US Senate Finance Committee
Charles O. Rossotti, Commissioner of Internal Revenue, 1997-2002
September 20, 2006

Simplifying Taxation of Business in America

Mr. Chairman Thank you for inviting me to talk about how we can simplify taxation of business in America.

My involvement in the tax world has been more than a bit strange. For the first 30 years of my career I was a businessman and taxpayer, but not at all a tax expert. By a quite unexpected turn of events, I then ended up spending five years as IRS commissioner. When I left the IRS I went happily back into the business world, while repeatedly explaining to my new colleagues that indeed I was not the one to consult on technical tax matters. Last year the totally unexpected happened again when President Bush asked me to serve on his advisory panel on income tax reform. Despite these occasional forays into the tax world, I remain a person whose main life experience has been that of a businessman.

After traveling on this unexpected path through tax territory, one observation overwhelms all others, and that is that the US tax system is astoundingly inefficient as a result of mind-numbing and unnecessary complexity. I find it remarkable that the time and money that taxpayers in this country spend trying to comply costs them 140 billion dollars per year.

And the complexity continues to get worse every year.

Since the adoption of 1986 tax reform, Congress has passed 14, 400 amendments to the tax code. That's an average of 2.9 changes for every single working day in the year for 19 years.

When you add in the 300 billion dollars per year in taxes that should be paid but are not, in part because of the complexity of the Code, you arrive at an overhead burden on honest taxpayers of around 450 billion dollars per year. That's about what we spend on social security and more than one third of what we actually pay in income taxes.

While all taxpayers suffer from this inefficiency, it is a fact that the majority of the cost is borne by businesses, especially small businesses. Of the 140 billion dollars per year spent on compliance, approximately 75% of the total is shouldered by businesses, including self-employed individuals.

Beyond this staggering compliance cost, businesses suffer from inefficiency because the actual tax burden on businesses is capriciously uneven and often unpredictable. Many businesses pay the full statutory rates on their income. But many other businesses, sometimes in the same competitive industry, pay far less, and that is for two reasons. One,

they fail to report what they should and simply get away with it because of lack of resources in the IRS; or, two, they happen to be better able to take advantage of special provisions and complexities in the code to reduce their actual tax rate. This situation is not only unfair; it creates great inefficiency by distorting the business playing field and diverting scarce attention from improving efficiency to planning how to minimize taxes.

I have personally experienced the implications of this terrible inefficiency on both sides of the table, as business man and tax administrator, and have often reflected to myself that America is indeed a rich and productive country if it can afford the monumental burden of such an inefficient tax system. But that begs the question of whether it has to be that way. There may be political factors at work that lock in this inefficiency. I can't judge that question because I'm not a politician. But I do know that there is a better way available, if our political leaders wanted to adopt it. And that is to adopt a much, much simpler system that would even the playing field among businesses, and would enable lower statutory rates in the process, while raising the same amount of revenue.

The tax reform panel has laid out in some detail how this could be done so I will not repeat that here. I would only summarize four principles that I think are essential to making a simpler, fairer and more efficient system of business taxation.

1. **Lower rates are better than special preferences.**

   Over the years a large number of special preferences for particular kinds of business activities have been put into the code. Some of these, such as the R&E credit, are substantial in size and affect a significant percentage of businesses, and others are much smaller and affect only a few businesses. But each of this long list of preferences requires complex rules and regulations to define who is entitled to get these preferences; they are the source of enormous controversy and often confusion between taxpayers, Treasury and the IRS, and they all have the effect of raising the rates for all businesses. In addition, I should note that in a world of increased scrutiny of financial reporting, they are also a source of great complexity and potential error in reconciling tax accounts with financial reporting.

   Nearly every witness at the numerous hearings held by the tax reform panel supported this principle: eliminate preferences, lower rates. As an incentive for investments, lower rates are clear cut factors that improve the calculation of the return on almost every investment decision. Special preferences may or may not be taken into account when investment decisions are made. Their impact is not only uneven and unpredictable; it is often weak or non-existent in practice.

   This is why the tax reform panel unanimously proposed eliminating nearly all special preferences for businesses in favor of lower rates.

2. Rules for small businesses should be and can be far simpler than for large businesses.

It makes no sense to impose the complex rules needed to measure income in a multi-billion dollar global business on a local business with a few employees. Attempting to do so imposes large unnecessary costs on small business. It also impedes compliance by diverting IRS resources into technical issues at the expense of the major compliance problem with small business, which is to ensure that all income is reported.

During my tenure as commissioner, we took steps toward simplifying IRS tax reporting rules for small businesses. The tax reform panel went further and proposed very simple rules that would apply to almost 98% of all businesses. Taxpayers for the most part would report taxes as they keep their check-books, cash in minus cash out and report the difference. This would not only be enormously simpler and easier to understand, it would facilitate increased compliance. As part of the plan, the panel proposed increased reporting requirements by credit card companies and banks, which would aid businesses in knowing what to report and the IRS in spotting potential underreporting.

3. Double taxation of businesses should be reduced or eliminated, but all business income should be taxed once at approximately the same rates.

Because businesses take different legal forms, some, but not all, businesses pay tax at the business level while their shareholders also pay tax at the individual level. To mitigate this problem, the tax code now provides for lower rates on capital gains and most dividends. As our tax reform witnesses noted, this blunt method means that some business income may still be taxed twice, once at the 35% corporate rate and again at the capital gain or dividend rate. On the other hand, it can also mean that some business income is taxed only at the lower capital gain and dividend rates even though it was taxed very little or not at all at the corporate level.

Solving this problem in a way that does not impose even more complicated rules is not easy. The tax reform panel in its Simplified Income Tax plan did propose a workable solution. Gains on sales of stock held for more than a year in corporations that pay tax at the corporate level would receive a 75% exclusion from the individual income tax, meaning that the top rate would be only 8.25%. The double taxation of dividend income from US taxpaying corporations would be eliminated, since there will be a 100% exclusion from income of individuals for dividends received on the US income of US corporations. All other business income would be taxed once at ordinary rates. The net result is that double taxation would be nearly eliminated but single taxation would be achieved in all cases.

It is important to note that this proposal would only work if most special tax preferences are eliminated. Otherwise, some income would escape all taxation, or much more complicated rules would be required.

4. The tax system should be updated to reflect the reality that a large fraction of business is now routinely done on a global basis.

Most large businesses and many smaller ones now do business inside and outside the US in ways that go well beyond simply exporting or importing commodities and finished goods. Companies source their purchases globally, locate service as well as manufacturing operations where they can get the greatest efficiency, raise capital in markets around the world, and increasingly depend on intellectual property as a principal source of income.

In this context, the US tax code, which in principle taxes worldwide income of US corporations, has grown to have so many exceptions and complexities that it raises very little revenue from this theoretically worldwide reach, but it does so at tremendous cost in the form of tax planning and compliance. Furthermore, this aspect of the code more than any other gives rise to the remarkable unevenness among businesses in the tax rate they actually pay.

The tax reform panel proposed to deal with this issue in a manner similar to that proposed by the Joint Committee on Taxation. It would exempt from US taxation income earned abroad by US corporations except certain categories of highly mobile passive income. This would eliminate much complexity, would cost little or nothing in revenue, and would actually eliminate some opportunities for manipulations that reduce US tax. It would be a big improvement over the current system

The tax panel proposal would, however, still depend on separating the worldwide income of multi-national corporations into that earned in the US and that earned elsewhere, an inherently complex and unreliable process. A more far-reaching approach, which I would personally favor, would be to shift the entire measurement of taxable income of large corporations to that reported under Generally Accepted Accounting Principles on a worldwide basis, with a simplified system for crediting foreign taxes paid. This system would allow the same amount of revenue to be raised with a much lower corporate tax rate, no more than 25% and possibly lower. It would make the system simpler, more reliable, and would greatly reduce the opportunity and the need for businesses to move income producing activities based on taxes.

The conclusion I hope you will come to, Mr. Chairman and members of the Committee, is that the US tax system does not have to be as complex and inefficient as it is. While it would take considerable political leadership to make a major reform, the benefits for the taxpayers of the US would be worth it.

Responses to Questions From the Senate Finance Committee
From Charles O. Rossotti

Questions From Senator Grassley:

Mr. Rossotti, you mentioned in your testimony that the Tax Reform Panel's Simplified Income Tax Plan proposed "a workable solution" to the problem of double taxation of corporate income, referring to a proposal that would integrate the personal and corporate income taxes for domestic earnings of U.S. firms.

I have three questions on this subject:

1. You cautioned that integration would work only if most special tax preferences are eliminated. Could you please elaborate on that point?

2. As you stated in your testimony, integration is designed to tax business income once. How would that be achieved in a territorial tax system? How would it be achieved in a worldwide GAAP approach that you personally favor?

3. Combining integration with a territorial system, would the distinction between U.S. and foreign earnings create any distortions? For example, wouldn't a U.S. multinational's cost of equity capital be affected by its mix of domestic and foreign earnings, and isn't that at odds with the purported reason for a territorial system—to enhance competitiveness of U.S. multinationals in foreign markets?

Answer to Question 1. The panel proposal on integration aimed to eliminate double taxation of corporate profits by taxing all domestic income at the corporate level at the same rate while eliminating all taxation of domestic dividends at the individual level and exempting 75% of capital gains on corporate stock. This simple approach works if one can assume that the corporation actually pays the corporate rate on its income. To the extent that preferences creep in that reduce or even eliminate the tax at the corporate level, then the plan doesn't work because the income would not be taxed at either level.

Answer to Question 2. Using the territorial system, all U.S.-based income would be taxed and domestic dividends would be 100% exempt. Presuming (as in question 1) that preferences are eliminated, it is relatively simple to calculate the percentage of dividends that are domestically derived and therefore exempt. Dividends derived from non-U.S. income would not be exempt from U.S. tax because this non-U.S. income would not be taxed at the corporate level by the U.S.

In the worldwide GAAP-based system which I mentioned, one could exempt all dividends of U.S.-based corporations from tax since all worldwide income (less a highly simplified crediting system for foreign taxes paid) would be taxed currently.

Answer to Question 3. Under the panel proposal, U.S. corporations could conduct operations outside the U.S. without paying any U.S. tax at all, which would eliminate U.S. corporate taxes as a factor in their competitive activities outside the U.S. Dividends arising from this income that are paid to their U.S.-based shareholders would be taxed, but so would dividends paid to U.S. shareholders of their foreign corporate competitors—thus putting them on an equal footing in this respect.

Questions From Senator Hatch:

1. Commissioner Rossotti, I appreciate your being here today and sharing your thoughts with us. I understand and generally agree with your statement that lower tax rates are preferable to special tax preferences for businesses. However, it is much easier to state this as a general principle than it is to apply it in specific cases. For example, let's consider the research credit. Although the research credit has been criticized by some for granting tax benefits for activity that would have taken place anyway, I still believe it is vital for the United States to have a vibrant incentive for research. Without one, are we not at risk of seeing U.S.-based research lured away to other nations that offer stronger research tax incentives?

2. A commonly overlooked trend has been the dramatic increase in business activity conducted through sole proprietorships, partnerships, S corporations, and limited liability companies. This has had the result of shifting a significant amount of business-source income from the corporate tax system into the individual tax system. Given the attractiveness of paying just one level of tax instead of two, I believe that S corporations and LLCs will continue to outpace C corporations. Do you see any problems inherent in this transfer from the corporate tax system to the individual tax system?

Answer to Question 1. Concerning the research credit, I answer this question based on my experience having spent 30 of the last 35 years in the technology business. The research credit is of course very welcome, but it seldom influences practical decisions on whether or what projects to undertake. It is too small a factor and too uncertain in its application. On the other hand, lower tax rates unquestionably influence every business decision. My fellow panelist from Ernst & Young explained the reason for preferring lower tax rates to preferences in great detail.

Answer to Question 2. I do see a problem, in that business activities and business complexity are in part driven by a single level of taxation in flow through legal entities. This is an important reason that the panel proposed a simple system for virtually eliminating double taxation of corporate income.

Question From Senator Baucus:

In 2002, you predicted to the IRS Oversight Board that the IRS would be able to significantly improve tax administration by improving its computer systems. In fact, you

stated that "the problem" could be solved by the end of this decade, now just four years away. Yet, every IRS estimate of the tax gap grows larger. Reports from the Office of the Treasury Inspector General for Tax Administration and the Government Accountability Office demonstrate that the IRS has failed to properly oversee contracts, leading to very serious problems such as the Electronic Fraud Detection System. IRS budgets for computer modernization have declined almost 20% in recent years, and we all know costs tend to go up, not down. Why is computer modernization so important to effectively administer our tax laws? What is your assessment of the state of computer modernization at the IRS? What impact do IRS failures to effectively monitor modernization projects have on the tax gap? What steps must the IRS take to get its computer systems and technology into the 21st century, how long will it take, and how much will it cost? Is the current level of funding for IRS systems modernization adequate, and, if not, what should it be?

Other Advisory Panel Members have testified before the Finance Committee about the problems of operating under certain constraints. What impact did the assumption that the 2001 and 2003 tax cuts would be made permanent have on your ability to devise recommendations?

Early last year, Chairman Grassley and I sent a request to the tax reform panel asking that your recommendations and background details (such as revenue tables, assumptions, etc.) be shared with the Joint Committee on Taxation, since that is the organization which scores tax bills considered by Congress. Can you work with us to see that such information is provided, either to Joint Tax or to the public in general?

Answer. This question deserves a longer and more detailed response than I can provide here, but the essence of my comments on my 2002 report were that a combination of investing in computer modernization, together with steady increases in IRS staffing, could address at least the known caseload that is currently not being addressed, and could do so with increasing efficiency and productivity.

I am confident that this conclusion is still true. Although modernizing IRS's huge and extremely obsolete set of computer systems is an extremely difficult task, it is encouraging that in the last year of my administration and the following two years, very tangible and impressive progress was made. However, this was only a beginning, and following up on this will require a substantially greater level of investment, every year, than is currently being provided.

Modernization should not be thought of as single "project" that is funded and then stopped. While it is true that modernization must be broken down and managed into discrete projects, the investment level should continue permanently at a higher level, just as all well-managed corporations do.

I would be happy to do what I can to work with the Joint Committee and the Finance Committee concerning the tax panel recommendations.

United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance, U.S. Senate

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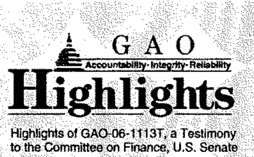
BUSINESS TAX REFORM

Simplification and Increased Uniformity of Taxation Would Yield Benefits

Statement of David M. Walker
Comptroller General of the United States

GAO-06-1113T



Highlights of GAO-06-1113T, a Testimony to the Committee on Finance, U.S. Senate

Why GAO Did This Study

Business income taxes, both corporate and noncorporate, are a significant portion of federal tax revenue. Businesses also play a crucial role in collecting taxes from individuals, through withholding and information reporting. However, the design of the current system of business taxation is widely seen as flawed. It distorts investment decisions, hurting the performance of the economy. Its complexity imposes planning and record keeping costs, facilitates tax shelters, and provides potential cover for those who want to cheat.

Not surprisingly, business tax reform is part of the debate about overall tax reform. The debate is occurring at a time when long-range projections show that, without a policy change, the gap between spending and revenues will widen.

This testimony reviews the nation's long term fiscal imbalance and what is wrong with the current system of business taxation and provides some principles that ought to guide the debate about business tax reform.

This statement is based on previously published GAO work and reviews of relevant literature.

www.gao.gov/cgi-bin/getrpt?GAO-06-1113T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-9110 or whitej@gao.gov.

September 20, 2006

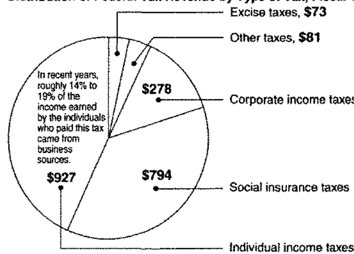
BUSINESS TAX REFORM

Simplification and Increased Uniformity of Taxation Would Yield Benefits

What GAO Found

The size of business tax revenues makes them very relevant to any plan for addressing the nation's long-term fiscal imbalance. Reexamining both federal spending and revenues, including business tax policy and compliance must be part of a multipronged approach to address the imbalance.

Distribution of Federal Tax Revenue by Type of Tax, Fiscal Year 2005 ($ billions)



Source: GAO analysis of data from the Office of Management and Budget and from Internal Revenue Service (IRS).

Some features of current business taxes channel investments into tax-favored activities and away from more productive activities and, thereby, reduce the economic well-being of all Americans. Complexity in business tax laws imposes costs of its own, facilitates tax shelters, and provides potential cover for those who want to cheat. IRS's latest estimates show a business tax gap of at least $141 billion for 2001. This in turn undermines confidence in the fairness of our tax system—citizens' confidence that their friends, neighbors, and business competitors pay their fair share of taxes.

Principles that should guide the business tax reform debate include:

- The proposed system should raise sufficient revenue over time to fund our current and future expected expenditures.
- The tax base should be as broad as possible, which helps to minimize overall tax rates.
- The proposed system should improve compliance rates by reducing tax preferences and complexity and increasing transparency.
- To the extent other goals, such as equity and simplicity, allow, the tax system should aim for neutrality by not favoring some business activities over others. More neutral tax policy has the potential to enhance economic growth, increase productivity and improve the competitiveness of the U.S. economy in terms of standard of living.
- The consideration of transition rules must be an integral part of any reform proposal.

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to contribute to your consideration of business tax reform.

Businesses, both corporate and noncorporate, are a crucial pillar of our tax system. Corporate businesses paid $278 billion in federal corporate income taxes in fiscal year 2005. In addition, between roughly 14 and 19 percent of the income of individuals who pay federal income tax comes from business sources.[1] Beyond paying income taxes, businesses are also responsible for remitting both the employer and employee shares of social insurance taxes, which amounted to $794 billion in fiscal year 2005. Businesses are vital to our tax system in other ways too. They collect and remit a large fraction of individual income taxes through withholding. They report information about individuals' income and deductible expenses to the Internal Revenue Service (IRS). Such withholding and third-party information reporting greatly increases individual taxpayers' compliance while reducing the size and intrusiveness of IRS.

Taxes are necessary because they fund a broad array of essential services provided by the government. However, business taxes are part of our overall fiscal system that, as the committee is aware, is currently running large deficits and, as GAO's long-term budget simulations illustrate, is projected to run ever larger deficits in the future.

Beyond raising revenue, taxes affect business decision making, thereby affecting the performance of the economy. Taxes are only one factor affecting business decisions—others include input costs and market conditions—but they are a key factor controlled by policymakers. Making business decisions based on tax considerations, rather than on the underlying economic benefits results in the channeling of some investments into less productive activities. This, in turn, reduces the standard of living of all Americans.

Complexity in business tax laws imposes costs of its own, facilitates tax shelters, and provides cover for those who want to cheat. Although the precise amount of business tax avoidance is unknown, IRS's latest estimates show a business tax gap of at least $141 billion for 2001. This in

[1]See the explanation below for how these percentages were estimated and why we could not estimate them in terms of percent of taxed paid.

turn undermines confidence in the fairness of our tax system—citizens' confidence that their friends, neighbors, and business competitors are paying their fair share of taxes.

Not surprisingly, there is a growing debate about reforming the tax system, including business taxes. The debate is partly about whether to reform the current income tax so that it has a broader base and lower rates or switch in whole or part to some form of a consumption tax. But it is also about other fundamental design issues such as whether to maintain different tax treatment for corporate and noncorporate business and the extent to which business's foreign-source income should be taxed. The President's Advisory Panel on Federal Tax Reform has taken a major step in beginning this debate. The panel suggested two alternative proposals for coordinated reform of the individual and corporate income taxes.

My statement reviews the nation's long-term fiscal imbalance, describes what is wrong with our current system of business taxation, lists some of the major strategic choices we must make about how to tax businesses in the future, and then provides some principles that ought to guide the debate about business tax reform. These principles are based on three long-standing criteria typically used to evaluate tax policy—equity; economic efficiency; and a combination of simplicity, transparency, and administrability—which are discussed later.[2] The principles include the following:

- The proposed system should raise sufficient revenue over time to fund our current and future expected expenditures.
- The tax base should be as broad as possible, which generally helps to minimize tax rates, reduce complexity, lower compliance costs, lower economic efficiency costs per dollar of revenue raised, and which may improve equity.
- The proposed system should have attributes associated with high compliance rates—namely, taxable transactions that are transparent and few tax preferences or complex provisions.

[2]These criteria are also discussed at greater length in GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

- To the extent that other objectives, such as equity and simplicity, allow, the tax system should aim for increased economic efficiency by remaining as neutral as possible in its other structural features; for example, avoiding differences in taxation based on legal form of organization, source of financing, or type of asset. More neutral tax policy has the potential to enhance economic growth, increase productivity and improve the competitiveness of the U.S. economy in terms of standard of living

- Finally, the consideration of transition rules needs to be an integral part of the design of a new system.

My statement today is drawn from previous GAO reports and testimonies covering tax reform, alternative tax systems, and the costs of the current system, which were done in accordance with generally accepted government auditing standards, as well as reviews of relevant literature. The discussions in this statement that are not based on our own work reflect the consensus (and in some cases competing) views of economists as summarized in studies by the Joint Committee on Taxation, the Congressional Budget Office, the Congressional Research Service, the Department of Treasury, and the President's Advisory Panel on Federal Tax Reform. (See app. I for a list of relevant studies by GAO and these other sources.)

Background

Current Federal Taxation of Businesses

Most income derived from private sector business activity in the United States is subject to federal corporate income tax, the individual income tax, or both. The tax treatment that applies to a business depends on its legal form of organization. Firms that are organized under the tax code as "C" corporations (which include most large, publicly held corporations) have their profits taxed once at the entity level under the corporate income tax (on a form 1120) and then a second time under the individual income tax when profits are transferred to individual shareholders in the form of dividends or realized capital gains. Firms that are organized as "pass-through" entities, such as partnerships, limited liability companies, and "S" corporations are generally not taxed at the entity level; however, their net incomes are passed through each year and taxed in the hands of their partners or shareholders under the individual income tax (as part of

those taxpayers' form 1040 filing).[3] Similarly, income from businesses that are owned by single individuals enters into the taxable incomes of those owners under the individual income tax and is not subject to a separate entity-level tax.

The base of the federal corporate income tax includes net income from business operations (receipts, minus the costs of purchased goods, labor, interest, and other expenses). It also includes net income that corporations earn in the form of interest, dividends, rent, royalties, and realized capital gains. The statutory rate of tax on net corporate income ranges from 15 to 35 percent, depending on the amount of income earned.[4] The United States taxes the worldwide income of domestic corporations, regardless of where the income is earned, with a foreign tax credit for certain taxes paid to other countries. However, the timing of the tax liability depends on several factors, including whether the income is from a U.S. or foreign source and, if it is from a foreign source, whether it is earned through direct operations or through a subsidiary.

The base of the individual income tax covers business-source income paid to individuals, such as dividends, realized net capital gains on corporate equity, and income from self-employment. The statutory rates of tax on net taxable income range from 10 percent to 35 percent. Lower rates (generally 5 percent and 15 percent, depending on taxable income) apply to long-term capital gains and dividend income.[5] Sole proprietors also pay both the employer and employee shares of social insurance taxes on their net business income. Generally, a U.S. citizen or resident pays tax on his or her worldwide income, including income derived from foreign-source

[3]Limited liability companies can elect to be taxed as C corporations, partnerships, or as "disregarded entities." Under the last option the company's income and expenses are simply attributed to its parent corporation.

[4]Also, marginal rates are higher over limited income ranges to recapture the benefits of the rates below 35 percent. In addition, present law imposes an alternative minimum tax (AMT) on corporations to the extent that their minimum tax liability exceeds their regular tax liability. In general, the AMT applies a lower tax rate to a broader tax base. Specifically, the regular tax base is increased for AMT purposes by adding back certain items treated as tax preferences and disallowing certain deductions and credits.

[5]Individuals may also pay tax under the alternative minimum tax (AMT). The base of this tax equals regular taxable income, plus the value of various tax items, including personal exemptions and certain itemized deductions that are added back into the base. This AMT income base is then reduced by a substantial exemption and then taxed at a rate of 26 percent or 28 percent, depending on the taxpayer's income level. Taxpayers compare their AMT tax liabilities to their regular tax liabilities and pay the greater of the two.

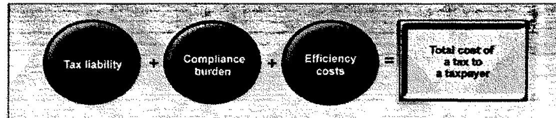
dividends and capital gains subject to a credit for foreign taxes paid on such income.

Criteria for Evaluating Business Tax Systems

Three long-standing criteria—economic efficiency, equity, and a combination of simplicity, transparency and administrability—are typically used to evaluate tax policy. These criteria are often in conflict with each other, and as a result, there are usually trade-offs to consider and people are likely to disagree about the relative importance of the criteria.

Specific aspects of business taxes can be evaluated in terms of how they support or detract from the efficiency, equity, simplicity, transparency, and administrability of the overall tax system. To the extent that a tax system is not simple and efficient, it imposes costs on taxpayers beyond the payments they make to the U.S. Treasury. As shown in figure 1, the total cost of any tax from a taxpayer's point of view is the sum of the tax liability, the cost of complying with the tax system, and the economic efficiency costs that the tax imposes. In deciding on the size of government, we balance the total cost of taxes with the benefits provided by government programs.

Figure 1: Components of the Total Cost of a Tax to Taxpayers



Source: GAO.

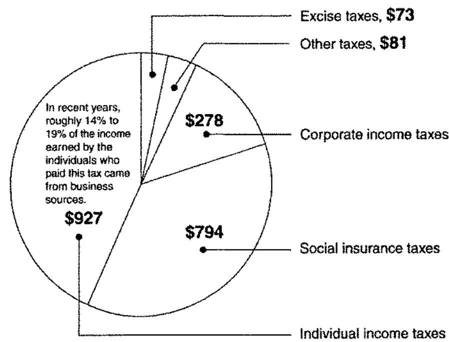
A complete evaluation of the tax treatment of businesses, which is a critical element of our overall federal tax system, cannot be made without considering how business taxation interacts with and complements the other elements of the overall system, such as the tax treatment of individuals and excise taxes on selected goods and services. This integrated approach is also appropriate for evaluating reform alternatives, regardless of whether those alternatives take the form of a simplified income tax system, a consumption tax system, or some combination of the two.

Taxes on Business Income Are a Significant Source of Federal Revenue and Must Be Part of the Overall Considerations for Fiscal Reform

Businesses contribute significant revenues to the federal government, both directly and indirectly. As figure 2 shows, corporate businesses paid $278 billion in corporate income tax directly to the federal government in 2005. Individuals earn income from business investment in the form of dividends and realized capital gains from C corporations; income allocations from partnerships and S corporations; entrepreneurial income from their own sole proprietorships; and rents and royalties. In recent years this business-source income, which is all taxed under the individual income tax, has amounted to between roughly 14 percent and 19 percent of the income of individuals who have paid individual income tax.[6] In addition to the taxes that are paid on business-source income, most of the remainder of federal taxes is collected and passed on to the government by businesses.

[6]Given the time frame available for preparing this statement we could not obtain the detailed data we would need to estimate the average rates of tax applied to business-source and non-business-source income. Consequently, we have not tried to estimate the percent of individual income tax attributable to business-source income.

Figure 2: Distribution of Federal Tax Revenue by Type of Tax, 2005 (Billions of Dollars)



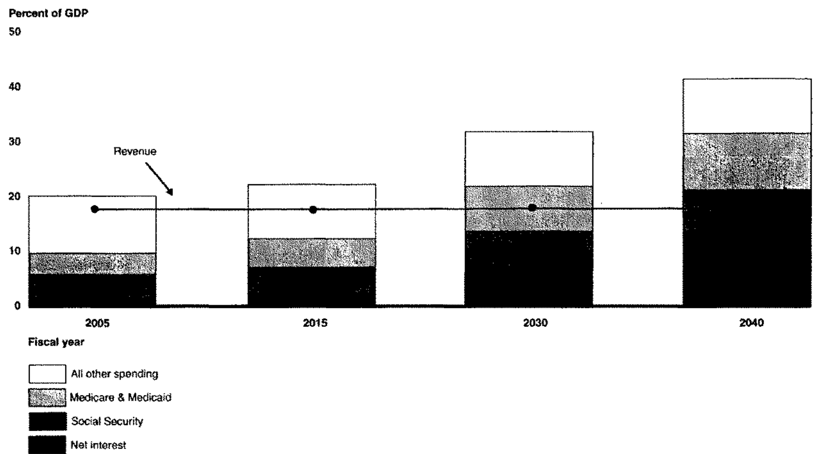
Source: GAO analysis of data from the Office of Management and Budget and from Internal Revenue Service (IRS).

Note: The business source income referred to in the figure includes the income of sole proprietors, income from partnerships and S corporations, dividends, capital gains, rents, and royalties. The percentage equals the ratio of (net business-source income minus losses) over adjusted gross income. When computing these percentages we did not include any income or losses of individuals who did not have a tax liability in a given year.

Business tax revenues of the magnitude discussed make them very relevant to considerations about how to address the nation's long-term fiscal imbalance. Over the long term, the United States faces a large and growing structural budget deficit primarily caused by demographic trends and rising health care costs as shown in figure 3, and exacerbated over time by growing interest on the ever-larger federal debt. [7] Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security.

[7]Additional information about GAO's long-term fiscal simulations, assumptions, data, and charts can be found at http://www.gao.gov/special.pubs/longterm/.

Figure 3: Composition of Federal Spending as a Share of Gross Domestic Product (GDP), Assuming Discretionary Spending Grows with GDP after 2006 and All Expiring Tax Provisions Are Extended



Source: GAO's August 2006 analysis.

Note: The revenue projection in this figure includes certain tax provisions that expired at the end of 2005.

We cannot grow our way out of this long-term fiscal challenge because the imbalance between spending and revenue is so large. We will need to make tough choices using a multipronged approach: (1) revise budget processes and financial reporting requirements; (2) restructure entitlement programs; (3) reexamine the base of discretionary spending and other spending; and (4) review and revise tax policy, including tax expenditures, and tax enforcement programs. Business tax policy, business tax expenditures, and business tax enforcement need to be part of the overall tax review because of the amount of revenue at stake.

Business tax expenditures reduce the revenue that would otherwise be raised from businesses. As already noted, to reduce their tax liabilities, businesses can take advantage of preferential provisions in the tax code, such as exclusions, exemptions, deductions, credits, preferential rates,

and deferral of tax liability. Tax preferences—which are legally known as tax expenditures—are often aimed at policy goals similar to those of federal spending programs. For example, there are different tax expenditures intended to encourage economic development in disadvantaged areas and stimulate research and development, while there are also federal spending programs that have similar purposes. Also, by narrowing the tax base, business tax expenditures have the effect of raising either business tax rates or the rates on other taxpayers in order to generate a given amount of revenue.

Efficiency, Complexity, Compliance, and Equity Concerns Contribute to Calls for Business Tax Reform

The design of the current system of business taxation causes economic inefficiency and is complex. The complexity provides fertile ground for noncompliance and raises equity concerns.

Varying Effective Rates of Taxation Across Different Types of Business Investments Reduce Economic Efficiency

Our current system for taxing business income causes economic inefficiency because it imposes significantly different effective rates of tax on different types of investments.[8] Tax treatment that is not neutral across different types of capital investment causes significant economic inefficiency by guiding investments to lightly taxed activities rather than those with high pretax productivity.

However, the goal of tax policy is not to eliminate efficiency costs. The goal is to design a tax system that produces a desired amount of revenue and balances economic efficiency with other objectives, such as equity, simplicity, transparency, and administrability. Every practical tax system imposes efficiency costs.

There are some features of current business taxation that have attracted criticism by economists and other tax experts because of efficiency costs. My point in raising them here is not that these features need to be

[8]Statutory and effective tax rates are not necessarily the same. An effective tax rate, which is often lower—even substantially lower—than the statutory rate, measures the amount of tax that a corporation actually pays on a dollar of its economic income, when all aspects of the tax (deductions, credits, deferrals, etc.) are taken into account.

changed—that is a policy judgment for Congress to make as it balances various goals. Rather, my point is that these economic consequences of tax policy need to be considered as we think about reform. The following are among the most noted cases of nonneutral taxation in the federal business tax system:

- Income earned on equity-financed investments made by C corporations is taxed twice—under both the corporate and individual income taxes, whereas no other business income is taxed more than once. Moreover, even noncorporate business investment is taxed more heavily than owner-occupied housing—a form of capital investment that receives very preferential treatment. As a result, resources have been shifted away from higher-return business investment into owner-occupied housing, and, within the business sector, resources have been shifted from higher-return corporations to noncorporate businesses. Such shifting of investment makes workers less productive than they would be under a more neutral tax system. This results in employees receiving lower wages because increases in employee wages are generally tied to increases in productivity. [9] As noted above, such efficiency costs may be worth paying in order to meet other policy goals. For example, many policymakers advocate increased homeownership as a social policy goal.
- Depreciation allowances under the tax code vary considerably in generosity across different assets causing effective tax rates to vary and, thereby, favoring investment in certain assets over others. For example, researchers have found that the returns on most types of investments in equipment are taxed more favorably than are most investments in nonresidential buildings. [10] These biases shift resources away from some investments in buildings that would have been more productive than some of the equipment investments that are being made instead.

[9]Although it is difficult to estimate effective tax rates for broad categories of assets with precision, the estimates from one recent study showing the marginal effective tax rates on corporate investment, noncorporate investments, and owner-occupied housing to be 32 percent, 18 percent, and 2 percent, respectively, suggest the potential magnitude of the distortions. See Jane Gravelle, "The Corporate Tax: Where Has It Been and Where Is It Going?" *National Tax Journal*, vol. 57, no. 4 (2004): 903-23.

[10]See Jane G. Gravelle, *Capital Income Tax Revisions and Effective Tax Rates*, Congressional Research Service Report RL32099 (Washington, D.C.: Jan. 5, 2005); and U.S. Department of the Treasury, *Report to The Congress on Depreciation Recovery Periods and Methods* (Washington, D.C.: July 2000).

- Tax rules for corporations favor the use of debt over shareholder equity as a source of finance for investment. The return on debt-financed investment consists of interest payments to the corporation's creditors, which are deductible by the corporations. Consequently, that return is taxed only once—in the hands of the creditors. In contrast, the return on equity-financed investment consists of dividends and capital gains, which are not deductible by the corporation. These forms of income that are taxed under the individual tax are paid out of income that has already been subject to the corporate income tax. The bias against equity finance induces corporations to have less of an "equity cushion" against business downturns.[11]

- Capital gains on corporate equity are taxed more favorably than dividends because that tax can be deferred until the gains are realized (typically when shareholders sell their stock). This bias against dividend payments likely means that more profits are retained within corporations than otherwise would be the case and, therefore, the flow of capital to its most productive uses is being constrained.[12]

- The complex set of rules governing U.S. taxation of the worldwide income of domestic corporations (those incorporated in the United States) leads to wide variations in the effective rate of tax paid on that income, based on the nature and location of each corporation's foreign operations and the effort put into tax planning. In effect, the active foreign income of some U.S. corporations is taxed more heavily than if the United States followed the practice of many other countries and exempted such income from tax. However, other U.S. corporations are able to take advantage of flexibilities in the U.S. tax rules in order to achieve treatment that is equivalent to or, in some cases, more favorable than the so-called "territorial" tax systems that exempt foreign-source active business income. As a consequence, some U.S. corporations face a tax disadvantage, while others have an advantage, relative to foreign corporations when competing in foreign countries. Those U.S. corporations that have a disadvantage are likely to locate a

[11]For a more detailed discussion of these issues see U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, D.C.: January 1992).

[12]Recent legislation has, at least temporarily, reduced and equalized the tax rates on dividends and realized capital gains. These changes have both reduced the extent of double taxation and the extent to which capital gains are favored over dividends. Capital gains still receive some preferred treatment because of the tax deferral.

smaller share of their investment overseas than would be the case in a tax-free world; the opposite is true for those U.S. corporations with the tax advantage. Moreover, the tax system encourages U.S. corporations to alter their cash-management and financing decisions (such as by delaying the repatriation of profits) in order to reduce their taxes.

The taxation of business income is part of the broader taxation of income from capital. The taxation of capital income in general (even when that taxation is uniformly applied) causes another form of inefficiency beyond the inefficiencies caused by the aforementioned cases of differential taxation across types of investments. This additional inefficiency occurs because taxes on capital reduce the after-tax return on savings and, thereby, distort the choice that individuals make between current consumption and saving for future consumption. However, although research shows that the demand for some types of savings, such as the demand for tax exempt bonds, is responsive to tax changes, there is greater uncertainty about the effects of tax changes on other choices, such as aggregate savings.

Sometimes the concerns about the negative effects of taxation on the U.S. economy are couched in terms of "competitiveness," where the vaguely defined term competitiveness is often defined as the ability of U.S. businesses to export their products to foreign markets and to compete against foreign imports into the U.S. market. The goal of those who push for this type of competitiveness is to improve the U.S. balance of trade. However, economists generally agree that trying to increase the U.S. balance of trade through targeted tax breaks for exports does not work. Such a policy, aimed at lowering the prices of exports, would be offset by an increase in the value of the dollar which would make U.S. exports more expensive and imports into the Unites States less expensive, ultimately leaving both the balance of trade and the standard of living of Americans unchanged.[13]

[13]See relevant discussions in Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses*, JCX-22-06 (Washington, D.C.: June 21, 2006); CBO, *Effects of Adopting a Value-Added Tax*, (Washington, D.C.: February 1992); Brumbaugh, David L., *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*, Congressionsl Research Service report RL33171 (Washington, D.C.: December 20, 2005); and Eric Toder, Assistant Deputy Secretary (Tax Analysis), U.S. Department of Treasury, Testimony before the Senate Budget Committee, February 22, 1995.

An alternative definition of competitiveness that is also sometimes used in tax policy debates refers to the ability of U.S.-owned firms operating abroad to compete in foreign markets. The current U.S. policy of taxing the worldwide income of U.S. businesses places some of their foreign operations at a disadvantage. The tradeoffs between a worldwide system and a territorial tax system are discussed below.

Businesses Bear Significant Compliance Burdens Arising Both from the Complexity of the Tax System and from Their Multiple Roles within the System

Tax compliance requirements for businesses are extensive and complex. Rules governing the computation of taxable income, expense deductions, and tax credits of U.S. corporations that do business in multiple foreign countries are particularly complex. But even small businesses face multiple levels of tax requirements of varying difficulty. In addition to computing and documenting their income, expenses, and qualifications for various tax credits, businesses with employees are responsible for collecting and remitting (at varying intervals) several federal taxes on the incomes of those employees. Moreover, if the businesses choose to offer their employees retirement plans and other fringe benefits, they can substantially increase the number of filings they must make. Businesses also have information-reporting responsibilities—employers send wage statements to their employees and to IRS; banks and other financial intermediaries send investment income statements to clients and to IRS.[14] Finally, a relatively small percentage of all businesses (which nevertheless number in the hundreds of thousands) are required to participate in the collection of various federal excise taxes levied on fuels, heavy trucks and trailers, communications, guns, tobacco, and alcohol, among other products.

It is difficult for researchers to accurately estimate compliance costs for the tax system as a whole or for particular types of taxpayers because taxpayers generally do not keep records of the time and money spent complying with tax requirements. Studies we found that focus on the compliance costs of businesses estimate them to be between about $40 billion and $85 billion per year.[15] None of these estimates include the costs

[14]Although this information reporting increases the compliance burden on businesses, it does enable IRS to enforce tax compliance by wage earners and investors at lower cost. This reduction in administrative costs, which are paid out of the federal budget, means that taxes are slightly lower than they otherwise would have to be.

[15]See GAO, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*, GAO-05-878 (Washington, D.C.: Aug. 26, 2005).

to businesses of collecting and remitting income and payroll taxes for their employees. The accuracy of these business compliance cost estimates is uncertain due to the low rates of response to their data-collection surveys. In addition, the range in estimates across the studies is due, among other things, to differences in monetary values used (ranging between $25 per hour and $37.26 per hour), differences in the business populations covered, and differences in the tax years covered.

Business Tax Complexity Also Makes IRS's Job of Enforcing Tax Rules Very Challenging and Can Reduce Public Confidence in the Fairness of the System

Although the precise amount of business tax avoidance is unknown, IRS's latest estimates of tax compliance show a tax gap of at least $141 billion for tax year 2001 between the business taxes that individual and corporate taxpayers paid and what they should have paid under the law.[16] Corporations contributed about $32 billion to the tax gap by underreporting about $30 billion in taxes on tax returns and failing to pay about $2 billion in taxes that were reported on returns. Individual taxpayers that underreported their business income accounted for the remaining $109 billion of the business income tax gap.[17]

A complex tax code, complicated business transactions, and often multinational corporate structures make determining business tax liabilities and the extent of corporate tax avoidance a challenge. Tax avoidance has become such a concern that some tax experts say corporate tax departments have become "profit centers" as corporations seek to take advantage of the tax laws in order to maximize shareholder value. Some corporate tax avoidance is clearly legal, some falls in gray areas of the tax code, and some is clearly noncompliance or illegal, as shown by IRS's tax gap estimate.

[16]Overall, IRS estimated a gross tax gap of $345 billion for tax year 2001. It further estimated that eventually $55 billion of the tax gap would be recovered through late payments and enforcement actions, resulting in a net tax gap of $290 billion. The tax gap includes underreporting of taxes on tax returns, underpayment of taxes reported on returns, or nonfiling, which is when taxpayers fail to file returns on time or altogether.

[17]The amount of the business income tax gap attributed to individual taxpayers could be greater than $109 billion. Although IRS estimated the tax gap for individual income tax underpayment and nonfiling ($23 billion and $25 billion, respectively, for tax year 2001), it did not estimate to what extent such noncompliance was attributed to business income, as opposed to nonbusiness income such as salaries and wages. Also, IRS estimated the tax gap that arises from individuals misreporting tax deductions and credits, but does not estimate what portion of the misreporting was from business-related deductions and credits.

Often business tax avoidance is legal. For example, multinational corporations can locate active trade or business operations in jurisdictions that have lower effective tax rates than does the United States and, unless and until they repatriate the income, defer taxation in the United States on that income, thus reducing their effective tax rate. In addition, investors can avoid paying the corporate income tax by putting their money into unincorporated businesses or into real estate.

Complicating corporate tax compliance is the fact that in many cases the law is unclear or subject to differing interpretations. In fact, some have postulated that major corporations' tax returns are actually just the opening bid in an extended negotiation with IRS to determine a corporation's tax liability. An illustration—once again from the complex area of international tax rules—is transfer pricing. Transfer pricing involves setting the appropriate price for such things as goods, services, or intangible property (such as patents, trademarks, copyrights, technology, or "know-how") that is transferred between the U.S.-based operations of a multinational company and a foreign affiliate. If the price paid by the affiliate to the U.S. operation is understated, the profits of the U.S. operation are reduced and U.S. taxable income is inappropriately reduced or eliminated. The standard for judging the correct price is the price that would have been paid between independent enterprises acting at "arm's length." However, it can be extremely difficult to establish what an arm's length price would be. Given the global economy and the number of multinational firms with some U.S.-based operations, opportunities for transfer pricing disputes are likely to grow.

Tax shelters are one example of how tax avoidance, including corporate tax avoidance, can shade into the illegal. Some tax shelters are legal though perhaps aggressive interpretations of the law, but others cross the line.[18] Abusive shelters often are complex transactions that manipulate many parts of the tax code or regulations and are typically buried among legitimate transactions reported on tax returns. Because these transactions are often composed of many pieces located in several parts of a complex tax return, they are essentially hidden from plain sight, which contributes to the difficulty of determining the scope of the abusive shelter

[18] In a 2003 testimony, we reported that IRS had identified 27 kinds of abusive shelter transactions—called listed transactions—promoted to corporations and others. As of September 2006, IRS's Web site lists 31 such listed transactions. IRS also had a number of other transactions that had to be reported to IRS and may have had some characteristics of abusive shelters but were not, and possibly never would be, listed.

problem. Often lacking economic substance or a business purpose other than generating tax benefits, abusive shelters have been promoted by some tax professionals, often in confidence, for significant fees, sometimes with the participation of tax-indifferent parties, such as foreign or tax-exempt entities. These shelters may involve unnecessary steps and flow-through entities, such as partnerships, which make detection of these transactions more difficult.

Regarding compliance with our tax laws, the success of our tax system hinges greatly on individual and business taxpayers' perception of its fairness and understandability. Compliance is influenced not only by the effectiveness of IRS's enforcement efforts but also by Americans' attitudes about the tax system and their government. A recent survey indicated that about 10 percent of respondents say it is acceptable to cheat on their taxes. Furthermore, the complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so and for IRS to explain and enforce tax laws. The lack of transparency also fuels disrespect for the tax system and the government. Thus, a crucial challenge in evaluating our business tax system will be to determine how we can best strengthen enforcement of existing laws to give businesses owners confidence that their competitors are paying their fair share and to give wage earners confidence that businesses in general bear their share of taxes. One option that has been suggested as a means of improving public confidence in the tax system's fairness is to make the reconciliation between book and tax income that businesses present on schedule M-3 of their tax returns available for public review.

Business Tax Reform Entails Broad Design Choices about the Overall Tax System

Reform of our business tax system will necessarily mean making broad design choices about the overall tax system and how business taxes are coordinated with other taxes. The tax reform debate of the last several years has focused attention on several important choices, including the extent to which our system should be closer to the extreme of a pure income tax or the other extreme of a pure consumption tax, the extent to which sales by U.S. businesses outside of this country should be taxed, the extent to which taxes should be collected from businesses or individuals, and the extent to which taxpayers are compensated for losses or costs they incur during the transition to any new tax system. Generally there is no single "right" decision about these choices and the options are not limited to selecting a system that is at one extreme or the other along the continuum of potential systems. The choices will involve making tradeoffs between the various goals for our tax system.

Income vs. Consumption as the Tax Base

The fundamental difference between income and consumption taxes lies in their treatment of savings and investment. Income can be used for either consumption or saving and investment. The tax base of a pure income tax includes all income, regardless of what it is ultimately used for; in contrast, the tax base of a consumption tax excludes income devoted to saving and investment (until it is ultimately used for consumption). The current tax system is a hybrid between a pure income tax and a pure consumption tax because it effectively exempts some types of savings and investment but taxes other types.

As noted earlier, evidence is inconclusive regarding whether a shift closer to a consumption tax base would significantly affect the level of savings by U.S. taxpayers. There is, however, a consensus among economists that uneven tax treatment across different types of investment should be avoided unless the efficiency costs resulting from preferential tax treatment are outweighed by the social benefits generated by the tax preference. That objective could be achieved under either a consumption tax that exempts all new savings and investment from taxation (which means that all business profits are exempt) or a revised income tax that taxed all investments at the same effective rate. In comparison to the current system, a consumption tax's exemption of business-source income would likely encourage U.S. businesses to increase their investment in the United States relative to their foreign investment.

Both income and consumption taxes can be structured in a variety of ways, as discussed in the following subsections, and the choice of a specific design for either type of tax can have as significant implications for efficiency, administrability, and equity as the choice between a consumption or income base. [19] The exemption of saving and investment can be accomplished in different ways, so consumption taxes can be structured differently and yet still have the same overall tax base.

[19]For additional information on how differences in the structures of both income and consumption taxes can affect tax administration and taxpayer compliance burdens, see *Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators*, GAO/GGD-98-37 (Washington, D.C.: Jan. 14, 1998).

Collecting the Tax at the Business or Individual Level

Both income and consumption taxes can be levied on individuals or businesses, or on a combination of the two. Whether collected from individuals or businesses, ultimately, individuals will bear the economic burden of any tax (as wage earners, shareholders, or consumers). The choice of whether to collect a tax at the business level or the individual level depends on whether it is thought to be desirable to levy different taxes on different individuals. A business-level tax, whether levied on income or consumption, can be collected "at source"—that is, where it is generated—so there can be many fewer tax filers and returns to administer. Business-level taxes cannot, however, directly tax different individuals at different rates. Individual-level taxes can allow for distinctions between different individuals; for example, standard deductions or graduated rates can be used to tax individuals with low income (or consumption) at a lower rate than individuals with greater income (or consumption). However, individual-level taxes require more tax returns, impose higher compliance costs, and would generally require a larger tax administration system.[20]

A national retail sales tax, a consumption value-added tax, and an income value-added tax are examples of taxes that would be collected only at the business level. A personal consumption tax and an integrated individual income tax are examples of taxes that would be collected only at the individual level. The "flat tax" proposed by economists Robert Hall and Alvin Rabushka that has received attention in recent years is an example of a tax collected at both the business and individual level.[21] Our current system for taxing corporate-source income involves taxation at both the corporate and individual level in a manner that results in the double taxation of the same income.

Territorial vs. Worldwide Taxation under an Income Tax

Under a pure worldwide tax system the United States would tax the income of U.S. corporations, as it is earned, regardless of where it is earned, and at the same time provide a foreign tax credit that ensures that the combined rate of tax that a corporation pays to all governments on each dollar of income is exactly equal to the U.S. corporate tax rate. Some basic differences between the current U.S. tax system and a pure worldwide system are that (1) in many cases the U.S. system permits corporations to defer U.S. tax on their foreign-source income until it is repatriated and (2) the U.S. foreign tax credit is limited to the amount of

[20]For a further discussion of these issues, see GAO/GGD-98-37.

[21]See app. II for brief descriptions of each of these types of taxes.

U.S. tax that would be due on a corporation's foreign-source income. In cases where the rate of foreign tax on a corporation's income exceeds the U.S. tax rate, the corporation is left paying the higher rate of tax.

Under a pure territorial tax system the United States would simply exempt all foreign-source income. (No major country has a pure territorial system; they all tax mobile forms of foreign-source income, such as royalties and income from securities.) The current U.S. tax system has some features that result in some cases in treatment similar to what would exist under a territorial system. First, corporations can defer U.S. tax indefinitely on certain foreign-source income, as long as they keep it reinvested abroad. Second, in certain cases U.S. corporations are able to use the excess credits that they earned for taxes they paid to high-tax countries to completely offset any U.S. tax that they would normally have to pay on income they earned in low-tax countries.[22] As a result, that income from low-tax countries remains untaxed by the United States—just as it would be under a territorial system. In fact, there are some cases where U.S. corporations enjoy tax treatment that is more favorable than under a territorial system. This occurs when they pay no U.S. tax on foreign-source income yet are still able to deduct expenses allocable to that income. For example, a U.S. parent corporation can borrow money and invest it in a foreign subsidiary. The parent corporation generally can deduct its interest payments from its U.S. taxes even if it defers U.S. tax on the subsidiary's income by leaving it overseas.

Proponents of a worldwide tax system and proponents of a territorial system both argue that their preferred systems would provide important forms of tax neutrality. Under a pure worldwide system all of the income that a U.S. corporation earns abroad would be taxed at the same effective rate that a corporation earning the same amount of income domestically would pay. Such a tax system is neutral in the sense that it does not influence the decision of U.S. corporations to invest abroad or at home. If the U.S. had a pure territorial tax system all of the income that U.S. corporations earn in a particular country would be taxed at the same rate as corporations that are residents of that country. The pure territorial system is neutral in the specific sense that U.S. corporations investing in a

[22]In cases where a U.S. corporation earns income in a country with a higher income tax than in the United States that corporation earns a larger tax credit than is needed to offset the U.S. tax owed on that foreign-source income. The difference between the foreign tax credit earned on a specific amount of foreign-source income and the amount of U.S. tax owed on that income is known as an excess foreign tax credit.

foreign country would not be at a disadvantage relative to corporations residing in that country or relative to other foreign corporations investing there.[23] In a world where each country sets its own tax rules it is impossible to achieve both types of neutrality at the same time, so tradeoffs are unavoidable.

A change from the current tax system to a pure territorial one is likely to have mixed effects on tax compliance and administration. On the one hand, a pure worldwide tax system, or even the current system, may preserve the U.S. tax base better than a territorial system would because U.S. taxpayers would have greater incentive under a territorial system to shift income and investment into low-tax jurisdictions via transfer pricing. On the other hand, a pure territorial system may be less complex for IRS to administer and for taxpayers to comply with than the current tax system because there would be no need for the antideferral rules or the foreign tax credit, which are among the most complex features of the current system.

Destination-Principle vs. Origin-Principle Consumption Tax

Broad-based consumption taxes can differ depending on whether they are imposed under a destination principle, which holds that goods and services should be taxed in the countries where they are consumed, or an origin principle, which holds that goods and services should be taxed in the countries where they are produced. In the long run, after markets have adjusted, neither type of tax would have a significant effect on the U.S. trade balance. This is true for a destination-based tax because products consumed in the United States would be taxed at the same rate, regardless of where they were produced. Therefore, such a tax would not influence a consumer's choice between buying a car produced in the United States or one imported from Japan. And at the same time, U.S. exports of cars would not be affected by the tax because they would be exempted. An origin-based consumption tax would not affect the trade balance because the tax effects that taxes have on prices would ultimately be countered by

[23] The disadvantage that U.S. corporations have under the current system is one reason why some U.S. multinational businesses have undergone "corporate inversions," whereby their parent corporations have changed their place of incorporation from the United States to a foreign country.

the same price adjustment mechanism that we discussed earlier with respect to targeted tax subsidies for exports.[24]

A national retail sales tax limited to final consumption goods would be a destination-principle tax; it would tax imports when sold at retail in this country and would not tax exports. Value-added taxes can be designed as either destination or origin-principle taxes.

A personal consumption tax, collected at the individual level, would apply to U.S. residents or citizens and could be formulated to tax their consumption regardless of whether it is done domestically or overseas. Under such a system, income earned abroad would be taxable but funds saved or invested abroad would be deductible. In that case, foreign-produced goods imported into the United States or consumed by U.S. citizens abroad would be taxed. U.S. exports would only be taxed to the extent that they are consumed by U.S. citizens abroad.

The Extent of Transition Provisions

A wide range of options exist for moving from the current business tax system to an alternative one, and the way that any transition is formulated could have significant effects for economic efficiency, equity, taxpayer compliance burden, and tax administration. For example, one transition issue involves whether tax credits and other tax benefits already earned under the current tax would be made available under a new system. Businesses that are deducting depreciation under the current system would not have the opportunity to continue depreciating their capital goods under a VAT unless special rules were included to permit it. Similar problems could arise with businesses' carrying forward net operating losses and recovering unclaimed tax credits. Depending on how these and other issues are addressed, taxpayer compliance burden and tax administration responsibilities could be greater during the transition period than they currently are or than they would be once the transition ends. Transition rules could also substantially reduce the new system's tax

[24]This time the mechanism would operate in the reverse direction—the tax on U.S. exports would decrease the foreign demand for those products, leading to a drop in the value of the dollar. That decline in the dollar's value would reverse the tax-induced increase in the price of U.S. exports and would raise the price of imports into the United States, offsetting any price advantage they had gained from being exempt from the consumption tax.

base, thereby requiring higher tax rates during the transition if revenue neutrality were to be achieved.[25]

Criteria for a Good Tax System Provide Principles to Guide Decisions and Issues for Consideration

Our publication, Understanding the Tax Reform Debate: Background, Criteria, and Questions,[26] may be useful in guiding policymakers as they consider tax reform proposals. It was designed to aid policymakers in thinking about how to develop tax policy for the 21st century. The criteria for a good tax system, which our report discusses, provide the basis for a set of principles that should guide Congress as it considers the choices and tradeoffs involved in tax system reform. And, as I also noted earlier, proposals for reforming business taxation cannot be evaluated without considering how that business taxation will interact with and complement the other elements of our overall future tax system.

The proposed system should raise sufficient revenue over time to fund our expected expenditures. As I mentioned earlier, we will fall woefully short of achieving this end if current spending or revenue trends are not altered. Although we clearly must restructure major entitlement programs and the basis of other federal spending, it is unlikely that our long-term fiscal challenge will be resolved solely by cutting spending.

The proposal should look to future needs. Like many spending programs, the current tax system was developed in a profoundly different time. We live now in a much more global economy, with highly mobile capital, and with investment options available to ordinary citizens that were not even imagined decades ago. We have growing concentrations of income and wealth. More firms operate multinationally and willingly move operations and capital around the world as they see best for their firms.

As an adjunct to looking forward when making reforms, better information on existing commitments and promises must be coupled with estimates of the long-term discounted net present value costs from spending and tax commitments comprising longer-term exposures for the federal budget beyond the existing 10-year budget projection window.

The tax base should be as broad as possible. Broad-based tax systems with minimal exceptions have many advantages. Fewer exceptions generally

[25]For further discussion of transition issues see GAO-05-1009SP.

[26]GAO-05-1009SP.

means less complexity, less compliance cost, less economic efficiency loss, and by increasing transparency may improve equity or perceptions of equity. This suggests that eliminating or consolidating numerous tax expenditures must be considered. In many cases tax preferences are simply a form of "back-door spending." We need to be sure that the benefits achieved from having these special provisions are worth the associated revenue losses just as we must ensure that outlay programs—which may be attempting to achieve the same purposes as tax expenditures—achieve outcomes commensurate with their costs. And it is important to supplement these cost-benefit evaluations with analyses of distributional effects—i.e., who bears the costs of the preferences and who receives the benefits. To the extent tax expenditures are retained, consideration should be given to whether they could be better targeted to meet an identified need.

If we must raise revenues, doing so from a broad base and a lower rate will help minimize economic efficiency costs. Broad-based tax systems can yield the same revenue as more narrowly based systems at lower tax rates. The combination of less direct intervention in the marketplace from special tax preferences, and the lower rates possible from broad-based systems, can have substantial benefits for economic efficiency. For instance, one commonly cited rule of thumb regarding economic efficiency costs of tax increases is that they rise proportionately faster than the tax rates. In other words, a 10 percent tax increase could raise the economic efficiency costs of a tax system by much more than 10 percent.

Aside from the base-broadening that minimizes targeted tax preferences favoring specific types of investment or other business behavior, it is also desirable on the grounds of economic efficiency to extend the principle of tax neutrality to the broader structural features of a business tax system. For example, improvements in economic efficiency can also be gained by avoiding differences in tax treatment, such as the differences in the current system based on legal form of organization, source of financing, and the nature and location of foreign operations. Removing such differences can shift resources to more productive uses, increasing economic performance and the standard of living of Americans. Shifting resources to more productive uses can result in a step up in the level of economic activity which would be measured as a one-time increase in the rate of growth. Tax changes that increase efficiency can also increase the long-term rate of economic growth if they increase the rate of

technological change; however, not all efficiency-increasing tax changes will do so.[27]

Impact on the standard of living of Americans is also a useful criterion for evaluating policies to improve U.S. competitiveness. As was discussed earlier, narrower goals and policies, such as increasing the U.S. balance of trade through targeted tax breaks aimed at encouraging exports, are generally viewed as ineffective by economists. What determines the standard of living of Americans and how it compares to the standard of living in other countries is the productivity of American workers and capital. That productivity is determined by factors such as education, technological innovation, and the amount of investment in the U.S. economy. Tax policy can contribute to American productivity in several ways. One, discussed in this statement, is through neutral taxation of investment alternatives. Another, which I have discussed on many occasions, is through fiscal policy. Borrowing to finance persistent federal deficits absorbs savings from the private sector reducing funds available for investment. Higher saving and investment from a more balanced fiscal policy would contribute to increased productivity and a higher standard of living for Americans over the long term.

A reformed business tax system should have attributes associated with high compliance rates. Because any tax system can be subject to tax gaps, the administrability of reformed systems should be considered as part of the debate for change. In general, a reformed system is most likely to have a small tax gap if the system has few tax preferences or complex provisions and taxable transactions are transparent. Transparency in the context of tax administration is best achieved when third parties report information both to the taxpayer and the tax administrator.

Minimizing tax code complexity has the potential to reduce noncompliance for at least three broad reasons. First, it could help taxpayers to comply voluntarily with more certainty, reducing inadvertent errors by those who want to comply but are confused because of complexity. Second, it may limit opportunities for tax evasion, reducing intentional noncompliance by taxpayers who can misuse the complex code provisions to hide their noncompliance or to achieve ends through

[27]See GAO-05-1009SP for further discussion on the relationship between efficiency and economic growth.

tax shelters. Third, reducing tax-code complexity could improve taxpayers' willingness to comply voluntarily.

Finally, the consideration of transition rules needs to be an integral part of the design of a new system. The effects of these rules can be too significant to leave them simply as an afterthought in the reform process.

Concluding Observations

The problems that I have reviewed today relating to the compliance costs, efficiency costs, equity, and tax gap associated with the current business tax system would seem to make a strong case for a comprehensive review and reform of our tax policy. Further, businesses operate in a world that is profoundly different—more competitive and more global—than when many of the existing provisions of the tax code were adopted. Despite numerous and repeated calls for reform, progress has been slow. I discussed reasons for the slow progress in a previous hearing on individual tax reform before this committee. One reason why reform is difficult to accomplish is that the provisions of the tax code that generate compliance costs, efficiency costs, the tax gap and inequities also benefit many taxpayers. Reform is also difficult because, even when there is agreement on the amount of revenue to raise, there are differing opinions on the appropriate balance among the often conflicting objectives of equity, efficiency, and administrability. This, in turn, leads to widely divergent views on even the basic direction of reform.

However, I have described some basic principles that ought to guide business tax reform. One of them is revenue sufficiency. Fiscal necessity, prompted by the nation's unsustainable fiscal path, will eventually force changes to our spending and tax policies. We must fundamentally rethink policies and everything must be on the table. Tough choices will have to be made about the appropriate degree of emphasis on cutting back federal programs versus increasing tax revenue.

Other principles, such as broadening the tax base and otherwise promoting tax neutrality, could help improve economic performance. While economic growth alone will not solve our long-term fiscal problems, an improvement in our overall economic performance makes dealing with those problems easier.

The recent report of the President's Advisory Panel on Federal Tax Reform recommended two different tax reform plans. Although each plan is intended to improve economic efficiency and simplify the tax system, neither of them addresses the growing imbalance between federal

spending and revenues that I have highlighted. One approach for getting the process of comprehensive fiscal reform started would be through the establishment of a credible, capable, and bipartisan commission, to examine options for a combination of selected entitlement and tax reform issues.

Mr. Chairman and Members of the Committee, this concludes my statement. I would be pleased to answer any questions you may have at this time.

Contact and Acknowledgments

For further information on this testimony, please contact James White on (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Individuals making key contributions to this testimony include Jim Wozny, Assistant Director; Donald Marples; Jeff Arkin; and Cheryl Peterson.

Appendix I: List of Studies Reviewed

Government Accountability Office

Individual Income Tax Policy: Streamlining, Simplification, and Additional Reforms Are Desirable. GAO-06-1028T. Washington, D.C.: August 3, 2006.

Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches. GAO-06-1000T. Washington, D.C.: July 26, 2006.

Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting. GAO-06-851T. Washington, D.C.: June 13, 2006.

Understanding the Tax Reform Debate: Background, Criteria, & Questions. GAO-05-1009SP. Washington, D.C.: September 2005.

Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined. GAO-05-690. Washington, D.C.: Sept. 23, 2005.

Tax Policy: Summary of Estimates of the Costs of the Federal Tax System. GAO-05-878. Washington, D.C.: August 26, 2005.

Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies. GAO-05-527T. Washington, D.C.: April 14, 2005.

21st Century Challenges: Reexamining the Base of the Federal Government. GAO-05-325SP. Washington, D.C.: February 1, 2005.

Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators. GAO/GGD-98-37. Washington, D.C.: January 14, 1998.

Congressional Budget Office

Corporate Income Tax Rates: International Comparisons. Washington, D.C.: November 2005.

Taxing Capital Income: Effective Rates and Approaches to Reform. Washington, D.C.: October 2005.

Effects of Adopting a Value-Added Tax. Washington, D.C.: February 1992.

Congressional Research Service

Brumbaugh, David L. *Taxes and International Competitiveness.* RS22445. Washington, D.C.: May 19, 2006.

Brumbaugh, David L. *Federal Business Taxation: The Current System, Its Effects, and Options for Reform.* RL33171. Washington, D.C.: December 20, 2005.

Gravelle, Jane G.. Capital Income *Tax Revisions and Effective Tax Rates.* RL32099. Washington, D.C.: January 5, 2005.

Joint Committee on Taxation

The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses. JCX-22-06. Washington, D.C.: June 21, 2006.

Options to Improve Tax Compliance and Reform Tax Expenditures. JCS-02-05. Washington, D.C.: January 27, 2005.

The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations. JCX-67-03. Washington, D.C.: July 3, 2003.

Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series. JCX-23-02. Washington, D.C.: April 4, 2002.

U.S. Department of the Treasury

Report to The Congress on Depreciation Recovery Periods and Methods. Washington, D.C.: July 2000.

Integration of The Individual and Corporate Tax Systems: Taxing Business Income Once. Washington, D.C.: January 1992.

President's Advisory Panel on Federal Tax Reform

Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System. Washington, D.C.: November 2005.

Appendix II: Descriptions of Alternative Tax Systems

Over the past decade, several proposals for fundamental tax reform have been put forward. These proposals would significantly change tax rates, the tax base, and the level of tax (whether taxes are collected from individuals, businesses, or both). Some of the proposals would replace the federal income tax with some type of consumption tax levied only on businesses. Consumption taxes levied only on businesses include retail sales taxes (RST) and value-added taxes (VAT). The flat tax would also change the tax base to consumption but include both a relatively simple individual tax along with a business tax. A personal consumption tax, a consumption tax levied primarily on individuals, has also been proposed. Similar changes in the level at which taxes are collected could be made while retaining an income tax base. This appendix provides a brief description of several of these proposals.

National Retail Sales Tax

The consumption tax that Americans are most familiar with is the retail sales tax, which in many states, is levied when goods or services are purchased at the retail level. The RST is a consumption tax because only goods purchased by consumers are taxed, and sales to businesses, including sales of investment goods, are generally exempt from tax. In contrast to an income tax, then, income that is saved is not taxed until it is used for consumption. Under a national RST, different tax rates could be applied to different goods, and the sale of some goods could carry a zero tax rate (exemption). However, directly taxing different individuals at different rates for the same good would be very difficult.

Consumption Value-Added Tax

A consumption VAT, which like the RST, is a business-level consumption tax levied directly on the purchase of goods and services. The two taxes differ in the manner in which the tax is collected and paid. In contrast to a retail sales tax, sales of goods and services to consumers and to businesses are taxable under a VAT. However, businesses can either deduct the amount of their purchases of goods and services from other businesses (under a subtraction VAT) or can claim a credit for tax paid on purchases from other businesses (under a credit VAT). Under either method, sales between businesses do not generate net tax liability under a VAT because the amount included in the tax base by businesses selling goods is equal to the amount deducted by the business purchasing goods. The only sales that generate net revenue for the government are sales between businesses and consumers, which is the same case as the RST.

Income Value-Added Tax

An income VAT would move the taxation of wage income to the business level as well. No individual returns would be necessary, so the burden of complying with the tax law would be eliminated for individuals. An income VAT would not allow businesses to deduct dividends, interest, or wages, so the income VAT remitted by businesses would include tax on these types of income. Calculations would not have to be made for different individuals, which would simplify tax administration and compliance burdens but not allow for treating different individuals differently.

Flat Tax

The flat tax was developed in the early 1980s by economists Robert Hall and Alvin Rabushka.[1] The Hall-Rabushka flat tax proposal includes both an individual tax and a business tax. As described by Hall and Rabushka, the flat tax is a modification of a VAT; the modifications make the tax more progressive (less regressive) than a VAT. In particular, the business tax base is designed to be the same as that of a VAT, except that businesses are allowed to deduct wages and retirement income paid out as well as purchases from other businesses. Wage and retirement income is then taxed when received by individuals at the same rate as the business tax rate. By including this individual-level tax as well as the business tax, standard deductions can be made available to individuals. Individuals with less wage and retirement income than the standard deduction amounts would not owe any tax.

Personal Consumption Tax

A personal consumption tax would look much like a personal income tax. The major difference between the two is that under the consumption tax, taxpayers would include all income received, amounts borrowed, and cash flows received from the sale of assets, and then deduct the amount they saved. The remaining amount would be a measure of the taxpayer's consumption over the year. When funds are withdrawn from bank accounts, or stocks or bonds are sold, both the original amount saved and interest earned are taxable because they are available for consumption. If withdrawn funds are reinvested in another qualified account or in stock or bonds, the taxable amount of the withdrawal would be offset by the deduction for the same amount that is reinvested. While the personal consumption tax would look like a personal income tax, the tax base would be the same as an RST. Instead of collecting tax on each sale of consumer products at the business level, a personal consumption tax

[1]See Robert E. Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, Calif.: Hoover Press, 1995).

would tax individuals annually on the sum of all their purchases of consumption goods. Because it is an individual-level tax, different tax rates could be applied to different individuals so that the tax could be made more progressive, and other taxpayer characteristics, such as family size, could be taken into account if desired.[2]

[2]To tax certain types of consumption that can occur within a business, such as fringe benefits or the personal use of goods such as cars, many personal consumption tax proposals also include a business-level "cash flow" tax. Investment would be expensed under such a tax to ensure that the overall tax base would be consumption.

Questions for the Record for Hon. David Walker
September 20, 2006

From Senator Hatch:

General Walker, in my view, if there is one tax reform goal that trumps all others, even simplicity, it is that our tax code should maximize economic growth. You mentioned in your testimony that the best way for our business tax system to promote economic growth was through neutrality, by not favoring some business activities over others. How do incentives such as bonus depreciation or targeted credits fit into this view?

Tax neutrality increases economic efficiency, which increases short-term economic growth and, in some cases, can increase long-term growth as well. Changes to the tax system that increase economic efficiency may or may not increase the long-term rate of economic growth—it depends on whether those changes also increase the rate of technological change and growth in the capital stock.

Incentives such as bonus depreciation or targeted tax credits, if they are designed properly, may stimulate additional investment that results in a larger capital stock and new technology. However, if that capital stock and technology are not allocated to the most productive uses, the resulting level of well-being may be lower than what might be achieved with somewhat lower levels of capital and technology that are used more efficiently. Importantly, lowering tax rates through base-broadening has the potential both to stimulate additional investment and promote a more efficient allocation of that investment. In theory, targeted tax incentives could conceivably achieve an equal and, perhaps, even better combination of growth and efficiency; however, designing incentives that would do so is extremely challenging and involves substituting the government's judgment for the markets.

What is your view of immediate expensing of business equipment as a policy to foster both simplicity and economic growth?

We have not done any work to evaluate this specific policy option. The revenue cost of providing the expensing benefit must be made up by raising tax rates or cutting back on other incentives. Importantly, there is significant disagreement within the business community and the economics profession as to whether expensing or lower tax rates would foster higher levels and more efficient use of business investment.

Do you favor a tax system that features border adjustability, so that we could exempt our exports but apply business tax to imports? What do you think about a territorial tax system versus our current system of worldwide taxation?

The current consensus among economists is that border tax adjustments, such as the ones you describe, would not have a significant effect on the U.S. trade balance in the long run. Imposing a U.S. consumption tax on imports would mean that products consumed in the United States would be taxed the same, regardless of where they were produced. Therefore, such a tax, by itself, would not influence a consumer's choice between a car produced in the United States and one imported from overseas. And at the same time, U.S. exports of cars would not be affected by the tax because they would be exempted. Importantly, economists agree that the overall effect of this policy on the trade balance would not be significantly different than what would result if the U.S. did not exempt exports from any future consumption tax because price adjustments in international markets would serve to largely offset the effect of the tax over time. The tax on U.S. exports would decrease the foreign demand for those products, leading to a drop in the value of the dollar. That decline in the dollar's value would serve to offset the tax-induced increase in the price of U.S. exports and would raise the price of imports into the United States.

Proponents of a worldwide tax system and proponents of a territorial system both argue that their preferred systems would provide important forms of tax neutrality. Under a pure worldwide system all of the income that a U.S. corporation earns abroad would be taxed at the same effective rate that a corporation earning the same amount of income domestically would pay. Such a tax system is neutral in the sense that it does not influence the decision of U.S. corporations to invest abroad or at home. If the U.S. had a pure territorial tax system all of the income that U.S. corporations earn in a particular country would be taxed at the same rate as corporations that are residents of that country. The pure territorial system is neutral in the specific sense that U.S. corporations investing in a foreign country would not be at a disadvantage relative to corporations residing in that country or relative to other foreign corporations investing there. In a world where each country sets its own tax rules it is impossible to achieve both types of neutrality at the same time, so tradeoffs are unavoidable

A change from the current tax system to a pure territorial one is likely to have mixed effects on tax compliance and administration. On the one hand, a pure worldwide tax system, or even the current system, may serve to preserve the U.S. tax base better than a territorial system would because U.S. taxpayers would have greater incentive under a territorial system to shift income and investment into low-tax jurisdictions via transfer pricing. On the other hand, a pure territorial system may be less complex for IRS to administer and for taxpayers to comply with than the current tax system because there would be no need for the anti-deferral rules or the foreign tax credit, which are among the most complex features of the current system.

From Senator Baucus:

The President's Tax Reform Advisory Panel operated under the premise that its proposals should be revenue neutral relative to the President's budget baseline. Given that constraint, are you concerned that the panel's recommendations are unrealistic from the outset given the potential deficits we face in the relatively near future?

You criticize the Tax Reform Panel's two recommendations since neither addresses the growing fiscal imbalance. Do you believe that any tax reform proposal which is simply revenue neutral is not sufficient?

I believe that the guidance the President's tax reform panel followed with respect to preparing revenue-neutral tax reform options based on the President's projections served to reduce the credibility and limit the longer-term usefulness of their proposals. Both of the two proposals the panel developed appear to provide much less than the necessary revenue to fund expected government spending. Although we have not evaluated the revenue effects of these proposals, other respected analysts have and they point to future revenue yields that would likely worsen an already serious fiscal challenge the nation faces.

Long-term budget simulations by GAO, the Congressional Budget Office, the Office of Management and Budget, and nongovernment analysts show that, absent policy changes, the federal budget is on an unsustainable path. Known demographic trends and rising health care costs will ultimately result in deficits and debt that will threaten our national security as well as the standard of living for the American people in the future. While additional economic growth is critical and can help to ease the burden, the projected fiscal gap is so great that it is unrealistic to expect that growth alone will solve the problem without also changing our tax policies to raise more revenue than the current tax system will. Tough choices will have to be made about the appropriate degree of emphasis on reforming existing federal entitlement programs, restructuring and constraining other federal spending and reforming our tax system while raising additional revenue.

Previously, you testified that you filled out your own tax return without the benefit of software. You stated that you found the process "confusing, complex and extremely frustrating." As I stated at this hearing, the staff of the Finance Committee has been advised by the IRS and software providers that the 2006 tax forms will be missing crucial information if the widely-applicable tax incentives pending in the "extenders" package are not enacted by October 15. Leaving the explanation as to how to claim these popular benefits for supplementary documents to the Form 1040 or computer upgrades will surely create great confusion for the millions of taxpayers who utilize them. To what extent is the tax gap and tax compliance impacted because taxpayers are confused, forms are complicated, and the risk of error is high?

There is no question that complexity is a real problem that results in taxpayer frustration and affects the "tax gap" in various ways. It would be difficult to make a reliable quantitative estimate of the extent to which complicated forms, taxpayer confusion, and the high risk of error affect compliance because the impact of complexity cannot easily be separated from the effects

of other contributing factors. The difficulty is more basic than simply the limitations of available data and statistical methodologies. Complexity is difficult to define, let alone measure, and it is also difficult to distinguish between unintentional and intentional noncompliance. In fact, for many taxpayers who want to understate their tax, the complexity of the tax code gives them opportunity and cover to do so. At the same time, complexity and confusion can also result in additional revenues. For example, in a 2002 study we estimated that as many as 2 million taxpayers overpaid their 1998 taxes by $945 million because they claimed the standard deduction when it would have been more beneficial to itemize.[1] Importantly, the current tax system complexity imposes additional compliance costs on taxpayers and serves to reduce the perceived credibility and fairness of the tax code.

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[1] GAO, Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing, GAO-02-509 (Washington, D.C.: Mar. 29, 2002).

COMMUNICATION

Our Business Tax System: Objectives, Deficiencies, and Options for Reform

Senate Committee on Finance
September 20, 2006

Statement Submitted by
J. Michael Keeling
President, CAE
The ESOP Association
1726 M Street, NW
Suite 501
Washington, DC 20036

On behalf of the thousands of employee-owned companies in the United States, and certainly for the nearly 2,500 members of The ESOP Association, we put to the members of the Senate Finance Committee this one thought, which came to us as we read with interest statements by the Chair, Senator Grassley, ranking member Senator Baucus, and the distinguished panel.

Many goals were articulated in the statements by the speakers who felt that if the goals were reached because of a major reform of U.S. tax laws impacting business, we would make our nation's businesses more competitive, more productive, and easier to manage due to less tax compliance costs, among other things. These are all worthy goals, and, of course, debate will revolve around whether the details of proposals accomplish these goals.

Every American wants to have a booming economy and healthy businesses providing good jobs with good benefits.

But, we were somewhat disappointed that no one said, "You know, who owns American businesses is very important in terms of fairness and equity." We ask, should we look at the scheme we use to tax businesses with no regard to concentration of wealth? Should we not care that the most important element of a free enterprise society, ownership, is not part of the mix of the debate?

In sum, we would submit that who owns businesses in our nation is very much entwined with how business are taxed, and that as reform of business taxation is studied, the members of the Committee on Finance and their staffs keep in mind that broad based ownership of American businesses should be another goal of any tax regime developed.

On behalf of the ESOP community, I thank you for taking note of this thought.