PRESIDENT'S FISCAL YEAR 2001 BUDGET

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

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PRESIDENT'S FISCAL YEAR 2001 BUDGET

WEDNESDAY, FEBRUARY 9, 2000

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

The Committee met, pursuant to notice, at 10:09 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
February 2, 2000
FC–17

Archer Announces Hearing on the President's Fiscal Year 2001 Budget

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on President Clinton's fiscal year 2001 budget proposals within the jurisdiction of the Committee. The hearing will take place on Wednesday, February 9, 2000, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

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

BACKGROUND:

On January 27, 2000, President Clinton delivered his State of the Union address. In it, he outlined numerous budget and tax proposals. Among them was a proposal to set aside Social Security surpluses for debt reduction, and a proposal to offer prescription drug coverage to Medicare beneficiaries. Among the tax items was a proposal to reduce the marriage tax penalty by increasing the standard deduction for two-income couples filing jointly, a proposal for tax incentives for retirement, and a proposal for relief from the alternative minimum tax. Among other things, the President proposed a number of new tax credits for a wide variety of purposes. His budget is expected to include various other tax, fee, and revenue increases.

The details of these proposals are expected to be released on February 7, 2000, when the President is scheduled to submit his fiscal year 2001 budget to the Congress.

In announcing the hearing, Chairman Archer stated: I look forward to receiving the President's budget proposals. The President has already announced many of his ideas and it's appropriate we now review them in complete detail. I'm sure they will raise important questions for thoughtful discussion."

FOCUS OF THE HEARING:

The Committee will receive testimony on the President's fiscal year 2001 budget proposals from Secretary Summers. The Secretary is expected to discuss the details of the President's proposals which are within the Committee's jurisdiction.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the *close of business*, Wednesday, February 23, 2000, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they

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

FORMATTING REQUIREMENTS:

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

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

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

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

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

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

Note: All Committee advisories and news releases are available on the World Wide Web at "http://waysandmeans.house.gov".

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

Chairman ARCHER. Welcome, Mr. Secretary. We are happy to have you before the committee.

Before I begin my prepared statement, I am going to discuss a recent concern that is disturbing to me and I believe to all members of the committee on both sides of the aisle. I refer to the steady stream of news reports about computer hackers disabling major Internet web sites and accessing consumer credit information.

Obviously, our committee is concerned because your Treasury Department computer systems must guard some of the most sensitive records of the American people—the IRS records, the tax records of all our citizens. I know the IRS and the Treasury have world-class computer security measures in place, and I am sure this is a top priority for you and Commissioner Rossotti. I commit publicly to you that you have the full support of this committee to help protect the privacy of the American people.

Of course, this committee oversees other agencies that protect similar information like Social Security wage information, Medicare health records, and a host of other personal records. We will focus on those areas as well. But we must do everything we can to apprehend Internet hijackers and put an end to this cyber terrorism.

Perhaps you would like to comment briefly before I make my statement relative to the budget, which is before us today.

Mr. SUMMERS. Mr. Chairman, we share your concern and I will be speaking with Commissioner Rossotti about this question of integrity of our systems. Frankly, privacy at the IRS has been a top priority for us for a number of years. We have taken steps, working with this committee, with respect to employees who have made unauthorized use of the systems and issues of that kind.

I might just say, Mr. Chairman, financial privacy generally is something that is a very, very important issue for us. There is both the question of what is illegal hacking and also the question of what is absolutely legal in terms of the widespread dissemination of information. As the President made clear in the State of the Union Address, this is something on which we will be suggesting legislation to the Congress this year to further protect financial privacy. We welcome your interest in this area.

Chairman ARCHER. It is important that we work together. This is something that knows no party lines and something that we need to cooperate fully on.

Having said that, I would like to turn to the President's budget request.

After saying in 1998 that we should "save Social Security first," and saying in 1999 that we "should save Social Security now", the President appears to have abandoned his pledge in this budget request. He apparently told reporters just last week that while he would like to save Social Security—in his words—he can't. It is a little disappointing when the most powerful elected official in the free world says, "I can't."

More disappointing and confusing, perhaps, is that the President has changed his mind again on the idea that the Federal Government should invest Social Security funds in private financial markets. We went through that with the original request and it was negated powerfully by Mr. Greenspan, who sat in exactly the chair where you are, after it was proposed. And the President then left it out of his October Social Security proposal.

Now in the budget it is back in again. I am eager to know why when there is massive concern on the part of people across the country on a bipartisan basis of having the Federal Government own corporations in this country.

I would also like to know why it is necessary to keep raising taxes on the American people at a time when the tax rate is at a peacetime high, we not only have balanced the budget, we are paying down the debt, we are protecting every dime of the Social Security surplus, and our fiscal house—I think we both would agree—is on a solid foundation. Last year, the President signed a tax relief bill that was funded largely out of the non-Social Security surplus. Why does the White House believe that we should push for tax hikes?

There are plenty of other items we need to discuss like helping low-income seniors with the high cost of prescription drugs, making health care more affordable and accessible, continuing with the success of welfare reform, and creating better jobs and growth here at home by opening markets overseas.

These are some of the things I look forward to hearing your thoughts on.

With that, I yield to Mr. Rangel for any opening statement he might like to make.

Without objection, each member will be permitted to enter any written statements into the record.

Mr. Rangel?

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

Welcome again, Mr. Secretary. On behalf of the full committee, we welcome Sylvia Matthews, the new Deputy OMB Director. When you first started saying that you were disturbed, Mr. Chairman, I took a deep breath because I did not know where you were going to go with that. I was hoping you were disturbed because there were reports that we were not working closely together in a bipartisan way in order to do the best for the Congress and the country.

There are many things I have problems with in the President's budget. But I do hope and truly believe that it would be helpful to both Democrats and Republicans if we can get something done in this session because I am not convinced that the voters are just going to blame the majority party. They just might not be that sophisticated and take it out on us, too.

So if we are concerned about Social Security, Medicare, prescription drug benefits, patient bill of rights, and education initiatives, it would seem to me that there was a time when the President met with the House and Senate leaders and that some of these things could be worked out—not to adopt what the President's creative imagination would present to us—but to select from those things that just made sense, whether you are Republican or Democrat, to see whether or not we could work together on it.

This type of thinking was shattered when I found out that the Republican—shall I say, leadership—decided that the marriage penalty relief would be the first thing coming out of the Ways and Means Committee. I know how important it is for the majority to get this thing done before Valentine's Day because it is important that we send a message to the voters for Valentine's Day that we love them and we want to give them relief.

But how we can do this before we have a budget, I do not know. And I know that you have abandoned the 792 tax cut bill, and you have accepted the George W. Bush $1.3 trillion tax cut bill. And I understand that instead of bringing it all to us at once, since we cannot digest it any more than the American people can, that we will be getting it in little slices. But at some point, it adds up.

I think the first slice we get is the $182 billion marriage tax penalty that benefits mostly people who do not have a penalty. That does not bother me because I am just as political, perhaps, as you are. But what bothers me is that this is an opportunity to tell Mr. Summers and Ms. Matthews to take a message back to the President that there are some things that we want to get done, that we

are going to select those things, and we hope we work together because the majority does not have enough votes to override the President.

So clearly, if we cannot override the President, we are going to have to work with the President. As unfortunate as it may seem sometimes, you may even have to work with me—the Democrats. But if we are going to get anything done, we have to stop taking shots at each other and suggest in a more positive way how we can get something—no matter how small it may appear to be—done.

I really think that the President has laid out for the Nation a blueprint of exciting ideas, some of which we may not be able to do. We may not be able to do it because we have other priorities. Maybe we may not be able to because we won't agree that it is the best way to do it. But out of two hours of suggestions, many of which we were able to get the majority party to give support at least in applauding, I would like to believe that out of that meeting with the President—or subsequent meetings—we can agree to do something.

And I do hope that the President is receptive to that. First, it is important to the American people and the Congress. Also, because both Chairman Archer and President Clinton will not be returning. I would like to be a part of leaving some type of legacy in being able to say that they have done something that the country and the Congress will treasure.

I think we can do that and still have enough differences to have a knock-down, drag-out fight in November to see which team—the Democratic team or the Republican team—the American people would want. I am convinced that there is not that much difference between what we would want, it is just how we get there.

I welcome you coming. I certainly will be working with you. Of course, if we can't work together, there is another way to do it, but I prefer to do it in a bipartisan way.

Thank you, Mr. Chairman.

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

Opening Statement of Hon. Robert T. Matsui, a Representative in Congress from the State of California

ROBERT T. MATSUI
FIFTH DISTRICT, CALIFORNIA

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Extension of Remarks

THE HONORABLE ROBERT T. MATSUI

Committee on Ways and Means
Hearing on the Administration's FY 2001 Budget
February 9, 2000

Mr. Secretary:

On December 9, 1999, I sent you a letter asking you to consider including in the FY 2001 budget submission to Congress a modest provision addressing a problem that relates to the extension of the 7.5 percent aviation excise tax to purchases from air carriers of frequent-flyer miles by credit card companies, hotels, telephone companies and other consumer businesses for the benefit of their customers. Specifically, the tax applies to mileage awards even if the transportation for which such awards are used has no connection to the U.S. My understanding is that Congressman Rangel and Congressman Foley and Farr sent you similar correspondence.

Although a provision to address the problem was not contained in the Budget, I am committed to finding a solution this year and am interested in your thoughts in writing on the following:

Is the Administration favorably disposed to solving this problem in as expedient a manner as possible? If not, why?

What is the Administration's view on Section 911 of the Taxpayer Refund and Relief Act of 1999 which proposed to exempt from tax air transportation rights that are credited to accounts of persons with mailing addresses outside of the U.S.?

Does the Administration have an alternative approach for resolving this issue? If so, please outline it briefly.

Mr. Secretary, I would like to briefly raise another important tax issue with you and commend the Administration for its work in this area. As you know, since 1992 no taxpayer has ever been able to claim one penny of tax credits under section 45 for biomass power production because the code section was drafted too narrowly.

Biomass power provides important waste removal and rural employment benefits to rural communities both in California and around the country. Unfortunately, many of the plants are shutting down or running at reduced capacity.

I have cosponsored legislation with Congressman Herger to fix section 45, and I am pleased to know that the President is aware of this problem and has adopted this solution of providing a tax credit for existing facilities. I look forward to working with you on this issue.

Opening Statement of Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota

Mr. Chairman, thank you for calling this important hearing today to review the President's fiscal year 2001 budget proposal.

The budget proposal before us today is a mixed bag—not as good or bad as many of my colleagues will claim. There are elements worth considering, as well as elements worth disregarding.

I applaud the President's proposal to pay off the public debt by 2013 because we must quit mortgaging the futures of our children and grandchildren. However, I do not support the President's excessive spending, at twice the rate of inflation. As

Chairman Greenspan has warned, Congress and the President must keep federal government spending in check so we don't see the return of soaring interest rates.

I am disappointed the President provides such little tax relief, and at the same time, imposes significant tax hikes. With a non-Social Security surplus of $2 trillion, Congress should save Social Security, pay down the debt and provide responsible tax relief.

As a Member of the Health Subcommittee, I am very concerned that the President once again proposed to spend Medicare dollars on *new* programs while, at the same time, cutting a number of payments for current beneficiaries. In the BBA of 1997, we set out to save the Medicare system $115 billion, but the Administration's implementation of it has almost doubled that figure. In response, we restored $16 billion in funding in 1999 after providers predicted dire situations. *Now the President would take another $70 billion out of the system*. It certainly makes me wonder—*is he not hearing the cries from providers that every Member of Congress is hearing*?

Instead of cutting payments and raising taxes through fees to pay for new spending, Congress and the President should modernize Medicare to reflect the advancements in our health care system, including a targeted prescription drug proposal to cover low-income seniors without displacing the coverage that 65% of our seniors already enjoy. I hope the President will work with us on this important issue this year!

In addition, I am concerned about the President's return to the idea of having the federal government invest Social Security money directly into private financial markets—a concept respected experts like Alan Greenspan and Rep. Bill Frenzel have strongly recommended against.

Mr. Chairman, thanks again for calling this hearing. I look forward to learning more of the details of the President's proposal from Secretary Summers.

Chairman ARCHER. Mr. Summers, welcome again. We are happy to have you before the committee. We will be pleased to hear your verbal presentation. Without objection, your entire written statement will be printed in the record.

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

Mr. SUMMERS. Thank you very much, Mr. Chairman, Congressman Rangel. It is a pleasure for Ms. Matthews and I to be here to discuss the President's fiscal year 2001 budget at a remarkable moment in our Nation's economic history.

It was reported yesterday that productivity had grown at a five percent annual rate in the third and fourth quarters of last year, a performance that is nearly unprecedented, and performance that suggests that we live in a moment of great possibility.

The President's top priority in formulating this budget was to preserve our progress and to build our future. Above all, preserving our progress means maintaining budget surpluses and continuing to pay down the debt at a rapid rate. It is the pay-down of debt that makes room for the investments that allow us to take advantage of the opportunities of this moment in information technology, in biotechnology, in productivity creating machinery and equipment.

The President's budget has five primary objectives. Let me summarize them in turn.

First, debt reduction. This is a budget that provides for the elimination of the national debt by 2013 and steady reductions in its magnitude in the meantime. Debt reduction is tantamount to a tax

cut in two important respects. Because it removes the burden on taxpayers of interest payments and ensures that principal payments will not need to be made on newly issued debt in the future, and because—as we have seen—reducing Federal debt and expected Federal debt reduces pressure on interest rates, allowing them to decline. Each percentage point reduction in the interest rate over 10 years results in an approximately $250 billion tax cut in the form of lower mortgage costs for American families.

And budgeting for debt reduction has another important benefit. It increases the resilience of our economy with respect to the shocks and uncertainties that will happen with respect to any forecast. Reloading the fiscal cannon gives us a chance to respond to any future problems that may arise. Creating valuable fiscal space allows us to address challenges of an aging society.

The second objective of the President's budget is to meet the needs of an aging society. Paying down debt will ultimately eliminate the nearly $200 billion in interest costs that are contained in this year's budget. The question naturally arises of what is the best use of the fiscal space that is thereby created. Here the President's budget gives a clear answer: support for Social Security, funding of our existing obligation to Social Security beneficiaries.

Mr. Chairman, the President's budget does provide for a portion of those transfers to be invested in equities. That reflects judgments that we discussed at some length when I testified before this committee in early November about the importance of allowing Social Security beneficiaries to take advantage of the return the private market can provide and the miracle of compound interest that we discussed. But it is our judgment that this is best done within the context of a defined benefit framework that does not transfer risk to Social Security beneficiaries and one that conserves and minimizes administrative costs.

The budget also calls for the modernization of the Medicare program in three important respects. First, by providing seniors with prescription drug coverage. If Medicare were enacted today, it would surely include a prescription drug benefit. Second, by providing a choice-based approach involving competition, but an approach that encourages the selection of lower-cost care alternatives, provides financial incentives for seniors to choose those alternatives, but avoid—and this is crucial—financial coercion that could interfere with existing relationships between seniors and their caregivers.

And reflecting the rising size of the aging population, the age of the aged population as life expectancy increases, the President's budget also proposes to fortify the Medicare Trust Fund with the savings from debt pay-down and allot several hundred billion dollars for that purpose.

Third, the President's budget establishes a framework in which it is possible to provide significant targeted tax cuts and it proposes some $350 billion in tax cuts over 10 years in a number of crucial areas. These include the promotion of savings through a new program of retirement security accounts that works with the grain of the existing employer-provided pension system and private financial institution-provided IRA system, but works to provide extra in-

centives to motivate 75 million Americans who do not have a pension or 401(k) to save.

Expansion of educational opportunity by allowing the deduction of as much as $10,000 in higher education costs for middle-income families. Steps to make health care more affordable by tripling the long-term care credit and helping those who have lost jobs to maintain continuity in their insurance in a number of ways. Support for working families, including crucially a reduction in marginal tax rates under the earned income tax credit programs and targeted and appropriate marriage penalty relief. Tax simplification through the alternative minimum tax and increases in standard deduction.

There are also measures contained in the President's budget to address the environmental concerns, to address the digital divide, and to support philanthropy.

Let me highlight one area of the President's tax offsets, and that is the area of corporate tax shelters.

In my judgment, there is ample room for reason and debate about a variety of tax subsidies of various kinds that are contained in the budget. But it seems to me that we all ought to be able to agree that transactions that are devoid of economic substance and are marketed in secret ought to be curbed, revenue considerations apart, in support of the maintenance of the integrity of the system. And yet it has become increasingly clear to thoughtful observers of our tax system that these transactions are increasing and are becoming increasingly pervasive and a source of pressure on honest taxpayers.

It would be my hope that wherever we come down on the broad range of business subsidies, that we and the Congress can work together to address this problem of abusive shelters, which it seems to me is becoming a very serious problem in the same way that the individual tax shelter problem became a very serious problem in the 1980s, before legislative action was taken.

Fourth, spending targeted on key priorities. Let me highlight one aspect of the President's budget. It is built around a current services baseline. That baseline starts from a Government that is smaller today in terms of public employees, smaller today in terms of total spending as a share of GNP, smaller today in terms of discretionary spending as a share of GNP, and smaller today in terms of domestic discretionary spending as a share of GNP than at any time since the 1960s. And it shrinks the Government steadily over 10 years by each of those measures. With this budget, the Government as a share of GNP will be smaller than at any time since the middle of President Eisenhower's term.

This is a conservative, prudent fiscal assumption in which all of our initiatives are financed by changes in the pattern of Government spending. To budget for a lower rate of growth than this would be to count on slower growth in discretionary spending than we had between 1981 and 1993 or slower growth in discretionary spending than we have had since 1993. It would, it seems to me, take a great risk of relying on cuts that ultimately would not come, thereby putting our fiscal progress, our debt reduction—which is so crucial to the maintenance of prosperity—at substantial risk.

Within this restricted current services envelope, the President's budget includes a number of initiatives: health care initiatives to

substantially expand coverage, education to reduce class sizes to enable a million more children to participate in HeadStart by 2002 and to repair the Nation's classrooms, and law enforcement where among other things we are proposing the largest ever expansion in our efforts to prosecute firearms violations involving 300 more agents, 200 more inspectors, and 1,000 more prosecutors.

Let me finally highlight an area that I know is of great concern to you, Mr. Chairman, and that is our international engagement. At a moment of such economic strength for our country, we must always remember that as Chairman Greenspan once testified, we cannot forever be an oasis of prosperity in a troubled world. That is why it is crucial that we find a way to move together to support an open global trading system, including the passage of the Permanent Normal Trading Relations Bill that is essential for China's entry into the WTO, and the African Growth and Opportunity Act and the Enhanced CBI.

In our judgment, it is also particularly important in this year that we do our part to include support for the poorest countries, including continued funding of the highly indebted poor countries, and debt relief initiatives. I would highlight something that is of particular concern to me. Our proposed measures include a tax credit to accelerate development and delivery of vaccines for infectious diseases such as AIDS, malaria, and tuberculosis that kill more than a million people each year.

To conclude, we are at a special moment in our national economy. But above all, it is not a moment for complacency. We cannot assume that without proper choices we will always enjoy this good fortune. Indeed even with the proper choices, we may not always enjoy this good fortune. That is why it is crucial that we act responsibly this year to continue paying down debt, prepare for the liabilities of an aging society, to prudently assure that we can continue to fund core Government, and then provide tax benefits to American families to meet some of their most important needs. We can do all of that working together.

[The prepared statement follows.]

Statement of Hon. Lawrence H. Summers, Secretary, U.S. Department of the Treasury

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

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

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

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

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

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

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

A virtuous circle of declining debt, lower interest rates, and a stronger economy, in turn producing still less debt, further downward pressure on interest rates, and stronger growth.

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

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

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

OVERVIEW OF THE FY2001 BUDGET

I. Safeguarding Our Economy by Reducing Federal Debt

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

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

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

Debt reduction also creates fiscal space, widening the range of choices available to us, and giving us greater capacity to respond to unforeseen problems. Today, the

Federal Government is spending more than $200 billion a year on interest payments that would be eliminated under our proposals. The President proposes that resources not paid in interest be used to help ease the burden of the Social Security and Medicare costs that will arise once the baby-boom generation begins to retire.

II. Meeting the Needs of an Aging Society

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

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

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

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

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

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

2. Modernizing Medicare

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

By extending competition

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

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

By providing coverage for prescription drugs

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

And by extending the solvency of Medicare

A third aspect of responsible Medicare reform is the addition of new resources into the Hospital Trust Fund. In the coming decades we expect to see a doubling in the number of Medicare beneficiaries, and continued advances in the ability of modern medicine to improve the length and quality of seniors' lives. We cannot meet the

rising future demands on Medicare through our structural reforms alone. But by enacting the combination of reforms and transfers in the President's budget, the projected solvency of the Medicare program could be extended to 2025.

III. Using Tax Cuts to Strengthen Our Communities

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

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

Retirement Savings

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

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

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

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

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

Helping Working Families

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

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

Revitalizing our Communities.

By expanding the New Markets tax credit the budget would help spur $15 billion in new investment for businesses in inner cities and poor rural areas. The budget

also proposes to extend and expand incentives for businesses to invest in empowerment zones.

Health

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

Education

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

Tax Simplification and Fairness

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

Corporate Shelters and Tax Havens

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

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

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

Other Provisions

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

IV. Investing in Health, Education and Other National Priorities

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

The first principle is that we use realistic projections of the level of spending needed to maintain core government functions. To meet this requirement, we begin

with a "current services" baseline under which discretionary spending is held constant on an inflation-adjusted basis.

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

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

Let me briefly summarize our proposals in these four areas.

Health Care

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

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

Education

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

Law Enforcement

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

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

Technology and the Environment

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

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

V. American Leadership in the World

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

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

China

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

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

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

Multilateral Development Banks

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

Highly Indebted Poor Countries Initiative

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

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

Vaccines

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

VI. Concluding Remarks

I began my remarks today by focusing on the link between fiscal discipline and the performance of our economy over the last seven years. Having worked hard to help bring us to the remarkable economic moment that we are now enjoying, the Members of this Committee know well the value to our economy and our country of further paying down the national debt held by the public. If we can act to reduce the debts we bequeath to our children, while continuing to fund our obligations to seniors and pursuing the vital purpose of making the economy work for all our people and communities, then we can maximize the extraordinary opportunities with

which we are now presented. I look forward to working together with this Committee and others in Congress to turn these high-class challenges into even higher-class solutions. Thank you. I would now be happy to respond to any questions that you might have.

Chairman ARCHER. Mr. Secretary, thank you for your succinct presentation.

Does Ms. Matthews wish to make a statement?

Ms. MATTHEWS. No, thank you, Mr. Chairman.

Chairman ARCHER. We are happy to have you with us.

This problem that you mentioned toward the end of your presentation is a very serious one. If FSC, which is one of our few tools to help exports, is negated by the Europeans, then it will fall very heavily on the good jobs that have been created for exports. I am glad you mentioned it, because we need to work together in every possible way to find some relief from this.

I am constrained to say that there is one easy answer, and that is to abolish the income tax and go to a consumption tax. I wish that I could have intrigued the President to join me in pushing for that, but apparently that will be for a later day. That in one fell swoop would take care of the problem, not only the disadvantage, but give us a fair advantage under the world trading rules.

I think ultimately we must come to it, because otherwise we are going to see—as we heard testimony from witnesses last year—more and more American corporations being merged to become foreign corporations. We saw it with Chrysler. Our tax code singlehandedly forced Chrysler to become a German corporation at the end of the merger. That testimony is in the record from a Chrysler executive.

Bankers Trust is now Deutsche Bank because of our tax code. Amoco is now BP because of our tax code. And we will see more and more and more of that if we do not get serious about eliminating the massive negative impact of the way that we tax foreign source income. This FSC part is only one small part of that entire problem. I will work very, very aggressively with you in trying to find an answer to it.

Mr. Secretary, there are so many things that I would like to ask about. I am going to limit it to a couple and then the other members, of course, will want to have their turn in the questioning.

You provide significant increases in spending, but you do not talk about how we can eliminate wasteful spending. We just found out that the Defense Department's records are so bad that we cannot even have an audit to determine missing billions of dollars. The same is true of the Department of Education where billions of dollars have been unlocated.

It seems to me that we should start talking about eliminating wasteful spending before we start talking about increases in spending.

Let me go on to the debt. I am looking at the figures in your budget relative to the aggregate debt of this country. If I read them correctly, they go up every year from 2000 through 2013, necessitating an increase in the debt ceiling. Yet you say that you are going to pay off the debt. Obviously, you are not paying off the debt

if we have to have an increase in the debt ceiling. It is almost like a shell game. You are transferring debt being held from one group to that being held for another group, but the aggregate is going up. And, that is still money that future taxpayers are going to have to pay off. Those debt service charges continue to go up. They are going to have to be paid.

I think we ought to be very forthright with the American people, both the Republicans and Democrats because we both get involved in this. Neither party is not paying off the debt. The debt is going up. And debt service charges, depending on what interest rates are, are going up, too. That is a very serious factor for this country.

Then finally I would ask you to comment on why you believe that you need to have $14 billion of extra revenue coming into the Federal Government at a time when the tax take is the highest in peacetime. Your budget, integrating all the revenue items and all the tax reduction items, is a net $14 billion by your numbers. It may be different by CBO and Joint Committee—we haven't had time to get those numbers yet. But by your numbers, it is an increase of $14 billion that will be taken into the Federal Treasury on a net basis.

For the life of me, I cannot understand why the productivity and the people of this country are going to have to put more money into the Treasury at a time when revenues are skyrocketing. I would be happy to have your comments on that.

Mr. SUMMERS. Mr. Chairman, I am glad you have given me the opportunity to address three important issues.

First, with respect to Government waste, we have over the years taken management to the Government very seriously. That is why the civilian labor force in the Government is one-sixth smaller than it was in 1993. Treasury, for example, has reduced its work force by 10 percent, even though there are a lot more tax returns and a lot more people crossing the border than there were. We think that represents real progress, although there is a lot more to do.

You are absolutely right in raising the concern about funds that cannot be fully accounted for. When these programs began taking on the task for the first time of accounting for all Federal assets as a result of legislation we worked together with Congress on in the mid-1990s, there was far more in the way of unaccounted for assets. Year after year we have improved the quality of financial controls. That is a crucial task for us all to continue.

But let's recognize that we are making progress in improving our financial control. We are making progress in shrinking Government. We are making progress in shrinking civilian Government for the first time in a very, very long time.

Chairman ARCHER. Mr. Secretary, very quickly—yes, so much more to do and so little time.

Mr. SUMMERS. There is a great deal to do. The establishment of a fully satisfactory set of controls is not something that is going to happen this year. It may not be something that happens in the next several years. But we are getting much better controls on these expenditures, and we are doing much more with much less for the first time in a long time.

With respect to the debt, it is the convention of economists, of financial analysts—almost all experts that look at these issues—to

focus on the issue of publicly-held debt. They focus on the publicly-held debt because that represents the obligation of the Government to its citizens and to net out the intra-governmental debt much as in looking at the financial position of my family, one would net out any debt obligation between me and my wife. It was the publicly-held debt figures to which I was speaking. It is that which reflects pressure on credit markets and the unified deficit. I would argue very strongly that experts of both parties would agree that it is the publicly-held debt and the net interest flow of the Federal Government that is relevant for analyzing the Government's fiscal position.

The third issue is an important one, and that is the question with respect to the gross versus the net tax cut. As I indicated, the President's budget has $350 billion in gross tax cuts. It has $100 billion in tax offsets, such as the tax on corporate shelters that I referred to in my testimony.

It also includes a number of other measures that generate revenues for the Federal Government. Some of those are measures such as user fees, which do generate receipts but which we do not think of as a tax. A large part of those represent tobacco policy, which we feel is the best way of stopping a fraction of the 3,000 kids who start to smoke each day, a thousand of whom will die, from starting to smoke. We think that is an appropriate public health investment in our country's future. It is a judgment on which one can disagree, but the motivation for it is very clearly not generation of revenue, it is the protection of the public health.

Chairman ARCHER. Mr. Secretary, again I compliment you on the succinctness of your responses, which the committee appreciates.

A tax is a tax is a tax. A tax on cigarettes means that those people who use cigarettes are going to have less money to spend on other things. It is highly aggressive. It hits very, very hard the lowest income people. It has not been proved to be a deterrent, but it is a tax and it is raising more money out of the economy.

User fees—and you tried to reclassify certain things from a tax to a user fee—but a user fee technically is only something which is voluntary. If you want to use a service, then you pay a fee. That is the technical definition of whether it is a fee or a tax. I would say that what you are calling fees will not pass muster in most cases under that definition.

But in any event, you are raising—by your own figures—$14 billion more out of the economy net than is currently being raised today, at a time when revenues are burgeoning already. We just have a disagreement about whether that is an appropriate thing to do.

Mr. SUMMERS. I think we may.

Let me just emphasize that a large share of the tobacco policy represents a penalty on tobacco companies if they are not sufficiently successful in reducing the incidence of youth smoking. So it seems to me that a fine for failing to achieve a public health objective as a policy—one could argue both sides—it does not seem to me best to think of it as a tax.

And of course, nobody has to pay any of this who chooses not to smoke. So by your voluntary criterion—which I am not sure I

would agree with—but by that criterion, one could distinguish the tax.

I would like to bring up one other point. It is sometimes suggested that taxes are at some kind of high level at this point. I would hasten to observe that if you look at the tax burden on a family with half the median income, the median income, or twice the median income, it is lower than it has been at any time in the last two decades. It is true that taxes relative to GNP are at a high level. That is a reflection of two things. It is a reflection of the fact that income is at a high level relative to GNP because of the strength of the stock market and all of that, and it is a reflection of the fact that—something we are working to try to address—the income gains over the last two decades have gone heavily to those who are in higher tax brackets and heavily in the form of profits that are particularly heavily taxed.

Those two considerations account for the tax to GNP ratio having risen. But I think we do need to be clear to anyone who is listening to this hearing that if you measure the tax burden on a family with the given median income, that tax burden at the Federal level for either income taxes or income plus payroll taxes has fallen over the last two decades.

Chairman ARCHER. No matter how you spin it, Mr. Secretary, the take out of our economy is at the highest percentage of GDP than at any time in peacetime history. that money is coming out of the productive private sector into the Government. And the danger is that will perhaps be a magnet to pull up the total spending level which may become entrenched at the highest level of GDP in history and which then would be difficult to maintain if you have a change in the economy.

I would love to discuss this more with you. You are the economist and I am not.

Mr. Rangel?

Mr. RANGEL. Thank you, Mr. Chairman.

I find intriguing that the cigarette tax is not a tax but a penalty because I have been wrestling with the Republican marriage penalty tax relief. They are giving the relief to people who have no penalty and indeed have a bonus. So it would be good if we could have a course between the White House and the Congress in what worries me.

But I like the word penalty instead of taxes. [Laughter.]

Mr. RANGEL. Let's see what we are up against.

When the President met with the congressional leaders, were you present?

Mr. SUMMERS. Yes.

Mr. RANGEL. It has not been shared with us in the minority, but do you have some guideline as to where the Republican leadership is taking us with the tax bill?

Mr. SUMMERS. I think it is best to let the Republican leadership state their own intentions. I would rather not be put in a position of trying to characterize or predict their judgments. I am happy to speak for the Administration.

Mr. RANGEL. Was this a secret meeting you had? This was a meeting to determine if we could cooperate—I thought—between

the Congress and the Executive Branch. I assume they wanted to work with the President.

Mr. SUMMERS. I think there is a sense that we would like to work together. We in the Administration would certainly like very much to work together with the Congress, both houses and both parties, to try to accomplish the key things I have been talking about: paying down the debt, helping health, helping—

Mr. RANGEL. No, it is clear where the Administration is coming from. But we do not have a budget from the Republicans, so we do not have a blueprint to work with. I assume that nothing was given to you to share with us.

Social Security—we don't have a bill in the House. Was that discussed with the President to see whether we could work together on that? It doesn't bother me that they don't talk with me, but did they talk with the President about a bill on Social Security?

Mr. SUMMERS. Certainly there is no specific private proposal of which I am aware.

Mr. RANGEL. I would hate to see this year go by without us really dealing with the question of education initiatives. It is so important that our country be prepared to keep up with the advancements in technology. I know many of my Republican friends would want to support some initiatives there.

Certainly the earned income tax credit provisions is just the equitable thing to do with so many people becoming instantly wealthy. This would give an opportunity to pull hard-working people out of poverty.

The Speaker has said that he shares the new market initiatives working with the private sector. Have people talked with you about how we have to work this thing together, especially the tax portion of it?

Mr. SUMMERS. My hope would be, Mr. Rangel, that coming out of this hearing we could move toward trying to establish a framework for the budget this year into which some of the crucial tax components could fit. In addition to the earned income tax credit, school construction, and the digital divide you have mentioned, I would highlight the alternative minimum tax and the retirement savings questions as areas where I very much hope that we can work together.

Mr. RANGEL. It is clear that many objections are going to be raised from the points of view of you, the President, and the Administration. I am trying desperately to find out if you got a sense of any areas in which the majority can work in positive ways with the President, or are we just talking about your hopes and the President's hopes?

Mr. SUMMERS. I think it is best for me not to hold myself out as a spokesman for the majority, Congressman Rangel. Certainly I think we have all seen and welcomed statements indicating a desire—such as the one the chairman expressed today—to work together on a range of issues. My hope would be that this would prove to be possible.

Mr. RANGEL. Now that you have all these hopes on the table, there is a bill coming to the Floor tomorrow, a marriage tax penalty bill.

Did the Republicans discuss this with the President? It was included in his State of the Union, and while it is a dramatically different approach, did they reach out to you to try to work something out on this issue?

Mr. SUMMERS. No, I have communicated my view in a letter to both you and Chairman Archer with respect to that proposal.

Mr. RANGEL. What is your view in respect to this proposal?

Mr. SUMMERS. I have written indicating that the President believes that it is important to address marriage penalty issues, but it should done in the right way, in the right framework, at the right time and expressing the judgment that I and the President's other senior advisors would not be able to recommend that he sign the current legislation because of an absence of an overall framework for a tax cut of this magnitude.

Mr. RANGEL. I have been used as an interpreter for White House language, and I have been telling my friends that you not recommending that the President sign means veto, but I understand that you cannot say that.

If you are going to veto the bill, and they are still going to push the bill, then it seems to me that your hopes for cooperation in taxes are not well founded.

Mr. SUMMERS. I am an optimist. I think there are real opportunities this year. It seems to me that there is a great deal of consensus on the idea of paying down debt. I have been encouraged by the number of people who have shared the view that we need to provide that prescription drug benefit, by a number of people who recognize that choice in Medicare is possible without financial coercion, and who see that really in the tax area the priority is helping middle class families at crucial points in their lives and particularly helping those who have been left behind. I think there are an increasing number of voices who are recognizing that.

My hope would be that it would be possible to work together to do things that will strengthen our national economy because it won't always be this strong. This is a moment when we have a real opportunity to work together.

Mr. RANGEL. Your inspiring presentation has given me now hope. So I am going to hope that the majority would put the Archer-Shaw Social Security concept into some type of legislative language so that we could get the Administration to look at it. I am going to hope that the death penalty provisions and the tax cuts that have been placed on the patient bill of rights and that the Republican retirement savings incentives and the tax cuts that are on the minimum wage bill and the exciting education saving accounts and the community renewal and the repeal of the Social Security earning test—I am only up to $1.4 trillion, but this is still part of an overall concept the Republicans have put together in small parts.

We only have the first slice of this trillion dollar package for tomorrow. But if you have hope, I am going to have hope that one day the majority would come to us with the rest of these very important issues to see whether we can work together with you and the President. But if that doesn't happen, you might want to pick out the most important things, like the vaccine and the trade bills, and then maybe we will operate on plan two.

But I am going to have hope, too.

Mr. Chairman, I hope you were nearly as inspired as I was by the Secretary's eternal desire and hope that you and I work more closely together.

Chairman ARCHER. I am always inspired by your comments, Mr. Rangel. [Laughter.]

Chairman ARCHER. Mr. Crane?

Mr. CRANE. Fist I would like to remind Mr. Rangel that Congress makes policy. The function of the White House is to administer policy.

Let me touch on one other thing that is a major concern because it can have a profound impact on our ability to remain competitive in world markets.

Our chairman talked about how his consumption tax would eliminate that disadvantage that potentially we are confronted with. I pushed for a flat tax for 30 years that would eliminate any tax on business whatsoever on the grounds that they don't pay taxes in the first place. That is a cost like plant, equipment, and labor. You have to pass them through and get a fair return. Either one of those approaches would eliminate that problem that we are facing.

One other issue you touched on, Mr. Secretary, is the tobacco tax. Are we contemplating taxing sugar, too?

Mr. SUMMERS. I am not aware of any proposals the President has put forward.

Mr. CRANE. Because excessive consumption of sugar puts on all that fat, and that is injurious to your health. Shouldn't we punish people for going down that path?

Mr. SUMMERS. That is not something—let me emphasize the thrust of the President's policy in the tobacco area. It is focused on kids. It is focused on people below what we normally take to be the age of consent, who become addicted before reaching the age of 18. I don't remember the precise figure, but it is something like three-fourths of smokers have become addicted before the age of 18.

So it becomes a rather different kind of context than a number of other issues.

Mr. CRANE. If you will yield, Mr. Secretary, putting that huge tax on a pack of cigarettes—that is going to discourage that teenage from going to the market because he can't lay his hands on all that money. Is that it?

Mr. SUMMERS. Let me just say that there is an extensive body of evidence that on another occasion, if the committee is prepared to take this issue up seriously I would be pleased to come present to the committee documenting the price responsiveness of cigarette demand, particularly among young people to the level of prices. That evidence comes from cross-State comparisons. That evidence comes from inter-temporal comparisons. That evidence comes from international comparisons. It is corroborated by the work of Nobel Prize winners like Gary Becker.

There are a number of aspects to the tobacco question that one can debate, but the proposition of price elasticity in response to the tax I think is one of the better established facts in empirical microeconomics.

Mr. CRANE. I hope it doesn't encourage any young kid who has a breakdown in terms of moral standards to engage in increased theft and stealing to finance that bad habit.

Now let me turn to another subject that is of major concern to me, and it has to do with trade. Given the failed outcome at Seattle, how have our objectives changed for achieving further trade liberalization, and what is the Administration's strategy for achieving those objectives?

Mr. SUMMERS. Congressman Crane, we are engaged in quite active consultation with a number of countries around the world to try to establish a basis for consensus that would allow a new round of WTO to move forward. Crucial issues include agriculture, the treatment of services, the definition of what kind of rules will apply to investment—if that is going to be a subject that is going to be treated—and of course, what kinds of discussions are going to take place with respect to issues of environment and labor.

The President spoke in considerable detail to the U.S. position in his address in Davos and made what I think is the central point, which is that there is no alternative to a free trade open market approach, but that for such an approach to be sustainable and successful, it is essential that it be complimented by efforts to address the other consequences of global integration. Much has taken place as interstate commerce increased in the United States in the first part of this century.

I would say that in terms of starting the round, in terms of moving ahead with trade, the most important decision that will be made in the United States will be the decision as to whether Congress gives impetus to the global trading system by passing China's entry into the WTO and by passing the Africa and CBI initiatives. My hope would be that it would be possible for us to give in to that system through those two pieces of legislation.

Mr. CRANE. I have one quick question. Many foreign delegations and others expressed concern over the President's remarks regarding labor standards and trade sanctions in Seattle. With those comments still echoing in the minds of delegates, how can we take the next steps to create an atmosphere of cooperation?

Mr. SUMMERS. We have been speaking to countries all over the world. I had a chance to discuss these questions on my visit to India and Indonesia. I think there is an increasing recognition that it is absolutely unacceptable for labor and environment to be used as cloaks for protection. But at the same time, if we are all coming together in a smaller world, we have to find approaches to address what everyone agrees is a real problem.

Children who are working in mills rather than being in schools, and environmental problems that cross international borders—we are going to have to work to find a formula. I think there is now considerable agreement on ends, and the question and issue really goes to means.

Chairman ARCHER. The gentleman's time has expired.

Mr. Thomas?

Mr. THOMAS. Thank you, Mr. Chairman.

Welcome, Mr. Secretary.

I was pleased to see in the written testimony you provided, on pages four and five, that you focused on modernizing Medicare.

However, in the first paragraph you say, "But there is now a very broad consensus that it is time to reform Medicare." So my assumption is that modernizing is also reform. I would not want to get into a semantic squabble about what is going on.

I am also pleased because in that first paragraph, in talking about the President's interest in extending competition—that was one of the core interests of the Medicare Commission—I was pleased that the President chose you and your Department to put together a competitive market structure for future service.

I think the majority is ready to sit down and talk about competitive models both for fee for service and for managed care. Some of the President's proposals we think are forward-looking and positive. Obviously there are some items that have been presented to both Democratic and Republican Congresses and simply have not been accepted. But the core of working together is there.

Should I read anything at all into the fact that the White House chose the Treasury Department to put together a competitive model on Medicare rather than using the Health Care Finance Administration, which is currently charged with the responsibility of running the old-fashioned structure of Medicare?

Mr. SUMMERS. Let me just say, Congressman Thomas, that I appreciate the kind words about the Treasury Department, but I would hasten to point out—as is the case with virtually all of the proposals that the Administration puts forward that reflect the hard work of an interagency process overseen by a principle—

Mr. THOMAS. I understand that, but I have a short period of time, and my question would be: Was there any discussion, or are you at liberty to be able to tell us?

In looking at the models the Treasury Department put together, from my perspective it was not inconceivable that you could have simply then added a little frosting on top of that nice cake you baked for competition saying we should use a new entity to oversee the competitive model.

We, of course, on the Commission would have called it the Medicare Board. You can call it anything you want as long as Treasury is the one that proposes the structure.

Is that an area you think we could work toward modernizing and reforming Medicare?

Mr. SUMMERS. The Administration has real concerns about making sure that there is full political accountability with respect to any mechanism that is established for overseeing competition. But we very much want to be in discussion with the Congress to find the right approach to choice.

Mr. THOMAS. I appreciate that.

So if I have the Thesaurus that the gentleman from New York has where you won't say "veto", you didn't say "no". So my assumption is that is an area in which we can work, and I appreciate that response.

One of the concerns in terms of reform in the next paragraph on prescription drugs—it is still a kind of stand-alone proposal which isn't integrated. Frankly, prescription drugs as part of the tool chest for medicine today really does tend to integrate the use of drugs with other more traditional medical practices. I would hope that we have the ability to move forward on looking at perhaps an

integrated prescription drug program along with more traditional Medicare.

I also noticed that the President changed the proposal from last year because I know there was major criticism along the fact that it wasn't a very good structure you proposed because you had to have a certain level to get your money back at the front end, and then at the $2,000.00 amount people were paying 100 cents on the dollar. I wish I could have seen some structure to this $35 billion proposal, but I assume that is going to come out.

Last question. I assume you folks did not recommend a veto to the about $16 billion adjustment to Medicare called the Balanced Budget Refinement Act. The President signed the bill. So my assumption was that where we placed the money—especially for hospitals, outpatient, for skilled nursing facilities, and for home health care—that all of us were concerned that seniors were going to be denied services because the original package in 1997 did not have as finely crafted tools that we would have liked to adjust the marketplace.

CBO is now telling us—and I am anxious to see what OMB's numbers are—that from just the last baseline estimate to today's revision we are going to be getting about $62 billion over five years of ongoing Medicare savings. In light of those numbers, why would the Administration recommend cutting Medicare by an additional $70 billion over 10 years when you just voted last year to put $16 billion back in?

Mr. SUMMERS. Congressman Thomas, we will be getting new information on the long-run baseline when the actuaries prepare their report on Medicare in April or May. The Administration certainly did hear the same voices the Congress heard in passing the Balanced Budget Refinement Act last year. Our proposals do contemplate certain economies that we believe are still possible within the Medicare program, but does so in a rather more limited—

Mr. THOMAS. I am sorry. Did I read the budget wrong? There isn't $70 billion of reduced payments which are extenders for the BBA? Did the budget not contain that?

Mr. SUMMERS. I indicated that it does, but I indicated that those proposals were scaled back from the proposals that had been contained in last year's budget and—

Mr. THOMAS. So instead of $109 billion in cuts, you scaled them back to $70 billion in cuts. That still doesn't answer the question of why you voted to put money in last year and you are still on a track of—albeit reduced cuts—$70 billion over 10 years of cutting back on Medicare when we are trying to get it right.

I guess my response to you would be, I would love to sit down and work on the competitive model. I think we can save some money over projection and that we ought to take any surplus that we are now getting from Medicare and reinvest it so that we can create a better Medicare, but not go back to the old-fashioned cutting of Medicare, which to a very great extent is what the President's program offers. If we can make savings, then we don't have to make that massive transfer in the President's program to argue that we can get to 2025. We know we are going to make it to the teens, and there can be some mid-course corrections so that if Medicare is saving money, we can reinvest it to build a better

Medicare, include prescription drugs, and more importantly take care of low-income seniors.

I really don't understand why the President offered $70 billion of Medicare cuts over 10 years.

Mr. SUMMERS. Could I turn that to Ms. Mathews?

Chairman ARCHER. Ms. Mathews, as quickly as possible, please. The gentleman has exceeded his time.

Ms. MATHEWS. I will be brief.

Our proposals get back to something the chairman raised in his first presentation about waste, fraud, and abuse and assuring that we make appropriate payments. We believe that the proposals this year are not extenders as we did last year, simply taking a policy and extending it, but instead we are looking at areas such as competition and other places where we believe there are inappropriate or double payments or those sorts of things.

Mr. THOMAS. So last year you were cutting back on potential benefits, this year you have tweaked it a little bit and the $70 billion in reductions are not in fact squeezing Medicare under extenders? You are saying that there are no BBA extender positions in the President's budget?

Ms. MATHEWS. In the policy last year—

Mr. THOMAS. The question was, Are there no Medicare extenders in the President's budget which would cut Medicare?

Ms. MATHEWS. In the President's budget there are some of the things that were included in last year's package.

Mr. THOMAS. And that is why this year's is less than last year's because you are simply cutting from the $100 billion plus to the $70 billion?

Chairman ARCHER. The chairman is constrained to transfer further discussion of this into the hearings of the Health Subcommittee, which will I am sure be voluminous this year.

Mr. THOMAS. Mr. Chairman, I would love to have the Secretary there, but they never send him.

Chairman ARCHER. Maybe you can get Ms. Matthews to come.

Mr. Matsui?

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

I would like to make three observations and then ask one question, Secretary Summers.

First of all, I want to thank you and Ms. Matthews for being here.

I appreciate very much the fact that you mentioned the three trade bills, the CBI, the African Trade Bill, and China's entry into the WTO. I think the fact that you mention this in a budget hearing shows the commitment of the Administration to pass all three of these this year, obviously with the cooperation of the House and Senate.

Secondly, I would like to discuss briefly the comment the chairman made with respect to the President's resolve in terms of Social Security. He said that the President can't deal with this issue this year.

The President certainly is willing and wants to complete Social Security and have a reformed package across his desk this year. The problem is that it is in our hands—Congress—at this time. The President came up with a proposal in the form of the Bradley-Ran-

gel Bill last year. The Administration in its budget package has come up with a proposal. It gives a 50-year life to Social Security. Now the issue is, How does the Congress deal with it?

We can continue to keep pressing the President, but he has a proposal and now it is really up to us.

Lastly—and I don't need a response on this right now in terms of my comments—Mr. Rossotti is doing a very good job in terms of management of the IRS, but there is a concern, according to press reports, about enforcement and collections. I really hope that you in the Treasury Department will really get into this issue. I know Mr. Rosetti is trying to address it. But nevertheless, I am afraid that if we allow this process to continue on for an indefinite future, we could find ourselves as we were in the early 1980s where collections were down and morale was down and obviously we had a huge underground economy—tax reform somewhat brought it back.

But I know the direction. We don't want abuse, but on the other hand, we want to make sure that the principal focus of the IRS is collecting taxes that are legitimate.

The last thing I want to ask you a little bit about is FISC. I think the chairman raised that issue.

We did have DISC, as you know. That was declared ineffective or inappropriate by the GATT in the early 1980s, and then we came up with the DISH. We appealed the loss we had and I understand the decision should be sometime in the next few months. Under the WTO's ruling, we have to come up with a final approach to this issue by October 1st of this year.

This is obviously a major incentive for U.S. corporations to export. If we lose this opportunity by the third quarter of this year, it could have a significant impact on our competitiveness.

It is being appealed now. Is there any effort by the Administration to try to come up with a compromise on it with the Europeans who filed the initial action? Is there any effort to perhaps take a look at some alternatives? I don't want to concede a loss yet, but at least we need to have something in place if in fact we are not successful.

Mr. SUMMERS. On FSC, let me say that this is a very important issue. I have asked Deputy Secretary Eizenstat to take the lead in the Department and for the Administration on this issue.

The case was appealed on January 19th and January 20th. Our people felt that they received a fair hearing and a number of aspects were explored. We don't yet know the decision.

Clearly what would be best, from our point of view, would be a decision that upheld the U.S. position. We are working very hard in an advocacy context for such a decision. In the event that such a decision is not forthcoming, I think it will be important to work as a matter of urgency to craft a solution that preserves the incentive and does so in a way that is WTO-legal. We will be pleased to work with members of this committee and Senate Finance Committee to achieve that objective in as expeditious and effective a way as possible.

I might just mention if I could, Congressman Matsui, with respect to your very thoughtful question on compliance, that this is something that Commissioner Rossotti and I have talked a great deal about. I think it is our feeling that perhaps the greatest threat

in that area to the integrity of the system is around the corporate tax shelter issue. And the essence of that issue is, frankly, a tendency to play with what some refer to as the audit lottery, carrying out these transactions and just sort of hoping that nobody notices.

The commissioner has taken a number of administrative steps to increase enforcement in this area, but it is our feeling that containing the abuse problem—and again, this is a separate issue from what everyone thinks about—containing the abuse problem will require certain legislative remedies. It would be our hope—regardless of what happens on the larger tax picture but just in terms of maintaining the integrity of our system—that is something that we all could discuss this year.

Mr. MATSUI. Let me say this—I know my time has expired and you do not need to respond to it—but I think it is important to deal with obvious tax shelters. It is about $23 billion to $30 billion over five years. But the larger issue in my comment to you was the potential for people to say that they do not have to comply any longer because it is a voluntary system. We don't have to comply any longer because the Service isn't going to check up on us and enforce the laws anyway.

If you recall, back in the early 1980s, we were talking about a potential loss. In an underground economy, it went from $100 billion to $200 billion a year. I am talking about a much larger issue that I think deals with the whole process of the Service and what it stands for.

Mr. SUMMERS. You are raising a very crucial issue. I see Congressman Portman sitting who has been enormously thoughtful as a member of the Commission on these issues.

The judgment that we have come to—and it is really heavily Commissioner Rossotti's judgment—is that just as business has moved past the idea that there is a trade-off between quality and cost, and have come to recognize that pursuing the highest quality is often the way of pursuing the way of the lowest cost.

And thinking of this in terms of a pendulum that swings between customer service and enforcement is not the right way. We are working very hard. I think it would be a serious mistake for anyone to rely on the IRS' lack of enforcement capacity in the years ahead. I think we are going to be providing better service to the vast majority of honest taxpayers—more appropriate service for the small minority of dishonest taxpayers.

But this is an absolutely critical priority for us. If you look to Commissioner Rossotti's exemplary report on his first two years and his strategy for the IRS going forward, I think you will find that it is responsive to the kinds of concerns you are addressing, which are enormously important.

Chairman ARCHER. Well stated, Mr. Secretary.

The gentleman's time has expired.

Mr. Shaw?

Mr. SHAW. Thank you, Mr. Chairman.

Mr. Secretary, a few minutes ago you described yourself as an optimist. I have been an optimist, particularly on Social Security. The other day I saw a report that said that optimists live longer, which made me more optimistic. But I will say that I am losing my optimism when it comes to the question as to whether this Presi-

dent or this Congress is going to be able to work together to solve the problem of Social Security.

I also have to express profound disappointment that in a 12-page statement that you have provided us here in the Ways and Means Committee, only a half-page is devoted to Social Security, which consumes a very large percentage of the budget over which you preside. And this hearing is about the national budget.

But my optimism is further diminished into pessimism when I read what is contained in that actually less than a half-page, that the Administration is suggesting two things with regard to Social Security reform. One is accumulating more Federal debt within the trust fund—which you and I both know, as we have discussed in the past, will be a call upon our kids and grandkids to pay off. This is not a real economic asset. Chairman Greenspan has testified to that. As a doctor in economics, you are well aware of that. So this really does nothing to help our the further generations, even though we may not run out of Treasury bills until 2050 something under the President's plan.

As those Treasury bills are paid off, that is going to call upon the taxpayers, and we get closer to a situation where we are going to have two workers supporting each retiree when Social Security originally had 40 some workers supporting each retiree. What an awful thing to leave to our kids and our grandkids, that for them to pay for their parents' pensions, there will only be two of them paying into the system to take care of them. This is a terrible legacy.

And I am also very, very disappointed by the fact that the President has proposed in his budget that we use the Social Security trust fund to buy into the corporate sector of this country. That is classic privatization of the Social Security trust fund. The American people don't want it. Poll after poll say that they don't want it. I don't think there is anyone on either side of the aisle supporting privatization of Social Security. I don't think the President has any takers with this.

So you have not only given us something that is dead on arrival, this thing died months ago. This thing died years ago when the President first brought it up and pulled back from it. Now it has gone nowhere.

I would also like to say to my good friend Charlie Rangel—he is talking about reaching across the aisle on January 5th in a letter—I asked him to comment on the Archer-Shaw plan. We have been reaching out. We reached out to the leadership on the Democrat side in the Congress—Mr. Gephardt and the other Democrat leadership—and we have been met with nothing but a wall of silence.

In order to solve the problem of Social Security in this country, it has to be done in a bipartisan fashion. And you can't do it in a bipartisan fashion unless we are willing to reach out across the aisle and work with each other. There is no question in my mind but that we are being stonewalled as a political motivation.

I am not talking about people necessarily on this committee, but I am very concerned that we are getting absolutely no leadership from the White House on this and we are getting no leadership from the Democratic leadership with regard to saving Social Security. It is time that we move together.

The President has put out as part of his budget and plan—he has had it sitting out there for several years there—the question of USA accounts. Those are private accounts that are set up for American workers. Why can't we bring that into the Social Security system so that it leaves the Social Security system totally alone, as Mr. Archer and I do in our plan? We don't touch it. It stays exactly as it is, but we take funds and set up individual retirement accounts.

Don't take it out of Social Security. It is totally separate and apart that is out there for the retirement of tomorrow's seniors that will be used to save the system so that they won't get absolutely lambasted by a system that our generation refused to fix.

Would you care to comment on that?

Mr. SUMMERS. You have raised a number of very important issues in your comments, Congressman Shaw. Let me just first say that I did have an opportunity to testify before the committee in early November on Social Security, as you know. At that time I had a rather lengthy and detailed statement defending the Administration's perspective and presenting the Administration's perspective. I also provided rather extensive comments on the individual accounts approach. So we certainly have done our part in reaching out and seeking to consult to find a common solution.

Mr. SHAW. I have to interrupt here.

I delivered to you a letter personally to be delivered to the President just asking him to meet with Mr. Archer and me or someone on this side in order to try to map out this private ground.

This was done months ago. This letter was sent to you and you assured me that you were going to deliver it to the President's desk, and I am sure you did. I have heard nothing.

Mr. Archer and I have sent letters to the President. We have heard nothing. The President told us over a year ago at the White House Summit on Social Security that he was going to be sending us a plan that would save Social Security for all time. We are still waiting.

What is wrong?

Mr. SUMMERS. Congressman Shaw, from my perspective, looking at this as an economist, we have a defined benefit pension plan that works well for beneficiaries, that is at this point under-funded. That is the actuarial deficit.

It seems to me that the responsible course for the trustees of a defined benefit pension plan that is under-funded in the private sector context would be to look and see if it was an extremely profitable year so that larger contributions could be made and—

Mr. SHAW. Mr. Archer and I have introduced a plan that also continues it as a defined benefit pension plan with the possibility of increases in the amounts people are relying on in retirement.

Mr. SUMMERS. And I think we have recognized that the proposal you have put forward is a valuable contribution to the debate. We have expressed concerns about the magnitude of future budgetary commitments that are implicit in a proposal of the kind that you and Mr. Archer have put forward. There are concerns about what it could mean over the longer term for the ultimate coalition and progressivity that Social Security depends on. There are certain

concerns about administrative costs and the fraction that would be used up in administrative costs within a proposal of that kind.

But we are very much prepared to discuss—if there is formal legislation embodying it—we in the Administration and the Treasury Department would certainly be prepared to provide commentary with respect to that formal legislation and our concerns regarding it.

But I would urge you, Congressman Shaw, to take seriously the plan that the President has put forward as something that we can feasibly accomplish this year. I think it is not accurate to suggest that it is simply placing I.O.U.s in the trust fund because every penny that is contributed to the Social Security trust fund in the President's plan represents a direct allocation of interest saving that has resulted from debt pay-down. Therefore, we are taking resources and transferring them from one use—a sterile payment of interest—to another use—the meeting of an existing obligation for Social Security. I think that is fiscally responsible.

I think it is responsible, as the trustee of a large pension plan, to look at the way its assets are managed, and to be very reluctant to see those assets managed in a way that earns a lower return than almost any other defined benefit plan in the country.

That is why we introduced the discussion of equities. If others prepared to rule that opportunity out, I think that is an unfortunate reduction in the scope for us to compromise and find common solutions. We very much would like to see this get done, but it does depend on a willingness to take each other's proposals seriously. I think the Administration has put forth a very constructive foundation for anything that is going to happen in the Social Security area by extending the life span of the Social Security trust fund out past the life span of the baby boom generation, and doing so in a fully paid-for way based on debt reduction.

I think it should also be supplemented by investment policy changes, but that is an issue that can be separated in either direction from the issue of debt pay-down.

Mr. SHAW. I know my time is long past, but I would like to say that the American people do not want us to privatize the Social Security trust fund, and Republicans are not going to privatize the Social Security trust fund. But we are very anxious to talk to the President or talk to you to try to hammer out a program. You know our telephone numbers, the President has our telephone numbers, and we are waiting for the phone to ring.

Mr. SUMMERS. Congressman Shaw, you have used the phrase "privatize the Social Security trust fund"—I would certainly agree that it would be a very poor idea to privatize Social Security.

Mr. SHAW. But that is what you do by buying corporate equities out of the trust fund. That is what your statement said. I did not make that up. You can read it back into the record, if you want to, but that is what it says.

Mr. SUMMERS. Let me say that I don't think of the Federal Employee Retirement Fund as being privatized. I don't think of the Pension Benefit Guarantee Corporation as being privatized. I don't think of the California Public Employees Retirement System being privatized, even though each of those entities do, as is the best practice for defined benefit pension plans, invest in equities.

Chairman ARCHER. The gentleman's time has expired, but since my name has been mentioned a couple of times, I feel compelled to very briefly make a couple of comments.

The American people do not view the Social Security trust fund in the same way they do the other pension plans you mentioned, Mr. Secretary. It is a very sacred fund to the American people.

And the American people do not trust the Federal Government to invest that sacred money in private corporations for two reasons: number one is risk, and number two is their view that the Federal Government should not have the potential to control any private corporations in this country and thereby be in a position to set policy. Those are the concerns Mr. Greenspan has and those are the concerns of 80 percent of the American people.

Very quickly, the President's so-called plan in your budget is not really a plan, Mr. Secretary. It is simply a placeholder. It simply makes a promise that in the years ahead, when there is a shortfall in the fund, that the Treasury will write a check to the trust fund from general revenues. That has never happened in the history of the trust fund. That sacred trust fund has been set apart from the general treasury.

I am surprised that AARP has just not gone up the wall about this because year after year after year it has opposed infusion of general treasury funds into the Social Security trust fund. There is no immediate reform in the President's so-called plan—no restructuring, no reform—other than the small part of the fund that would be invested in the private sector to gain added earnings. You might call that a reform, but that is a reform that is dead on arrival with the American people.

So there really is no reform. It is a placeholder.

Finally let me say, as you know, Congress has never been able to handle a significant reform of Social Security. It has happened either from presidential leadership, as it did with President Carter in the late 1970s, or it has happened through the creation of a bipartisan commission as in the early 1980's. No other major reform of Social Security has ever occurred simply from within the Congress.

I have tried as hard as I know how. I have tried to get Mr. Rangel to come over and say, What can we do to join together on a plan? I have talked to minority leader Gephardt. Nothing has happened because Congress cannot develop this within its structure. It just has never been able to do so.

But the White House opposed the Social Security Reform commission that we created in this committee, which had strong bipartisan support and was passed by the House of Representatives because the President said that he had his own plan. He called for a national dialogue culminating in a White House conference which would launch a bipartisan effort. I had high hopes after that conference, as I walked across the street from the Blair House to the White House with the President.

I don't believe that I am at liberty now to repeat the private commitments that he made to me, but they are very different from what has come out publicly. And I am not trying to create controversy between me and the Congress and the White House, but

I will simply say that this will not happen without aggressive, direct Presidential leadership.

As a result of the Administration's flip-flop on this issue we will not find the solution to Social Security this year. I am terribly, terribly saddened about that. And I apologize to the committee for resuming on the time of the committee.

Mrs. Johnson?

Mrs. JOHNSON. Thank you, Mr. Chairman.

Mr. Summers, I have a rather specific question, but I certainly do want to put on the record a couple of other things.

First of all, at the beginning of this hearing it looked like this committee had been acting in a very partisan fashion. I want the record to note that the subcommittees are for the most part running in a totally bipartisan fashion, and it is because of the response—when the chairman of the Ways and Means Committee calls the President and doesn't even get a call back, there really is a problem. And I'm proud to say that most of the legislation that actually comes out of this committee comes out as a result of bipartisan action.

There is a lot of ground for bipartisan tax action in this Congress. If you look at the package we proposed to go with the minimum wage bill, much of those details are already in your budget. And unless you are just going to on principle oppose a tax package being coupled with a minimum wage bill, there is plenty of ground for agreement—the low income housing tax credit, the pensions reforms, the expensing for small business, lots of things. And if philosophically we believe that those provisions should help offset the cost to small businesses of increasing the minimum wage so people don't have to get fired and jobs can be protected, I really don't think that is such a bad rationale. I hope it won't be a rationale that will mean that you will a priori decide not to support tax changes as part of the minimum wage bill.

If you look at the health access bill, I have heard the President many times support our proposal to let people deduct the cost of their health insurance premiums. Everybody else gets to deduct the cost of their health insurance premiums except individuals who pay their own health insurance. So in fairness, just plain fairness, there are things we need to do this session. And I will end up with the fairness issue on the marriage penalty bill.

But before I do, I do want to mention that I am very disappointed that your Medicare proposal does not propose any new money back into Medicare. We all know that particularly in the area of hospitals we only deferred certain problems for one year. I have never seen the hospital system, from our sophisticated medical centers on which the quality of American health care depends and the world depends right down to our little rural facilities, under such crushing distress.

I urge you to give specific directives to HCFA that they can make proposals to increase spending in that area, that they are not in the budget but you are going to support them. I don't want to go through what we went through last time with your people sitting over there knowing how serious the problems were, saying we must address the problems, but not being able to make specific proposals because you had cut Medicare in your budget, you cut it again

when you brought the tax package up to try to avoid the 1 percent across the board, and so their hands are tied. Untie their hands. We have got to do something again this year for hospitals. So on Medicare, this is not enough.

On retirement security, I hear you about that and I am pleased there are some pension proposals in here. But your big money is for matching. At least those people already have a pension plan. Fifty percent of working people in America work for employers who provide no pension plan. You have some proposals that will help that. But let's get our money out there so that everyone can have an income stream that will compliment Social Security. And that is why I do not understand why you would take $8 billion more out of the insurance industry that will increase the cost of the kinds of retirement products that are the only option people have to really create a retirement economic security; that is, Social Security and a complimentary privately saved income stream.

So on retirement security, I think there is common ground but I think there are some backhanded hits in your budget. And the irony is that those provisions have already been rejected by this committee and House on many occasions, by Democrats as well as Republicans.

Lastly, let me get to the marriage penalty bill that we are going to vote on tomorrow. I am very pleased that in your bill you do provide for stay at home moms. Now those can be described as people already benefitting from the marriage bonus. That's true. But they are also the little families in America making the greatest sacrifice to live on a single income.

You provide a total of $1,000 new deductibility. Can you tell me how does that compare to the new deductibility we provide for stay at home moms? Because if we care about families and children, we have got to do something about the bias in the system against those who are making the really tough choice of staying home and taking care of their children. And in addition to the provisions specifically for deductibility, then I want to ask a question about refundability.

Mr. SUMMERS. Let me respond if I could to five points in what you raised. First, with respect to stay at home moms, our proposal does, as you say, directly benefit them. We believe it does so in a more targeted, progressive, and less costly way than the alternative that the committee is considering.

Mrs. JOHNSON. But why is it less costly? Because it provides $1,000 and we provide how much?

Mr. SUMMERS. Because it is more targeted to be progressive.

Mrs. JOHNSON. No, no, it is not more targeted to be progressive. I am talking specifically about the stay at home provision which would be the same for every stay at home, as my understanding of your proposal from your write-up in the summary pages. In other words, you are not going to provide a stay at home deduction for a mom whose husband makes more than a certain income.

Mr. SUMMERS. Excuse me, Congressman Johnson, I thought you were speaking about the marriage penalty. I think I now understand that you are speaking about the child and dependent care.

Mrs. JOHNSON. They have the effect that we get from a very simple mechanism in our marriage penalty of helping stay at home

moms or stay at home dads, whatever the case may be. You do it through other programs but the impact is the same. Do you limit that to very low income families?

Mr. SUMMERS. We have certain limits, I don't remember what the limit is, but you receive the full benefit up to an income of $59,000 in our proposal and after that it phases down. My impression is that the limits are somewhat higher in your proposal.

Mrs. JOHNSON. But you take no consideration for the number of children, because $59,000, if you have three or four children, is really still pretty tough sledding.

Mr. SUMMERS. This is something we are happy to work with the Congress on. I think that is a crucial point. In our EITC proposals the question of multiple child families is something we very explicitly pick up on because there is a real problem with the way our tax system and our AMT proposal treats families with multiple children.

Mrs. JOHNSON. Now in the EITC area, have you been able to lower the fraud rate below 20 percent which are most recent figures? Do you have any more recent figures on error and fraud in the EITC?

Mr. SUMMERS. We do not have more recent figures. But we have taken a number of steps, including the allocation of a specific enforcement budget for the EITC, including simplification measures to conform the earned income definitions which we expect will significantly reduce the rate of error, including an outreach effort to tax preparers in this area, and including a requirement that the EITC beneficiaries give their Social Security numbers.

Mrs. JOHNSON. I would just say that having chaired the committee that oversaw that for a number of years, we worked hard to eliminate the amount of fraud there is. If there were an appropriated program that had a 20 percent fraud rate around here, it would not be there long. And for us to expand a tax program that has a 20 percent fraud rate when there are very direct and simple ways to help people, stay at home moms and make families stronger seems to me questionable. But I am very pleased that you do recognize the need to provide better support to stay at home moms. I hope your colleagues on this committee will work with us on that provision in our marriage penalty bill.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Houghton?

Mr. HOUGHTON. Thank you, Mr. Chairman.

Mr. Secretary, good to see you.

Mr. SUMMERS. Good to see you.

Mr. HOUGHTON. I have two questions. One has to do with complexity, the other has to do with the Customs issue in terms of ACE.

On complexity, we have had, and I happen to be on the oversight committee, we have had Val Oveson, who is sort of the taxpayer advocate from the IRS, come up here and he says the number one issue really with taxpayers is tax complexity. I totally agree with him. You take a look at the Treasury introductions to the budget, I have a report here from 1995 and it is that thick, and the one this year is that thick. Proposals of just geometrically increased. This is not just the fault of the Administration. As a matter of fact,

it is the fault of Congress also. We complexify this whole thing. It is bothersome.

Now you have attended this in a certain way in terms of your report. In terms of tax simplification, you say you propose to redress a particular problem with the AMT by allowing taxpayers to deduct all their exemptions for dependents against the AMT. You know, that is a good idea but it really does not get at the complexity because I am making out my tax form and I have to still go through all the arithmetic before I come to the point to where maybe I will have an exemption here.

It is a very important issue. I think, frankly, from a personal standpoint, it is even more important than tax reduction, the tax complexity issue. I do not see really either of us getting at this. And I would appreciate any comments you have.

The second issue is in terms of the customs. We have had the head of the Customs Service up here quite a few times. He has talked about this automated commercial system, ACE, and you know about this. It is really important. The problem is one of money and where does it come from and where does it go. It is going to cost another $200 million and you feel that is a good idea, but at the same time, it should be paid for by user fees.

The business community sort of feels that they have given at the office. In other words, they pay in user fees almost $1 billion and a whole bunch to the Customs Service, about $900 million. And so then to sort of lay on another $200 million doesn't really seem to me to make an awful lot of sense.

So those are two issues, the tax complexity, which is really a huge megaissue, and the other thing specifically in terms of helping our Customs Service.

Mr. SUMMERS. Let me say, Congressman, I agree with what you said about the seriousness of the tax complexity issue and it is something that we are very focused on. I think we have done some things that are constructive; the AMT is constructive, raising the standard deduction and reducing the number of itemizers is constructive, expensing for small business is constructive. But I think there is a lot more that can be done.

I would say that I think this is a largest problem for a small minority of relatively fortunate taxpayers. Some 30 million Americans are able to file their taxes by pushing buttons on a telephone in less than seven minutes. The increased emphasis on the use of software to do this is making many of things that used to be very computationally burdensome much less burdensome. So you are getting a kind of simplification in that way.

But I think this is a crucial issue and it is one that we need to be in a position to work together on. I would be sorry though if that were to be seen as a reason not to extend existing mechanisms. We have tried to work in our budget by achieving some of the social objectives by working with existing mechanisms—expanding EITC, expanding the child and dependent care credit. It seems to me those things provide important benefits to families without creating increased complexity. But I think it is a fair concern.

With respect to—

Mr. HOUGHTON. Can I just interrupt a minute. I really think that we are probably equally to blame with the Administration. But in

something like this you need leadership and it really ought to come from the White House. So last year, you know, there were 28 different tax credits, this year there were 18 or 20. It just seems to roll on and roll on and roll on. So the only thing I ask you is if you could really think in terms of what does the White House do to lead all of us, because that is where the direction must come from on this.

Mr. SUMMERS. We will carefully consider it. I would also say that I think if you probe what people don't like about complexity, some of it is the hassle of filling out their own returns, and some of it is the sense that out of all that complexity somebody else is getting an unfair break. The reason I have put such emphasis in my remarks today on the corporate shelters is that, I think, is an important thing that is stimulating anger or even outrage with respect to the code and that if we do not address it will do so even more in the future.

With respect to ACE, I think we all have a common position that this is very important to get done if we are going to have the efficient flow of goods across our borders. I should say that we in the Department have learned a lot from the painful TSM experience at the IRS, the computer program at the IRS. I think we have this under control so that those kinds of mistakes will not be repeated.

Budget realities being what they are, this program is not it seems to me likely to be fully funded without a contribution of the business community. We have reconfigured the proposal that is in this year's budget relative to the proposal that was in last year's budget so as to make very tangible that the contribution the business community is making is going right to the things that will benefit them. But as important as this issue is, I do not think I could responsibly propose measures that would reduce the number of people who were monitoring narcotics on incoming flights or agents who were doing that kind of work protecting our borders against drug incursions in order to invest more heavily in this computer system.

So my hope would be that we could work with the affected people in the private sector to find a solution. We were very mindful in the design of this year's proposal, frankly, that, as you put it, the private sector had given at the office and we had to find a proposal in which what they were being asked to do was commensurate with some benefit they were going to receive. That is what we tried to do. We are obviously happy to work with members of this committee and the affected trade associations to try to find a solution to this problem.

Mr. HOUGHTON. I think that is really important because the Customs Service clearly is important. This is very, very important for the Customs Service. And you want to have people working with it rather than bucking it all the time. And I think the private sector has really made an enormous contribution already for that.

Thanks very much, Mr. Chairman.

Chairman ARCHER. Mr. Coyne?

Mr. COYNE. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. As a result of last year, the Administration came around to signing legislation relative to rectifying the 1997 Balanced Budget Act inequities relative to hospitals. I wonder

if you or Ms. Mathews could explain in the proposal this year are we doing more to try and rectify the problem that was created as a result of the 1997 Balanced Budget Act relative to reimbursement for hospitals.

Ms. MATHEWS. We do not have a specific extension or additional proposal to the BBRA that we passed last year. What we did, in trying to do our efficiency proposals, is ensure that we take steps that are consistent with what we did last year in terms of increasing competition, as we discussed earlier. For example, in some of our proposals there are distinctions made for rural hospitals that build upon some of the concepts that were discussed as part of what passed and was signed last year.

Mr. COYNE. Well, can hospitals look with any encouragement to additional help in this proposed budget, help from what occurred in the 1997 situation?

Ms. MATHEWS. We do not currently have a proposal, as I said, that extends in the same way that the BBRA did last year. There are proposals such as GME hospitals where we have doubled the funding on the discretionary side from $40 to $80 million. There are specific proposals like that. But I think you are referring in a particular area, and we do not have those.

Mr. COYNE. On another subject, I wonder if the Secretary or yourself could tell us a little bit about who is going to benefit from the proposal in the proposed budget about the Earned Income Tax Credit and extending the benefits. What grade of income level in the country is going to benefit from expansion of the EITC?

Mr. SUMMERS. I think most of the benefits will go to those with incomes between, say, $10,000 and $30,000, and the groups will principally be those with more than two children, married couples who will avoid the marriage penalty, and those who are making special efforts to save who will benefit from the conformity of the earnings definition.

Let me say that the EITC has probably been more successful than any other social program we have had in moving people from poverty to work. I would also say, at this point, when more than at any time in the last 35 years, our economy's issue is jobs looking for people as well as people looking for jobs. Doing everything we can to stimulate work incentives and improve the supply of labor is crucial if we are going to be able to keep growing at these rates without running into a bottleneck.

Mr. COYNE. We have a responsibility in Congress to do everything we can to ensure the solvency of the Social Security program and the Medicare program. But in a time like this when the economy is so strong, it seems that it is time to invest in public infrastructure, to have a growth in the future of workmanship for workers to become more productive in the economy. And along those lines, what is this budget going to do to invest in trying to make workers more productive and also to help the public infrastructure of the country?

Mr. SUMMERS. Let me comment on some components of that and then I will turn to Ms. Mathews if I could. I think probably among the most important infrastructure investments we can make as a country are in satisfactory schools. It is wrong that with all the prosperity that we have children in America beginning the school

day at 4:00 because their schools work in three shifts. Other children in America are going to school in closets. Other children in America have the lunch period begin at 9:45 in the morning because the school facility is so constricted. The restroom facilities in some of our schools are an embarrassment.

If we want kids to take learning seriously, it seems to me we ought to take seriously the kind of facilities that we provide them. That's why one of our priorities in the tax area is the school construction proposal. That is why we are also proposing measures for repair and modernization of schools in the discretionary budget.

More generally, it stands to reason, and statistics confirm what common sense suggests, that when there are fewer kids per teacher the kids learn more. When there is more emphasis on quality, more learning takes place. So we are focused very much on improvement in education. This year's budget includes the most robust improvements in education budget that we have had in a number of years. I think that is an important step.

Ms. Mathews could probably add something on the worker training side.

Ms. MATHEWS. On the worker training side, we are continuing our youth formula grants which include the Summer Jobs programs. There are a number of specific programs, such as the Head Start increase of $1 billion which is starting at the very beginning of the educational process. Additionally, our After School monies which we have put in before are proposed again. There is a smaller schools initiative with regard to infrastructure issues that relates to our building of schools and our modernizing of schools. Another part of that is addressing the digital divide. As part of our school modernization plan on the tax side, we want to modernize and create an ability for those schools to wire and get the computers in. Some of the schools don't have the ability to do that. So those are some infrastructure as well as some programmatic things we do in the area of education.

Mr. COYNE. Thank you.

Chairman ARCHER. Mr. Herger?

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Secretary, it is good to have you with us. I would like to ask you a question concerning a provision that I understand was recommended by the Treasury, was put in the President's budget at the end of the budget cycle this last year and which the Congress passed. I think it was done inadvertently. It had to do with the installment sales method for the accrual method of selling small businesses. The way it used to be, people with small businesses maybe worth $100,000 who would be retiring and would be selling these small businesses. If they sold it over ten years there would be $10,000 per year that maybe they would receive in payments and the capital gains then would be on that $10,000 say per year. What this has done is that now these small businesses have to pay all of the taxes up front, which on $100,000 the 20 percent capital gain would be $20,000.

What is happening is that these businesses are not able to sell for as much. The buyers of these small businesses who many times are unable to obtain credit from the banks, their only way of getting into small businesses is through this method, are unable to

buy. Again, I feel that we are hearing as Members of Congress from literally hundreds of small business people throughout our districts, and it is not just my district, I'm sure every congressional district in the Nation is hearing this.

My question is, were the end results of this anticipated by Treasury and by the Administration at the time that it was proposed? And if it was not, I understand that Chairman Archer did send a letter to the President requesting that this correction be made in the President's budget. My question would be, was it anticipated? And if it was, why was this not included in the President's budget?

Mr. SUMMERS. Thank you for raising that issue, Mr. Herger, which touches on what is a very real concern for us as well. My colleagues in the tax policy area at the Treasury and in the IRS have had a series of meetings with the NFIB and other representatives of the affected parties. I think it is clear that these provisions have impacted in a way that was much more broad than was originally intended. We expect in the very near future to provide regulatory guidance that I think will, at least in a large part and perhaps completely, clear up what have been very legitimate concerns. We are working in tandem with the groups that represent many of the small businesses because this is a serious problem. I would be happy to ask my colleagues to provide you or your staff with a more detailed briefing on what is involved.

Mr. HERGER. Very good. I appreciate that, and that will help us very much because these businesses that are selling right now are being very dramatically affected. I am authoring legislation along with Mr. Tanner from this committee and Mr. Matsui. It is bipartisan legislation. We have some 21 members just of Ways and Means who are on legislation to correct this. Of course, this will take some time. But if you could work on this in the meantime to help these businesses that are being affected right now, that would be very helpful.

I would gather by what you are saying—well, let me just state. We would really appreciate your support as well, not only in correcting it now but in changing the legislation, repealing what I believe was inadvertent certainly by the Congress and I believe, by what you are saying, by the Administration.

Mr. SUMMERS. Let me suggest that those who are more knowledgeable than I about the technical details take this up. You have my commitment to address in a regulatory way the overly broadness of the past legislation. Whether we are in precise agreement on any specific proposal or not is something that I can say until I have had a chance to review it. But I think we will be able to act and act very quickly, frankly, on a shorter timeframe than would be possible legislatively to address this concern in large part. And I very much appreciate your having raised it.

Mr. HERGER. Mr. Summers, thank you very much.

[An additional statement by Mr. Herger was subsequently received.]

Statement of Mr. Herger to Secretary Summers

Rep. Herger: "Mr. Secretary, since 1992 no taxpayer has ever been able to claim one penny of tax credits under section 45 for biomass power production because the code section was drafted too narrowly.

Biomass power provides important waste removal and rural employment benefits to rural communities such as my district in Northern California and around the country. Unfortunately, many of the plants are shutting down or running at reduced capacity.

I have introduced legislation to fix section 45, and I am pleased to know that the President is aware of this problem and has adopted my solution of providing a tax credit for existing facilities.

I applaud the Administration for stepping up to bat on this issue and look forward to working with you to fix section 45 this year."

Chairman ARCHER. Mr. Secretary, obviously, it is going to take some significant additional time to let all members have an opportunity to inquire. My guess is that you may need a wee bit of relief at this point.

So the Chair is going to recess the committee. Hopefully, everybody can grab a bite of lunch and return at a quarter to one.

Mr. SHAW. Mr. Chairman, could I read something into the record very quickly because there was a question as to the definition of "privatize" or "privatization" a moment ago.

Chairman ARCHER. Without objection, so ordered.

Mr. SHAW. In the American Heritage Dictionary, "privatize/privatizing" is described as "To change in industry or business, for example, from government or public ownership or control to private enterprise." And the American Academy of Actuaries describes "privatization" as "The broad concept of investing funds in the private sector which, in turn, implies accumulating substantial advanced funding is known as privatization."

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Secretary, if you can accommodate another five minutes, Mr. Levin is going to have to go to another meeting and would like to get his five minutes of questioning. I will leave it up to you. If you can handle another five minutes—

Mr. SUMMERS. I would be delighted to.

Chairman ARCHER. The Chair will recognize Mr. Levin.

Mr. SUMMERS. I will remain with Mr. Levin as long as Mr. Levin wishes.

Mr. LEVIN. I will take my five minutes. I think the Chairman will grant another five minutes on the other side. Thank you, Mr. Chairman.

Mr. Secretary, Mr. Crane raised the trade issue, and I am glad he did. And in response, reflecting your own views and that of the President as he articulated at Davos so well, you talked about the need for expanded trade and also for an expanded perspective of trade in this new era. And in terms of a new perspective to incorporate considerations of the environment and labor, you referred to child labor. But I trust that when you refer to labor you are talking about, as the President did, issues of core labor standards, not universal minimum wages, but core labor standards as articulated by the ILO.

Let me also say a word about the reference to waiting for a call from the President on Social Security. I just hope the Republican majority would look back at how they handled the marriage penalty. As I understand it, when there was the meeting of the leadership with the President there wasn't even a reference to this first

step in their tax program. I think that if we are going to get off on the right foot in terms of bipartisanship, there needs to be a willingness on the part of the majority to raise issues like the marriage penalty and try to work them out before they are simply sprung on the minority.

One other quick comment, and this relates to Mr. Shaw's reference to privatization. However one thinks about investment of equities by the Government, a small portion, I do not think it is fair to refer to that as privatization, and you mentioned that.

Let me now close by just talking about the share of income that people today pay in Federal income tax. You discussed this earlier but I think the record should be clear. I have from the Treasury Department a chart that talks about the Federal income and FICA tax rates and it uses the median income for a four-person family. As I read the chart, it shows that average combined tax rate—we are now talking about for the median income—is less today than it was in 1979. Is that correct? Do I read that chart correctly?

Mr. SUMMERS. Yes.

Mr. LEVIN. The projected rate for 1999 is 15.11 percent compared to 16.97 percent twenty years ago. That is reflected in the CBO chart that compares the effective tax rate, this is the Federal tax rate, projected 1999 compared to 1981. I just want to read the figures. For the lowest quintile, 4.6 percent compared to 8 percent in 1981; the second quintile, 13.7 percent compared to 15 percent; the middle quintile, 18.9 percent versus 19.5 percent; the fourth quintile, 22.2 percent compared to 22.9 percent. The only increase is for the highest quintile. The retort is, of course, that takes money out of private investment.

So if you would comment quickly on what really has happened in terms of the Federal tax rate and the fact that the highest income category is paying a higher tax rate but whether that has had a negative impact in terms of growth in this country.

Mr. SUMMERS. Let me make these comments if I could, Congressman Levin. First, from the mid-1990s on we have had what some would call the greatest, and it is certainly one of two or three greatest, economic expansions in the history of our country, driven by productivity growth, driven by capital formation and investment. We have had record levels of investment as a share of GNP, record levels of investment in absolute terms, and record levels of growth in investment during this period.

And so it seems to me difficult to argue that we have seen new or serious impediments to the capital formation process from anything we have done with tax policy. Indeed, I would argue that the budget surpluses have been major sources of strength for investment.

The tax rates for the same family, configured in the same way for something like 90 percent of American families have come down and are lower now than they were at any time in the last twenty years. As I indicated earlier, the statistic is frequently cited that a ratio of taxes to GNP has gone up. That is a reflection of two things. It is a reflection of the fact that income relative to GDP has gone up because there is more foreign income, because there is more capital gains than there once was. And so, in some sense, GDP is not really the right denominator for looking at taxes. And

the other factor that it represents is that a larger share of income represents corporate profits which are taxed at the corporate level and represents income to higher income people that is taxed at a higher rate.

So, and this is the crucial point, the changes in the taxes to GNP ratio do not reflect tax increase policies. They reflect instead changes in the pattern of who is receiving the income. A universally agreed technique for measuring the impact of policies is to look at taxpayers configured in a given situation and seeing what happens to their tax burden. And by that standard, for the vast, vast majority of Americans taxes have declined since the late 1970s, taxes have declined since the early and mid-1990s.

Mr. LEVIN. Federal taxes.

Mr. SUMMERS. Federal taxes.

Mr. LEVIN. Thank you. And thank you, Mr. Chairman, for your indulgence.

Chairman ARCHER. Your welcome, Mr. Levin.

I must say I can't just let that stand because, as usual, when you deal with statistics there are any numbers of ways to receive them, present them, analyze them, and ultimately reach conclusions.

Mr. Secretary, what you did not mention is that as we sit here today America has the lowest private savings rate in all of its history—in all of its history. It is negative. What you did not allude to is that a great part of the investment on which we are presently building our economy is foreign investment, the savings of foreigners who save far in excess of what we do in this country. And the great danger to the stock market, the cloud that hangs over the stock market is that if these foreigners begin to have more confidence in their own domestic economies than in ours, there could be an outflow of this investment capital and we would be in very big trouble. So we do need to be concerned about that, and I think you probably share that concern. I am not saying it is imminent but it is a cloud hanging over the economy.

Now, if we are not to care about what percent of GDP the Federal Government is taking, that all that we care about is what median families are paying in taxes, then we can increase taxes on everything that does not relate to median families and it would not affect anybody. Now, as an economist, you know that is not true. The embedded cost of the income tax represents roughly 20 percent in the price of the products on average in this country, according to the very, very comprehensive study done at Harvard by one of your colleagues. And so if you keep taxing everything else and you say, "Oh, but the median family's taxes have not gone up," you are ignoring this reduction from the economy that must be paid for by the median families in the price of their products which is hidden from them.

And so on the thesis that Mr. Levin and you are exchanging, we could take 50 percent of the GDP provided that the median family did not show any increase in taxes. That clearly would not be wise. And so the percent that we are taking out of the economy, particularly at a time when this goes in the other direction, which it will at some point sometime, I don't know when, it may be ten, fifteen, twenty years from now, will leave us at this bigger demand at the

Federal level. You and I may disagree, but I think this is something to be concerned about.

Mr. SUMMERS. Mr. Chairman, let me clarify very explicitly my position. You are, of course, correct that if you raised taxes on some people but not the median person and you looked only at the median person, that would be a misleading statistic. That is why I was careful to cite those with half the median income, those with the median income, those with twice the median income.

But I suspect you could agree that if the stock market goes up and more individuals realize capital gains and nothing else changes, it would be quite misleading to describe that situation as a tax increase on the American people. And yet the statistic that is frequently cited comparing taxes to GNP suggests a tax increase when that has taken place.

If the distribution of income changes and no tax law is changed so that more income is received by those in the 28 percent bracket relative to those in the 15 percent bracket, then more taxes will be collected and compared to GNP. But again, it would be hard to see that as having been a legislative tax increase. We would be happy to do more comprehensive analysis, but what I can assure you that analysis will show is that the increase in the tax ratio to GNP that is of concern to you, and is something we do need to investigate, we will find that it is not a consequence of tax law policy changes but is instead a consequence of the two factors that I have been citing—an increase in income that is not reflected in GDP, such as capital gains, and a change in the composition of income towards those who have higher tax rates. And it would surprise me if one took the view that a stock market increase constituted a tax increase, and yet that is the logic of the comparison of taxes to GNP.

With respect to savings, I can only agree with you. I think we can take common satisfaction that whereas our country's national savings rate had reached its historic low ever in 1992, as a consequence of the progress we have made in increasing public savings, that national savings rate has more than doubled over the last seven years. I think we have made great progress in the public area and I think we can all agree on the importance of working to increase private savings.

I was particularly encouraged by Congresswoman Johnson's suggestion that we stress the needs of the 70 to 75 million Americans who do not have any kind of pension plan. I think if we can agree on that as a primary objective rather than raising the limits for those who are already most fortunate, I think if we can agree on the 70 million, as Mrs. Johnson suggested, then I think we would be in a very strong position to work out an approach that I believe would be the most effective approach and provide the greatest incremental benefit in encouraging personal and private savings.

Chairman ARCHER. Mr. Secretary, we will continue this comprehensive economic discussion at a seminar somewhere. For the time being, the committee will be recessed now until 1:00.

[Whereupon, the committee recessed, to reconvene at 1:01 p.m., the same day.]

Chairman ARCHER. The committee will come to order.

Mr. Secretary, I know that you have a lot of demands upon your time. I inquire as to how long you can comfortably stay with us?

Mr. SUMMERS. The discomfort level would start rising geometrically after 2:00.

Chairman ARCHER. Well, we will see if we can expedite the inquiry so that we can release you, as it were, at 2:00.

Mr. SUMMERS. Thank you.

Chairman ARCHER. Next on the list is Mr. Nussle.

Mr. NUSSLE. Pass.

Chairman ARCHER. He passes.

Is Ms. Dunn here?

[No response.]

Chairman ARCHER. Mr. Collins?

[No response.]

Chairman ARCHER. Mr. Portman?

Mr. PORTMAN. Thank you, Mr. Chairman.

Thanks to you, Mr. Secretary, for being willing to be patient and stay for the second round. I have lots of questions and what I would like to start with, if I could, is picking up where we left off a moment ago on the pension issue.

You mentioned in your dialogue with the Chairman the importance of increasing the private savings rate in this country. In my view, nothing would be more important with regard to the tax code and what we could do this year than encouraging people to save more for their own retirement. We have a crisis I believe among baby-boomers not saving enough. We also have a Social Security crisis which we have talked a lot about today. And the solvency of Social Security and the backstop that private retirement savings can offer is another reason to move forward. And finally, we have half the workforce, about 75 million Americans who have no pension coverage today, which I think is something this Congress and the Administration ought to focus on because it is unacceptable.

We have a proposal, as you know, to allow all Americans to save more for their own retirement. In this budget, you have again picked up some of the so-called Portman-Cardin provisions. I know Mr. Cardin, who is here with us now, is also interested in talking about some of the differences between your proposals and ours. But I want to start by focusing on the fact that there are a lot of similarities, and we appreciate the movement that you have made toward the Portman-Cardin proposal in the area now called the Retirement Savings Account, which was the USA Account. I think the RSA proposal that you have is an improvement from the USA Account. It, frankly, takes away some of what I viewed to be a counterproductive proposal that could compete with the private side.

I do have some questions about how RSAs would work. If I could just quickly go through some of those questions and, to the extent you have answers today, it would be very helpful I think for our further understanding. If you don't, we are happy to have you follow up in writing through the appropriate person.

First, how would they work in terms of the employee and the employer? One of the concerns that I have is if it is based on a matching basis from the Government, does the employer have to know what the employee's adjustable gross income is to make that calculation, and how would that work?

Second, and I think this is in relation to that in terms of the practicality, if there is a tax credit provided as the match, what is

the timing of that? Is it practical for an employer or a financial institution, because, as you know, financial institutions can also be involved in this, to provide that match before the tax credit is available? I see a timing issue there.

If you could briefly address those practical issues, and then let me just go ahead and put on the table one other issue because it is really of question of how it would work. When there is no tax liability, for instance, a governmental entity, a nonprofit, a hospital where you don't have the ability to take advantage of that tax credit, how would this work?

Mr. SUMMERS. Let me first say that our objective is to find common ground with you and Congressman Cardin and the others who are working in this area. And towards that end, the President's budget contains a number of new proposals, new for us, that incorporate many of the elements that you have been working on. My hope would be that we could forge a common approach that would meld all our priorities. My understanding is that my staff has already begun meeting with your staff and Congressman Cardin's towards that objective.

With respect to the questions that you raised, we would envision a procedure that benchmarked the size of the accounts towards last year's AGI. So there would be no recordkeeping burden on employers but a relatively simple certification by the individual.

The time value of money issues with respect to the credit is something that I think we would have to work on. Once the program was started and there was a regular flow of new accounts at the financial institution or new pensions and a regular flow of estimated tax payments, I would expect that they could be dovetailed very closely. But there are some start-up issues and those are things that we would be happy to work with you to find the best way to address.

With respect to nonprofits, this is something that is of concern to us. Our expectation would be that nonprofits would contract with some kind of financial institution that was for profit who was involved in the benefits who would be able to make use of the credits and would pass on the benefits to the employees of the nonprofit.

But those are very important issues. I have given you what our preliminary thoughts are but these would be things we would be very happy to work with you and other Members of Congress on.

Mr. PORTMAN. I appreciate that. I do think there is an opportunity to make progress here. I have been disappointed, as you know, with Treasury's inability to accept some of our very modest increases in limits. You mentioned earlier in your dialogue with the Chairman you were concerned about raising limits. All we do in our legislation is take the limits that somebody can put into a 401(k), for instance, back to where they were in the early 1980s. In the aggregate, it is not even keeping up with inflation, as you know.

It is not just about allowing people who are bumping up against the limits now to be able to save more for their own retirement, which I think is a good idea. It is about allowing small businesses, most of whom offer no pension at all today, to offer pensions to workers who are low or middle income workers. We have to under-

stand how those decisions are made. They are made by business owners, they are made by managers who will have an incentive to set up a plan if they can see some benefit to it.

I would hope that we can take the blinders off, talk about the crisis that is at hand, which is half of America's workers not having a pension, get the politics aside, get out of the rich-poor debate, and really begin to help all Americans save more for their own retirement.

Mr. SUMMERS. I would agree with that general orientation. And to the extent that raising limits can be constructive in raising the number of employers who are covered by pensions, we will be particularly enthusiastic.

I think we all agree that 75 million people without pensions represents a major problem in our country. There will undoubtedly be a combination of approaches that will be most effective. We obviously feel that we have suggested some constructive ideas, we have incorporated some of your ideas which we think are particularly constructive, and we are certainly prepared to work in a spirit of compromise to try to find the best way forward in this.

Mr. PORTMAN. Thank you, Chairman. I have lots of other questions but I will be following up later.

Mr. MCCRERY [presiding]. Thank you.

Mr. Hulshof?

Mr. HULSHOF. Thanks, Mr. Chairman.

Mr. Secretary, thank you for bearing with us. I have some technical questions regarding qualified zone academy bonds and the new proposal on qualified school modernization bonds that I will probably need to follow up in writing because my time will not permit, and I would appreciate Treasury, as it has done in the past, responding to those questions.

What I do want to do, Mr. Secretary, is to make some comments, and maybe there will be some time at conclusion that you can respond to any of these points or none of these points as you so deem. What I would like to highlight are what I believe are some inconsistencies from what I have been hearing through the questions that you have sat through this morning.

Earlier, you said that we are "in a remarkable moment in our Nation's economic history." And I don't disagree with that. What I find troubling, however, is an insistence, as we look at the President's budget, on raising taxes and user fees especially in an era of surplus. That to me seems to be somewhat inconsistent.

You were quick to point out that the amount of Government spending as a percentage of GDP has gone down. And yet when the Chairman pointed out that the tax take on the American worker in this country continues to be at the highest percentage of GDP, you were quick to explain that away. I find that somewhat inconsistent. I find that troubling.

Talking about waste, fraud, and abuse, Ms. Mathews made an excellent point to Mr. Thomas' question about Medicare. We always invoke the mantra, we want to eliminate waste, fraud, and abuse. And yet, Mr. Secretary, you mentioned as far as expanding the Earned Income Tax Credit, and I think we all share your opinion that this has been a useful program as far as the income supplement to working Americans, we have got an over 20 percent error

and fraud rate with the Earned Income Tax. So, in other words, for every five dollars that are being paid out in income supplements one of those dollars is not deserved under the law. And yet we are continuing to talk about this very wasteful program. We have had hearings on that and representatives of your office have talked about that. I find that extremely troubling.

I want to focus just another comment on something that I think in principle we agree on, and something you talked about, corporate tax shelters. I notice my colleague from Texas was nodding very vigorously in the affirmative. I know this is an issue he finds very important. You talked about closing corporate transactions that are void of substance. We agree with you.

But what I find inconsistent, Treasury came to us in 1997, and maybe even before but I got here in 1997, but I remember we had hearings on the President's budget proposals back in 1997 and Treasury asked us for some additional authority to crack down on corporate shelters. Specifically, we passed a provision that would require registration of corporate tax shelters. Two and a half years later we still are waiting for regulations and rules to come from Treasury on something we passed two and a half years ago. And I find that inconsistent.

When we talk about tax cuts or tax fairness, we have heard every excuse imaginable, not from you, Mr. Secretary, but from those who oppose tax cuts. We have heard back in 1997 with the Taxpayer Relief that it was inconsistent to give tax cuts at a time when we had deficit spending. When we had the 1999 tax bill that we debated we heard from some on the other side that this is not the time, it would overheat the economy, as the Minority Leader said on the floor. And then there were the others who said we can't cut taxes because the economy is too fragile. When we had the extenders package, and I certainly appreciate the fact the President signed that RND credit and these extenders, but the thought was we can't do that because it is not paid for. Now we are hearing from the other side that we don't have this budget document in place.

And I follow along with what Ms. Johnson said in her comments, Mr. Secretary, and that is there are so many areas of agreement, whether it is the Portman-Cardin pension plan, whether it is the marriage penalty, whether it is the long-term dependent care, you have a credit, we had a deduction. The point is that I find that our substance doesn't match our rhetoric. And even here today in this hearing, there are so many things that I think there is agreement on, and yet when the rubber meets the road we aren't actually putting into practice what we profess regarding those changes.

My time is running short, but one quick point. I know that there are some school bond proposal, going to the technical question, school bond proposals that would invoke Davis-Bacon prevailing wage requirements on school districts that utilize these tax credit bonds. If you can give me a yes or no answer on this, in the Treasury's "green book" it is silent on this issue. Where is the Administration on Davis-Bacon. And if that is something where you need to respond in writing, that would be fine. I have got some other questions I will submit in writing regarding the school construction bond proposal.

With that, if you have any comments, my time has expired and so I would yield.

Mr. SUMMERS. I will respond in writing on the school construction question.

I would stress in response to a number of your points, Congressman Hulshof, that we believe that debt reduction, which removes the obligation to pay principal and pay interest, takes pressure off interest rates and holds down their costs is probably the most effective form of tax relief that we can provide. And we believe that we need to not do anything that puts that at risk in terms of unrealistic budgeting.

Mr. HULSHOF. If the Chairman would indulge me on that point. Just as you say we are trying to put pressure on interest rates, the Fed does not agree. Mr. Greenspan and the Federal Reserve are doing just the opposite as far as pushing interest rates up to try to curtail so-called inflation. Not to put you at odds with the Chairman.

Mr. SUMMERS. Congressman Hulshof, I of course cannot comment on Federal Reserve policy. What I can say is that every, and I use that word every advisedly, serious professional economist who has looked at these issues would agree that an environment of paying down debt will be an environment of lower interest rates, whatever else happens, than an environment without paying down debt. That is the operative principle and the reason why debt reduction is such an important and effective form of tax cut.

The President's budget contains $350 billion in tax cuts for American families. We are prepared to legislate those any time we are sure that they are in the context of a program that is paying down debt and assuring our ability to strengthen Social Security and Medicare.

With respect to tax shelters, the regulations you described I expect will be announced within the next month. But, frankly, as we have drafted them, we have realized that the legislative authorities were in some ways insufficient and would permit tax shelters to still be marketed in stealth to those who play the audit lottery. That is why we will be coming back and asking for new legislation.

With respect to the EITC, there are real compliance problems. We have addressed them in the ways I mentioned—more budgeting, Social Security numbers, conforming definitions, tax preparer's initiative. But I think it is quite a misleading suggestion about the compliance statistics to suggest that one dollar out of every five dollars is somehow fraudulently wasted. The 20 percent figure refers to returns in which there is some kind of error. The error is often not of large magnitude. The error is in most cases not fraudulent. In many cases the error comes from anomalies that the President's proposing to simplify this year, such as the distinction between earned income for EITC purposes and earned income for other purposes.

With respect to the taxes over GDP figure, we will just have to agree to disagree. I don't see how it can be said that more capital gains from a stronger economy constitutes a tax increase even though it does raise tax revenues. And every evaluation of the situation of the typical working family, or the working family that is at half the typical income, or family at twice the typical income

does say that they are paying less taxes today than at any point in the last twenty years.

Finally, with respect to the question of the revenue offset measures that you raised, it seems to me that just as you take the position that even in a time of surplus we need to eliminate any wasteful spending, it is also appropriate to take the position that if there are tax measures that constitute distortionary subsidies or inappropriate measurement of income, that is something we should also be looking at for fairness and integrity of the tax system regardless of what the overall budget surplus is. And it is from that perspective that the President has put forward his offset proposals.

Chairman ARCHER. The gentleman's time has expired.

The Chair observes that there are nine members who have not yet inquired. The Chair will attempt to conclude the hearing at 2:00, so the Chair will be constrained to strictly invoke the five minute rule so that every member will have their full five minutes.

Mr. Cardin?

Mr. CARDIN. Thank you, Mr. Chairman, for calling on me, even under the new interpretation of our five minute rule.

Let me thank Mr. Summers for his testimony and for laying out I think a very comprehensive budget that we can follow. Just in response to some of my colleagues' points about why we are so concerned about voting tomorrow on a tax bill without having a budget is that the Administration has laid out a very clear agenda; five objectives that you spelled out, Mr. Secretary, at the beginning of your comments—reducing the debt, dealing with Social Security and Medicare to protect those programs, targeted tax cuts, and our international commitments, and some of our new spending priorities. Most of that is within the jurisdiction of this committee.

It was interesting to hear comments about Social Security. Well, your budget provides that we can preserve Social Security. I question the Republicans and their tax proposals, that will exceed $1 trillion dollars over ten years, whether they can do that and still pay down the debt and deal with Social Security. You have given us a blueprint that we can deal with Social Security. I question whether the Republican budget allows us to really modernize Medicare to include prescription drugs for our seniors, which we need to do.

I was interested in Mr. Thomas' comments about competition. I can tell you what the Medicare Plus choice has done in my State, a rather urban State, where now 14 of our 24 jurisdictions do not have any Medicare Plus choice. No option but the fee-for-service as a result of changes we made. So I am not so sure there is the interest in the private sector that some of my colleagues believe in ensuring our seniors.

I do want to emphasize though a point that was made by Mr. Levin on trade because I do hope that we can develop a broader consensus in this Congress on expanding international opportunities. Mr. Secretary, our concern about labor and environment is not for protectionist policies to protect American markets, but that we should be a leader in establishing international core standards in these areas. Where it is right for us to be a leader in the world, as we were on financial services, as we were on intellectual property rights, we should be with labor and environment. I think if

you do that, you are going to find a broader consensus in this Congress on both sides of the aisle on the trade agenda.

But let me in the few minutes I have just underscore the point that Mr. Portman made on the private retirement and savings and the Chairman made right before our break. The economic figures are very encouraging for this Nation but we still need to save more. You understand that, we understand that. And what the Portman-Cardin bill attempts to do is make it easier for Americans to be able to save for their retirement by eliminating some of the complexity and making it easier.

I really do appreciate your comment about finding common ground. I applaud the President's RSA proposal because you put some money on the table. We weren't quite that bold. We didn't spend quite as much on most of our proposals as you are putting on the table. That is good because we should be willing to have targeted tax relief for people who are willing to put money away for their retirement, particularly lower wage workers. We agree with you, we want to get to that 70 million who do not have private retirement. We also want to get the low wage workers, small businesses, and the decisionmakers to have pension plans so those 70 million can get pension plans.

Just one last point on this, and then I invite your response. We are not suggesting increasing the caps. We are suggesting that we go back and bring the caps where they used to be. We have had such a regression in the ability of Americans to put money away for private retirement because we are so concerned that some people might put more away than others that we find that people aren't putting anything away.

So, our objectives are to deal with the 70 million, but it is also to deal with the low savings rates, to put more money into private retirement plans so we can have less pressure in the future on Social Security. Social Security is supposed to be just one leg of a three-legged stool. So I really do appreciate your comments, and your proposal, on common ground on the pension issues. But I invite you to work with us so that we can bring out legislation in this Congress to deal with that issue. And I invite your comments.

Mr. SUMMERS. I think I agree with everything you said, Congressman Cardin, and I look forward very much to working with you and Congressman Portman and other members of this committee to address what I think is a macro economic problem for our country in terms of too low a personal savings rate, and what is a personal problem for a large number of individuals in terms of their preparation for retirement. I think this is an issue which ought to, and I think does, reach across party lines, reach across generational lines, and it is one that I would hope that as we pay down the debt and strengthen Social Security and Medicare this year we could also work on.

Mr. CARDIN. Thank you, Mr. Secretary.

Chairman ARCHER. The gentleman's time has expired.

Mr. McInnis?

Mr. MCINNIS. Thank you, Mr. Chairman.

Mr. Secretary, I will have a number of questions here I would like your response to in writing since I am limited to five minutes.

Let me kind of put it in context because I think you and I come from opposing ends in regard to the estate tax. I always think of your quote when you were talking about estate tax, that the advocation of the repeal of the estate tax is "about as bad as it gets." That is when you were the Deputy Secretary. And then you went on to say that, "When it comes to the estate tax there is no other case other selfishness." As you know, my district is geographically larger than the State of Florida, comprised primarily of farms and ranches. Needless to say, we take strong issue with that position. Further on, I would like you to confirm in writing so I am sure of the accuracy of the quote, but the Washington Post on April 22, 1997, says, "You have to raise revenue somewhere and the ability to pay seems like a good way to do it."

So I expected that the Administration was going to continue in its opposition to relief on the estate tax. Although I would be curious as to the upper income level of members of the cabinet or in the Administration. My guess is that most of them have taken steps to hire tax accountants to be sure that they are not hit with this estate taxation, unlike the middle class for whom they are advocating no repeal of the estate tax. But what I did not expect from the Administration in the budget, and what I would like confirmation on in the letter, is in fact an estate tax increase.

I knew you weren't going to give us any kind of relief out there with the estate tax. I didn't expect an increase. I would like just to confirm that my numbers or the proposals are correct. They restore the phase-out of the unifying credit for large estates. The Administration proposes a $1.1 billion increase in that element of the estate state. They propose a $214 million increase in required consistent valuation for estate and income tax purposes; $55 million increase in the estate tax for basis allocation for part sale/part gift transactions; a $1.054 billion increase in conformed treatment of surviving spouses in community property States; $18 million include the QTIP trust assets and surviving spouses estates; $6 billion in eliminate nonbusiness valuation discounts in the estate tax; eliminate gift taxation exemption for personal residents trusts, $408 million; limit use of the CRUMY powers, $208 million.

So the proposal in this new budget on an increase in the estate taxation is $9 billion. I would like some comment in writing on that.

The second issue is last year we had 28 members of this committee, Democrat and Republican, sign a letter that I had drafted opposing what we call tracking stock. The Administration appeared to somewhat backtrack but, kind of like the estate tax, they didn't give it up. And lo and behold, as I look at the new budget, you are back again but this time with a different mask. Now I understand that under the tracking stock, instead of taxing the issuing corporation, you are now going to tax the stockholder. So you are still back on the tracking stock. Apparently the Administration is still taking the position, and I stand to be corrected I would hope when you answer these questions, but you are still at the position apparently that the tracking stock is an income and should be taxed.

Both of those issues are issues that I think are important.

The other thing, and I will conclude with these comments, I believe early in your remarks you said the drop in the interest rate

of mortgages is an administrative way of a tax cut for families. Now I kind of think the Administration in this economy takes credit for rain. I want to tell you, this is the market's benefit to the families. This is not a tax cut to the families out there of America that the Administration and the Congress have decided to cut your mortgage rates. That is a result of market functions, not a result of a tax cut.

I think it is somewhat of a misappropriation of the term tax cut when you talk about interest factors, interest rates being lowered out there and you all of a sudden now put that in the classification of a tax cut. When I talk to middle America out there, when I talk to the average person and I say "If the interest rate on your car, the financing of your car drops from 10 percent to 9 percent, is it a tax cut?" They don't see it as a tax cut. I think there is confusion with the words.

Thank you, Mr. Chairman.

Chairman ARCHER. Unfortunately, Mr. Secretary, your answers will have to be submitted in writing because the gentleman's time has expired.

Ms. THURMAN. Mr. Chairman, I think some of the rest of us members would like to have those answers as well. So if we could have—

Chairman ARCHER. Perhaps the gentlelady will provide time within her five minutes. I have got to be able to release the Secretary and still let everybody have their five minutes.

Mr. SUMMERS. Mr. Chairman, I would be prepared to stay till 2:03 in order to take three minutes to respond to the gentleman's thoughtful question.

Chairman ARCHER. Mr. Secretary, whatever you want.

Mr. SUMMERS. Let me just say with respect to interest rates, I think the words I used were tantamount to a tax cut to take the pressure off credit markets and allow interest rates to fall. I don't believe for a moment that we would have anything like the interest rate environment we do if we had not made progress in creating budget surpluses.

With respect to tracking stock, I would simply say to you that I think it is appropriate for us to conform tax rules for corporations to all forms of corporate distributions in some level playing field way. That is the thrust of our corporate tracking stock regulation.

With respect to the estate tax, I have made clear both in writing and in public comments immediately after the remarks you quoted that I had what might be referred to as a learning experience with respect to those observations and that they were not a fair statement with respect to the motives of those who advocated estate tax repeal and have worked very hard in connection with the 1997 legislation to provide tax relief to farmers and to small businesses and to be part of a program to generally raise the limits on the estate tax.

With respect to the set of provisions that you identified, to say that estate tax burdens are a legitimate concern for many small businesses and farmers is not to say that we shouldn't be responsive to loop holes that arise in estate tax that in many cases were not intended. The references to QTIP trusts, to the CRUMY powers, to certain valuation discounts, to residential trusts, these are

responses to various systems that have been designed over time to avoid the intent of the estate tax as it was legislated. I think it is much better for us to debate what the appropriate level of that tax is and make decisions explicitly rather than to allow loop holes to be expanded. The legislation is not directed at increasing the tax but only at responding loop hole concerns that have arisen.

Chairman ARCHER. Now Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman.

Mr. Secretary, thank you very much for being here and for being so patient with your time. Let me also compliment you and certainly the President and Vice President on the proposal that you have put before us in your budget to try to address Social Security, Medicare, and certainly of course to pay down the debt. I would also congratulate you on what you did with the EITC. I think it is great that we are looking at more ways to make work pay for working families that otherwise would fall in the poverty limits of what we have defined as poverty. And by the way, I think we should acknowledge Chairman Archer as well because he also had a similar proposal on EITC.

You mentioned a number of things, you answered a number of questions on a number of subjects. Let me just touch on a couple. First, FSC. I hope that Treasury will take with as much seriousness the issue of FSC and what happens with the WTO on that issue as the USTR is taking it. I think if we don't treat that as a very high priority, we could find ourselves at a great disadvantage, competitively speaking, with our European counterparts. I think the last thing we want to see is a loss of jobs in this country because we are not able to export on competitive terms with our European colleagues.

The digital divide. I am glad you spoke a little bit about that. I am very pleased to see the President's proposal to help households acquire computers and help young people and adults get connected. I am fortunate to work with Mr. Portman on a bill that we call the New Millennium Classroom Act which does something very similar. It tries to provide a tax deduction for companies or individuals that contribute computers to classrooms and to senior citizen centers to help child and seniors get connected. So I hope you will take a close look at that bill that we have.

I am not sure if it was mentioned, but because so much of your budget talks about working families, I hope that we can count on you to work with us on an issue that is affecting a number of States more and more dramatically every year, and that is the whole issue of runaway productions in the entertainment industry. We are seeing more and more countries offer tax credits to companies that would leave the United States to do their productions abroad, places like Canada, Australia, England. And as a result, they are getting tax credits of up to 40 percent on the production costs, principally in labor. It has become very difficult for a number of companies in the U.S. to stay here and for us to compete to keep those companies here.

I hope that you will take a close look at the opportunities to try to help those industries. And by the way, we are not talking about helping the movie star who makes $5 million to $20 million with a movie, or the producer, or the writer, or the director who is mak-

ing megabucks. We are talking for the most part about the folks behind the camera, the stagehands in productions, the boom individuals who operate all of the equipment, we are talking about the caterers who provide the lunch to those who are actors who make working man's wage. So if you could do us a favor and take a close look at that. That is becoming more and more an important issue.

And finally, if I can focus the remainder of my time on an issue that I hope you will take a close look at dealing with Customs. Customs right now has an automation problem. It has a computer system that works to track product that is imported into this country that uses 1980s technology. As a result, we have already experienced on occasions brown-outs, delays in the ability to move a lot of this product. And with our in and out system of production these days where it is time sensitive to be able to bring in what you need to produce your product, a lot of companies in this country would suffer greatly if we found not just a brown-out but a black-out where products that are supposed to be coming in to help manufacturing here in America would not reach their location.

I have a letter that I will leave with you rather than getting into detail since we are constrained on time. But you are probably familiar with the new system that Customs is trying to implement, the ACE system that would replace the ACS system that is in place right now. The problem becomes that at this stage the Administration has proposed only to fund the modernization through a new fee. I think most of us have seen that hasn't worked. I would hope that you all would think seriously about other options to try to do that. I know that at some point there was an exploration of the possibility of earmarking some of the merchandise fee that is used right now and collected from importers to offset the cost of that modernization or perhaps using a straight appropriation to do that.

Somehow or another we have to get this resolved because if we don't get that new computer system in place I think we are going to find that we are all going to be hurt. Certainly, American business will suffer, consumers will suffer, and our competitiveness will suffer. I don't know if you have any comment on the whole issue with Customs and automation, but I would welcome an answer.

Mr. SUMMERS. I will take one minute to respond to your four points, if I could. I've got a clock in front of me.

On FSC, I agree. We are absolutely committed. Deputy Secretary Eizenstat is leading the effort.

On computer donations, we share the objective with respect to the digital divide but we have some concerns about the form of your proposal in terms of encouraging overly old computer donations rather than ours which is focused on newer equipment. But I am sure we could work something out.

Mr. BECERRA. We could work on that.

Mr. SUMMERS. On runaway production in the entertainment area, this points up the generally important issue of tax competition which we are pursuing very actively through the OECD because this is an issue that arises in a number of contexts.

On ACE, we agree with you on its importance. We have reconfigured the proposal in this year's budget to much more clearly link the benefits to the business community to their contribution. And

I hope we can move forward with it because you are absolutely right that it is essential.

Mr. BECERRA. Thank you very much.

Chairman, thank you very much.

Chairman ARCHER. Mr. Lewis?

Mr. LEWIS. Thank you, Mr. Chairman.

Mr. Secretary, over the next ten years, the Federal Government is going to be taking in about $24 trillion in money from the taxpayers' pockets in this country, with a sizeable projected surplus. Do you think that the American people are not paying enough to take care of the needs of the Federal Government?

Mr. SUMMERS. I think there is room to meet the needs of the Federal Government and to provide for appropriate tax relief. Although I think we have had a real accomplishment in the last seven years in reducing the number of Federal employees by a sixth and bringing Government, by a wide variety of measures, down to its smallest size since the 1960s, and that we have enjoyed the first decade in which we have been significantly cutting discretionary spending, which I think represents a real achievement for our country, we have got to be very disciplined.

Mr. LEWIS. Do you think $170 billion in net tax relief over ten years is a significant amount of tax relief? That is basically seven-tenths of 1 percent. That is not a lot of tax relief. And let me say this, you have increased taxes by $181 billion, $69 billion of which comes out of families in Kentucky, tobacco farmers that are struggling. They just had a 45 percent cut in their quota, last year 30 percent. They are dying out there on those family farms. Their income has been cut in half.

Is it the President's desire to totally tax legal tobacco out of existence and the family farmer?

Mr. SUMMERS. With respect to the tax cuts, $170 billion is a lot of money where I come from.

Mr. LEWIS. Out of $24 trillion?

Mr. SUMMERS. But $350 billion in gross tax cuts is even more.

With respect to tobacco, the core of the President's proposal is a youth penalty that would fall on companies whose products are sold to young people below the age of consent. I'm sure that if there were proposals to ensure that those penalties were borne by the companies rather than passed on to consumers, if there were an approach along those lines, I am sure that is something we would be prepared to join in working on.

Mr. LEWIS. Let me ask you this. One of the major causes of death with teenagers today is automobile accidents. Are we going to make automobile manufacturers responsible for decisions made in the family home? One of the biggest causes of cancer today is exposure, over exposure to the sun. Are we going to make those manufacturers of swimwear responsible for kids getting out on the beach and being over-exposed to the sun? Are we going to have lookback provisions for every company in this country for decisions that should be made in the home and the responsibility should be there? Where will this all end? Are we going to always have lookback provisions? Where is the responsibility here?

Mr. SUMMERS. I think that is a fair and important question. Let me just emphasize that whatever we do, it is very important that

we protect the interests of tobacco farmers who are not the people who are responsible for all of this.

That said, we have had effective public health policies around automobile accidents that have reduced the number of fatalities per mile by 50 percent over the last 35 years. We have had effective policies in the other areas that you cited that have reduced fatalities very substantially. We, frankly, have not had similar effectiveness with respect to tobacco even though tobacco is a far, far greater cause of death than either of the examples you cited.

This is the best strategy as judged by all the public health authorities to rely on price to achieve the same kinds of benefits the Government has achieved with respect to most of the other sources of—

Mr. LEWIS. Let me interrupt just for a second. My time is short here. When I said legal tobacco, there is a law of diminishing returns here. The reason that the tobacco farmers have been cut by 45 percent is because they can't afford to stay in business any longer. Underground tobacco products are already being sold. Our kids are going to be exposed to illegal tobacco where they are going to be buying it at cheaper prices because you are going to force the legal people out of business.

Mr. SUMMERS. Congressman Lewis, that is something we would be happy to discuss with you. I think the Bureau of Alcohol, Tobacco, and Firearms and others who have looked at this issue can make a compelling case that youth penalties in the range that we are considering can quite comfortably be administered. But the concern you are raising, if it did lead to smuggling or illegal use, obviously is a very serious one but it is one that we have given a lot of thought to and that I believe can be controlled.

Chairman ARCHER. The gentleman's time has expired.

Ms. Dunn?

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

Welcome, Secretary Summers. I enjoyed your presentation. It did clarify where the Administration stands from different points of view and it will be useful as we compare your proposals to those that we intend to propose as we put together our budget document.

I did want to move back to asking you some questions about the death tax. In some areas that I do a lot of work, the minority community and women business owners, where we see women starting businesses at twice the rate of men, and they are small businesses but they are businesses that are being built and that these women would like to provide as a legacy to their children when they finish their life.

The 1993 budget agreement increased the rates of inheritance tax up to 53 and 55 percent. That puts us at the second highest inheritance tax rate of the whole world. Japan is the only country that is ahead of us. That concerned me when it happened then. But now as I have done work in the entrepreneurial community, I have learned that many minority groups, particularly black enterprises, see that it takes about three generations to create a business that provides a legacy, that provides them standing in the community so that they can continue to do well in their lives. And for them the death tax becomes a true enemy.

I know that you agree with me that we need to encourage entrepreneurial women and minority women to get into the business market to become more independent. I wanted to ask you, when Congressman Tanner's bill, my bill, the death tax repeal that phases out death tax in ten years, when it is supported by groups like the National Association of Women Business Owners, the Black Chamber of Commerce, the National Indian Business Council, the National Congress of American Indians, the United States Hispanic Chamber of Commerce, the Hispanic Business Round Table, the United States-Pan-Asian American Chamber of Commerce, and the Texas Conference of Black Mayors, why doesn't the Administration want to help by repealing the death tax? In fact, why do they stand in the way of that repeal even to the extent of increasing it as they do in this budget? And I would like to know from you the answer to that question. I think it would be very useful to those of us who believe that this onerous tax should go away. I know that the Administration's position is in opposition to positions you took, for example, when you were teaching at Harvard University.

So I ask your comments.

Mr. SUMMERS. Let me say first, just with respect to your last comment, the Administration's position is consistent with positions that I took as an academic. I did write something that summarized the conclusions of another researcher, who took a position favoring the estate tax.

I think you have very powerfully stated what is a very important concern, which is the proper treatment of small businesses, and it should not be the way things work, that the estate tax is a force for liquidation of small businesses.

We have proposed—and supported in 1997, and at other points—a variety of proposals that are designed to provide relief from what can be a liquidity problem, an enormous problem, for small businesses at the most threatening moment in the business' experience, when the founder or the owner passes away. That is a very real and large concern to us.

With respect to the full-scale elimination of the estate taxes that some have proposed, we would share the view of many tax experts that the estate tax provides a very important backstop to the income tax. If the estate tax were completely removed, you would see a very substantial erosion not just of the estate tax revenue, but also of the income tax revenue, as income was put into various forms where it accumulated tax-free and there was never any taxation with respect to the income that had been earned.

So we think it would be dangerous to our fiscal integrity to, full-scale, repeal the estate tax.

We would also have a concern about the very large volume of philanthropic contributions to the Nation's universities, to the Nation's religious institutions, to the nongovernmental organizations and social organizations that do so much of the Nation's work, that would not be there but for the deductibility that takes place under the estate tax.

So we would be pleased to work on proposals to address the specific inequities with respect to small businesses to the extent that they can be identified, but we do not believe that it would be pru-

dent to eliminate a tax that does, after all, as real as the issues are, only impact about seven-tenths of a percent of all American estates.

Chairman ARCHER. The gentlelady's time has expired.

Ms. Thurman?

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

Mr. Secretary, thank you very much for being here today and spending all of this time with us.

First I would like to say something to our colleagues that I think is important because we have talked about this abuse and fraud issues. You know, that is really some part of our responsibility as well. We have governmental operations to overlook, these kinds of issues. I served on that committee; we had some 300 reports on Defense spending that we should have been looking at, but we did a lot of other investigations instead. And I think we have to take some responsibility; and then, in those findings, how we're putting them into legislative proposals.

We, in fact, should take some credit for that because we did that under the EITC. We did that in 1995. We did it again in 1997 under the leadership here. So I think we should be careful of how we address some of these issues.

Mr. Secretary, I would suggest, though, for some of us in the idea of this Medicare issue and the idea that some things are just cutting across the board on hospitals, I just met with my hospitals this last week and one of the things that they told me was because of the uninsured rate going up, of people not having insurance, has created a real problem for them because of indigent health care.

So in your proposals—I mean, you may want to reiterate all of the new steps that you are taking to bring people into insurance, because I think this is very important in the fact that we really are helping the health care system. So if you could just give us kind of a little run-down, a little bit more, on that.

Another issue, though, in all due respect to my colleagues, if I remember correctly under the Social Security proposal that was given—in fact, for many of us—I can't speak for the President not returning the phone call, but many of us sat for almost an entire day with the Chairman and others, trying to learn the intricacies of Social Security. You all weren't invited; some outside folks came in and gave us that. But in that proposal, if I remember correctly, it was done so that 60 percent of the surpluses were going to be put into equities as well, or some sort of investment. And I understand the difference between the private account and the 15 percent, but I don't think you can just say out there, "Oh, you guys are doing this, but you're not doing this." That's just wrong.

Thirdly, I would like to ask—and I am particularly interested in this proposal, which is on the sustainable or renewable energies issue; I am co-chair of that—and in looking at the issues that we've been talking about over the last couple of months, how this economy has grown with technological innovations—what in this budget, because your comment at the beginning was, "You know, we have to make some choices here." In this budget, where do you see and what do you see as choices that we've made that will sustain this economy?

Mr. SUMMERS. I think the most important—

Ms. THURMAN. Wait, one last thing. Prescription drugs, as well. If we have a prescription benefit, which you've proposed, or which has been proposed, let me tell you the dollars that we're going to save in Medicare by not hospitalizing people, because they can have their medicines and stay on their medicines and not cut them in half to choose between food and medicine. They will stay on them and we will save money there.

Mr. SUMMERS. I share your last point. I think there is a general issue in all of the scoring exercises that we do that I think that, probably appropriately, we're very conservative about taking account of the various feedback effects. Just as the Chairman has expressed concern at some points that we don't take account of all the behavioral effects of tax policies, and that raises certain questions, I think similar kinds of questions can be raised with respect to the economies that come from prescription drugs.

All things considered, I think in the formal scoring processes it's best to be conservative, but there certainly is the effect that you described.

With respect to promoting the recovery in a broad sense, the most important thing we're going to do to promote the recovery is have a large-scale pay-down of debt.

In the sense of sustainable development, in the environmental sense, the most important provisions are the increases in research and development at the Department of Energy. And of particular importance to me, the tax credits for more miles to the gallon automobiles, greater use of biomass, and other kinds of carbon-conserving policies. We've had a great achievement in that while we've had this remarkable growth in the economy, we've actually had record low growth in carbon emissions in recent years. That's a tribute to the move to the information technology type economy, and that's something that I think that we need to build on.

I think Ms. Mathews can say something about the question you raised with respect to Medicare.

Ms. MATHEWS. I think it's absolutely true in that we will be helping our hospitals by ensuring that their indigent care numbers go down.

I would just point to a couple things quickly. One is family care, which is the expansion of something that was passed in 1997 on a bipartisan basis, which was the CHIP proposal. We've proposed expanding it to cover the parents of those children. In addition, also getting more information so that children that are not yet covered, are. That's two examples.

Chairman ARCHER. The gentlelady's time has expired.

Mr. McCrery?

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Secretary, welcome, and thank you for staying so long.

You made the point earlier that spending by the Federal Government is at, probably, a 40-year low, or close to it. I think if you go back to find a year in which spending as a proportion of our national income was lower, you would have to go back to 1966, if I'm not mistaken. And I think that is good, I agree with you that it's good that we have restrained spending to the extent that we have. We have made progress in shrinking Government at the Federal level.

But I would want to make a point that we could have done better had the Clinton Administration not fought the Republican Congress every year since we've been in control, for more spending. And here you are, back again this year, asking for more spending.

I think President Clinton deserves some of the credit for restraining spending, but I am reminded of Secretary Shalala coming and sitting right where you are, back in 1995, promoting welfare reform, which was great; we were all for welfare reform, but her welfare reform program—that is, the Clinton Administration's welfare reform program—actually would have spent more money than we were then currently spending on welfare; whereas, as you know, the welfare reform program that was ultimately adopted by the Congress and finally signed by the President, after two vetoes, actually reduced spending on welfare by some $60 billion over five years.

Here we go again. At a time when we have surpluses, when the Federal Government is taking in more money than we need to finance Government, as pointed out by Chairman Archer, tax revenues, unlike spending, are at an all-time high for peacetime. Over 20 percent of our gross domestic product is coming into the Federal Government in the form of revenues, and instead of coming in and saying, "Let's have a tax cut, let's let the people who have created this strong economy to keep doing the good things they're doing," you all are coming in asking us to increase taxes.

Your budget proposal, as it is designed, would continue the surpluses, you're right. But if the tax increases and the fee increases that you have asked for don't materialize, then you've got a problem with your budget; it doesn't work, the numbers don't work. And I think it's safe to say this Congress is not in a mood to raise taxes.

I would like for you to explain to us any contingency plans that you have for scaling back the spending increases that you all have proposed, just in case we don't adopt the tax increases that you've proposed.

Mr. SUMMERS. Let me respond, if I could, in three ways to what you've said.

First, with respect to the question of credit allocation, I think the news is good enough that we can all take credit for what's happened, although I would note that spending has increased and Federal employment has increased, but far less than it did in either the legislation between 1981 and 1993, or in the Executive Branch's proposals between 1981 and 1993.

With respect to the level of taxes, I would just respectfully have to disagree. I honestly don't see how it's possible to argue that higher stock prices and more capital gains taxes, coupled with more of the income going to those in high brackets, constitutes a tax increase. And if one looks at standardized families, one does, once again, see that taxes are lower than they've been in 20 years.

Mr. MCCRERY. Well, Mr. Secretary, though, if you compare—I like your figure on spending, and I congratulate the Administration and the Congress for working together to get spending down to 18.7 percent of GDP this year. But if you're going to compare apples to apples, you have to say that the Federal Government is tak-

ing in over 20 percent of GDP in the form of revenues, and that's an all-time high for peacetime.

So as an economist, don't you have any concerns that we are taking an ever-higher proportion of our national income into Washington to redistribute?

Mr. SUMMERS. As an economist I have analyzed that figure very, very closely, and the increase does not derive from any legislative change. It derives from higher stock prices and more capital gains, with a constant tax law, and it derives from a change in the income distribution towards those who are more highly taxed.

When one looks at the tax law as a measure, one finds that it is taking less relative to income than at any time in the last 20 years.

With respect to the question of tax cuts, the Administration's budget, of course, does propose net tax cuts over the next 10 years, and quite significant gross tax cuts.

You spoke of new spending, but those calculations are done relative to one of the first two CBO baselines, which would require either a scaling-back of the defense buildup, or cuts on the order of 20 to 25 percent in a number of key areas of Government expenditure. I'm not sure just what is envisioned by those who invoke that baseline.

Our judgment is that it's better to use a current services baseline, because just as we learned in the 1980s that it was important to avoid overly-optimistic economic forecasts, we believe that unrealistically-optimistic forecasts about future spending could put us in a situation where we were back in deficit. These forecasts are volatile and we can't always rely on the kind of good news that is reflected in this year's forecast.

Chairman ARCHER. The gentleman's time has expired.

Mr. Secretary, unfortunately, if we're going to get to the other three members who have not enquired, assuming we stay strictly within the five-minute rule, we're looking at another 15 minutes. Can you handle that?

Mr. SUMMERS. Yes.

Chairman ARCHER. Without objection, I would insert in the record at this point a compilation of the figures in your budget, based on your estimates, which show that there is a $14 billion net tax and user fee increase, over and above what you give in the way of tax relief.

[The material follows:]

Administration's FY01 Budget

Tax and User Fee Increase of $14,730 Million Over Five Years

Tax Relief	Fiscal Years 2001–2005 (Millions of Dollars)
Claimed gross tax relief including refundable credits (AP, p. 88)	−101,749
Less three tax increases	
(1) Accelerated vesting for qualified plans (AP, p. 87	−550
(2) Electricity restructuring (AP, p. 88)	−105
(3) Levy tariff on certain textiles (AP, p. 88)	−676
Less other provisions affecting receipts	
(1) Replace harbor maintenance tax (AP, p. 90)	−3,197
(2) Roll back Federal retirement contributions (AP, p. 90)	−1,206

Administration's FY01 Budget—Continued

Tax and User Fee Increase of $14,730 Million Over Five Years

Tax Relief	Fiscal Years 2001–2005 (Millions of Dollars)
	−36
(3) Provide Government-wide buyout (AP, p. 90)	+5,999
Plus refundable credits (actually increased spending) (AP, p. 88)	**−101,520**
Actual gross tax relief:	
Tax and User Fee Increases	+47,151
Claimed tax increases (p. 90)	+550
Plus three tax increases	+105
(1) Accelerated vesting for qualified plans (AP, p. 87)	+676
(2) Electricity restructuring (AP, p. 88).	
(3) Levy tariff on certain textiles (AP, p. 88)	+2,466
Plus other provision affecting receipts (AP, p. 90)	+3,823
(1) Environmental tax (AP, p. 90)	+6,667
(2) Superfund excise taxes (AP, p. 90)	+31,194
(3) Airport user taxes (AP, p. 90)	+431
(4) Tobacco taxes (AP, p. 90)	+3,752
(5) Recover state bank supervision (AP, p. 90)	+49
(6) Maintain federal reserve surplus (AP, p. 90)	+218
(7) Premiums for United Mine Workers (AP, p. 90)	+25
(8) Abandoned mine reclamation fees (AP, p. 90)	+19,143
(9) Corp of Army Engineer fees (AP, p. 90).	
Plus other user fees not included above (AP, pp. 98–99)	**+116,250**
Actual gross tax and user fee increase:	**+14,73**
Actual net tax and user fee increase:	

Chairman ARCHER. These are your figures, Mr. Secretary, and they are right here in black and white.

Mr. SUMMERS. I would hope that you would permit me to insert a response to that analysis in the record.

Chairman ARCHER. Absolutely.

Chairman ARCHER. Mr. Ramstad?

Mr. RAMSTAD. Thank you, Mr. Chairman.

Mr. Secretary, thank you for your indulgence. It's good to see you again.

I have a question concerning one of the items in the revenue-raising portion of the Administration's budget, and I refer to the proposal affecting employee stock ownership plans, the so-called "ESOPs," that are for S-corporation employees.

First, I must say that I am relieved that this year's proposal doesn't go as far as last year's proposal, which would have effectively killed this effective retirement savings program for thousands of S-corp employees. As you know, a strong bipartisan majority—in fact, 23 members of this committee; I see Ms. Thurman shaking her head affirmatively—a strong bipartisan majority of this committee went on record as opposed to that approach.

So this year's proposal certainly moves in a better direction, and we're happy to see that, Mr. Secretary. It seems that it's an attempt to preserve broad-based employee ownership, but I think there's a problem—and we certainly differ on what constitutes

"broad-based." Quite candidly, we believe that the "highly-compensated employee test," so-called in the Administration's proposal, is unworkable.

The legislation that 23 of us, Democrats and Republicans alike, on this committee have introduced, H.R. 3082, uses a control test to determine whether an ESOP is truly benefitting rank and file employees.

The important question here, I think, Mr. Secretary, can I interpret the Administration's new proposal as an offer to work with us, to work with Congress, on preventing possible misuses of the 1997 law, which everyone agrees we should do? But at the same time, preserving employee ownership opportunities for rank and file workers of S-corporations?

Mr. SUMMERS. If I understood you right, Congressman, you're asking for my agreement on the dual principles, that we want to preserve the ESOP as an important tool, and at the same time we want to avoid any shelter opportunities created by the 1997 legislation, and we want to do those two things in the most effective and reasonable way possible.

We are absolutely prepared to work with you and members of this committee toward those two objectives, and that is precisely the motivation behind our proposals.

Mr. RAMSTAD. Well, I certainly appreciate that movement and that willingness to work together in a collaborative way, because the last thing we want to do is kill ESOPs for S-corporation employees. I mean, that makes absolutely no sense at all when we're trying to improve and increase savings programs and retirement programs. They're doing it right, and for us—for the Administration, for anybody—to try to put a damper on this sort of employee stock ownership plan is, I think, counterproductive to any good public policy.

Mr. SUMMERS. I agree.

Mr. RAMSTAD. I am glad to hear that you do agree.

Let me also just ask you parenthetically, could you provide us with a definition of the term "highly-compensated employee" that you are using in this year's proposal?

Mr. SUMMERS. Not off the top of my head, but wait just one second.

I have just been provided with an answer that you may or may not find helpful.

We define "highly-compensated employee" for this purpose in a way that parallels the definition of "highly-compensated employee" in other areas of the pension law. [Laughter.]

It may be better for us to pursue some parts of this in writing because it would be difficult to underestimate my degree of knowledge of these details. [Laughter.]

Mr. RAMSTAD. Let me use the remaining minute. I want to focus on the President's prescription drug proposal.

We all agree that for many low-income seniors, prescription drugs are a crisis, the lack of accessibility, for the 35 percent that aren't covered under Medicare. Why not, instead of spending $76 billion, as the President's budget does, why not target prescription drug coverage to low-income seniors? Why displace the coverage that a majority of enrollees have? Why not target the 35 percent

of low-income seniors? And I ask that in good faith; I'm not trying to politicize this issue. In my judgment, this is the last issue that we should politicize. I really don't understand why we don't simply target the 35 percent of those Medicare beneficiaries without prescription drug coverage.

Mr. SUMMERS. That's something we've—

Chairman ARCHER. Mr. Secretary, you have one minute. It just expired. [Laughter.]

Chairman ARCHER. Go ahead.

Mr. SUMMERS. Thank you, Mr. Chairman.

Three reasons. First, more than half of those without prescription drugs have incomes above 150 percent of the poverty line.

Second, many of those with some coverage have completely inadequate coverage that is important to build on, and our proposal contains incentives for the preservation of that coverage, and wraps a better form of coverage around that base coverage.

Third, the strength of Medicare has traditionally been its universality. Everybody pays in and everyone receives the benefits. To carve out certain portions of Medicare benefits and make them only available to some individuals, it seems to us, would weaken the program.

For those three reasons, we favored a universal approach.

A fourth reason is to avoid various kinds of adverse selection effects.

Mr. RAMSTAD. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman's time has expired.

Mr. RAMSTAD. Let me just say I hope we can work together, and I hope the Administration doesn't persist with an all-or-nothing approach to this, because it's too—

Chairman ARCHER. The gentleman's time has expired.

Mr. Doggett?

Mr. DOGGETT. Thank you, Mr. Secretary, for your leadership on so many issues.

Let me say first that I really applaud the initiative that you've taken on tax havens, these international tax havens that have been used to provide tax shelters, and I'm already working on some legislation in this area and I look forward to cooperating with you.

Second, with reference to tobacco, do I understand that your recommendation basically is to use the tax code to address the problem of youth smoking and the leading cause of preventable death in America today in much the same way we used the tax code to encourage research and development, or accomplish some other reasonable social objective?

Mr. SUMMERS. It could be put that way, Congressman Doggett. I think I would prefer to think of it as not using the tax code, but simply working to create a youth penalty in an overall tobacco program that would reduce youth smoking, and some of which would be administered through the tax system.

I think we've made much greater progress, frankly, with respect to most other forms of public health problems than we have with respect to tobacco, and I think the price sensitivity is very clear. And that's why we're going with this approach.

Mr. DOGGETT. We certainly have in some other areas, as you have noted. There is a smuggling problem, and I do have some legislation on that, that I think we need to work together on. But it just seems to me that your tobacco area that you're working on here deserves the title "death tax" much more than the misapplication of that term to the alleged inheritance tax plight of the Steve Forbes family.

Let me say as a third area that I am concerned about that you have addressed, and I am pleased to see you do it, is something similar to the approach that I have advocated through H.R. 2255 on addressing corporate tax shelters.

During last year, when this Congress largely ignored the problem of abusive corporate tax shelters and never got around to even having a hearing on it until Members were packing in the middle of November to leave town, I noted recently that period was described by a top official at the Internal Revenue Service in the Wall Street Journal as one in which there was "almost a product of the week, or a product of the day, that these tax hustlers were promoting."

Let me just ask you if you would characterize the problem of abusive shelter tax evasion as having grown much worse during 1999.

Mr. SUMMERS. You know, it's the nature of this problem that it is very difficult to track, because it takes multiple years until one can fully analyze corporate returns, and those who engage in these transactions don't take out advertisements indicating that they have engaged in these transactions. So any evidence has to be inherently circumstantial.

But from the conversations that we've had with a range of practitioners, I think both Commissioner Rossotti and I have come away with a sense that there is more and more pressure to engage in these transactions, and in part it takes the form of a kind of competitive pressure, where Chief Tax Officers of corporations are told by their CFOs, you know, "The other CFOs are engaging in that transaction; why won't you?" And then increasingly, law firms are giving opinions in support of transactions that they would have been unwilling to give several years before, because of the competitive pressure.

So it is our sense that this is a problem that is of growing significance.

Mr. DOGGETT. I believe you refer to that as a "race to the bottom" in your written testimony.

You know, at our last and only hearing on this in November, Mr. Kies, who has been a real head cheerleader for these abusive tax shelters, indicated he had no familiarity with the BOSS transaction marketed by his company. I was so pleased to see Treasury move forward to deal with the BOSS problem. My question to you would be, why is it that legislation is necessary? Why can't you just go and solve these problems administratively?

Mr. SUMMERS. Let me say we have had, I think, a number of successes in dealing with these problems administratively, and I am proud of the work which my colleagues have done which I think has saved the Treasury over the last three years literally tens of billions of dollars as a consequence of their alertness.

But I don't think we can rely for the integrity of our tax system on an approach based on Treasury staff picking up rumors, going and investigating, finding out about transactions, and closing them. It seems to me that the people and the companies that engage in these transactions know that these are transactions of a somewhat questionable nature, and it seems to me appropriate that they be expected to flag these transactions so that they can be clearly considered. And if they are within the law, no one should pay more taxes than the law requires them to pay, but they should flag these transactions rather than being encouraged to carry them out by stealth.

It seems to me that where we have situations—not where people make an honest error, or a controversial judgment is ruled against them—but where there are transactions that are devoid of economic substance, if we want to deter those types of transactions, some increases in penalties seem to us to be appropriate in those cases.

It also seems to me appropriate that as part of a simplification that a number of people have espoused here, that rather than encouraging reliance on a common law approach where everybody reads a lot of different court cases to seek to understand what the definition of "economic substance" is, it seems to me appropriate to codify what is meant by "economic substance" and for this to be an area in which policy is set by the Congress rather than by the Judiciary.

And so for all of these reasons, it seems to me appropriate to legislate in this area, although you have my assurance that the Department and the IRS will do what we can within our authorities, but we want to be very careful not to overstep our authorities. That's why we're looking to Congress for what we regard as very much necessary legislation.

Chairman ARCHER. The gentleman's time has expired.

The last member to enquire, you will be happy to hear, Mr. Secretary, is Mr. English.

Mr. ENGLISH. And thank you, Mr. Chairman. Hopefully, as in the Bible, the last shall be first.

I thank you for the opportunity to enquire, Mr. Secretary. There are some things in your budget that I really don't care for. Probably at the head of that list is the $70 billion in unitemized Medicare cuts, and I understand why they're in there.

I do think you deserve credit for having included a number of tax changes that could be positive. I would specifically reference the end of the Section 415 restrictions on multiemployer defined benefit plans, which unnecessarily restricts the pension rights of many workers in this country. You have proposed the elimination of the 60-month limit on student loan interest deduction; that makes a great deal of sense. You have proposed to extend the exclusion for employer-provided education assistance to graduate education, and I've come to recognize how important that is.

Mr. Secretary, I am interested in your comments on earned income tax credit, because I think the modest proposal you put forward probably does not increase fraud and is probably worth doing for the working poor, but that's something that I want an opportunity to examine.

If I might, because my time is limited, I would appreciate your written response on a number of points.

One, you proposed modifying the Section 179 expensing provision for small business, which is a very important provision, all out of proportion to its size. You propose putting the additional limit on it, liberalizing it elsewhere, applying it only to firms with $10 million in gross receipts.

If you would, I am interested in that proposal and I would like your further justification of it.

[The information was not available at the time of printing.]

Mr. ENGLISH. I would like for you to outline for me in writing, in proposing your exemption of severance pay from income tax, which seems to be a solid proposal going in the direction of income stabilization. Why do you apply it only to the first $2,000, if it's for some reason other than simply limiting the revenue loss?

[The information was not available at the time of printing.]

Mr. ENGLISH. I would look forward to your justification of your proposal to tax the gains from the sale of a principal residence if it is a residence that has been obtained through a "like kind" exchange within the prior five years. I don't understand the abuse you're trying to address here, if there is one. In my view, I don't want to see us move back in the direction of taxing the capital gains on residences for taxpayers; that exclusion is one of the best things we've been able to do in recent years, and I would like you to justify, if you would, why you have again proposed to moving to monthly payments of UC taxes for small employers. I don't see that does anything positive in terms of regulation or recordkeeping except impose an enormous paperwork burden on many small employers.

[The information was not available at the time of printing.]

Mr. ENGLISH. If you could get back to me in writing on those, I would like you to comment now—while, as I have noted, I support some of the things the Administration has proposed in the area of education tax policy, I am disappointed that you have not proposed any additional tax break for college savings. That seems to me to be something that we ought to be encouraging. We ought to be taking college savings out from aid calculations.

I wonder if you can comment on why the Administration didn't pursue this area, and how your proposed college opportunity tax cut would interact with the Hope Scholarship, with a phase-out starting at $50,000 in some cases. That, to me, seems to be an extremely low threshold. I look forward to your comments.

[The information was not available at the time of printing.]

Mr. SUMMERS. We will get back to you in writing on the multiple concerns you raised.

With respect to education, the so-called RSAs, Retirement Savings Accounts, despite their name, would be available for college education and would involve withdrawals for college education. We've had some concerns about how some of the Education Savings Account proposals could be turned into an estate planning technique, frankly, and that's why we prefer our Retirement Savings Account approach.

With respect to the college opportunity deduction, my understanding is that it would have a substantially higher income limit than you suggested, somewhat closer to $100,000—

Mr. ENGLISH. That's for joint filers, though. I think for single income filings it starts at $50,000 to $60,000, is that not correct?

Mr. SUMMERS. It is, as you suggest, lower for single filers.

We also have the existing IRAs and the existing approach to qualified State tuition plans. Those provide additional incentives for saving.

With respect to your question about college financial aid formulas, speaking personally I have very considerable sympathy for your view, although in the reauthorization legislation a year or two ago it wasn't possible to make that change in the higher education area.

My sense is that we now have, particularly if we have the RSAs, the IRAs, the qualified State tuition plans, very substantial inducements to save for tuition, but that it is important also to provide direct assistance as college educations become economically more important, particularly for the third and fourth years. Only about a third of Americans who begin college actually graduate, and that points up the importance of support in the third and fourth years.

Mr. ENGLISH. Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman's time has expired.

Ms. Mathews, thank you for your patience and for appearing with the Secretary today.

Mr. Secretary, thank you very much. We appreciate your responses. We appreciate the succinctness with which you deliver them, and we appreciate your patience for spending so much time with us today.

There being no further business before the committee, the committee will stand adjourned.

[The following questions submitted by Chairman Archer, and Secretary Summer's reponses, are as follow:]

DEBT BUYBACK PLAN

1.) How has Treasury's announcement to buy back up to $30 billion of outstanding debt affected the bond market?

The Treasury's announcement that it expects to purchase up to $30 billion in debt this year has had a positive effect on the bond market. In a period of budget surplus such as we now enjoy, debt buybacks allow us to maintain larger, more liquid issuance of securities while simultaneously preventing an unjustified increase in the average maturity of the national debt. In conjunction with Treasury's announced policy of re-openings for 5, 10 and 30-year notes and bonds, buybacks will help to preserve the liquidity that is the hallmark of the US Government securities market.

2.) What is the estimated cost of the debt buyback plan in FY 2001?

Debt buybacks allow us to enhance the liquidity of Treasury's benchmark securities, which promotes overall market liquidity and should reduce the government's interest costs over time. The budget treatment (in accordance with CBO and OMB) for any price premium is as a "means of financing." This is the section of the budget that includes funds used for debt reduction (or borrowed to finance deficits), seigniorage on coins, changes in Treasury cash balances, and other items that, like debt buybacks, do not represent a true cost to the Federal government.

3.) Other countries that implemented debt buyback plans have abandoned the policy because it created unintended effects. Have you taken the experience of other countries into account in announcing this policy, and how do you plan to avoid the unintended effects that other countries experienced?

The Treasury Department is aware that other countries have conducted, and still conduct, debt buyback operations somewhat similar to our own. Canada, for instance, conducts regular debt buybacks and Sweden recently announced its own buyback program. However, those countries that have stopped buybacks appear to have done so for budgetary reasons as opposed to any adverse effects related to the buyback programs themselves.

SOCIAL SECURITY

1.) The President's legislative proposal submitted last fall dropped the idea of government investing in the stock market, which he had proposed in two prior versions of his plan. Why was government investing dropped from the President's bill, which was introduced by Mr. Gephardt and Mr. Rangel, among others? Why was the provision revived in the most recent plan?

The President believes that part of the new Social Security solvency transfers should be invested for higher returns, and he has held this belief consistently ever since he put forward his first framework for Social Security reform in the 1999 State of the Union address. The President omitted this proposal from the legislation he submitted in October because it was late in the Congressional session and he was looking for agreement on a starting point for Social Security reform. The President recognized that implementing a plan that included investing the solvency transfers in equities is a complex process that requires substantial discussion. So, in the interest of a bipartisan agreement, he put forward a plan he thought could attract support from a wide spectrum of opinion in the Congress in a very short amount of time. This year, with the benefit of a full Congressional year before him, the President returned to a full specification of the package he believes should be put in place to shore up Social Security for the long term.

2.) Why does the President's plan wait until 2011 to transfer "interest savings" to the Social Security Trust Funds? Why aren't the interest savings transferred this year to gain compounded returns immediately?

First, the policy begins in Fiscal Year 2001, with the reduction in publicly held debt from the Social Security surpluses and the associated interest savings. It is these interest savings that are credited to the Social Security Trust Fund, starting in 2011.

Second, the problems facing Medicare are more immediate than those facing Social Security. At the time the President put forward his budget the Hospital Insurance (Medicare Part A) Trust Fund was projected to be exhausted in 2015, compared with 2034 for the Social Security Trust Fund. Even now, it is still projected to be insolvent 12 years earlier, in 2025, compared to 2037 for Social Security. Therefore, the President has proposed using $299 billion of the on-budget surpluses over the next ten years to strengthen Medicare.

Third, on-budget resources are limited. Within these limits, the President put forward a framework that keeps the on-budget account in balance or surplus; preserves core government functions at realistic levels; extends Social Security solvency and Medicare solvency; provides a long-overdue Medicare prescription drug benefit and extends health insurance to millions of currently uninsured Americans; pays down the national debt by 2013; and provides tax cuts that are affordable, targeted, and progressive.

3.) How does the President's plan seek to protect the Trust Fund investments from political interference? What firewalls are in place?

The President has emphasized that the Administration and Congress must work together to put mechanisms in place that ensure that any investments are made independently and without political interference.

The President has proposed that equity investment be implemented in a manner that:

- Is independent and non-political;
- Uses the most effective private sector management services;
- Invests with a broad-based, neutral approach; and
- Minimizes administrative costs.

One approach that would satisfy these principles would be to establish an independent Social Security investment board. This board would, in turn, engage private money managers in a competitive process for the right to manage a portion of the Trust Fund's equity investment. These managers would each be instructed to invest their pool of money "passively"—that is, according to a broad-based index of equity prices that reflects the movement of all or a very substantial portion of the equity

market. Overall investment of the Trust Fund in equities would be strictly limited—to no more than 15 percent of the total value of the Trust Fund. We anticipate that total Trust Fund holdings would average about 3 percent of the overall market over the next 30 years.

We are confident that these protections will result in an investment structure that is maximally effective in strengthening the financial standing of the system. The Federal government's Thrift Savings Plan is a good example of how we expect the equity investment to be managed.

4.) Why hasn't the President submitted a plan that saves Social Security for 75 years—his stated goal in the State of the Union address in 1998?

The President has consistently stated that achieving full 75-year solvency would require a bipartisan effort. He has also consistently believed that he could best move that effort forward by working with the Congress to jointly develop a bipartisan plan, rather than by unilaterally putting forward a plan of his own. That said, the President clearly has taken the first step. He submitted a budget that, under the assumptions underlying last year's Trustees' Report, would extend the solvency of the Social Security Trust Fund from 2034 to 2054. With the President's reforms, the 75-year actuarial deficit would have been reduced by more than half, from 2.07 percent of taxable payroll to 0.80 percent. (Under the assumptions of the 2000 Trustees' Report, the President's proposal would extend solvency from 2037 to 2058, and reduce the 75-year actuarial deficit from 1.89 percent of taxable payroll to 0.67 percent.) The President encourages Congress to work with him in a bipartisan fashion to close the rest of the 75-year solvency gap through sensible reforms to the Social Security system.

5.) The latest plan has a "safeguard" mechanism to ensure that the general revenue transfers do not exceed the size of the on-budget surplus in any given year. Since the plan relies on annual transfers from 2011 through 2050, is OMB projecting that we will have sizeable on-budget surpluses every year for the next 50 years to make this plan work? If the surpluses do not materialize, what will happen to Social Security's solvency? Do you have an alternate plan for Social Security in case these surpluses do not materialize over the next 50 years?

OMB is indeed currently projecting that, under current policy, the on-budget account would remain in balance past 2050. This projection was developed under conservative economic assumptions—in fact, slightly more conservative than either CBO's or the Blue Chip consensus. Many respected private forecasters have more optimistic projections. For seven years in a row, throughout the Clinton Administration, both economic and budget results have been better than predicted.

Our policy of paying down the debt and securing the future of Social Security and Medicare is the best insurance against adverse developments in the future. Eliminating the publicly held debt by 2013 frees up the 13 percent of Federal spending now going to interest payments. And we believe the benefits of debt reduction should be earmarked to meeting our existing commitments to Social Security and Medicare, not to create new obligations.

The "safeguard" referred to in the FY 2001 Budget places annual dollar-specified limits on the maximum amount of the general revenue transfers to the Social Security Trust Fund. The general revenue transfers in the President's budget are based on the amount of interest savings from using the Social Security surpluses to reduce publicly held debt, up to these limits. If the actual on-budget surpluses turn out to be smaller than projected, the transfers to the Trust Fund would still occur. Even in that event, we would still be better off having used the resources to improve the net financial position of the government than to have paid for new spending or new tax cuts. Even with adoption of the President's proposal, the Trust Fund would be exhausted in 2058, and the 75-year actuarial deficit would be 0.67 percent of taxable payroll, under the assumption underlying the 2000 Trustees' Report. A bipartisan effort will still be needed to close the remainder of the 75-year gap.

6.) The President's plan extends Social Security's solvency through 2054, according to Social Security's actuaries. Does this mean that the President's plan ensures that taxes will not need to be raised and benefits will not be reduced before 2054?

First, the 2054 figure is a projection, based on economic and demographic assumptions. Actual performance of the Social Security Trust Fund could be better or worse than projected, which could result in the need for additional measures to secure Social Security's solvency even to 2054.

Second, the fact that OMB is projecting on-budget surpluses past 2050 means that it will be possible to implement the President's Social Security plan while paying full benefit and not increasing taxes. In fact, OMB's projections are based on the

President's policy, which cuts taxes below the baseline with targeted tax cuts totaling $256 billion from 2001–10.

[Whereupon, at 2:27 p.m., the hearing was adjourned, to reconvene at the call of the Chair.]

[Submissions for the record follow:]

Statement of the Air Courier Conference of America International, Falls Church, VA

This statement is submitted by the Air Courier Conference of America ("ACCA") in conjunction with the House Ways and Means Committee's February 9 hearing on President Clinton's proposed budget for fiscal year 2001. ACCA is the trade association representing the air express industry. Its members include large firms with global delivery networks, such as DHL Worldwide Express, Federal Express, TNT U.S.A. and United Parcel Service, as well as smaller businesses with strong regional delivery networks, such as Global Mail, Midnite Express and World Distribution Services. Together, our members employ approximately 510,000 American workers. Worldwide, ACCA members have operations in over 200 countries; move more than 25 million packages each day; employ more than 800,000 people; operate 1,200 aircraft; and earn revenues in excess of $50 billion.

ACCA would like to comment on one aspect of the President's proposed budget as it relates to the U.S. Customs Service. This is a critical area of interest to our industry because Customs administrations play a vital role in ensuring expeditious movement of goods across borders and consequently are critical to our industry's ability to deliver express international service. To give a sense of the size of our industry in U.S. trade—and as a customer of U.S. Customs—the express industry accounts for roughly 25 percent of all Customs formal and informal entries. In addition, express operators enter more than 10 million other manifest entries on low-value shipments, plus millions of clearances on letters and documents. In short, the flow of international commerce carried by express operators has become a significant portion of the total entering the United States, and American business has incorporated express service as an integral part of regular business operations. Express operators and these American businesses are highly dependent upon an efficient and effective Customs Service.

For the U.S. Customs Service to be efficient and effective, it must have modern, fully functional automation systems. Unfortunately, as the Ways and Means Committee knows, the current Customs automation system—the Automated Commercial System, or ACS—is antiquated and in desperate need of replacement. ACCA is extremely concerned about the pending obsolescence of ACS because the express industry operates in a virtual seven-day, 24-hour mode and thus relies on automation more than any other mode of transportation. We have invested tens of millions of dollars in automated systems designed to expedite shipment and delivery of goods within an express timeframe. An interruption in Customs' automation programs would devastate our ability to meet our express delivery deadlines and would harm a significant portion of the U.S. economy.

ACCA is extremely concerned that the Clinton Administration budget for FY2001 once again fails to acknowledge the critical importance to the U.S. economy of maintaining and improving an automated Customs environment. The budget proposes a new user fee to pay for Customs' automation programs, with the expectation that this would generate $210 million in the next fiscal year. First, this proposal fails to acknowledge the true cost for Customs to maintain its existing system, ACS, and develop a next-generation automation regime. The actual cost of this effort is probably close to $400 million annually. Second, the Clinton budget proposal fails to acknowledge the fact that the trading community has been and continues to pay an enormous annual stipend in the form of the merchandise processing fee (MPF) that should be directed to U.S. Customs' operations, including automation programs. MPF revenues total about $900 million annually and would be more than enough to pay for Customs automation programs. However, the MPF revenues have not been channeled to U.S. Customs; instead, they have gone to the general revenue fund of the U.S. Treasury.

With respect to user fees for Customs services, the express industry has a unique perspective because we pay for dedicated Customs resources at our facilities; this is a revenue source distinct from the MPF paid on entry. In order to obtain inspectional services whenever needed at our hub and express consignment facilities, the express industry agreed about 12 years ago to pay "reimbursables" to Customs. These fees are supposed to cover the costs to Customs of providing inspectors when needed. However, in recent years the cost of reimbursables has escalated well beyond the understood intent of the law and regulations, to the extent that

reimbursables have become a serious burden on the express industry. Reimbursable charges cost the industry more than $20 million last year—and the bills are mounting rapidly. On top of that, the express industry generated in excess of $75 million in MPF revenues in 1999. Since the MPF collected already exceeds the cost of services provided by Customs for express operations, the reimbursables system represents a hidden tax that is borne by the express industry and that is ultimately paid by U.S. importers. Yet, notwithstanding the significant user fees we already pay to U.S. Customs, we are facing a situation where we may not be able to provide express international service because of possible breakdowns in Customs' automation systems.

ACCA commends the Ways and Means Committee for opposing past Clinton Administration proposals to impose user fees on the trading community to pay for Customs automation, and we urge Congress to deny once again the Clinton Administration's request for a user fee for FY2001. However, we also urge Congress to recognize the critical need for new Customs automation systems and to acknowledge the fact that the trading community has already been paying for such a service without receiving any return on its investment. If Customs automation programs are allowed to founder for an additional year without any appropriated monies, the consequences could be dire for the entire U.S. economy. Therefore, ACCA urges Congress, as part of its FY2001 budgetary process, to appropriate MPF monies specifically for the development of a next-generation Customs automation program.

Statement of the Alliance of Tracking Stock Stakeholders

I. Position Statement

The Administration's proposal to impose a tax on certain distributions or exchanges of tracking stock (Tracking Stock) is unsound tax policy which, if enacted, will harm shareholders. It will also restrain new business and technology investment and development, cost jobs, cause severe harm to companies with Tracking Stock presently outstanding, and reduce business expansion.

In 1999, a substantial majority of the members of the House Ways and Means Committee (28 of 39 members) opposed a proposal by the Administration to impose a tax on corporations that issue tracking stock. The Committee should reject the current Administration proposal because it is even more onerous than last year's proposal for a number of reasons:

• It imposes a tax on shareholders upon the receipt of Tracking Stock in a distribution or recapitalization, even though the shareholder's overall investment in the corporation remains the same before and after the receipt of the Tracking Stock.

• The shareholder does not receive any cash with which to pay the taxes imposed and could be forced to liquidate part of his/her investment.

• The proposal gives the Treasury Department the authority to treat Tracking Stock as non-stock or as stock of another entity "as appropriate for other purposes," thus granting the Treasury unlimited authority to impose a tax on corporations that issue Tracking Stock.

• The new Treasury Department authority could preclude companies with Tracking Stock from being able to engage in ordinary nontaxable corporate recapitalizations (e.g., stock for stock exchanges) and distributions, thus limiting their ability to compete with companies with traditional equity structures.

Therefore, this proposal should be rejected.

• The issuance of Tracking Stock is motivated by compelling business needs. It provides a market-efficient source of capital, particularly to corporations attempting to grow lines of business that would not be valued appropriately by the equity markets without Tracking Stock.

• The proposal, if enacted, would eliminate a valuable source of capital to new businesses, deter the use of Tracking Stock, and possibly also force companies with over $500 billion of equity securities outstanding or pending to recapitalize at a considerable cost to them and to their shareholders.

• If Treasury becomes aware of inappropriate uses of Tracking Stock, it should resolve the issues administratively (through Treasury regulations and pronouncements) in a targeted way that avoids adverse consequences to business-driven Tracking Stock issuers. In abusive situations, Treasury has authority under current law to do this.

• The revenue estimates are unrealistic. The proposal would economically eliminate the use of Tracking Stock and provide little if any revenue to the Treasury.

II. Definition of Tracking Stock

Tracking Stock is a type of equity security issued by some companies to track the performance or value of one or more separate businesses of the issuing corporation. The holder of Tracking Stock has the right to share in the earnings or value of less than all of the corporate issuer's earnings or assets while retaining voting rights, liquidation rights and other risks of the issuing corporation as a whole. The Tracking Stock instrument has developed largely in response to the dual economies arising from the equity market's preference for "pure-play" securities (i.e., pure, single line of business companies) and the debt market's preference for diversified corporate balance sheets.

III. Business Considerations

Since General Motors first used it as an acquisition currency in September 1984, to acquire Electronic Data Systems Corporation (EDS), Tracking Stock has found wide receptivity by shareholders in North America.

To date, a total of 23 public companies have issued 33 separate Tracking Stocks for a variety of business reasons including:

- Acquisitions
- Growth of start-up businesses
- Source of equity capital
- Creation of stock-based employee incentive programs
- Continuation of economies of scale for administrative costs
- Retention of operating synergies
- Maintenance of consolidated credit and existing borrowing arrangements
- Valuation enhancement
- Increasing shareholder knowledge, and
- Broadening of the investor base

Numerous real-life examples demonstrate the beneficial impact the issuance of Tracking Stock has had on the U.S. economy:

- USX Corporation raised sufficient capital, through its U.S. Steel Tracking Stock, to modernize its steel operations and transform U.S. Steel from a company that generated billions of dollars in losses throughout most of the 80's into a more efficient steel company. It is the largest employer in the domestic steel industry, with high paying jobs, generating taxable income rather than losses and paying substantial income and payroll taxes to federal, state and local governments.
- Genzyme Corporation, a biotechnology company founded in 1981, develops innovative products and services to prevent, diagnose, and treat serious and life-threatening diseases. It initiated its use of Tracking Stock in 1994 when it founded a new program to develop tissue repair technologies. More recently, it adopted a new Tracking Stock to fund molecular oncology research, including cancer vaccine clinical trials in breast, ovarian and skin cancer.
- Perkin-Elmer (now PE Corporation), a high technology company, chose Tracking Stock for several business reasons including: facilitating new business and technology development; recruiting and retaining key employees; exposing and facilitating appropriate valuation for new technology opportunities; and providing flexibility for raising future capital and optimizing further development and expansion of each of its businesses.

The economic benefits of Tracking Stock to these and other companies will be substantially eliminated if a tax is imposed on shareholders or issuers.

IV. Financial Market Impact of the Administration's Budget Proposal to Tax Tracking Stock

- Should the Tracking Stock proposal be enacted, many future uses of Tracking Stock would be deterred and companies currently capitalized with Tracking Stock—and their shareholders—would be severely impacted. The imposition of tax upon the issuance or exchange of equity to shareholders would effectively shut down a Tracking Stock company's ability to access the equity capital markets.
- The new Treasury Department authority could preclude companies with Tracking Stock from being able to engage in ordinary non-taxable corporate recapitalizations (e.g., stock for stock exchanges) or distributions, thus limiting their ability to compete with companies with traditional stock structures.
- The proposal would seriously reduce the ability of Tracking Stock companies to raise capital through the debt markets. It would undermine their credit worthiness in the marketplace by hampering their ability to continue to use Tracking Stock to raise equity to strengthen their balance sheets and build their businesses in a cost efficient manner.

• High-technology companies in particular would lose a medium used to attract and retain key personnel.
• As a result of these consequences, investors would see Tracking Stock as an inefficient capital structure and equity valuations would suffer.
• Ultimately, as a result of this Tracking Stock proposal, over $500 billion of equity securities currently outstanding or pending could need to be restructured at great cost and under intense market pressure, causing a loss of shareholder investment and competitive vulnerability.

V. Tax Policy Considerations

Treasury states that the use of Tracking Stock is outside the contemplation of subchapter C and other sections of the Internal Revenue Code. Treasury also states that receipt of Tracking Stock by a shareholder in a distribution or exchange for other stock of the issuing corporation is a recognition event, as the shareholder has altered its interest in the issuing corporation. Both of these statements are wrong.
• Tracking Stock is consistent with subchapter C of the Internal Revenue Code because the tracked business remains in the same corporation and the Tracking Stock represents equity in that same corporation.
• Tracking Stock does not reduce a corporation's tax liability compared to its tax liability prior to the issuance of Tracking Stock. Thus, revenues to the U.S. Treasury are the same before and after the initial transaction. If the tracked business is successful, however, it will generate taxable income, create jobs, and pay additional taxes to federal, state and local governments. Likewise, increased equity valuations generate additional capital gains for individuals.
• Tracking Stock is not used to circumvent the requirements of section 355 of the Internal Revenue Code, including the Morris Trust provisions in section 355(e).
• Unlike Morris Trust transactions, corporations do not use Tracking Stock to dispose of businesses tax-free. Tracking Stock is a vehicle used for building and maintaining business assets within a single corporation.
• Tracking Stock does not result in a sale of the tracked business. Subsequent to adopting Tracking Stock, a corporation will recognize gain on any future disposition of the tracked assets, unless all of the provisions of Section 355 are satisfied.
• A shareholder receiving Tracking Stock has not altered his/her overall investment in the issuing corporation.
• The shareholder continues to own an equity interest in the same corporation, continues to have voting rights in the same corporation, and continues to participate in the growth of the same corporation.
• Although dividends paid to the shareholder on Tracking Stock may be based on the performance of a division or subsidiary, and not on the entire issuing corporation, the dividends are still subject to limitations at the corporate level.
• It is inappropriate to tax a shareholder at the time he/she receives Tracking Stock in a distribution or exchange for other stock of the issuing corporation, as the shareholder has received no cash to use to pay the tax. The shareholder may be required to liquidate a portion of his/her holdings to pay the tax. The proper time for taxation is when the shareholder disposes of the Tracking Stock.
• Corporations do not issue Tracking Stock for tax reasons. The fiduciary responsibilities incumbent on the directors of a corporation with Tracking Stock (i.e., to multiple shareholder interests) far outweigh any conceivable tax motivation.
• Legislation is unnecessary. In abusive situations, Treasury has authority to address transactions it perceives as inappropriate under current law, through regulations and pronouncements, in a way that avoids adverse consequences to business-motivated Tracking Stock issuers.
• A statutory attack is unnecessary and inappropriate because:
• It harms shareholders by reducing the market value of their shares and by imposing a tax upon a distribution or exchange of Tracking Stock.
• It harms employees and customers. Unless a replacement source of capital is found, businesses will scale back operations, adversely impacting employees, customers, and the communities in which the companies operate.
• It harms corporations, impairing their equity and adversely impacting their ability to raise capital.
• It adds more complexity to the Internal Revenue Code.
• Tracking Stock transactions undertaken to-date have been driven by business considerations. The complexities associated with the issuance of Tracking Stock should prevent it from becoming a tax motivated vehicle. Tracking Stock is only appropriate for those companies for which the business advantages outweigh the complexities. These complexities include:
• The fiduciary responsibilities of the Board of Directors to shareholders of all classes of common stock, which may create conflicts.

• Each Tracking Stock business has continued exposure to the liabilities of the consolidated entity.
• The Administration's published revenue estimates for the proposal are unrealistic. Taxing Tracking Stock at issuance or upon receipt by shareholders would make it non-competitive relative to other sources of capital. Thus, the legislation would generate little or no revenue.

VI. Conclusion

Last year, the Administration proposed to tax corporations when they issued Tracking Stock to their shareholders. This year, the Administration proposes instead to tax shareholders when corporations issue Tracking Stock to them. The same tax considerations that mandated rejection of last year's proposal also require rejection of this year's proposal. Indeed, this new proposal is even more onerous as it attempts to impose tax on shareholders who have sold nothing and have received no cash with which to pay the tax.

Issuance of Tracking Stock is motivated by compelling business needs. Treasury's Tracking Stock proposal will disrupt financial markets and cause severe harm to companies with Tracking Stock since it will not only restrict access to capital in the future, but also require massive financial re-engineering for some companies. Individual investors, and possibly entire communities in which Tracking Stock companies operate, will be adversely affected as a result of the competitive pressures this tax would impose.

Alliance of Tracking Stock Stakeholders

The Alliance is an informal group of companies that currently utilize or are considering using Tracking Stock. Members of the Alliance include companies such as Cendant Corporation, Circuit City, Comdisco Inc., General Motors, Genzyme Corporation, PE Corporation, Quantum Corporation, Staples Inc., The Walt Disney Company, USX Corporation, and others. These companies share a common concern for the value of shareholder investment in tracking stocks, as well as their continued ability to meet various business objectives through the issuance of tracking stock. For further information, contact Scott Salmon, Manager, Governmental Affairs, USX Corporation, 202–783–6797.

Statement of American Association for Homecare, Alexandria, VA

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

WHAT IS A HOME HEALTH AGENCY?

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

WHAT IS AN HME PROVIDER?

Home medical equipment (HME) providers supply medically necessary equipment and allied services that help beneficiaries meet their therapeutic goals. Pursuant to the physician's prescription, HME providers deliver medical equipment and supplies to a consumer's home, set it up, maintain it, educate and train the consumer and caregiver in its use, provide access to trained therapists, monitor patient compliance with a treatment regimen, and assemble and submit the considerable paperwork needed for third party reimbursement. HME providers also coordinate with physi-

cians and other home care providers (e.g., home health agencies and family caregivers) as an integral piece of the home care delivery team. Specialized home infusion providers manage complex intravenous services in the home.

HOME CARE IS JUST BEGINNING

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

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

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

HOME CARE IS ECONOMICAL

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

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

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[1] For recent studies, please see:

- Styring, William & Duesterberg, Thomas, The Cost Effectiveness of Home Health Care: A Case Study on Indiana's In-Home/CHOICE Program, (Vol. 1, No. 11), November 1997, (Hudson Institute, Indianapolis, IN).
- Mann, Williams C. et al, "Effectiveness of Assistive Technology and Environmental Interventions in Maintaining Independence and Reducing Home Care Costs for the Frail Elderly," Archives of Family Medicine, May/June 1999 (Vol. 8, pp. 210–217).

RESIST THE RUSH TO COMPETITIVE BIDDING

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

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

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

THE POLK COUNTY DEMONSTRATION

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

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

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

ELIMINATE ADDITIONAL CUTS TO THE HOME HEALTH BENEFIT

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

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

cant concern has been lack of access for eligible Medicare beneficiaries to the home health benefit.

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

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

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

HOME HEALTH PROSPECTIVE PAYMENT SYSTEM

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

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

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

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

CONCLUSION

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

Statement of American Bankers Association

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

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

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

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

REVENUE INCREASE MEASURES

Modify the Corporate-Owned Life Insurance Rules

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

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

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

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

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

Increased Information Reporting/Substantial Understatement Penalties

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

The ABA also opposes the Administration's proposals to modify the substantial understatement penalty. The proposed increases would be overly broad and could

penalize innocent mistakes and inadvertent errors. The establishment of an inflexible standard could effectively discourage legitimate business tax planning. We urge you to reject this revenue proposal.

Require Current Accrual of Market Discount

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

Subject Investment Income of Trade Associations to Tax

The ABA opposes the Administration's

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

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

Environmental Taxes

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

Other Issues

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

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

TAX INCENTIVE PROPOSALS

Expand Exclusion for Employer Provided Educational Assistance to Include Graduate Education

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

Retirement Savings Accounts

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

Low-income Housing Tax Credit

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

Qualified Zone Academy Bonds

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

Other Issues

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

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

CONCLUSION

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

Statement of American Petroleum Institute

Introduction

These comments are submitted by the American Petroleum Institute (API) for inclusion in the written record of the February 9, 2000 Ways and Means hearing on the tax provisions in the Administration's FY 2001 budget proposal. API represents approximately 400 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing.

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

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

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

Administration Proposals

Our testimony will address the following proposals:

- modify rules relating to foreign oil and gas extraction income;

• reinstate excise taxes and the corporate environmental tax deposited in the Hazardous Substance Superfund Trust Fund;
• reinstate the oil spill excise tax;
• corporate tax shelters;
• Harbor Maintenance Tax Converted to User Fee; and
• tax investment income of trade associations

RULES RELATING TO FOREIGN OIL AND GAS EXTRACTION INCOME

President Clinton's budget proposal includes the following provisions:

• In situations where taxpayers are subject to a foreign income tax and also receive an economic benefit from the foreign country, taxpayers would be able to claim a credit for such taxes under Code Section 901 only if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers, and then only up to the level of taxation that would be imposed under the generally applicable income tax.

• Effective for taxable years beginning after enactment, new rules would be provided for all foreign oil and gas income (FOGI). FOGI would be trapped in a new separate FOGI basket under Code Section 904(d). FOGI would be defined to include both foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI).

• Despite these changes, U.S. treaty obligations that allow a credit for taxes paid or accrued on FOGI would continue to take precedence over this legislation (e.g., the so-called "per country" limitation situations.)

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

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

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

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

The FTC Is Intended To Prevent Double Taxation

Since the beginning of Federal income taxation, the U.S. has taxed the worldwide income of U.S. citizens and residents, including U.S. corporations. To avoid double taxation, the FTC was introduced in 1918. Although the U.S. cedes primary taxing jurisdiction for foreign income to the source country, the FTC is intended to prevent the same income from being taxed twice, once by the U.S. and once by the source country. The FTC is designed to allow a dollar for dollar offset against U.S. income taxes for taxes paid to foreign taxing jurisdictions. Under this regime, the foreign income of foreign subsidiaries is not immediately subject to U.S. taxation. Instead, the underlying earnings become subject to U.S. tax only when the U.S. shareholder receives a dividend (except for certain "passive" or "Subpart F" income). Any foreign taxes paid by the subsidiary on such earnings is deemed to have been paid by any U.S. shareholders owning at least 10% of the subsidiary, and can be claimed as FTCs against the U.S. tax on the foreign dividend income (the so-called "indirect foreign tax credit").

Basic Rules of the FTC

The FTC is intended to offset only U.S. tax on foreign source income. Thus, an overall limitation on currently usable FTCs is computed by multiplying the tentative U.S. tax on worldwide income by the ratio of foreign source income to worldwide taxable income. The excess FTCs can be carried back two years and carried forward five years, to be claimed as credits in those years within the same respective overall limitations.

The overall limitation is computed separately for not less than nine "separate limitation categories." Under present law, foreign oil and gas income falls into the general limitation category. Thus, for purposes of computing the overall limitation, FOGI is treated like any other foreign active business income. Separate special limitations still apply, however, for income: (1) whose foreign source can be easily changed; (2) which typically bears little or no foreign tax; or (3) which often bears a rate of foreign tax that is abnormally high or in excess of rates of other types of income. In these cases, a separate limitation is designed to prevent the use of foreign taxes imposed on one category to reduce U.S. tax on other categories of income.

FTC Limitations For Oil And Gas Income

Congress and the Treasury have already imposed significant limitations on the use of foreign tax credits attributable to foreign oil and gas operations. In response to the development of high tax rate regimes by OPEC, taxes on foreign oil and gas income have become the subject of special limitations. For example, each year the amount of taxes on FOGEI may not exceed 35 percent (the U.S. corporate tax rate) of such income. Any excess may be carried over like excess FTCs under the overall limitation. FOGEI is income derived from the extraction of oil and gas, or from the sale or exchange of assets used in extraction activities.

In addition, the IRS has regulatory authority to determine that a foreign tax on FORI is not "creditable" to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI nor FOGEI. FORI is foreign source income from (1) processing oil and gas into primary products, (2) transporting oil and gas or their primary products, (3) distributing or selling such, or (4) disposing of assets used in the foregoing activities. Otherwise, the overall limitation (with its special categories discussed above) applies to FOGEI and FORI. Thus, as active business income, FOGEI and FORI would fall into the general limitation category.

The Dual Capacity Taxpayer "Safe Harbor" Rule

As distinguished from the rule in the U.S. and some Canadian provinces, mineral rights in other countries vest in the foreign sovereign, which then grants exploitation rights in various forms. This can be done either directly or through a state owned enterprise (e.g., a license or a production sharing contract). Because the taxing sovereign is also the grantor of mineral rights, the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "a specific economic benefit" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign has resulted in such taxpayers being referred to as "dual capacity taxpayers."

To help resolve controversies surrounding the nature of tax payments by dual capacity taxpayers, the Treasury Department in 1983 finalized the "dual capacity taxpayer rules" of the FTC regulations. Under the facts and circumstances method of these regulations, the taxpayer must establish the amount of the intended tax payment that otherwise qualifies as an income tax payment and is not paid in return for a specific economic benefit. Any remainder is a deductible rather than creditable payment (and in the case of oil and gas producers, is considered a royalty). The regulations also include a safe harbor election (see Treas. Reg. 1.901–2A(e)(1)), whereby a formula is used to determine the tax portion of the payment to the foreign sovereign, which is basically the amount that the dual capacity taxpayer would pay under the foreign country's general income tax. Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (i.e., the U.S. tax rate is considered the country's generally applicable income tax rate).

The Proposal Disallows FTCs Of Dual Capacity Taxpayers Where The Host Country Has No Generally Applicable Income Tax

If a host country had an income tax on FOGI (i.e., FOGEI or FORI), but no generally applicable income tax, the proposal would disallow any FTCs on FOGI. This

would result in inequitable and destructive double taxation of dual capacity taxpayers, contrary to the global trade policy advocated by the U.S.

The additional U.S. tax on foreign investment in the petroleum industry would not only eliminate many new projects; it could also change the economics of past investments. In some cases, this would not only reduce the rate of return, but also preclude a return of the investment itself, leaving the U.S. business with an unexpected "legislated" loss. In addition, because of the uncertainties of the provision, it would also introduce more complexity and potential for litigation into the already muddled world of the FTC.

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

The proposal's concerns with the tax versus royalty distinction were resolved by Congress and the Treasury long ago with the special tax credit limitation on FOGEI enacted in 1975 and the Splitting Regulations of 1983. These were then later reinforced in the 1986 Act by the fragmentation of foreign source income into a host of categories or baskets. The earlier resolution of the tax versus royalty dilemma recognized that (1) if payments to a foreign sovereign meet the criteria of an income tax, they should not be denied complete creditability against U.S. income tax on the underlying income; and (2) creditability of the perceived excessive tax payment is better controlled by reference to the U.S. tax burden, rather than being dependent on the foreign sovereign's fiscal choices.

The Proposal Limits FTCs To The Amount That Would Be Paid Under The Generally Applicable Income Tax

By elevating the regulatory safe harbor to the exclusive statutory rule, the proposal eliminates a dual capacity taxpayer's right to show, based on facts and circumstances, which portion of its income tax payment to the foreign government was not made in exchange for the conferral of specific economic benefits and, therefore, qualifies as a creditable tax. Moreover, by eliminating the "fall back" to the U.S. tax rate in the safe harbor computation where the host country has no generally applicable income tax, the proposal denies the creditability of true income taxes paid by dual capacity taxpayers under a "scheduler" type of business income tax regime (i.e., regimes that tax only certain categories of income, according to particular "schedules"), merely because the foreign sovereign's fiscal policy does not include all types of business income.

For emerging economies in lesser developed countries that may not be ready for an income tax, as well as for post-industrial nations that may turn to a transaction tax, it is not realistic to always demand the existence of a generally applicable income tax. Even if the political willingness exists to have a generally applicable income tax, such may not be possible because the ability to design and administer a generally applicable income tax depends on the structure of the host country's economy. The available tax regimes are defined by the country's economic maturity, business structure and accounting sophistication. The most difficult problems arise in the field of business taxation. Oftentimes, the absence of reliable accounting books will only allow a primitive presumptive measure of profits. Under such circumstances the effective administration of a general income tax is impossible. All this is exacerbated by phenomena typical of less developed economies: a high degree of self-employment, the small size of establishments, and low taxpayer compliance and enforcement. In such situations, the income tax will have to be limited to mature businesses, along with the oil and gas extraction business.

The Proposal Increases The Risk Of Double Taxation

Adoption of the Administration's proposals would further tilt the playing field against overseas oil and gas operations by U.S. business, and increase the risk of double taxation of FOGI. This will severely hinder U.S. oil companies in their competition with foreign oil and gas concerns in the global oil and gas exploration, production, refining, and marketing arena, where the home countries of their foreign competition do not tax FOGI. This occurs where these countries either exempt foreign source income or have a foreign tax credit regime that truly prevents double taxation.

To illustrate, assume foreign country X offers licenses for oil and gas exploitation and also has an 85 percent tax on oil and gas extraction income. In competitive bidding, the license will be granted to the bidder that assumes exploration and develop-

ment obligations most favorable to country X. Country X has no generally applicable income tax. Unless a U.S. company is assured that it will not be taxed again on its after-tax profit from country X, it very likely will not be able to compete with another foreign oil company for such a license because of the different after-tax returns.

Because of the 35 percent additional U.S. tax, the U.S. company's after-tax return will be more than one-third less than its foreign competitor's. Stated differently, if the foreign competitor is able to match the U.S. company's proficiency and effectiveness, the foreign company's return will be more than 50 percent greater than the U.S. company's return. This would surely harm the U.S. company in any competitive bidding. Only the continuing existence of the FTC, despite its many existing limitations, assures that there will be no further tilting of the playing field against U.S. companies' efforts in the global petroleum business.

Separate Limitation Category For FOGI

To install a separate FTC limitation category for FOGI would single out the active business income of oil companies and separate it from the general limitation category or basket. There is no legitimate reason to carve out FOGI from the general limitation category or basket. The source of FOGEI and FORI is difficult to manipulate. The source of FOGI was determined by nature millions of years ago. FORI is generally derived from the country where the processing or marketing of oil occurs which presupposes substantial investment in nonmovable assets. Moreover, Treasury has issued detailed regulations addressing this sourcing issue. Finally, unless any FORI is earned in the extraction or consumption country, it is very likely taxed currently, before distribution, as Subpart F income even though it is definitely not passive income.

The FTC Proposals Are Bad Tax Policy

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

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

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

REINSTATMENT OF EXPIRED SUPERFUND TAXES

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

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

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

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

REINSTATMENT OF OIL SPILL EXCISE TAX

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

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

CORPORATE TAX SHELTERS

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

HARBOR MAINTENANCE EXCISE TAX CONVERTED TO COST-BASED USER FEE

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

API strongly supports the use of such funds for channel maintenance and dredge disposal. We object to the Administration's proposal to use these funds for port construction and other services. The Administration should earmark these funds to address the growing demand for harbor maintenance and dredging. Furthermore, the Administration's proposal would force commercial shipping interests to bear the entire cost of the Army Corps of Engineers' harbor maintenance and dredging program rather than spreading the costs among all beneficiaries. We urge Congress to pass

H.R. 3566 and create an off-budget trust fund for the Harbor Services Fund. Finally, API urges Congress to take the lead in seeking stakeholder input and developing a fair and equitable means of generating the needed revenue.

SUBJECT INVESTMENT INCOME OF TRADE ASSOCIATIONS TO TAX

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

Statement of Michael S. Olson, American Society of Association Executives

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

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

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

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

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

Association members spend more than $1.1 billion annually complying with association-set standards, which safeguard consumers and provide other valuable bene-

fits. Those same associations fuel America's prosperity by pumping billions of dollars into the economy and creating hundreds of thousands of jobs. Were it not for associations, other institutions, including the government, would face added burdens in the areas of product performance and safety standards, continuing education, public information, professional standards, ethics, research and statistics, political education, and community service. The work of associations is woven through the fabric of American society, and the public has come to depend on the social and economic benefits that associations afford.

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

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

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

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

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

I. Taxation of Section 501(c)(6) Organizations Under Current Law.

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

The UBIT rules were designed to prevent tax-exempt organizations from gaining an unfair advantage over competing, for-profit enterprises in business activities unrelated to those for which tax-exempt status was granted. Congress recognized, however, that Section 501(c)(6) tax-exempt organizations were not competing with for-profit entities or being unfairly advantaged by the receipt of tax-exempt income from certain "passive" sources: rents, royalties, interest, dividends, and capital gains. Tax-exempt organizations use this "passive" income to further their tax-exempt purposes and to help maintain modest reserve funds—to save for necessary

capital expenditures and to even out economic swings. Indeed, the legislative history regarding UBIT recognizes that "passive" income is a proper source of revenue for charitable, educational, scientific, and religious organizations [Section 501(c)(3) organizations], issue advocacy organizations [Section 501(c)(4) organizations], and labor unions and agricultural organizations [Section 501(c)(5) organizations], as well as trade associations, individual membership societies, and other voluntary membership organizations [Section 501(c)(6) organizations].

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

II. Taxation of Section 501(c)(6) Organizations Under the Administration Budget Proposal: Treating Professional Associations Like Social Clubs.

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

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

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

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

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

cation and professional standards manuals, and other forms of intellectual property which further exempt purposes.

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

III. Taxation of Association Lobbying Activities.

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

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

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

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

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

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

IV. Taxation of Member Dues.

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

This argument is flawed for a variety of reasons:

The argument implies that members voluntarily pay higher dues than necessary as an investment strategy. While in some circumstances members of tax-exempt associations can deduct their membership dues like any other business expense, members receive no other tax break for dues payments. As discussed above, they are in fact denied a deduction for any amount of dues their association allocates to lobbying expenses.

The argument implies that associations overcharge their members for dues, thereby creating a significant surplus of dues income. In fact, dues payments usually represent only a portion of an association's income; and dues are virtually always determined by a board or committee consisting of members, who would hardly tolerate excessively high dues. Finally, associations tend to maintain only modest surpluses to protect against financial crises, expending the rest on programs and services. Again, associations are member-governed; members would typically make certain that their associations do not accumulate a surplus beyond the minimum that is necessary and prudent for the management of their associations.

The argument assumes that Section 501(c)(6) organizations somehow pay dividends to their members. Tax-exempt organizations do not pay dividends or returns in any form to their members, let alone for payment of dues. Indeed, an organization's exempt status may be revoked if any portion of its earnings are directed to individuals.

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

V. Expenditures Attributed to Investment and Other "Passive" Income Would Generally Qualify As Deductible Expenses If Incurred by Members of the Association.

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

VI. The Administration's Proposed Tax Would Reach All Forms of "Passive" Income and Jeopardize Tax-Exempt Programs.

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

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

Drafting and disseminating educational materials.

Establishing skills development seminars and programs.

Creating training and safety manuals for various professions.

Producing books, magazines, newsletters, and other publications.

Increasing public awareness, knowledge, and confidence in an industry's or a profession's practices.

Conducting and sponsoring industry research and surveys.

Compiling statistical data for industries and professions, which is often requested or relied upon by government.

Providing professionals and businesses with new technical and scientific information.

Developing and enforcing professional safety and health standards.

Developing and enforcing ethical standards for industry practice.

Operating accreditation, certification, and other credentialing programs.

Organizing and implementing volunteer programs.

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

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

BETHESDA, MD 20824–0776
February 18, 2000

Chairman, Committee on Ways and Means
U.S. House of Representatives
Longworth House Office Building
Washington, DC 20515

Reform of Certain Private Foundation Rules

Dear Mr. Chairman

Relevant web sites have invited public commentary on changes proposed by the Treasury Department to certain of the federal tax laws affecting charities and charitable foundations. The comments submitted herein are personal to the undersigned and do not represent the comments of my religious society, the Society of Jesus, or the church where I am now in residence. The undersigned is a graduate of the University of Bombay (B. Sci. 1940), Woodstock Theological Seminary (S.J.D., 1952), and New York University (LLM, Tax, 1966).

Tax reduction is certainly to be applauded, especially with respect to amounts that might otherwise not reach the charitable mainstream. A review of the excise tax based on investment income, suggests that it was drafted with minute attention to various details, yet, based upon an equally careful reading of Treasury Department regulations, the law omitted certain matters found to be so important that the Treasury Department took upon itself the task of amending the statute via regulations.

It would seem prudent that if the excise tax based on investment income is being analyzed anew for changes which have the net effect of reducing total tax collections, the Congress should address matters which were originally omitted from the legislation but now covered, but not necessarily governed by, applicable regulations. Congress has the opportunity to decide whether the same public policy considerations which inhered in writing ameliorative regulations benefiting foundations should be confirmed by statutory changes aimed primarily at rate reductions.

It was not a particularly difficult task to read the statute, and applicable Treasury Department regulations, and find at least one half dozen gaps between the statutory language and provisions in the applicable regulations. It is the suggestion of the undersigned that, because there is no statutory authority supporting ameliorative regulations cited below, that these matters be addressed by Congress so that their beneficence is confirmed by statutory support.

The statute says plainly that gross investment income includes interest, rents, royalties, etc. The law also specifically provides that gains and losses are includable

in income respecting property "used for" the production of interest, rents, etc. Nevertheless, applicable regulation specifically exempt from the capital gains tax property which is so used but which is also used for a charitable or educational function by the foundation. The statute does not contain any such allowance as that granted by the regulation. It would seem that the statute should do so to protect the property of foundations which they have chosen to place within the charitable mainstream and, which at the same time, produces some of the income so designated.

It is worth re-examining whether or not interest earned from loans by a private foundation to a public charity which allow the borrower to better conduct its public function should be subject to the excise tax at all. Certainly, if a private foundation holds a municipality's indebtedness, the law specifically precludes taxation of such interest income (but not necessary any capital gain). From a tax policy standpoint, encouraging private foundations to lend monies to religious, scientific and charitable institutions for enhancement of their proper purposes by excluding the interest revenues would quite likely reduce borrowing costs of such public institutions for obvious reasons including the ancillary consideration that it increases competitors in the marketplace for such institutional indebtedness. Creating such a modest incentive for foundations to lend (tax free) monies to public institutions is also beneficial because such institutions would then avoid the tortuous processes now extant to qualify their debt for municipal status allowed by other Code provisions.

If a parishioner of mine, God forbid, is obligated by a court decree to pay alimony or child support and transfers property to satisfy any such obligation, there is irrefutable judicial authority which supports the income taxation of the transferor based upon the gain inherent in his transfer of property to satisfy his obligation. There is no significant difference between an ordinary debt and the annual mandatory pay out of private foundations (now fixed at 5%). Case law would deem a distribution of appreciated property by a foundation to satisfy this pay out obligation as a sale or exchange. The statute specifically provides that "net investment income shall be determined under the principles of subtitle A." Despite the specific language of the cited Code provision, Internal Revenue regulations specifically provide that a distribution of appreciated property, treated as a qualifying distribution, is not a "sale" or other disposition, i.e., not a taxable event. While this certainly is a salutary regulation and helpful to the private foundation community, it is nowhere to be found within the statute and directly contradicts the literal rule, meaning that the Treasury Department set itself above Congressional draftsmen in addressing the problem it discovered. To allow such regulation to continue without statutory support and in contradiction of law, does not promote the integrity of statutory authority nor does it conform Treasury behavior to expected norms. It is my suggestion that this particular provision, upon review and analysis, be added by law to preserve some foundation principal and make the statutory language more principled.

Apart from these regulatory flaws notated above, though helpful as they are, there are other statutory considerations addressed by Treasury Department regulations which also amend the law but to the detriment of the private foundation community. Again, the regulations have chosen to ignore language expressly written by Congress and seek revenue protecting regulations which are incongruous to the relief described above. It almost seems as if there were two complete sets of draftsmen for these regulations, those who favored reducing the exposure and liability of private foundations and those which favored their taxation. Whichever group was involved, it is time for Congress to reevaluate whether or not all these particular omissions (as corrected by regulations) should be confirmed or repealed in that they run counter to the present philosophy exhibited by the President's tax plan to reduce the tax burden on private foundations.

The specific statutory language precludes "capital loss carryovers" in connection with the computation of net capital gain income. Based upon a careful reading of the rules governing capital gain taxation, there is a plain distinction between a carryover, provided for by existing law, and a carryback, not now provided for by the excise tax on investment income. Despite the absence of the term "carryback" in the statute, the applicable regulations have nevertheless chosen to insert that word and that principle to dilute the effect of the Congressional omission by expressly providing that a current year's capital loss may not be used to reduce taxable gains realized in a prior taxable year. It is suggested that this policy question be resolved in favor of foundations and the policy of tax relief evidenced by the tax reduction proposal expanded to allow the use of net capitol losses in prior or future taxable years. It is therefore suggested that the "no carry forward" barrier for losses be amended to grant such minor relief for the future. One has to merely open the pages of the many "bear" journals to see some see the stock market as quite unstable. Denying the full utilization of net capital losses acts as a hindrance to prudent financial investments by foundation managers and their professional advisors.

The statute specifically provides that the tax on capital gains applies only with respect to property "used for" the production of interest, dividends, royalties, etc. Despite this express provision limiting the type of property whose capital gain is subject to tax, it appears from the tax literature, and text writers, that the government asserts the right to tax property which yields none of these forms of investment income. The authority for such assertion of liability arises from regulations which authorize the taxation of capital gains which arise solely through appreciation although the property is not or was not actually so used.

Real estate is commonly acquired for investment purposes, though not income producing via rents or royalties, and often held solely for its appreciation potential. It seems that with sharp change in investment philosophy for charities, *viz*, moving towards a total return portfolio, no longer balanced between "income" and capital appreciation, a revised tax statute should assure the foundation community that capital gains from property which yielded, during the taxable year, no interest, no dividends, no rents or no royalties, are exempt from capital gains tax when such are realized.

One last provision should be addressed because it again runs completely counter to the statement in the statute that the "principles of subtitle A" are to be followed in determining liability respecting the excise tax on investment income. The rules governing the income taxation of trusts, which make charitable distributions, are very clear. If a trust has a governing instrument which provides for a distribution to a charitable organization, or for charitable purposes, the trust is entitled to an income tax charitable deduction for the amount paid for that purpose. The income tax rules governing such payments specifically preclude the inclusion of any such amounts in the income of the donee charity and also remove from the donee charity the onus of the characterization of the amount so distributed. Thus, if a decedent, in year 2000, upon death created and funded a charitable lead trust, the amounts distributed by the charitable lead trust, to a private foundation, would be deductible by the charitable lead trust in the computation of its taxable income. Under the provisions of existing law, because the trust claimed and was entitled to claim a charitable deduction, the includability and characterization rules, otherwise invoked by a trust distribution, are specifically barred from application by law (sec. 663(a)). Nonetheless, Treasury Department regulations would treat the annuity amount received by a private foundation, in for example, 2005, as subject to the 4940 tax. This regulation purports to distinguish between trusts making charitable distributions which were funded before 1969 and those funded after 1969, which appears to be a highly arbitrary determination (unless some law occurred at that time which authorized such a distinction). But even if such a law did so provide, there is nothing within sec. 4940 which cross references to the trust taxation provisions so as to preclude the application of sec. 663(a) to a charitable lead trust distribution. But Treasury Department regulations demand that the amounts which are received by a private foundation from a post 1969 charitable lead trust be included in the computation of tax liability under Sec. 4940. Again, this is yet another example of these regulations, taken in sum, violating basic legal precept that interpretative regulations should follow closely the statutory text. Regulations, according to the esteemed Carl Lewellyn, are an agency's performance of "interstitial rites" and not a revision of principles Congress chose (or forgot) to enact. Regulations do not represent an opportunity of the Treasury Department to alter congressional policies or congressional language which was omitted by law, whatever the reason for the omission. These Treasury regulations -cited above -are contrary to principle, embodied in the Code, and need to be taken into account in your consideration of rate reduction.

Yours in Christ,

REV. VBB, SJ

Statement of Center for a Sustainable Economy

Embargoed until 9:00 a.m. Thursday, February 3.

Contact: Andrew Hoerner, 202–234–9665, ahoerner@wam.umd.edu

Organization: Center for a Sustainable Economy

Full Text: The full text of the study can be downloaded from http://www.sustainableeconomy.org/resources.html

Context: Next week the President will release a new package of tax incentives for clean energy as part of his climate plan. These credits have been controversial—embraced by Al Gore, and attacked by, e.g., the Cato Institute, as uneconomic. This

study finds that the economic benefits of such credits outweigh the cost by more than five times—even ignoring the environmental benefits.

Study Finds Economic and Environmental Benefits from Tax Incentives for Energy Efficiency and Renewable Energy

In a ground-breaking approach to measuring the costs and benefits of technology investments, the Center for a Sustainable Economy (CSE) released a study today showing net economic gains in addition to the environmental benefits expected from the President's proposed tax credits for energy efficiency. The U.S., long recognized as world leader in innovation and industry, has fallen behind its competitors in the areas of energy efficiency and renewable energy. "This study shows that measures to protect the climate can also benefit the economy," says study author J. Andrew Hoerner. "We found the tax credits would have non-environmental economic benefits that pay for the credits five times over." The U.S. has been lagging behind Europe and Japan in the deployment of many clean energy technologies. The Administration's proposed tax incentives would help reverse this trend by making it easier for Americans to invest in efficient homes, vehicles, building equipment, and renewable energy, such as wind and biomass.

The Climate Change Technology Initiative included tax incentives with an estimated revenue cost of $6.4 billion.[1] The purpose of these incentives was to promote a range of energy efficiency and renewable energy technologies, including high-mileage vehicles, energy-efficient buildings and homes, cogeneration (combined heat and power) facilities, and solar, wind and biomass energy. In order to evaluate the economic costs and benefits of the credits, CSE estimated the price and quantity of each technology produced with and without the credit, based on a detailed survey of over 80 experts in the six technologies from industry, academia, NGOs and government. "This methodology is a way to represent the consensus of the best thinking from experts on these technologies," said Hoerner.

The study, *Assessing Tax Incentives for Clean Energy: A Survey of Experts Approach,* by J. Andrew Hoerner and Avery Gilbert, has the potential to breach the stalemate that has long characterized debate over federal incentives for clean energy technologies. By assessing the long-term market transformation effect of the tax credits (as part of a larger clean energy policy), the study found that an expenditure of $5.7 billion on the tax incentives would:

- Cause reductions in the price of the technologies receiving the credits that are greater then the cost of the credit to the government;
- Have non-environmental economic benefits that exceed the cost of the credits (The present value of the non-environmental economic benefits will be roughly five times the cost of the credit over the 2000–2018 period. In addition, consumer savings from reduced energy bills would amount to $74 billion between 2000–2018);
- Cut local air pollution emissions to a degree that would save Americans two times as much in health care costs as the U.S. government would spend on the credits.
- Result in 116 million metric tons of carbon emissions reductions between 2000–2018. Although the carbon dioxide emission reductions from the credits in 2012 are still small (3 to 4 percent of the emission reductions that would be required under the Kyoto Protocol), the equipment installed as a result of the credits will continue to produce emissions savings over lives ranging up to 60 years. When these lifetime reductions are considered, carbon savings are achieved at approximately $11/ton. This compares favorably with the cost of achieving emission reductions through international trading as estimated by the Council of Economic Advisors.

It has often been claimed that most of the benefits from credits such as these go to people who would have purchased the equipment anyway. This study confirms that, during the period of the credit, the direct benefits go primarily to the taxpayers who would have purchased the equipment or energy in any case. The study nonetheless finds that the benefits to those who actually take the credit are greater than the cost of the credit and that the benefits to society at large in the form of lower prices for clean energy technologies and improvements in related technologies, as well as local environmental benefits, are also greater than the cost to the government of the credits.

Center for a Sustainable Economy is a non-profit non-partisan research and policy organization that promotes innovative market-based approaches to achieving a sustainable economy—one that integrates long-term economic prosperity, environmental quality and social fairness.

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[1] Estimate by U.S. Joint Committee on Taxation of Administration's FY2000 proposals (released in February 1999). CSE's estimate of the cost is $5.7 billion.

Assessing Tax Incentives for Clean Energy Technologies:

—A Survey of Experts Approach—

Abstract

Some analysts regard tax incentives for environmentally beneficial technologies as necessary to jumpstart new clean technologies; others see them as wasteful subsidies to the benefited industries. The magnitude of public benefits from a particular tax incentive provision depends on the nature of the market, the impact of the provision on the process of technological change, and the value of the environmental harm averted. Whether public benefits are greater or less than the revenue cost of a given tax subsidy is an empirical question that must be decided on a case-by-case basis.

This paper uses a survey-of-experts (single-round Delphi Analysis) approach to estimating the impact of the tax incentive portion of the Climate Change Technology Initiative (CCTI) proposed by the Administration as part of the fiscal 2000 budget. Based on the responses of a panel of 81 experts (at least ten per technology) drawn roughly equally from industry, government, academia and the non governmental organization (NGO) community, we provide mean forecasts for quantity and price of each of the technologies covered by the CCTI tax incentives with and without the tax package. These price and quantity estimates are then used to calculate the increase in consumer surplus in the market for that technology. We also asked the panel to estimate any spillover benefits from credit-induced technological progress on the efficiency of products not receiving the credit.

To be effective the tax credits cannot be enacted alone. Instead they must be part of a larger policy effort to stimulate the targeted technologies. Because this is true we did not attempt to estimate the impact of the credit absent additional policies that help counter other types of barriers to the penetration of the technologies. Instead, we assumed that a host of measures and policies to facilitate the market penetration of the technologies would be introduced and then asked our panel of experts what the additional penetration might be with a tax credit.

We conclude first that the credits are likely to have a revenue cost about 13 percent less than estimated by the Congress's Joint Committee on Taxation (JCT). This modest change disguises much greater disagreement on a provision-by-provision basis, with our estimates of the cost of the solar and the wind and biomass credits being more than double JCT's estimates, with all other provisions costing significantly less. Four of the six proposed credits would provide non-environmental economic benefits to the public more than sufficient to offset the cost of the credits: the credits for fuel-efficient vehicles, energy-efficient homes, energy-efficient building equipment, and combined heat and power systems. The credits for wind and biomass power and for rooftop solar systems have estimated non-environmental economic benefits to consumers comparable to their revenue cost.

Based on the expert forecasts of the quantity of each technology adopted we then estimated the energy savings attributable to each credit for each fuel type. The environmental value of these fuel savings were then monetized based on the high, medium and low estimates from a literature search and assessment by Viscusi, et al. (1994). These are local U.S. environmental benefits and do not include any benefit from reductions in impacts on the global climate. We conclude that, based on non-environmental benefits and local environmental benefits alone, the benefit/cost ratio is greater than one for all six credits, ranging from 1.5 to 1 (solar) to 75 to 1 (vehicles). These estimates use market-rate discounting. If lower social discount rates are used, the benefit is even higher.

However, it should be observed that in every case the precise level of public benefit is highly uncertain. Moreover, most of the benefits from accelerated technology development accrue from the continued use of that technology after the credits expire. In some cases, especially the vehicles credit, other energy policies need to be adjusted to prevent the effectiveness of the credit benefits from being undermined. Finally, the value of the local environmental benefit from the electricity oriented technologies (CHP, wind and biomass, PV's, and some heating and cooling equipment) is greatly reduced if the technologies are presumed to displace new natural gas fired generating plants rather than the average fuel mix.

In addition, we estimate the CCTI tax incentive package would reduce carbon emissions by 116 million metric tons over the forecast period 2000–2018. Estimates of the value of this reduction are provided on a credit-by-credit basis for a range of alternative carbon emission damage values. The cost of credit-induced carbon sav-

ings averages eleven dollars per ton of carbon saved over the lifetime of the equipment, a value that compares favorably with the cost of abatement through international trading as estimated by the President's Council of Economic Advisors.

The following table summarizes the present value of the costs and benefits of the CCTI tax incentives. It assumes that a package of low-cost technology promotion measures is enacted along with the CCTI incentives.

Value of Non-environmental and Environmental Benefits from the Tax Credits,

2000–2018 (millions 1999$)

	Non-Environmental Costs and Benefits			Environmental Benefits							
				Local Environmental Benefits		Climate Related Benefits					
	Expenditure	Consumer Surplus Spillover	Spillover Benefits**	Local Environmental Benefit	Local Environmental Benefits (Spillover)	$5/ton Direct Carbon Benefit	$5/ton spillover Carbon Benefit	20$/ton Direct Carbon Benefit	0$/ton Spillover Carbon Benefit	100$/ton Direct Carbon Benefit	100$/ton Spillover Carbon Benefit
Vehicles	1,181	20,197	67,232	550	517	43	40	172	161	859	807
Homes	35	115	728	33/7*	0.05/0*	0.8/.6*	0.0/ 0.0*	3/2*	0.02/ 0.01*	17/14*	0.1/ 0.0*
Building											
Eqpmt	108	146	N/A	190/18	N/A	6/5	N/A	24/19	N/A	120/96	N/A
CHP	208	4,674	N/A	5,016/ 46	N/A	92/58	N/A	366/ 229	N/A	1831/ 1144	N/A
Solar	358	406	N/A	132/8	N/A	9/7	N/A	38/30	N/A	189/ 151	N/A
Wind &											
Biomass	3,718	2,014	5,962	5,800/ 53	N/A	106/66	N/A	422/ 264	N/A	2112/ 1320	N/A
Total	5,608	27,552	73,921	11,721/ 682	517	256/ 180	40	1,025/ 716	161	5,127/ 3,584	807

*The second figure in each cell is the value of benefit when we assume that electricity savings displaces emissions only from natural gas combustion rather than the forecast average fuel mix.

** Only the economic value of the spillover benefits from hybrid vehicles, energy efficient homes, and biomass are included in this table Spillovers from wind and solar technologies are not included because of the difficulty distinguishing social benefits from mere redistribution of income.

Statement of Clark/Bardes, Dallas, TX

Introduction

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

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

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

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

Use of Employer-Owned Life Insurance

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

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

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

A simplified example may help to illustrate. ABC Company guarantees its employees a generous health benefits package upon retirement. Like all employers, ABC Company is required to book a liability on its balance sheet for benefits costs related to the eventual retirement of its employees, and needs to find ways to fund these obligations. As a solution, ABC Company takes out a series of life insurance policies on its employees. It pays level insurance premiums to the insurance carrier each year. The cash value on the life insurance policy accumulates on a tax-deferred basis and can be identified as a specific source of funds to meet benefit liabilities. In the event that the contract is surrendered, ABC Company pays tax on any gain in the policy. In the event that covered employees die, ABC Company receives the death benefit and uses these funds to offset the cost of benefits payments to its retired employees. Actuaries are able to match closely the amount of insurance necessary to fund ABC Company's liabilities.

The Administration's COLI proposal effectively would take away an employer's ability to finance retiree benefit programs using life insurance, and thus could force

businesses to severely limit or discontinue these programs. It is ironic that the President's proposal would hamstring a legitimate means of funding post-retirement benefits when a major focus of Congress is to encourage private sector solutions to provide for the needs of our retirees.

The Administration's COLI Proposal

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

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

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

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

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

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

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

The COLI proposal in the Administration's FY 2001 budget, submitted on February 7, 2000, would extend the section 264(f) interest deduction disallowance to COLI programs covering the lives of employees.[2] The proposal therefore would apply a proportionate interest expense disallowance based on all COLI cash surrender values. The exact amount of the interest disallowance would depend on the

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[1] For many companies, the effective key person limit under this rule is five employees. See section 264(b)(3).

[2] By eliminating the section 264(f)(4) exception that currently exempts COLI programs covering the lives of employees, officers, and directors.

ratio of the average cash values of the taxpayer's non-leveraged life insurance policies to the average adjusted bases of all other assets.

Lack of Tax Policy Justification

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

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

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

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

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

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

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

COLI is Not a "Tax Shelter"

Clark/Bardes strongly objects to the Administration's characterization of non-leveraged COLI as a "corporate tax shelter." The penalty provisions of the Internal Revenue Code define a tax shelter as any entity, plan, or arrangement with respect to which tax avoidance or evasion is a significant purpose.[8] A separate proposal in the Administration's FY 2001 budget proposes a new definition of "corporate tax

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[3] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress (JCS–12–96), December 18, 1996, p. 363.

[4] *Id*, at 364.

[5] H.R. Rep. No. 105–148, 105th Cong., 1st Sess. p. 501; S. Rep. No. 105–33, 105th Cong., 1st Sess., p. 186.

[6] Current law is quite specific that interest deductions resulting from both direct and indirect borrowing, i.e., using the policy as collateral, are disallowed. Sec. 264(a)(3).

[7] General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals, Department of the Treasury, February 2000, p.137.

[8] Section 6662(d)(2)(C)(iii).

shelter" under section 6662 that would apply to "attempts to obtain a tax benefit" in a "tax-avoidance transaction," defined as any transaction in which the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits.[9]

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

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

Attack on "Inside Buildup," Savings

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

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

Inappropriate Limitation on Business Deductions

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

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

The proposal becomes even more troubling when one considers the logical extensions of the Administration's rationale, which seems to be to deny interest deductions when a taxpayer at the same time enjoys the benefits of tax deferral. Might the IRS, using the same reasoning, someday seek to deny home mortgage interest deductions for individuals who also own life insurance? Might the government deny

[9] As a separate matter, Clark/Bardes believes the Administration's proposed new definition of "corporate tax shelter" is unnecessary, ill-advised, and could be broadly applied by IRS agents to attack many legitimate business transactions.

deductions for medical expenses for individuals that enjoy tax-preferred accumulations of earnings in 401(k) accounts or IRAs?

Conclusion

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

Statement of the Coalition for the Fair Taxation of Business Transactions [1]

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

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

I. Introduction

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

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

Furthermore, we believe the IRS currently has the necessary tools to challenge abusive transactions and additional statutory changes are unwarranted. The IRS has the authority to issue administrative pronouncements (notices, rulings, or other

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

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

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

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

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

II. Tax Shelter Definition

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

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

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

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

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

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

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

ing from the transaction, determined on a present value basis) of such transaction. Additionally, a financing transaction would be considered a tax avoidance transaction if the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing.

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

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

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

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

III. Modified Substantial Understatement Penalty

The Administration's budget proposal would increase the substantial understatement penalty from 20 percent to 40 percent with respect to any item attributable to a corporate tax shelter.[12] A corporation can reduce the 40 percent penalty to 20 percent by fulfilling specific disclosure requirements. Specifically, a taxpayer would be required to disclose a tax shelter transaction to the IRS National Office by filing a statement with the tax return describing the transaction. If the taxpayer meets a strengthened reasonable cause standard the penalty can be reduced from 20% to 0, even if the transaction ultimately is deemed to be a corporate tax shelter. The

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

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

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

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

[11] ACM at 247.

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

reasonable cause exception would be modified and strengthened by requiring that the taxpayer have a "strong chance of sustaining its tax position" (rather than "more likely than not").

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

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

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

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

IV. Increased Corporate Disclosure Requirements

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

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

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

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

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

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

V. Codification of the Economic Substance Doctrine

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

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

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

VI. Administrative Safeguards

Identifying and defining corporate tax shelters is a nearly impossible task. As evidenced by the various iterations of tax shelter definition, all of which are extremely

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

broad and lack a business purpose exception, both taxpayers and IRS agents are bound to disagree about which transactions are or are not tax shelters. Thus, especially in light of the proposed enhanced penalty regimes, taxpayers should be afforded remedies to protect against the potential abuse of power by IRS agents under these stricter yet ambiguous tax shelter definitions.

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

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

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

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

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

VII. Promoters, Tax Advisors and Standards of Practice

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

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

Finally, any income received by a tax-indifferent person with respect to a corporate tax shelter would be taxable to such person. To ensure that a tax is paid,

all corporate participants would be made jointly and severally liable for the tax. A tax-indifferent person would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, or a domestic corporation with a loss or credit carryforward that is more than three years old.

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

VIII. Conclusion

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

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

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

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

Statement of the Coalition of Service Industries[1]

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

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

[14] As noted previously, the IRS has successfully litigated many cases in this area, including most notably *Compaq Computer Corporation and Subsidiaries v. Commissioner of Internal Revenue,* 113 T.C. No. 17 (Sept. 21, 1999); *ACM Partnership v. Commissioner,* 73 T.C.M. 2189 (1997), *aff'd in part, rev'd in part,* 157 F.3d 231 (3d Cir. 1998), *cert. denied,* 119 S.Ct 1251 (1999) and *ASA Investerings v. Commissioner,* 76 TCM 325 (1998).

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

institutions were acting as integral parts of the U.S. government's system of withholding taxes and obtaining taxpayer information.

The Proposal

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

Current Penalties are Sufficient

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

- The **combined** standard penalty for failing to file correct information returns and payee statements is $100 per failure, with a penalty cap of $350,000 per year.
- Significantly higher penalties—generally 20 percent of the amount required to be reported (for information returns and payee statements), with no penalty caps—may be assessed in cases of intentional disregard.[4]
- Payors also may face liabilities for failure to apply 31 percent backup withholding when, for example, a payee has not provided its taxpayer identification number (TIN).

There is no evidence that the financial services community has failed to comply with the current information reporting rules and, as noted above, there are ample incentives for compliance already in place.[5] It seems, therefore, that most of the revenue raised by the proposal would result from higher penalty assessments for inadvertent errors, rather than from increased compliance with information reporting requirements. Thus, as a matter of tax compliance, there appears to be no justifiable policy reason to substantially increase these penalties.

Penalties Should Not Be Imposed to Raise Revenue

Any reliance on a penalty provision to raise revenue would represent a significant change in Congress' current policy on penalties. A 1989 IRS Task Force on Civil Penalties concluded that penalties "should exist for the purpose of encouraging voluntary compliance and not for other purposes, such as raising of revenue."[6] Congress endorsed the IRS Task Force's conclusions by specifically enumerating them in the Conference Report to the Omnibus Budget Reconciliation Act of 1989.[7] There is no justification for Congress to abandon its present policy on penalties, which is based on fairness, particularly in light of the high compliance rate among information return filers.

Safe Harbor Not Sufficient

Under the proposal, utilization of a 97 percent substantial compliance "safe harbor" is not sufficient to ensure that the higher proposed penalties apply only to relatively few filers. Although some information reporting rules are straightforward (e.g., interest paid on deposits), the requirements for certain new financial products,

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

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

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

[5] Also note that, in addition to the domestic and foreign information reporting and penalty regimes that are currently in place, for payments to foreign persons, an expanded reporting regime with the concomitant penalties is effective for payments made after December 31, 1999. See TD 8734, published in the Federal Register on October 14, 1997. The payor community is being required to dedicate extensive manpower and monetary resources to put these new requirements into practice. Accordingly, these already compliant and overburdened taxpayers should not have to contend with new punitive and unnecessary penalties.

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

[7] OBRA 1989 Conference Report at page 661.

as well as new information reporting requirements,[8] are often unclear, and inadvertent reporting errors for complex transactions may occur. Any reporting "errors" resulting from such ambiguities could easily lead to a filer not satisfying the 97 percent safe harbor.

Application of Penalty Cap to Each Payor Entity Inequitable

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

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

EXAMPLE I—Paying Agents

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

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

EXAMPLE II—Retirement Plans

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

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

EXAMPLE III—Related Companies

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

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

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

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

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

CONCLUSION

The Coalition of Service Industries represents the preparers of a significant portion of the information returns that would be impacted by the proposal to increase penalties for failure to file correct information returns. In light of the current reporting burdens imposed on our industries and the significant level of industry compliance, we believe it is highly inappropriate to raise penalties.

Congress has considered and rejected this proposal on three previous occasions, and we hope it will continue to reject this unwarranted penalty increase. Thank you for your consideration of our views.

Statement of the Committee of Annuity Insurers

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

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

As was the case last year, the Administration's proposed increase in the DAC would have a substantial, adverse effect on private retirement savings in America. The Administration continues to show that it does not understand the important role that annuities and life insurance play in assuring Americans that they will have adequate resources during retirement and adequate protection for their families.

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

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

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

As discussed below, the proposal contained in the Administration's FY 2001 budget to increase the DAC tax is in substance a tax on owners of non-qualified annuity

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

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

1. The Administration's DAC proposal is in substance a tax on the owners of annuities and life insurance.

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

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

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

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

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

2. Contrary to the Administration's claims, an increase in the DAC tax is not necessary to reflect the income of life insurance companies accurately.

The Administration claims that the proposed increase in the DAC tax is necessary to accurately reflect the economic income of life insurance companies. In particular, the Administration asserts that "life insurance companies generally capitalize only a fraction of their actual policy acquisition costs." The Administration is wrong. As explained below, life insurance companies already more than adequately capitalize

the expenses they incur in connection with issuing annuity and life insurance contracts. The Administration's proposal would further distort life insurance company income simply to raise revenue.

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

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

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

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

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

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

In summary, life insurance companies are already overcapitalizing policy selling expenses for income tax purposes because of the combination of the current DAC tax and the mandated use of preliminary term reserves. In these circumstances, increasing the DAC capitalization percentages will not result in a clearer reflection

of the income of life insurance companies. To the contrary, increasing the percentages as the Administration proposes would further distort life insurance company income simply to raise revenue.

3. Contrary to the Administration's suggestion, an increase in the DAC tax is inconsistent with GAAP accounting.

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

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

4. The Administration's proposal to increase the DAC tax retroactively is punitive and suggests that the Administration is simply seeking to raise a targeted amount revenue from the insurance industry

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

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

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

The Committee of Annuity Insurers Washington, D.C. 20004

Aetna Inc., Hartford, CT
Allmerica Financial Company, Worcester, MA

Allstate Life Insurance Company, Northbrook, IL
American General Corporation, Houston, TX
American International Group, Inc., Wilmington, DE
American Investors Life Insurance Company, Inc., Topeka, KS
American Skandia Life Assurance Corporation, Shelton, CT
Conseco, Inc., Carmel, IN
COVA Financial Services Life Insurance Co., Oakbrook Terrace, IL
Equitable Life Assurance Society of the United States, New York, NY
Equitable of Iowa Companies, DesMoines, IA
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
GE Financial Assurance, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Hartford Life Insurance Company, Hartford, CT
IDS Life Insurance Company, Minneapolis, MN
Integrity Life Insurance Company, Louisville, KY
Jackson National Life Insurance Company, Lansing, Ml
Keyport Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln Financial Group, Fort Wayne, IN
ManuLife Financial, Boston, MA
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Minnesota Life, St. Paul, MN
Mutual of Omaha Companies, Omaha, NE
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Phoenix Home Mutual Life Insurance Company, Hartford, CT
Principal Financial Group, Des Moines, IA
Protective Life Insurance Company, Birmingham, AL
ReliaStar Financial Corp., Minneapolis, MN
Security First Group, Los Angeles, CA
SunAmerica, Inc., Los Angeles, CA
Sun Life of Canada, Wellesley Hills, MA
Teachers Insurance & Annuity Association of America—College Retirement Equities Fund (TIAA–CREF), New York, NY
Travelers Insurance Companies, Hartford, CT
Zurich Kemper Life Insurance Companies, Chicago, IL

Statement of Dorthy S. Ridings, Council on Foundations

On behalf of the Council on Foundations, thank you for this opportunity to submit comments on the President's fiscal year 2001 budget proposals. The Council on Foundations is a membership organization representing the collective interests of more than 1,900 community, family, independent and company foundations as well as corporate giving programs. For more than 40 years, the Council has taken a keen interest in how federal tax laws support and promote philanthropy. President Clinton's proposed budget for fiscal year 2001 contains several proposals to encourage philanthropy. While we generally support them all, the Council wishes to comment on two that are of particular interest to its members: the proposal to clarify the public charity status of donor-advised funds and the proposal to simplify the annual tax on private foundation investment income imposed by section 4940. We look forward to working with the Committee to make technical improvements to these two much-needed changes that will ensure their objectives are truly accomplished.

Donor-Advised Funds

The first proposal would clarify the public charity status of organizations offering donor-advised funds. Specifically, it would provide that any organization that operates one or more donor-advised funds as its primary activity could qualify as a public charity only if it met three requirements: (1) the organization is free from any material restriction on its authority to manage and make distributions from the fund; (2) distributions from the donor-advised funds go only to public charities, private operating foundations or governmental entities; and (3) annual distributions

equal or exceed 5% of the aggregate fair market value of the assets the organization holds in donor-advised funds.

From the time community foundations were formed, more than 85 years ago, donors have made recommendations regarding the charitable projects or organizations that they consider worthy of support. Donor-advised funds offer a valuable way for a community foundation to establish a relationship with a donor and to encourage that person to take a continuing interest in the community's needs.

Recent developments, including the formation of new charities that make extensive use of donor-advised funds, have persuaded the Council of the need for clear and consistent rules for donor-advised funds, wherever they may be maintained. We are pleased that the President also recognizes this need. However, we believe that his specific recommendations raise several critical issues that, unless resolved, will interfere with legitimate and long-standing charitable activities carried on by community foundations and other public charities with donor-advised funds. Because these issues are vital to the interests of community foundations, Congress should not act until there has been adequate time to review the President's suggestions, and to understand their implications for the wide range of charities that have donor-advised funds.

The Council on Foundations would be happy to work with the members of the Committee and with staff in defining these issues and finding appropriate solutions to them.

1. *Definition of donor-advised fund.* There is a need to clarify this definition so that both community foundations and the Internal Revenue Service can easily determine which funds are "donor-advised."

2. *Permissible donees.* Many community foundations operate programs that make grants and award scholarships to individuals for charitable purposes. Many community foundations also make grants for exclusively charitable purposes to both U.S. and foreign organizations that are not recognized as exempt under section 501(c)(3) of the Internal Revenue Code. Frequently these programs are begun at the recommendation of individuals and businesses that have created donor-advised funds, as in the case of the many community foundations that offer local businesses the ability to create a donor-advised fund to provide educational scholarships for employees and their families. Community foundations should retain the ability to make distributions to individuals, to domestic non-charities, and to foreign organizations as long as they can demonstrate that distributions are used for exclusively charitable purposes.

3. *Sanctions.* The primary sanction in the President's budget proposal is loss of public charity status, either for the organization as a whole or for its donor-advised funds. The Council believes that a graduated set of penalties, analogous to those imposed on private foundations, would provide the Internal Revenue Service with a more flexible compliance tool, while protecting community foundations from the inadvertent loss of public charity status. Sanctions also should be appropriately distributed between the exempt organization and the donor/advisor, depending on which was in the best position to prevent the offence from occurring.

4. *Preventing abuse.* Community foundations want to be sure that donor-advised funds are used exclusively for bona fide philanthropy, not as a mechanism to get tax benefits without achieving charitable results. A limited rule that treats donor/advisors as disqualified persons with respect to distributions from their funds may help accomplish the goal of preventing distributions that confer an improper benefit on such individuals. There also may be some benefit in a five percent distribution requirement, although it, too, should be tailored to prevent real abuse.

The Council looks forward to working with the Committee and its staff to address these concerns. We are optimistic that the proposal can be revised successfully, and that once enacted, it will encourage significant philanthropic activity.

Reforming the Section 4940 Tax

The second proposal would reform the annual tax on private foundation investment income, replacing the current two-tier tax structure with a single rate. The Council on Foundations welcomes this change as a much-needed simplification, and we express our thanks to the Department of Treasury for recognizing that the current system is badly in need of adjustment. The current two-tier system actually has the unintended effect of penalizing foundations that make the extra effort to increase their annual grantmaking significantly in a given year. Such a decision forces the foundation to choose between two negative options: 1) Increase its long-term spending percentage (thus endangering its ability to maintain the real value of its assets), or 2) return to its normal spending percentage and be required to pay a higher level of tax (two percent) for the next five years. Lowering the effective private foundation investment income tax will automatically cause an overall increase

in foundation grants and other charitable distributions. Because foundations are given credit toward their payout for taxes paid under section 4940, reducing the tax automatically requires foundations to distribute more dollars to meet charitable needs.

While we strongly support amending the code to adopt a single, flat-percentage excise tax, we urge serious consideration of a lower rate, preferably 1.0 percent. Even though we recognize that a flat excise tax of 1.0 percent will result in a higher revenue loss to Treasury, we have learned from many of our members that a 1.25 percent flat tax will be a tax increase to them. Small and mid-sized foundations, in particular, usually can qualify for the 1.0 percent rate under the current system. To do so, these foundations must slightly increase their charitable spending each year. Ironically, with a flat, 1.25 percent rate, those foundations that have been slowly increasing their spending levels will be hit with a tax increase.

Again, we thank you for the opportunity to present our views. We look forward to working with the Committee in accordance with these comments to seek enactment of these proposals.

Statement of the Equipment Leasing Association, Arlington, VA

INTRODUCTION

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

WHAT TYPE OF COMPANY LEASES?WHAT TYPE OF COMPANY LEASES?

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

WHY COMPANIES LEASEWHY COMPANIES LEASE

Companies choose lease financing for several reasons:

*Leasing permits 100% financing;

*Leasing permits a close matching of rental payments to the revenue produced by the use of the equipment;

*Leasing allows companies to keep their debt lines open for working capital rather than tying it up in capital expenditures;

*Companies that lease know that they make money by using the equipment, not owning it;

*Leasing allows a company to focus on its core business—they don't have to worry about maintenance, upgrading or asset disposition;

*Leasing minimizes concerns about the technological obsolescence of the company's equipment;

*Leasing shifts asset management risk to the lessor, away from the user.

Leasing by commercial enterprises increases productivity and stimulates economic growth. While the federal and state tax codes provide various incentives to invest in new equipment, many companies find they are not in a financial position to utilize the incentives. However, through leasing, the intended incentives to invest can be passed through to the company using the equipment in the form of lower rental payments because the leasing company utilizes the intended investment incentives. The use of leasing in this manner has long been intended by Congress.

LEASING CREATES JOBSLEASING CREATES JOBS

It is estimated that each increase of $1 billion in equipment investment creates approximately 30,000 jobs (Brimmer Report). In 1999 alone, the equipment leasing industry financed over $200 billion in equipment acquisition and it is anticipated that equipment lessors will finance over $230 billion in new equipment acquisition in 2000.

STATE AND LOCAL GOVERNMENTS LEASE TOO

It is not only commercial enterprises that lease equipment. Tax-exempt entities such as states, cities, counties and other subdivisions around the U.S. often lease various types of equipment in an effort to keep taxpayer costs down. Equipment leased by local governments includes 911 emergency phone systems, computers, school buses and police vehicles. Tax-exempt hospitals often lease their emergency vehicles and high-cost, sophisticated diagnostic medical equipment, in an effort to keep health care costs down.

Lessors also lease equipment to other tax-exempt entities such as foreign corporate enterprises or individuals. Examples include automobile fleet leasing, leases of tractors and trailers, and leases of aircraft (both commercial and corporate). Further, many domestic lessees have the right to sublease assets into foreign markets in times when the equipment may be surplus. Very often, these subleases are to entities in foreign markets which have the need for the asset.

THE ADMINISTRATION'S "CORPORATE TAX SHELTER" PROPOSALS REPRESENT A SIGNIFICANT CHANGE IN U.S. TAX

An analysis of the Administration's sweeping and vague corporate tax shelter proposals raises the concern that leasing transactions which conform to long standing tax policy and Congressional intent could be negatively impacted by the Administration's proposals. If this is the case, these proposals represent a significant change in longstanding U.S. leasing tax policy, overturning longstanding I.R.S ruling polices set forth in Revenue Procedures 75–21 and 75–78, as well as established judicial precedent. Without a clear exclusion of leasing transactions that meet the standards of current law from the sweeping new corporate tax shelter proposals, ELA must oppose these proposals and urges Congress to reject them.

ELA has long supported two fundamental principles of federal tax policy. First, the form of financing chosen to facilitate the acquisition of assets, whether loans or leases, should be respected as long as economically valid. Second, is the principle that the tax treatment of an owner of an asset should not differ whether the asset is used directly by the owner or leased to another end-user. Again, in their current form, the Administration's proposals appear to violate these two principles and have already had a chilling effect on equipment acquisition in certain markets. Therefore, ELA opposes them and urges Congress to reject them.

ADMINISTRATION'S ANTI-LEASING SERVICE CONTRACT PROPOSAL

The service contract rules set forth in Section 7701(e) of the Code were enacted as part of the original Pickle legislation in 1984. These rules set forth explicit statutory standards based on clear economic distinctions for distinguishing leases from so-called service contracts. A lease of equipment is in fact different than a service contract and Congress clearly intended that an agreement that qualifies as a service contract would not be treated as a lease for purposes of the Pickle legislation or for any other tax purpose. The Administration's proposal would repeal this clear distinction and expand the scope of an already discriminatory statute that inhibits U.S. global competitiveness and no longer furthers a legitimate policy objective. Further, the proposed legislation overlooks significant business purposes that give rise to use of service contracts. Service contracts involve a tradeoff between rights and risks. Relative to a lessor, the service provider enjoys more control over the asset used to generate such services, but also assumes additional performance and operational risk with respect to such asset. The parties' preferences as to the division of rights and risks with respect to property determine the form of contractual arrangement they choose. The service contract arrangement has long been commercially recognized, particularly within certain industries including the utilities and shipping industries. Congress should reject the Administration's most recent misguided assault on leasing as it did in both 1998 and 1999. (See the enclosed 1999 letter signed by 26 members of the House Ways and Means Committee to Chairman Archer and Ranking Member Rangel.)

Clearly, the Administration's proposal goes far beyond what is necessary to prevent perceived abusive transactions as it encroaches upon non-abusive transactions that are permitted under current law. In fact, in light of the 1986 depreciation rules

providing for straight-line depreciation over the class-life of foreign use property (which were intended to replicate economic depreciation), we believe that the Pickle depreciation rules, insofar as they relate to foreign lessees, are no longer necessary or appropriate and do not reflect sound tax policy. Consequently, we urge Congress to reject this proposal and encourage the Treasury Department to support a depreciation rule which does not discriminate between property owned by a U.S. taxpayer that is used outside the U.S. and property owned by a U.S. taxpayer that is leased to a foreign person. In both cases the income is fully taxable.

In applying the Pickle rules, Treasury regulations adopted in 1996 (Treas. Reg. Section 1.168 (i)–2 (b) (1)) provide that the lease term will be deemed to include certain periods beyond the original duration of the lease. Under these regulations the lease term includes both the actual lease term and any period of time during which the lessee (or a related person) (i) agreed that it would or could be obligated to make a payment of rent or a payment in the nature of rent or (ii) assumed or retained any risk of loss with respect to the property (including, for example, holding a note secured by the property). Clearly, these regulations extend beyond the reach of the statute and should be overturned.

ADMINSTRATION'S PROPOSAL CONFLICTS WITH U.S. TRADE POLICY

If enacted, this proposal will have a devastating impact on U.S. companies currently involved in selling assets to foreign entities where lease financing has been a significant feature of the marketplace, for example, manufacturers of aircraft and aircraft engines. As such, the proposal is contrary to long-established policies of promoting U.S. exports and is in direct conflict with the Congressional objective of developing a U.S. trade policy which will provide U.S. companies with the ability to compete on a level playing field with their foreign competitors. If enacted, this legislation will severely inhibit the ability of U.S. exporters and financial institutions to compete effectively on a global scale. If U.S. companies are not able to compete on cross-border leases, tax revenues currently going to the U.S. Treasury will be lost to foreign Treasuries, as all leases, including cross-border leases, generate more taxable income than deductions over the life of the lease agreement.

HISTORY OF THE "PICKLE" RULES

As part of the Deficit Reduction Act of 1984, Congress amended the Code to limit the depreciation available for property leased to a tax-exempt entity to straight line depreciation over the longer of the property's class life or 125% of the lease term. These provisions, referred to as the Tax-Exempt Entity Leasing Rules or the "Pickle" rules, were enacted in response to a series of leasing and similar transactions which passed a significant portion of the economic benefit of the Accelerated Cost Recovery System (ACRS) depreciation deductions through to various U.S. federal, state and local governmental entities and tax-exempt organizations.

At that time, Congress was concerned that investment incentives, such as depreciation under ACRS, were being turned into unintended benefits for tax-exempt entities. These restrictions were extended to foreign persons not subject to U.S. tax on their operations as Congress concluded that it would be inappropriate to subsidize foreign persons that were not U.S. taxpayers by permitting accelerated depreciation for property leased to them.

However, as part of the Tax Reform Act of 1986, Congress limited depreciation on foreign use property to the straight-line method over an asset's class life. Thus, after 1986, property used predominantly outside the United States by an U.S. taxpayer was not entitled to accelerated depreciation. *Consequently, the changes in generally applicable depreciation rules enacted in 1986 rendered the Pickle rules unnecessary in order to achieve the 1984 policy objective of not passing accelerated depreciation through to foreign persons not subject to U.S. income tax.* Nevertheless, the Pickle rules were not amended in 1986 or subsequently.

THE PICKLE RULES ARE DISCRIMINATORY AND ANTI-COMPETITIVE AND SHOULD BE CONFORMED TO THE TAX ACT OF 1986 TO MAKE THE U.S. LEASING INDUSTRY GLOBALLY COMPETITIVE

The Pickle rules discriminate against property owned by a U.S. taxpayer which is used in its leasing business outside the United States, as compared to the same property owned by a U.S. taxpayer, and used in a non-leasing business outside the U.S. For example, a U.S. owner of an item of equipment operated outside the U.S. would be entitled to straight-line depreciation over the asset's class life, even though the benefit of that depreciation would be reflected in the price of the goods or services provided to non-U.S. taxpayers. By contrast, a U.S. lessor of the same item of equipment if leased to a foreign entity would be limited by Pickle depreciation to

straight-line depreciation over the longer of the property's class life or 125% of the lease term.

If U.S. companies are to compete effectively in a global marketplace, Congress should enact a depreciation rule which does not discriminate between property owned by a U.S. taxpayer which is used outside the United States, and property owned by a U.S. taxpayer and leased to a foreign person. *In both cases, the income is fully taxable.* This policy can be accomplished by simply conforming the 1984 Pickle rules to the Tax Reform Act of 1986.

PROPOSAL TO "DISALLOW INTEREST ON DEBT ALLOCABLE TO TAX-EXEMPT OBLIGATIONS" WILL INCREASE STATES' AND MUNICIPALITIES' COST OF CAPITAL

ELA also opposes the Administration's proposal to "disallow interest on debt allocable to tax-exempt obligations," as the elimination of the 2% de minimis rule will impair the ability of state and local governments to raise capital. While non-financial corporations may not account for a large percentage of total municipal securities outstanding, these corporate buyers do play a vital role in three important market segments: 1) short term municipal investments, 2) state and local government housing and student loan bonds, and 3) municipal leasing transactions.

CONCLUSION

Congress, the Treasury Department and the courts have long recognized that companies financing the acquisition of equipment through a loan are the recipients of various tax incentives. These same bodies also have long recognized that equipment acquired through leasing involves the transfer of tax benefits from the user of the equipment to the owner-lessor. As a direct result of these sound tax policies, American citizens are the beneficiaries of the most modern and productive economy in the world. While equipment lessors would undoubtedly be negatively impacted by the proposed changes discussed above, the ultimate impact will be to drive up the cost of capital equipment acquisitions for all businesses, particularly small businesses.

For over three decades, ELA members have provided lessees with various financing options within the spirit and intent of U.S. tax policy. In 1999 alone, the equipment leasing industry invested in excess of $200 billion in productive assets. However, the uncertainty caused by the Administration's proposals has already slowed down the market. To minimize further market disruptions and maintain strong economic growth while Congress deliberates the FY 2001 budget, we urge the respective Chairmen of the House Ways and Means and Senate Finance Committees to publicly state that the effective date for any tax code amendments restricting the use of incentives will be the date of enactment.

Statement of David Benson, Ernst & Young LLP, and LaBrenda Garrett-Nelson, Washington Counsel, P.C., Global Competitiveness Coalition 2000

The Global Competitiveness Coalition (the "Coalition") is a group of about 30 U.S.—based multinational business enterprises representing a broad cross section of American businesses.

Introduction

The proposed hybrid branch regulations that were issued pursuant to Notice 98–35 in July of last year provided for a six-year-plus "moratorium" on the application of rules that would restrict the ability to use hybrid branch arrangements to reduce foreign tax without triggering subpart F inclusions. The Coalition believes the Ways and Means Committee should reject the proposal relating to "identified tax havens," to the extent the proposal has the potential to alter Treasury's agreement to allow the Congress an opportunity to deal with hybrid branch arrangements during the "moratorium" on the finalization of hybrid branch regulations.

Summary of the Administration's "Identified Tax Haven" proposal

The Administration's proposal would require the reporting of payments to, and restrict tax benefits for income flowing through, "Identified Tax Havens."

Under the proposed reporting requirement, all payments (including money and tangible and intangible property) to entities (including corporations, partnerships and disregarded entities, branches, trusts and estates), accounts or individuals resident or located in Identified Tax Havens would be reported on the taxpayer's annual

income tax return. Jurisdictions would be considered tax havens and included on the list of Identified Tax Havens to be published by the Secretary of the Treasury based on certain criteria, including, but not limited to, whether a jurisdiction (1) imposes no or nominal taxation, either generally or on specific classes of capital income, and (2) has strict confidentiality rules and practices, and/or has ineffective information exchange practices. The proposal would not apply to payments if: (1) the Identified Tax Haven has in force with the U.S. an agreement providing for the exchange of tax information that is effective for both criminal tax and civil tax administration purposes, (2) the payee certifies to the payor that, through a legally effective confidentiality waiver or otherwise, information about the payment would be available to the IRS upon request, or (3) the payment is less than $10,000 (subject to an anti-abuse rule requiring related payments to be aggregated). A penalty of 20 percent of the amount of the payment would be imposed on payors who fail to report.

The proposal affecting tax benefits would deny foreign tax credits (FTCs) for taxes paid to Identified Tax Havens and would apply the FTC limitation rules separately to income earned in or through an Identified Tax Haven. The proposal also would reduce by a factor (similar to the international boycott factor) a taxpayer's (1) otherwise allowable FTC or foreign sales corporation benefit attributable to income from an Identified Tax Haven, and (2) the income, attributable to an Identified Tax Haven, that is otherwise eligible for deferral. This reduction of tax benefits would be based on a fraction, the numerator of which is the sum of the taxpayer's income and gains from an Identified Tax Haven, and the denominator of which is the taxpayer's total non-U.S. income and gains. The proposal would be effective for taxable years beginning after the date of enactment.

Although the proposal is generally effective for payments made after the date of enactment, because the proposal is limited to jurisdictions to be included on a published list; the proposal would only apply to taxable years beginning after the publication of the list.

Unresolved Issues Regarding the Identification of Tax Havens

At a Treasury briefing on February 7, 2000, the Acting Assistant Secretary for Tax Policy (Jon Talisman) acknowledged that this proposal was based on work done with the OECD. Indeed, elements of the proposal can be traced to the recommendations included in the OECD's 1998 report entitled "Harmful Tax Competition: An Emerging Global Issue." For example, one of the OECD recommendations is to deny a tax benefit to "foreign source income that has benefited from tax practices deemed as constituting harmful tax competition;" and another recommendation encourages OECD countries to "undertake programs to intensify exchange of relevant information concerning transactions in tax havens." It is unclear whether Treasury intends to build on the on-going work being done by the OECD "Forum on Harmful Tax Practices" to compile a list of tax havens, nor is it clear whether this proposal is intended to reach preferential tax regimes that may be available to particular activities in countries that are not generally viewed as tax havens.

The Concern About Hybrid Branch Arrangements

As currently described, the Administration's proposal on Identified Tax Havens would implement substantive changes consistent with indications of Treasury's continuing discomfort with hybrid branch arrangements. The Coalition is particularly concerned that the proposal can be read to indicate that Treasury may continue to seek to attack the use of hybrid branch arrangements by proposing changes to ancillary rules, notwithstanding the events that led up to the effective withdrawal of Notice 98–35 and the issuance of the proposed hybrid branch regulations having a substantially delayed effective date in July of last year.

The Coalition's concern is based in part on public statements by senior Treasury officials. For example, at the IRS/GWU international tax conference last December, one official stated that, in general, transactions resulting in differing U.S. and foreign tax results are against the policy of our tax rules, a statement that was made in the course of a discussion of a hybrid branch arrangement. More recently, Treasury's continuing concern with the use of such entities was noted by a member of Treasury's Office of International Tax Counsel, at a February 3 meeting of the International Tax and Finance Forum. A more tangible indication of Treasury's views, and basis for the Coalition's concern, is the issuance in late November 1999

of proposed regulations that would invalidate certain elections to treat foreign entities as hybrid branches (in the absence of an identified abuse).[1]

Potential Impact on Existing Hybrid Branch Arrangements

Where a taxpayer has already entered into a hybrid branch arrangement, there is a question about whether the Administration's Budget proposal on Identified Tax Havens could apply to effectively negate the benefits of the hybrid branch arrangement—a result that would appear to be contrary to the moratorium on restricting the use of hybrid branch arrangements. Depending on how Treasury decides to define a tax haven, this result could occur in a fairly common situation where a hybrid branch located in a high-tax jurisdiction makes deductible interest or royalty payments to a controlled foreign corporation ("CFC") located in a low-tax jurisdiction. Under current law, the CFC would not have a subpart F inclusion because the interest or royalty payment would be a nullity for U.S tax purposes. Under the Administration's proposal, however, the income otherwise eligible for deferral might be included in the CFC's income if the CFC is located in a country on Treasury's list of tax havens.

Conclusion

Treasury has agreed to refrain from finalizing regulations that would restrict the use of hybrid branch arrangements during a six-year-plus moratorium. Therefore, the Committee should reject the "Identified Tax Haven" proposal because it has the potential to alter Treasury's agreement.

Statement of Home Care Coalition

On behalf of the Home Care Coalition, thank you for the opportunity to provide comments on the President's budget proposal for fiscal year 2001. The Home Care Coalition was founded in 1991 to unite the efforts of home care providers, family caregivers, health care professionals, manufacturers, consumers, and consumer advocacy organizations. The Coalition has become a major voice in support of home health care, which is often patient-preferred and more cost-effective than institutional care. As the only national organization representing providers, consumers and manufacturers of home health services, we urge you to support proposals to help America's caregiving families.

This year, the President has placed more emphasis on providing home and community-based services through Medicaid and making assisted living facilities available to lower income elderly. Once again, he has called for the creation of a National Family Caregivers Support Program and non-subsidized long-term care insurance for federal employees, retirees and their families. In addition, a number of bills have been introduced in this Congress to expand access to long-term care insurance and provide relief to family caregivers.

The Home Care Coalition urges this Committee to act this year to support programs needed to relieve the burdens on family caregivers and to increase access to the home and community-based services so essential to the well being of millions of frail elderly, disabled and chronically ill Americans.

WHO WE ARE

The Home Care Coalition (HCC) is comprised of the following:

Consumers of Home Care: Not all home care beneficiaries are alike. As a result, their at-home needs are wide and varied. Those with chronic conditions such as emphysema require the constant assistance of oxygen systems to make breathing easier. Consumers in the final stages of complications brought about by diseases such as AIDS require extensive levels of care. Active elderly persons who may be recuperating from an injury need products and services for an interim period until they recuperate. Younger persons with disabilities may require fewer products and services, but may need them for a lifetime.

Family Caregivers: People who cannot completely care for themselves because of an illness or disability rely heavily on family members to provide a wide range of services. Typically, family caregivers provide assistance with basic needs such as

[1] Representatives of the Coalition testified at an IRS hearing on these regulations in January, and will submit written comments (on or before February 28, 2000) urging withdrawal of the regulations.

feeding, toileting, and dressing, as well as transportation, shopping, and cooking. Family caregivers give injections, change dressings, and help with rehabilitative exercises. They teach, advocate, and provide emotional support. Family caregivers provide these services out of feelings of love and a sense of duty. They are not paid for their services. It is estimated that there are over 25 million family caregivers in the United States, providing three-fourths of all home care services. Family caregivers make the difference between someone being alive and having a life.

Home Health Providers: Home health providers include individuals such as skilled nurses, rehabilitation specialists, therapists, pharmacists, physicians, nutritionists, medical social workers, home health aides, and homemakers. Health care services in the home setting provide a continuum of care for individuals who no longer require hospital or nursing home care, or to avoid an unnecessary hospital or nursing home admission. The range of home care services includes skilled nursing; respiratory, occupational, speech, and physical therapy; intravenous drug therapy; enteral nutrition; hospice care; emotional, physical, and medical care; assistance in the activities of daily living; skilled assessments; teaching; and financial assistance.

Home Medical Equipment (HME) Manufacturers: Manufacturers of home medical equipment (HME) are committed to producing quality products that promote the ability of persons with acute and chronic health conditions and disabilities to lead productive lives in their homes and communities. Products include everything from disposable items such as bandages to high-tech equipment such as power-driven wheelchairs, infusion therapy pumps and home oxygen delivery systems. As HME manufacturers produce advances in medical technology (e.g., telemedicine), home care will become even more cost-effective than it is today.

Home Medical Equipment Providers: Home medical equipment (HME) providers supply the equipment and related services that help consumers meet their therapeutic goals. Pursuant to the physician's prescription, HME providers deliver medical equipment to a consumer's home, set it up, maintain it, and educate and train the consumer and caregiver in its use. HME providers also interact with physicians and other home care providers as the consumer improves and his/her needs evolve. In addition, specialized providers of home infusion manage complex intravenous services, including chemotherapy and nutrition therapies, in the home.

Hospital Discharge Planners: Hospital discharge planners are health care professionals who are involved in the coordination of continuing care services for consumers and their families in all health care settings. The discharge planner is proactive in the health care delivery planning process and will begin an assessment of the consumer's needs either in the ambulatory care setting, at home prior to an admission for elective surgery, or within 24 hours of an acute care admission. This proactive perspective allows discharge planners to develop a plan of care that decreases the length of the hospital stay and reduces unnecessary acute care admissions. The discharge planner facilitates the progress of consumers and their families along the health care continuum whether it be home care, hospice, or inpatient care.

FAMILY CAREGIVERS AND TODAY'S LONG-TERM CARE SYSTEM

Family caregivers are literally underpinning our healthcare system. The National Family Caregivers Association reports that approximately 80% of all home care services are provided by family caregivers who are not reimbursed for their time and effort. They are family, friends and neighbors who stand by those they love as they face chronic illness or disability. Their help can take many forms: physical assistance with daily activities from going to the bathroom to going to the drug store; monitoring medical devices from IVs to ventilators; and providing emotional, financial, legal and spiritual support.

The National Family Caregivers Association conducted a study in 1997 that revealed the human face of caregiving. The results highlighted the experiences of today's "sandwich generation" that is increasingly asked to care for their ailing parents at the same time that they are juggling the demands of their own families and careers. More than 25 million individuals across the nation provide caregiving services. The vast majority of caregivers are married women over the age of 35; in fact, more than one in five women between the ages of 35 −64 are family caregivers. The majority of caregivers spend at least 40 hours a week in caregiving activities, mainly in their own homes. Nearly 70% of caregivers are providing care for their spouse or parent. Not only are the hours long, and the time spent considerable, 78% of caregivers expect to be active in caregiving for five years or more.

The United Hospital Fund of New York estimates that it would cost at least $196 billion a year to replace the vital services provided by family caregivers. The economic value of this "invisible" health care sector dwarfs the costs of both paid home health care ($32 billion) and nursing home care ($83 billion). Without the free and

loving care provided by our nation's caregivers, the national health care system would be much sicker than it is today.

THE NEED FOR FAMILY CAREGIVER SUPPORT

The need for caregiving is exploding at the same time that the number of available caregivers is evaporating. The aging of the baby boom generation will only make this situation more dire. People over 85 years of age are the fastest growing segment of the population, and they are also the group most likely to need care. By 2020, there will be 14 million elderly in need of long-term care. It won't be long before every family in America is involved in family caregiving.

Unfortunately, caregiving takes a high economic toll on America's families and businesses. Caregivers report that they suffer from headaches, sleeplessness and backaches as a direct result of their caregiving activities. Depression among caregivers is three times the norm for people in their age group. More than three-quarters of all family caregivers report they receive no consistent help from other family members, and feelings of isolation and lack of understanding from others are common. It is a sad fact that more people enter nursing homes because of caregiver burnout rather than an exacerbation of their own condition.

A recent study by the Center for Women and Aging and the National Alliance for Caregiving shows that family caregivers can lose over $650,000 in wages, pensions and Social Security because of their caregiving responsibilities. Lost wages, promotions and career opportunities are the normal consequence of family caregiving. In addition, a study conducted by the Alzheimer's Association in 1998 found that Alzheimer's disease alone costs US businesses $26 billion a year in caregiver absenteeism. The Alzheimer's Association reports that increased use of respite care at mild and moderate stages of Alzheimer's has shown to delay nursing home placement significantly, at a net savings of $600 to $1,000 a week.

Clearly, America's caregivers are in need of support. In addition, it is in the best interest of the health care system to help families care for their loved ones in their homes for as long a period as possible. Numerous studies have shown that simple caregiver interventions, such as respite care, counseling education and supportive services can have a major impact on the well being of caregivers and patients.

The President's proposal would provide state governments access to a network that provides respite care and other caregiver support services, information about community-based long-term care services, and counseling and support services. The Administration estimates that this program would assist approximately 250,000 families nationwide. In addition, the President proposes a $3,000 tax credit for individuals or families that care for individuals with three or more limitations in activities of daily living (ADLs) or a comparable cognitive impairment.

The Home Care Coalition believes that these proposals represent a critical first step in acknowledging the vital role that family caregivers play in our nations health care system. We can not assure the future of Medicare and there is no way to control the costs of Medicaid, if we let the family caregiving system collapse. We urge this committee to revisit the issues of family caregiver tax credits and caregiver support programs this year.

ACCESS TO HOME AND COMMUNITY-BASED SERVICES

The Omnibus Budget Reconciliation Act of 1981 established a program that allows states to apply for waivers (known as 1915(c) waivers) to reimburse home and community-based services for beneficiaries who would otherwise be institutionalized. In order to qualify for a waiver, the cost of institutionalization must be explicitly calculated and shown to be greater than the home and community-based services. Therefore, individuals must be shown to be deficient in at least three activities of daily living (e.g., bathing, dressing, toileting, transferring, continence, or eating) to qualify for a waiver. As states search for new and innovative means of controlling Medicaid costs, 1915(c) waivers have become more and more popular. There are currently 240 waiver programs in effect across the nation.

The President's budget includes a proposal to enable states to provide services to nursing-home qualified beneficiaries at 300% of the Supplemental Security Income (SSI) limit without requiring a federal 1915(c) waiver. This proposal would encourage states to implement these popular and cost-saving programs.

We are very concerned, however, about funding for the Title XX Social Services Block Grant Program, which funds adult day services, home and community care and adult protective services in many states. Two years ago, the program was funded at a level of $2.38 billion. The program was cut to $1.775 billion and, much to our surprise, President Clinton has proposed freezing spending at this lower level, far below the Administration's request last year of $2.38 billion.

The Home Care Coalition urges the Committee to support the President's proposal to recognize the effectiveness of home and community-based services by eliminating the need for 1915(c) waivers. However, we hope that you will back up this recognition by opposing drastic reductions in funding for the Title XX Social Services Block Grant.

CONCLUSION

The services provided by home health care providers—be they formal providers or informal family caregivers—are vital to America's chronically ill, frail elderly and disabled. These services are also key to securing the financial viability of the Medicare Program. The Home Care Coalition urges this Committee to recognize the importance of family caregivers by enacting long-term care proposals such as those proposed by the President this year. The Coalition looks forward to working with this Committee to address the many issues facing home health care.

Statement of Independent Sector

Independent Sector (is) is a coalition of more than 700 national organizations and companies representing the vast diversity of the nonprofit sector and the field of philanthropy. Its members include many of the nation's most prominent and far-reaching nonprofit organizations, leading foundations, and Fortune 500 corporations with strong commitments to community involvement. This network represents millions of volunteers, donors, and people served in communities around the world. is members work globally and locally in human services, education, religion, the arts, research, youth development, health care, advocacy, democracy, and many other areas. is is the only organization to represent a network so broad.

America's "independent sector" is a diverse collection of more than one million charitable, educational, religious, health, and social welfare organizations. It is these groups that create, nurture, and sustain the values that frame American life and strengthen democracy. In 1980, a group of visionary leaders, chaired by the Honorable John W. Gardner, became convinced that if the independent sector was to continue to serve society well, it had to be mobilized for greater cooperation and influence. Thus a new organization, named to celebrate the independent sector's unique role apart from government and business, was formed to preserve and enhance and protect a healthy, vibrant independent sector.

There are a number of initiatives relating to the nonprofit sector in the Administration's FY 2001 budget that we would like to bring to the committee's attention. These include a charitable deduction for nonitemizers, an increased limit for individual donations of appreciated assets, and taxation on the investment income of associations. IS would like to present the following comments to the committee.

Nonitemizer Deduction

The President's budget would create a charitable deduction for taxpayers who do not itemize their deductions. These individuals would be able to deduct fifty percent of their annual charitable contributions above a $1,000 floor, $2,000 for joint returns, through 2005. That floor will be lowered to $500, $1,000 for joint returns, beginning in 2006.

IS has long been supportive of any legislative effort to encourage charitable giving, particularly by permitting nonitemizers to deduct their generous gifts. The Charitable Giving Tax Relief Act, H.R. 1310, introduced by Representative Philip Crane (R–IL) and cosponsored by William Coyne (D–PA), Wally Herger (R–CA), and Karen Thurman (D–FL), is a case in point. This legislation is similar to the President's proposal with the exception that the $500 floor would become effective immediately. The bill currently has 122 bipartisan cosponsors, including 18 members of the Ways and Means Committee.

Charitable giving is a transfer of private resources for public purposes. Giving to charities promotes individual choice as well as public responsibility among nonprofit organizations. In a recent study, Giving and Volunteering in the United States, 1999, IS found that the average annual household contribution made by nonitemizers is $619. By creating a deduction for nonitemizers we would be recognizing those taxpayers who give above and beyond average levels.

The nonitemizer deduction is also based on generosity and sacrifice, not personal gain. Individuals are motivated to make charitable contributions primarily by their altruistic nature. However, as with any decision related to the use of limited resources, the amount a person gives to charitable causes will be influenced by the

cost to them of giving. The cost of giving can be significantly changed by the tax treatment of the gift.

This deduction would restore fairness to the tax code for nonitemizers who give generously. Currently, nonitemizers represent more than two-thirds of American taxpayers B over 84 million people. Americans who don't itemize on their returns would have a new opportunity to deduct some of their charitable contributions. In 1986, the tax deduction expired due to a sunset provision in the law. IS believes that it is time our public policies recognize those who give significant portions of their income to the causes they care about.

This is also an example of effective and meaningful tax policy. It recognizes the contributions of individuals and families while it also acknowledges the contributions charitable organizations make to communities.

We are grateful for the Administration's efforts to include incentives for charitable giving in his budget, and we urge you to support HR 1310.

Limitation on Individual Gifts of Appreciated Property

The President's budget includes a provision that would increase the limitation on the charitable deduction for gifts of appreciated property to charity. Current law permits taxpayers who itemize to take a deduction for gifts of appreciated property to a public charity or private foundation. However, the deduction is limited to a percentage of the taxpayer's adjusted gross income (AGI). We believe that the lowered value of the gift will discourage individuals from making the donation to the charity of their choice.

Presently, the charitable deduction is limited to thirty percent of AGI for gifts of appreciated property to charities, and to twenty percent for such gifts to private foundations. The Administration's proposal would increase these limits to fifty and thirty percent, respectively. This would become effective for gifts made after December 31, 2000.

As more Americans are acquiring additional income and assets as a result of the strong performance of the stock market, we hope the government will encourage these individuals to give a portion of their new wealth to charitable causes. For many Americans, donating gifts of appreciated property is a common form of philanthropy. We urge the committee to enhance this incentive by fully recognizing these generous contributions.

Association Investment Income Tax

The Clinton Administration has proposed once again to place an income tax on the investments made by trade associations (501(c)(6) organizations). Identical to the provision introduced by the President last year, the tax affects all trade associations with income exceeding $10,000 during any tax year. The tax is levied on the interest, dividend, royalty, and rental income of associations and essentially alters section of the tax code that had previously granted such groups exempt from taxation.

While the membership of many trade associations consists primarily of for-profit entities, some associations include substantial numbers of nonprofit organizations. We have concerns about this proposal since it erodes the principle of exempting from tax passive income earned by nonprofit organizations.

IS joins the American Society of Association Executives (ASAE) in opposing this misguided proposal. While the Administration maintains that this provision would close a loophole in the tax code encouraging members of associations to pay higher dues in order to claim a tax deduction, associations are not permitted to pay dividends to their members, and therefore are more likely to keep their dues levels at a minimum. In addition, investment income helps an association enhance the services it provides its members while creating reserve funds for the future.

Conclusion

Mr. Chairman, we appreciate the opportunity to submit these comments to the committee, and look forward to working with you and your staff on these matters.

Statement of the Leasing Coalition, PricewaterhouseCoopers LLP

I. INTRODUCTION

On behalf of a group of companies in the leasing industry (hereinafter the "Leasing Coalition"), PricewaterhouseCoopers appreciates the opportunity to present this

written statement to the House Ways and Means Committee in conjunction with its February 9, 2000, hearing on the Administration's FY 2001 budget proposals.

Our comments center on tax increases proposed by the Administration that would overturn the carefully constructed body of law, built over decades, governing the tax treatment of leasing transactions. These proposals include a leasing-industry specific measure that would further penalize U.S. companies using leasing to finance the export of manufactured goods abroad.[1] The Leasing Coalition also has strong concerns about the impact on leasing transactions of several general Administration proposals relating to "corporate tax shelters," including a proposal empowering IRS agents to deny tax benefits in "tax-avoidance transactions."[2]

In these comments, the Leasing Coalition discusses the rationale underlying the present-law tax treatment of leasing transactions and examines the impact of the Administration's proposals on commonplace leasing arrangements. We also discuss the adverse impact these proposals would have on the competitiveness of American businesses, on exports, and on the cost of capital.

We conclude by urging Members of the House Ways and Means Committee to reject the Administration's tax proposals that would adversely affect the leasing industry. These proposals inappropriately would overturn the longstanding body of tax law governing common leasing transactions, branding these legitimate business transactions as "corporate tax shelters." Instead of considering proposals at this time that would impair the competitiveness of the leasing industry, we respectfully suggest that the Administration and the Congress consider ways to help U.S. companies that use leasing as a form of financing expand in the global marketplace.

II. The Leasing Industry

Leasing is an increasingly common means of financing investment in equipment and other property. It is estimated that approximately 30 percent of all domestic equipment investment is financed through leasing rather than outright acquisition.[3] Approximately 80 percent of U.S. companies lease some or all of their equipment.[4] The leasing industry in 1998 financed more than $180 billion in equipment acquisitions, an amount that exceeded $200 billion in 1999.[5]

Lessees, or the users of the property, find leasing an attractive financing mechanism for a number of reasons. Because a lease allows 100-percent financing, the lessee is able to preserve cash that would be necessary to buy or make a downpayment on a piece of equipment. Moreover, lessees generally are able to secure financing under a lease at a lower cost than under a loan. A lessee also may wish to use the asset only for a short period of time, and may not want to risk having the value of the equipment decline more quickly than expected -or become obsolete—during this period of use. For financial statement purposes, leasing can be preferable in that it allows the lessee to secure off-balance sheet reporting with respect to the asset. Finally, the lessee may find rental deductions for lease payments more beneficial, from a timing perspective, than depreciation deductions taken over a certain schedule (e.g., double-declining balance).

Leasing also provides a number of business advantages to lessors. Manufacturing companies (e.g., automobile, computer, aircraft, and rolling stock manufacturers) may act as lessors through subsidiary companies as a means of providing their goods to customers. Financial institutions like banks, thrifts, and insurance companies engage in leasing as a core part of their financial intermediation business. As the owner of the equipment, the lessor is able to take full deductions for depreciation. Currently, more than 2,000 companies act as equipment lessors.[6]

Leasing also promotes exports of U.S. equipment, and thus helps U.S. companies compete in the global economy. Many lease transactions undertaken by U.S. lessors are cross-border leases, i.e., leases of equipment to foreign users. These involve all types of equipment, including tankers, railroad cars, machine tools, computers, copy machines, printing presses, aircraft, mining and oil drilling equipment, and turbines and generators. Many of these leases are supported in one form or another by the Export-Import Bank of the United States, which insures the credit of foreign lessees. Further, U.S. manufacturers demand global leasing solutions in support of their export activities.

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[1] *General Explanations of the Administration's Fiscal 2001 Revenue Proposals,* Department of the Treasury, February 2000, at 137–8.

[2] *Id.* at 124.

[3] U.S. Department of Commerce.

[4] Equipment Leasing Association.

[5] U.S. Department of Commerce.

[6] Equipment Leasing Association.

III. Present-Law Treatment of Leases

A substantial body of law has developed over the last forty years regarding the treatment of leasing transactions for federal income tax purposes. At issue is whether a transaction structured as a lease is respected as a lease for tax purposes or is recharacterized as a conditional sale of the property. If the transaction is respected as a lease for tax purposes, the lessor is treated as the owner of the property and therefore is entitled to depreciation deductions with respect to the property. The lessor also is entitled to interest deductions with respect to any financing of the property, and recognizes income in the form of the rental payments it receives. The lessee is entitled to a business deduction for the rental payments it makes with respect to the property. On the other hand, if the transaction is recharacterized as a conditional sale, the purported lessee is treated as having purchased the property in exchange for a debt instrument. The purported lessee is treated as the owner of the property and is entitled to depreciation deductions with respect to the property. In addition, the purported lessee is entitled to interest deductions for a portion of the amount it pays under the purported lease. The purported lessor recognizes gain or loss on the conditional sale and recognizes interest income with respect to a portion of the amount received under the purported lease. The purported lessor is entitled to interest deductions with respect to any financing of the property.

Guidance regarding the determination whether a transaction is respected as a lease for tax purposes is provided pursuant to an extensive body of case law. There also have been significant IRS pronouncements addressing this determination, which have been maintained for more than 25 years. Finally, statutory provisions provide specific rules regarding the tax consequences of certain leasing transactions.

A. Case law

The determination whether a transaction is respected as a lease for tax purposes generally is made based on the substance of the transaction and not its form.[7] This substantive determination focuses on which party is the owner of the property that is subject to the lease (i.e., which party has the benefits and burdens of ownership with respect to the property).[8] In addition, the transaction must have economic substance or a business purpose in order to be classified as a lease for tax purposes.[9]

The most important attributes of ownership are the upside potential for economic gain and the downside risk of economic loss based on the residual value of the leased property.[10] The presence of a fair market value purchase option in a lease agreement should not impact the determination of tax ownership.[11] Moreover, the fact that such an option is fixed at the estimated fair market value should not by itself cause the lease to be treated as a conditional sale.[12] However, where a lessee is economically or legally compelled to exercise the purchase option because, for example, the option price is nominal in relation to the value of the property, the lease likely would be treated as a conditional sale.[13]

Another important indicia of ownership for tax purposes is the holding of legal title; this factor, however, is not determinative.[14] The right to possess the property throughout its economic useful life also is an attribute of ownership for tax purposes. For example, the entitlement of the lessee to possession of the property for its entire useful life would be a strong indication that the lessee rather than the lessor should be considered the owner of the property for tax purposes.[15]

The economic substance test finds its genesis in the Supreme Court opinion in Frank Lyon Co. There, the United States Supreme Court determined that a sale and leaseback should not be disregarded for federal income tax purposes if the transaction:

is a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached. . . Expressed another way, so long as the lessor retains sig-

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[7] *Helvering v. F. & R. Lazarus & Co.,* 308 U.S. 252 (1939).

[8] *Estate of Thomas v. Commissioner,* 84 T.C. 412 (1985).

[9] *Rice's Toyota World, Inc. v. Commissioner,* 81 T.C. 184 (1983), *aff'd in part and rev'd in part*, 752 F.2d 89 (4th Cir. 1985); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

[10] *Swift Dodge v. Commissioner*, 692 F.2d 651 (9th Cir. 1982), *rev'g*, 76 T.C. 547 (1981).

[11] *Lockhart Leasing Co. v. Commissioner*, 54 T.C. 301, 314–15 (1970), *aff'd* 446 F.2d 269 (10th Cir. 1971).

[12] *See Frank Lyon Co. v. United States, supra.*

[13] *Oesterreich v. Commissioner,* 226 F.2d 798 (9th Cir. 1955), *rev'g,* 12 T.C.M. 277 (1953).

[14] *Coleman v. Commissioner,* 87 T.C. 178, 201 (1986), *aff'd* 883 F.2d 303 (3d Cir. 1987).

[15] *Pacific Gamble Robinson v. Commissioner,* 54 T.C.M. 915 (1987).

nificant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.[16]

The IRS challenged the sale-leaseback transaction in Frank Lyon on the grounds that it was a sham. However, the Court concluded that, in the absence of specific facts evidencing a sham transaction motivated solely by tax-avoidance purposes, a lessor need only possess "significant and genuine attributes of traditional lessor status," evidenced by the economic realities of the transaction, in order for a lease to be respected for federal income tax purposes. The Court recognized that there can be many business or economic reasons for entering into a lease. Legal, regulatory, and accounting requirements, for example, can serve as motivations to lease an asset. Instead of trying to identify one controlling factor, the Court used the same test as the other leasing cases—that all facts and circumstances must be considered in determining economic substance. Further, the Court noted that "the fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences." [17]

In the wake of Frank Lyon, the Tax Court has refined the analysis of whether a lease should be respected for tax purposes. Under Rice's Toyota World, Inc. v. Commissioner, and its progeny, the Tax Court will disregard a lease transaction for lack of economic substance only if (i) the taxpayer had no business purpose for entering into the transaction other than to reduce taxes, and (ii) the transaction, viewed objectively, offered no realistic profit potential. Further elaborating on this standard, the Tax Court in Mukerji v. Commissioner [18] set forth the test that in subsequent cases has been used to determine whether a lease should be disregarded for tax purposes:

[u]nder such test, the Court must find "that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction, and that the transaction had no economic substance because no reasonable possibility of a profit exists." [19]

Once business purpose is established, a lease transaction should not be classified as a "sham." A finding of no business purpose, however, is not conclusive evidence of a sham transaction. The transaction will still be valid if it possesses some economic substance. The Tax Court has developed an objective test for economic substance. A lease will meet the threshold of economic substance and will be respected when the net "reasonably expected" residual value and the net rentals (both net of debt service) will be sufficient to allow taxpayers to recoup their initial equity investment.[20] Applying this analysis, the Tax Court in several cases has concluded that a purported lease transaction was devoid of business purpose and lacked economic substance because the taxpayers could not reasonably expect to recoup their capital from the projected non-tax cash flows in the lease.[21]

Most recently, outside the context of leasing transactions, the Tax Court in Partnership v. Commissioner [22] had the opportunity to apply a form of economic substance test. There, the Tax Court stated that "the doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of a transaction that serves no economic purpose other than tax savings." [23] The court further found that the taxpayer could not have hoped to recover its initial investment and its costs under any reasonable economic forecast. This proposition that the economic substance test cannot be satisfied if a taxpayer cannot demonstrate a reasonable expectation of pre-tax profit is consistent with the long-standing body of case law regarding lease transactions.

B. Administrative pronouncements

Through revenue rulings and other administrative pronouncements, the IRS has identified certain principles and factors it considers relevant in determining whether a transaction should be treated for tax purposes as a lease or as a conditional sale.

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[16] *Id.* at 583.
[17] *Id.* at 561.
[18] 87 T.C. 926 (1986).
[19] *Id.* at 959 *Rice's Toyota World, supra,* at 91).
[20] *See* Mukerji, supra.
[21] See Goldwasser v. Commissioner, 56 T.C.M. 606 (1988); *Casebeer v. Commissioner,* 54 T.C.M. 1432 (1987); and *James v. Commissioner,* 87 T.C. 905 (1986).
[22] 73 T.C.M. (1997), *aff'd in part and rev'd in part,* 157 F.3d 231 (3d Cir. 1998), *cert. denied,* 1999 U.S. LEXIS 1899 (Mar. 22, 1999).
[23] Id. at 130.

In Rev. Rul. 55–540,[24] the IRS indicated that conditional sale treatment is evidenced where the lessee effectively has the benefits and burdens of ownership for the economic life of the property, as demonstrated by, for example, the application of rentals against the purchase price or otherwise to create an equity interest, the identification of a portion of rentals as interest, the approximate equality of total rentals and the cost of the property plus interest, or the existence of nominal renewal or purchase options. The passage of legal title itself is not determinative.

In addition, the IRS has issued a series of revenue procedures setting forth guidelines that must be satisfied to obtain an advance ruling that a "leveraged lease" (a transaction involving three parties—a lessor, a lessee, and a lender to the lessor) will be respected as a lease for tax purposes.[25] According to Rev. Proc. 75–21, the guidelines set forth therein were published:

to clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued and thus to provide assistance to taxpayers in preparing ruling requests and to assist the Service in issuing advance ruling letters as promptly as practicable. These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes and are not intended to be used for audit purposes. If these guidelines are not satisfied, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances. (Emphasis added.)

Thus, the IRS guidelines are intended only to provide a list of criteria that if satisfied ordinarily will entitle a taxpayer to a favorable ruling that a leveraged lease of equipment will be respected as a lease for tax purposes.

With respect to economic substance, the IRS guidelines set forth a profit test that will be met if:

the aggregate amount required to be paid by the lessee to or for the lessor over the lease term plus the value of the residual investment [determined without regard to the effect of inflation] exceed an amount equal to the sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property and the lessor's equity investment in the property, including any direct costs to finance the equity investment, and the aggregate amount required to be paid to or for the lessor over the lease term exceeds by a reasonable amount the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property.[26]

The IRS guidelines do not specify any particular amount of profit that a lease must generate.[27]

The IRS itself has not relied exclusively on the criteria set forth in the IRS guidelines when analyzing the true lease status of a lease transaction. Moreover, the courts have not treated the IRS guidelines as determinative when analyzing whether a transaction should be respected as a lease for tax purposes.[28] Rather, the IRS guidelines are viewed as constituting a "safe harbor" of sorts. Accordingly, satisfaction of the conservative rule set forth by the applicable IRS guideline with respect to a particular criterion usually is viewed as an indication that the transaction should not be challenged on such a criterion.

The IRS in March 1999 issued Rev. Rul. 99–14, with respect to a narrow class of relatively recent cross-border leasing transactions commonly referred to as "LILO" transactions. The IRS ruled that a taxpayer may not deduct rent and interest paid or incurred in connection with a LILO transaction that lacks economic substance.

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[24] 1955–2 C.B. 39. *See also* Rev. Rul. 55–541, 1955–2 C.B. 19.

[25] *See* Rev. Proc. 75–21, 1975–1 C.B. 715 (setting forth several requirements that must be satisfied for the Service to rule that a transaction is a lease for tax purposes); Rev. Proc. 75–28, 1975–1 C.B. 752 (specifying information that must be submitted pursuant to Rev. Proc. 75–21); Rev. Proc. 76–30, 1976–2 C.B. 647 (providing that the Service will not issue an advance ruling if the property subject to the "lease" is limited use property); Rev. Proc. 79–48, 1979–2 C.B. 529 (modifying Rev. Proc. 75–21 to allow the lessee to pay for certain improvements).

[26] Rev. Proc. 75–21, *supra.*

[27] The IRS guidelines understate the actual profit earned over the lease term by failing to adjust the residual value of the investment for inflation. The advance ruling practice of the IRS from 1975 has been to require a pre-tax profit, cash on cash return, that approximates the inflation rate projected for the leased asset.

[28] In a footnote in *Frank Lyon, supra* at n. 14, the Supreme Court specifically recognized that the IRS guidelines "are not intended to be definitive." Moreover, in *Estate of Thomas v. Commissioner,* 84 T.C. 412, 440 n. 15 (1985), the Tax Court viewed the failure to satisfy all the IRS guidelines as not determinative because the facts and circumstances demonstrated that the transaction satisfied the "spirit" of the guidelines.

C. Statutory provisions

The party that is treated as the owner of the leased asset is entitled to depreciation deductions in respect of such asset. The Deficit Reduction Act of 1984 enacted the "Pickle" rules (named after one of the sponsors of the provision, Representative J.J. Pickle), which restrict the benefits of accelerated depreciation in the case of property leased to a tax-exempt entity.

The Pickle rules generally provide that, in the case of any "tax-exempt use property" subject to a lease, the lessor shall be entitled to depreciate such property using the straight-line method and a recovery period equal to no less than 125 percent of the lease term.[29] Tax-exempt use property, for this purpose, generally is tangible property leased to a tax-exempt entity, which is defined to include any foreign person or entity.[30]

In applying the Pickle rules, Treasury regulations adopted in 1996 provide that the lease term will be deemed to include certain periods beyond the original duration of the lease. Under these regulations, which extend beyond the reach of the statutory provision, the lease term includes both the actual lease term and any period of time during which the lessee (or a related person) (i) agreed that it would or could be obligated to make a payment of rent or a payment in the nature of rent or (ii) assumed or retained any risk of loss with respect to the property (including, for example, holding a note secured by the property).[31]

IV. Administration's FY 2001 Budget Proposals

The Administration's FY 2001 budget includes several proposals that could have the effect of completely rewriting longstanding tax law on leasing transactions. These proposals, if enacted, would replace the substantial and specific body of law regarding leasing transactions that has developed over the last forty years with broad and largely undefined standards that could be used by IRS revenue agents to challenge traditional leasing transactions undertaken by companies operating in the ordinary course of business in good-faith compliance with the tax laws. Moreover, the proposal that would modify the tax rules applicable to cross-border leasing would penalize U.S. lessors and would further hamper the ability of U.S.-based multinationals to compete in export markets.

A. Proposal to codify the economic substance doctrine

The proposal would authorize the IRS to disallow any deduction, credit, exclusion, or other allowance obtained in a "tax-avoidance transaction." A "tax avoidance transaction" is defined generally as any transaction in which the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits. A financing transaction would be considered a tax-avoidance transaction if the present value of the tax benefits of the taxpayer to whom the financing is provided significantly exceed the present value of the pre-tax profit or return of the person providing the financing.

This proposal creates the entirely new and vague concept of a "tax-avoidance transaction." The inclusion of so many subjective concepts in this definition precludes it from operating as an objective test. As an initial matter, what constitutes the "transaction" for purposes of this test?[32] Next, what are the mechanics for computing pre-tax economic profits and net tax benefits and for determining present values (e.g., what discount rate should be used, particularly where rentals, residuals, and their tax benefits have significantly different risk and reward profiles?)? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits? Moreover, is the determination of "insignificance" transaction-specific; stated other-

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[29] I.R.C. section 168(g).

[30] I.R.C. section 168(h).

[31] Treas. Reg. Section 1.168(i)–2(b)(1).

[32] By itself, the determination of the scope of the transaction is both extremely complex and vitally important to the application of this test. Some of the questions to be resolved include: Do the qualified nonrecourse indebtedness rules control the determination of whether debt is considered part of a transaction? If recourse debt is taken into account in defining the transaction, how is the appropriately allocable amount of such debt to be determined? In addition, in defining the transaction, will an implicit charge for the use of capital be taken into account? Will allocations of internal expenses and corporate overhead to the transactions be required? Moreover, will a lease of multiple assets or multiple classes of assets be treated as a single transaction or multiple transactions? All of these questions and more must be answered in order to determine the scope of the transaction, which would be only the starting point in applying this test.

wise, does the form of the transaction affect the determination of what will be considered "insignificant" for these purposes? The presence of these same vague and undefined elements in the concept of a tax-avoidance financing transaction renders that test equally subjective.

Under this proposal, once the IRS had used its unfettered authority to determine independently that a taxpayer had engaged in a tax-avoidance transaction, the IRS would be entitled to disallow any deduction, credit, exclusion, or other allowance obtained by the taxpayer in such transaction. Thus, even though a taxpayer's transaction has economic substance and legitimate business purpose, the IRS would be empowered to deny the tax savings to the taxpayer if another route to achieving the same end result would have resulted in the remittance of more tax. In other words, if an IRS revenue agent believed for any reason that a taxpayer's transaction was too tax efficient, he or she would have the power to strike it down, even if the actual pre-tax return on the transaction satisfied any objective benchmark for appropriate returns. That power could be invoked without regard to the legitimacy of the taxpayer's business purpose for entering into the transaction or the economic substance underlying the transaction.

In the context of leasing transactions, this proposal effectively could wipe out the entire body of law that has developed over the last forty years. A leasing transaction that is scrutinized and passes muster under the benefits and burdens of ownership, business purpose, and economic substance tests could run afoul of this vague new standard. This proposal would completely disregard the presence of a business purpose, ignoring the business reality that lease transactions often are motivated by criteria that would not be taken into account under this new standard. It would replace the traditional economic analysis of lease transactions with this new and largely undefined standard. The long-standing law regarding the treatment of leasing transactions allows taxpayers to employ prudent tax planning to implement business objectives while giving the IRS the tools it needs to address potentially abusive transactions. The extraordinary power that would be vested both in Treasury and in individual IRS revenue agents is unnecessary and would create substantial uncertainty that would frustrate commerce done through traditional leasing transactions.

B. Proposal to increase depreciation life by service term of tax-exempt use property

The proposal would require lessors of tax-exempt use property to include the term of optional service contracts and other similar arrangements in the lease term for purposes of determining the recovery period under the Pickle rules.

As an initial matter, it should be noted that the reach of the proposal is not clear. The proposal does not define optional service contracts and does not provide any guidance regarding what would fall within the reach of the proposal as an "other similar arrangement."

The proposed legislation overlooks significant business purposes that give rise to use of service contracts. Service contracts involve a tradeoff between rights and risks. Relative to a lessor, the service provider enjoys more control over the asset used to generate such services, but also assumes additional performance and operational risk with respect to such asset. The parties' preferences as to the division of rights and risks with respect to property determine the form of contractual arrangement they choose. The service contract arrangement has long been commercially recognized, particularly within certain industries such as the utility, specified manufacturing, and shipping industries.

This proposal would exacerbate the anti-competitive impact of the Pickle rules by further limiting depreciation deductions for U.S. lessors financing assets being sold or developed in overseas markets. Domestic manufacturers, distributors, and retailers alike avail themselves of export leasing, not only as a pure financing vehicle for major equipment sales, but also as a powerful sales tool to promote equipment sales abroad. The proposal would put these U.S. companies at a further disadvantage compared to foreign-based companies that are able to offer lease financing for their goods on more favorable terms. The proposal similarly would adversely affect the ability of U.S. financial institutions to compete internationally with foreign lenders and financiers.

The service contract issue was addressed explicitly at the time the Pickle rules were enacted in 1984. Code section 7701(e), which was enacted with the Pickle rules, provides rules regarding the distinction between a service contract and a lease, and further specifically provides that certain service contracts will not be subject to potential recharacterization as leases. This proposal would reverse the safe harbor provided in 1984 for service contracts with respect to certain solid waste dis-

posal, energy, and water treatment facilities and would subject these facilities to the penalty of delayed depreciation. Moreover, the proposal would further extend the reach of the Pickle rules to other services contracts and to any arrangement that constitutes an "other similar arrangement," a concept which has not been defined. When the Pickle rules were enacted in 1984, their reach was limited by the rules of Code section 7701(e). Removing those limitations and expanding the reach of the Pickle rules would further impair the ability of U.S. leasing companies to compete in the global economy. As discussed further below, given the increasingly competitive global environment for leasing, this is not the time to remove those carefully considered limitations and expand the reach of the Pickle rules.

V. Administration's Proposals Are Anti-Competitive

A. Impact on Common Transactions

Consider a standard domestic leveraged lease under which an airline carrier enters into a "sale-leaseback" transaction in order to finance a newly manufactured aircraft. Under this transaction, the airline carrier purchases the aircraft from the aircraft manufacturer and immediately sells it to an institutional investor. The investor finances the acquisition through an equity investment equal to 25 percent of the $100 million purchase price and a fixed-rate nonrecourse debt instrument from a third-party lender equal to the remaining 75 percent. Immediately after the sale, the investor leases the aircraft to the airline carrier pursuant to a net lease for a term of 24 years. Upon the expiration of the lease term, the aircraft will be returned to the investor (the lessor). During year 18 of the lease, the airline carrier (the lessee) will have an option to purchase the aircraft from the investor for a fixed amount, which will be set at an amount greater than or equal to a current estimate of the then-fair market value of the aircraft. As the tax owner of the aircraft, the lessor is entitled to depreciation deductions in respect of the aircraft and deductions in respect of the interest that accrues on the loan.

The lease in this example complies with applicable case law and with the cash flow and profit tests set forth in Rev. Proc. 75–21. In fact, the sum of the rentals and the expected residual value exceeds the aggregate disbursements of the lessor and the lessor's equity investment, together with applicable costs, by approximately $18 million (or 18 percent of the asset purchase price).

Even though this transaction complies with the established body of leasing law, it appears that it potentially could be characterized as a "tax-avoidance transaction" under the Administration's proposal, discussed above. As noted above, the manner in which the proposal would test whether a transaction is or is not a "tax-avoidance transaction" is capable of numerous different interpretations and appears to be highly subjective. Under a range of potential applications of the proposal to this transaction, it might be determined that the lessor would reasonably expect an annual pre-tax return anywhere in the range of 2.5 percent to 5.5 percent. On an after-tax basis, the lessor might be determined to reasonably expect an annual return anywhere in the range of 6.5 percent to 8.5 percent. Depending on the particular manner in which the proposed test might be applied, the differential between the pre-tax and the after-tax returns could be large enough to suggest that an IRS agent might take the position that the discounted value of the reasonably expected pre-tax profit is not sufficient under the proposed test when compared to the discounted value of the reasonably expected net tax benefits.

Regardless of how the test is applied, however, the tax advantages received by the lessor in this example are identical to the tax benefits that would be received by any owner of the property financing the property in a similar manner and in the same tax bracket. If the tax benefits are disallowed only for lessors, leasing will be put at a disadvantage relative to direct ownership. There is no sensible policy that would declare a leasing transaction to lack economic substance where the same cash flows and tax benefits would occur for any similarly situated direct owner of such an asset.

B. Impact on Global Competitiveness and U.S. Exports

The ability of U.S. equipment manufacturers to compete in global markets depends in part on their ability to arrange financing terms for their potential customers that are competitive with those that can be arranged by foreign producers. The Administration's budget proposals would make it much more difficult and potentially impossible to arrange financing on competitive terms.

For example, consider the case of a U.S. aircraft manufacturer seeking to expand into the European market.[33] A European airline may find cost to be a final determining factor in comparing an aircraft manufactured by a U.S. company with one produced by a European manufacturer. Financing provisions, such as lease terms, directly influence the cost. The U.S. manufacturer's ability to sell its aircraft to the European airline may be contingent on its ability to assist the airline with arranging a suitable lease that is competitive with the lease terms that can be offered with respect to the European aircraft.

A U.S. aircraft manufacturer would have to take into account the current U.S. tax law in determining the rate at which it could offer a European airline a short-term operating lease or a long-term financial lease. In contrast, a European aircraft manufacturer, if it worked through a German investor, for example, might be able to offer financing to the airline at a much lower rate. A chief reason for this disparity is the favorable tax treatment of leased property under German law, including significantly accelerated depreciation for the lessor even when the lessee is a tax-exempt entity under German tax law. Under the present Pickle rules, a U.S. export lease on U.S. equipment cannot compete with a German lease on similar German equipment. The availability of favorable lease rules in foreign jurisdictions, such as the German rules, already hinders the ability of U.S. companies to compete in the global market. Changes to the rules further impairing the tax treatment of export leasing will further disadvantage U.S. leasing companies and U.S. manufacturers vis-à-vis their foreign counterparts.

If enacted, the Administration's budget proposals would tilt the balance in these competitive financing situations even further against the U.S. manufacturer. For leasing-intensive industries, the proposals could make it prohibitive to expand in existing markets or to enter emerging markets on a competitive basis. Because the Administration's proposals effectively would make U.S.-manufactured goods in leasing-intensive industries more expensive in foreign markets, these measures could be expected to have an adverse effect on American exports.

A significant percentage of American exports is attributable to leasing. While no exact data regarding this percentage is available, consider that data discussed in section II, above, indicated that nearly one third of all equipment investment, at least on a domestic basis, is financed through leasing. Further, consider that exports of equipment in 1998 represented 44 percent of all goods exported by the United States.[34] Moreover, the share of exported goods accounted for by equipment has been rising steadily since 1980. Despite the strong showing of U.S. exported equipment, we live in a highly competitive world and face worldwide competition in our export markets and at home for these products.

In certain sectors most likely to be leasing-intensive, exports are accountable for a substantial share of domestic production. For example, in 1996 exports accounted for 50 percent of U.S. production of aircraft, aircraft engines, and other aircraft parts; 28 percent of U.S. production of construction equipment; 31 percent of U.S. production of farm machinery; 40 percent of U.S. production of machine tools; and 56 percent of U.S. production of mining machinery.[35] In the absence of these exports, domestic employment in these equipment-producing industries would be substantially reduced.

The Administration's proposals also would impede the ability of U.S.-based financial institutions to compete in the worldwide leasing market. If enacted, the Administration's proposals would give foreign-based financial institutions a leg up in providing financing. The impact of these proposals on the U.S. financial sector, an important part the U.S. economy, should not be overlooked.

C. Impact on Start-Ups and Companies in Economic Downturn

Some companies that directly own their assets may find that they have a higher cost of capital than their competitors due to special tax circumstances. For example, companies in a loss position (as is the case for many businesses in the start-up phase) and companies paying AMT (which often hits companies experiencing economic downturns) often have a higher cost of capital because they cannot immediately claim all of the depreciation allowances provided under the tax law. These companies may be at a competitive disadvantage relative to other firms. Some regard it as unfair that a company in the start-up phase or recovering from an economic downturn faces higher costs for new investment than its competitors.

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[33] About half of the aircraft flown in Europe are leased rather than owned by airlines.

[34] U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, January 2000.

[35] U.S. Department of Commerce, International Trade Administration.

Through leasing, a company in these circumstances often can achieve a cost of capital comparable to that of its competitors. Leasing helps to "level the playing field" between companies in an adverse tax situation and their competitors by equalizing the cost of capital. For certain assets, leasing can lower the cost of capital for a firm in this tax situation by as much as one percentage point. This can mean the difference between successfully competing and bankruptcy. Rehabilitation or liquidation in bankruptcy can be more detrimental to U.S. revenues than the granting of ordinary depreciation and interest deductions.

By denying the benefits of leasing, the Administration's proposals would further increase the cost of capital for companies in such circumstances. As a result, the economy suffers real losses. Investment may be allocated not on the basis of who is the most efficient or productive producer, but who is in the most favorable tax situation. In the absence of leasing, a company in a loss position—facing a higher cost of capital than its competitors—might not be able to undertake new investment even if, in the absence of taxes, it would be the most efficient firm.

VI. Reforms Needed to Strengthen Competitiveness of U.S. Leasing Industry

As discussed above, the leasing industry is important to the American economy. U.S. manufacturers use leasing as a means to finance exports of their goods in overseas markets, and many have leasing subsidiaries that arrange for such financing. Many U.S. financial companies also arrange for lease financing as one of their core financial intermediation services. Ultimately, the activities of these companies support U.S. jobs and investment.

The present-law Pickle rules place the American leasing industry at a competitive disadvantage in overseas markets. Because of the Pickle rules and their adverse impact on cost recovery, U.S. lessors are unable in many cases to offer U.S.-manufactured equipment to overseas customers on terms that are competitive with those offered by foreign counterparts. Many European countries, for example, provide favorable lease rules for home-country lessors leasing equipment manufactured in the home country. The 1996 Treasury regulations regarding replacement leases compound this competitive disadvantage faced by the U.S. leasing industry. It is unclear why the Administration, through the proposals in its FY 2001 budget submission, would choose to further increase these competitive disadvantages.

Rather than follow the Administration's lead, the Leasing Coalition respectfully submits that Congress should consider reversing course. Specifically, we would ask that Congress explore whether, in light of the globalization of the economy, there is any tax policy or economic rationale for the present-law Pickle rules. The Leasing Coalition knows of no such legitimate rationale, and urges repeal of the Pickle rules applicable to export leases, which serve only to penalize the U.S. leasing industry. As an immediate step, we also would call on Congress to overturn the 1996 Treasury regulations that treat the lease term, for purposes of the Pickle rules, as including periods beyond the actual lease term. These regulations have no basis in the legislative history underlying enactment of the Pickle rules and have no policy justification. These changes would greatly strengthen the competitiveness of the U.S. leasing industry.

VII. Conclusion

The Leasing Coalition urges Members of the House Ways and Means Committee to reject the Administration's tax proposals that would adversely affect the leasing industry. As discussed above, we believe these proposals inappropriately would overturn the longstanding and carefully crafted body of tax law governing common leasing transactions and would have a deleterious impact on the U.S. economy. Moreover, we find it highly objectionable that these common and legitimate business transactions effectively are being cast by the Administration as "corporate tax shelters."

The Leasing Coalition appreciates the concern that a bipartisan majority of Ways and Means Committee Members expressed, in a June 9, 1999, letter to Committee Chairman Archer and Ranking Member Rangel, over the impact that the Administration's FY 2000 budget proposals would have had on the leasing industry and our ability to compete internationally. Those same concerns hold equally true today with respect to the Administration's FY 2001 budget proposals.

Instead of considering proposals at this time that would impair the competitiveness of the leasing industry and industries that manufacture goods commonly acquired through lease arrangements, we respectfully would suggest that the Administration and Congress consider ways to help U.S. companies that use leasing as a form of financing expand in the global marketplace. The Congress should act to re-

verse the overreaching 1996 Treasury regulations regarding replacement leases and, further, should consider repeal of the Pickle rules themselves.

Statement of the National Association of Real Estate Investment Trusts

As requested in Press Release No. FC–17 (February 2, 2000), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Committee on Ways and Means' hearing on the President's Fiscal Year 2001 Budget ("Budget"). NAREIT thanks the Chairman and the Committee for the opportunity to share its views on several important issues affecting REITs and publicly traded real estate companies.

NAREIT's comments address (1) the Budget's proposal to increase a real estate investment trust's ("REIT") distribution requirement to avoid the 4% excise tax; (2) the Budget's proposal to modify the treatment of closely held REITs; and (3) the Budget's proposal to made permanent the ability to deduct remediation expenses for Brownfields sites. We appreciate the opportunity to present these comments.

NAREIT is the national trade association for REITs and publicly traded real estate companies. Members are REITs and publicly traded businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. REITs are companies whose income and assets are mainly connected to income-producing real estate. By law, REITs regularly distribute most of their taxable income to shareholders as dividends. NAREIT represents over 200 REITs and publicly traded real estate companies that own over $250 billion of real estate assets, as well as over 2,000 industry professionals who provide a range of legal, investment, financial and accounting-related services to these companies.

Executive Summary

Excise Tax. The Budget's proposal to increase the distribution requirement to avoid the 4% excise tax ignores the capital intensive nature of REITs, as well as the practical differences between REITs and mutual funds in timely calculating the required distribution amounts. Further, this proposal would effectively nullify Congress' decision reached only a few months ago to restore the general distribution requirement from 95% to 90%, effective in 2001.

Closely Held REITs. The Budget proposes to prevent any entity from owning 50% or more of the vote or value of a REIT's stock. NAREIT does not oppose the Administration's intention to craft a new ownership test intended to correspond to a REIT's primary mission: to make investment in income-producing real estate accessible to ordinary investors. However, we believe that the Administration's proposal is too broad, and therefore should be narrowed to prevent only non-REIT C corporations from owning 50% or more of a REIT's stock (by vote or value). In addition, the new rules should not apply to so-called "incubator REITs" that have proven to be a viable method by which small investors can access publicly traded real estate investments. Last, the proposal should not apply to publicly traded REITs when one person owns less than 80% of the vote or value of a REIT's stock because it would deter legitimate business transactions.

Brownfields Expenses. The Budget proposes to make permanent the provision contained in the Tax Relief Extension Act of 1999 that allows a taxpayer to deduct remediation expenses for Brownfields sites. NAREIT strongly supports this proposal, but also recommends that Congress extend the expensing treatment to properties that do not currently fit within the definition of a "qualified contaminated site."

Background on REITs

A REIT is a corporation or business trust combining the capital of many investors to own, operate or finance income-producing real estate, such as apartments, shopping centers, offices and warehouses. REITs must comply with a number of requirements, some of which are discussed in detail in this statement, but the most fundamental of these are as follows: (1) REITs must pay at least 95% of their taxable income to shareholders (90% after 2000); (2) most of a REIT's assets must be real estate; (3) REITs must derive most of their income from real estate held for the long term; and (4) REITs must be widely held.

In exchange for satisfying these requirements, REITs (like mutual funds) benefit from a dividends paid deduction so that most, if not all, of a REIT's earnings are taxed only at the shareholder level. On the other hand, REITs pay the price of not having retained earnings available to meet their business needs. Instead, capital for

growth and significant capital expenditures largely comes from new money raised in the investment marketplace from investors who have confidence in the REIT's future prospects and business plan.

Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to investors from all walks of life. Based in part on the rationale for mutual funds, Congress decided that the only way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements.

In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals. REITs are owned primarily by individuals, with 49% of REIT shares owned directly by individual investors and 37% owned by mutual funds, which are mostly owned by individuals.

I. REIT DISTRIBUTION REQUIREMENTS

Background. Under current law, to maintain their tax status, REITs are required to distribute 95% of their taxable income while mutual funds are required to distribute 90% of taxable income. The Tax Relief Extension Act of 1999 (the "1999 Act") reduced the distribution requirement for REITs from 95% of taxable income to 90% of taxable income for years beginning after December 31, 2000.

In addition to the distribution requirement necessary to maintain their tax status, both REITs and mutual funds are subject to a 4% excise tax on the difference between their "required distribution" for a calendar year and their "distributed amount" for that year. For REITs, the required distribution under current law equals the sum of 85% of "ordinary income" for the calendar year (essentially, REIT taxable income for the year without reduction for the dividends paid deduction and without reference to capital gain or loss) plus 95% capital gain net income for that calendar year. For mutual funds, the required distribution equals 98% of a its "ordinary income" plus 98% of its capital gain net income.

For example, a REIT that generates $100x in ordinary income in 1999 must distribute at least $95x to its shareholders to receive a dividends paid deduction for 1999. However, if a REIT makes an election under I.R.C. § 858, the Code treats as paid in 1999 any dividend declared before it files its tax return (due, with extensions, on September 15, 2000) and paid in 2000 before its first regular dividend payment date after such declaration. To avoid the 4% excise tax for 1999, the REIT must distribute at least $85x during 1999 or, under the "look back" rule of I.R.C. § 857(b)(8), in January of 2000 if the dividend is declared in the last quarter of 1999.

Budget Proposal. The Administration proposes that in order to a REIT not to be assessed the 4% excise tax, its required distribution would be increased to the sum of 98% of its ordinary income and 98% of its capital gain net income. The Administration believes that this provision is necessary in order to conform the REIT excise tax to the mutual fund excise tax rules.

NAREIT Analysis and Position. While REITs were modeled after mutual funds, REITs have evolved separately as investment vehicles. The Budget would ignore Congress' recognition last year of the special capital needs of REITs and the increased difficulties a REIT faces in accurately calculating its taxable income during a taxable year.

Congress has mandated that REITs concentrate on owning and operating real estate. Unlike mutual funds that have relatively low overhead because they own the securities of other companies, REITs must continually invest capital into its projects for both upkeep and to prevent them from becoming obsolete. Reinvestment needs span the gamut of ordinary upkeep such as painting to capital expenditures (such as a installing new roof or repaving a parking lot) to renovations needed to meet customer demand (such as installing fiber optic lines for telecommunications). Thus, REITs have clear reasons why they need to retain more capital than mutual funds.

In addition, it takes considerable more time for a REIT to compute its taxable income than does a mutual fund. A mutual fund only needs to tabulate the dividends or capital gains from its portfolio, and the sources of this public information are manifold in this Age of the Internet. Conversely, a REIT must rely on non-public sources of information for which it does not control.

A REIT that owns shopping malls illustrates this lag time of information. A significant source of a typical retail REIT's annual taxable income is "percentage rents," under which the REIT landlord receives base rent throughout the year and

then additional rent if the tenant generates sales at the REIT's property above an agreed threshold. The Christmas Holiday Season is by far the biggest sales period for most shopping malls, and a retail REIT cannot compute its taxable income until its tenants have informed it of their sales and the consequent percentage rents. Since the Code does not compel the tenants to provide this information by any deadline, often a retail REIT does not receive the necessary breakdown of percentage rents until February or March. Accordingly, the REIT can approximate by year-end how much it needs to distribute to satisfy the current 85% requirement, but would be hard pressed to reach the precision required by a 98% requirement, as proposed in the Budget.

The increased distribution proposal would vitiate much of the benefits of Congress' decision in the 1999 Act to lower the 95% distribution requirement to 90%. To avoid the 4% excise tax, REITs very well could be compelled to distribute more than necessary during a taxable year because they would not have the necessary information to estimate 98% of their taxable income. This would be the **opposite** of what Congress authorized by restoring the 90% distribution requirement.[1] Accordingly, NAREIT strongly opposes this provision.

II. CLOSELY HELD REITS

Background and Current Law. As discussed above, Congress created REITs to make real estate investments easily and economically accessible to the small investor. To carry out this purpose, Congress mandated two rules to ensure that REITs are widely held. First, five or fewer *individuals* cannot own more than 50% of a REIT's stock.[2] In applying this test, most entities owning REIT stock are "looked through" to determine the ultimate ownership of the stock by individuals. Second, at least 100 persons (including corporations and partnerships) must be REIT shareholders. Neither test apply during a REIT's first taxable year, and the "five or fewer" test only applies in the last half of each subsequent taxable year of the REIT.

Budget Proposal. The Administration appears to be concerned about non-REITs establishing "captive REITs" and REITs engaging in transactions which the Administration finds abusive, such as the "liquidating REIT" structure curtailed by the 1998 budget legislation.[3] The Budget proposes changing the "five or fewer" test by imposing an additional requirement. The proposed new rule would prevent any "person" *i.e.*, a corporation, partnership or trust, including a pension or profit sharing trust) from owning stock of a REIT possessing 50% or more of the total combined voting power of all classes of voting stock or 50% or more of the total value of shares of all classes of stock. Certain existing REIT attribution rules would apply in determining such ownership, and the proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action.

NAREIT Analysis and Position. NAREIT agrees that the REIT structure is meant to be widely held and that it should not be used for abusive tax avoidance purposes. Therefore, NAREIT supports the intent of the proposal. Nevertheless, we are concerned that the Budget proposal casts too broad a net. A limited number of exceptions are needed to allow certain "entities" to own a majority of a REIT's stock. For instance, NAREIT certainly agrees with the Administration's decision to exclude a REIT's ownership of another REIT's stock from the proposed new ownership limit.[4] NAREIT would like to work with Congress and the Administration to ensure that any action to curb abuses does not disallow transactions necessary to foster the future REIT marketplace and to recognize the widely held nature of certain non-REIT entities.

First, an exception should be allowed to enable a REIT's organizers to have a single large investor for a temporary period, such as in preparation for a public offering

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[1] Since REITs likely would distribute extra amounts during a taxable year so the excise tax would not be imposed, it is unclear how this provision would raise any revenues. We note that the 90% rule was scored in the 1999 Act as a revenue raiser, so that any proposal such as that contained in the Budget that would deter a REIT from paying corporate taxes on its undistributed amounts would appear to be a revenue loser.

[2] I.R.C. § 856(h)(1). There is no apparent reason why the proposed ownership test similarly should not be aimed at limiting *more than* 50% stock ownership, rather than 50% or more as now proposed.

[3] NAREIT supported the Administration's and Congress' move to limit the tax benefits of liquidating REITs.

[4] If the proposed test remains applicable to all persons owning more than 50% of a REIT's stock, then Congress should apply the exception for a REIT owning another REIT's stock by examining both direct and indirect ownership so as not to preclude an UPREIT owning more than 50% of another REIT's stock. NAREIT supports the rule providing such clarification that was contained in the Taxpayer Refund and Relief Act of 1999.

of the REIT's shares. Such an "incubator REIT" sometimes is majority owned by its sponsor to allow the REIT to accumulate a track record that will facilitate its going public. The Budget proposal is silent on this important approach which, in turn, could curb the emergence of new publicly traded REITs in which small investors may invest. NAREIT supports the incubator REIT exception that was included as part of the Taxpayer Refund and Relief Act of 1999.[5]

Second, there is no reason why a partnership, mutual fund, pension or profit-sharing trust or other pass-through entity should be counted as one entity in determining whether any "person" owns 50% of the vote or value of a REIT. A partnership, mutual fund or other pass-through entity usually is ignored for federal tax purposes. The partners in a partnership and the shareholders of a mutual fund or other pass-through entity should be considered the "persons" owning a REIT for purposes of any limits on investor ownership. Similarly, the Code already has rules preventing a "pension held" REIT from being used to avoid the unrelated business income tax rules, and therefore the new ownership test should not apply to pension or profit-sharing plans.[6] Instead, NAREIT suggests that the new ownership test apply only to non-REIT C corporations that own more than 50% of a REIT's stock.[7] NAREIT is encouraged by the Budget's proposal for a "limited look-through rule" for partnerships, and suggests that any such rule be flexible enough to provide for the typical allocations used by real estate partnerships, such as preferred returns.

Third, none of the transactions identified by the Administration have involved publicly traded REITs. Such REITs must divulge information to the Securities and Exchange Commission that is then available to all. This "Sunshine" exposure typically is antithetical to tax shelters, and there is no reason to expect that such public attention should not work in this case. In fact, there does not appear to be a single example of a publicly-traded REIT serving as a tax avoidance vehicle. Therefore, NAREIT recommends that any closely held REIT legislation contain an exception for a REIT the stock of which is regularly traded on an established securities market, so long as no entity owns 80% or more of the vote or value of its common stock. NAREIT would support certain limits on this exception that would ensure that it would not be used for tax avoidance purposes. This exception would allow one entity to acquire a majority of the common stock of a public traded REIT for business purposes, such as forcing a change in strategy or certain types of takeover transactions.

III. BROWNFIELDS EXPENSING

Background. Under the Taxpayer Relief Act of 1997, certain remediation costs are currently deductible if incurred with respect to a "qualified contaminated site" (a "Brownfields" site). As part of the 1999 Act, this provision was extended for one year to allow deductions for expenditures paid or incurred on or before December 31, 2001.

Budget Proposal. The Budget would extend permanently the ability to deduct remediation expenses for Brownfields sites.

NAREIT Position. NAREIT applauds the Administration for proposing a permanent extension of current deductions for Brownfields remediation expenses. In addition, NAREIT encourages the Administration and other policymakers to consider the tremendous potential remediation that could occur at contaminated sites if the extension were expanded to properties that do not currently fit within the exact definition of a "qualified contaminated site," but are nevertheless in need of significant environmental remediation. NAREIT supports the Brownfields expansion contained in S.1792, the Senate version of the Taxpayer Refund and Relief Act of 1999, and urges Congress to enact such provision this year.

NAREIT thanks the Committee for the opportunity to comment on these important proposals.

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[5] NAREIT recommends that the 10% annual growth requirement contained in the Taxpayer Refund and Relief Act of 1999 as proposed section 856(l)(4)(v) be replaced with a requirement that the REIT not lease more than half of its properties to the principal owner of the REIT's stock.

[6] NAREIT supports the pension plan look-through rule contained int the Taxpayer Refund and Relief Act of 1999.

[7] As under the current "five or fewer" test, any new ownership test should not apply to a REIT's first taxable year or the first half of subsequent taxable years. *See* I.R.C. §§ 542(a)(2) and 856(h)(2).

Statement of PricewaterhouseCoopers LLP

I. INTRODUCTION

PricewaterhouseCoopers appreciates the opportunity to submit this statement to the Committee on Ways and Means for the record of its February 9, 2000, hearing on the proposals in the Administration's FY 2001 budget. This statement specifically addresses the Administration's general proposals regarding "corporate tax shelters."

PricewaterhouseCoopers, the world's largest professional services organization, provides a full range of business advisory services to corporations and other clients, including audit, accounting, and tax consulting. The firm, which has more than 6,500 tax professionals in the United States and Canada, works closely with thousands of corporate clients worldwide, including most of the companies comprising the Fortune 500. These comments reflect the collective experiences of many of our corporate clients.

We respectfully urge the Committee to reject the Administration's general "corporate tax shelter" proposals. We believe no justification has been presented that would support enactment of such sweeping changes. Economic data does not suggest any systemic erosion of the corporate income tax base attributable to tax shelters. Current-law administrative tools, if used properly, are more than adequate to detect and penalize abuses. Further, the Administration's proposals are at odds with sound tax policy principles and efficient tax administration, would threaten legitimate tax-planning activities undertaken by corporate tax professionals, and would exacerbate the complexity of the tax code.

II. THE ADMINISTRATION'S "CORPORATE TAX SHELTER" PROPOSALS

The Administration's latest general proposals regarding "corporate tax shelters," included in its FY 2001 budget, reflect a number of modifications to the proposals originally advanced in the Administration's FY 2000 budget. These modifications, which were discussed in the Treasury Department's "White Paper"[1] released in July, generally narrowed the scope of the original proposals. For example, the Administration dropped proposals to eliminate the reasonable cause exception to the accuracy-related penalty and to disallow deductions for fees paid to tax shelter promoters and advisors.

Surprisingly, Treasury estimates that its FY 2001 corporate tax shelter proposals, even though narrower in scope, would raise significantly more revenue than its previous proposals. The prior proposals were estimated by Treasury to raise $1.5 billion over five years. The new proposals are estimated to raise nearly five times as much—$7.3 over five years and $14.5 over ten years. It is difficult to understand this upward re-estimate, especially given the significant victories (discussed further below) won by the Internal Revenue Service (IRS) in the courts over the past year, which have strengthened the hand of the government in challenging aggressive tax positions taken by corporations. These court decisions presumably would operate to reduce the revenues that could be generated by further legislative changes.

Before turning to specific concerns over the Administration's proposals, we want to restate a general observation. Like individual taxpayers, corporations have the right to seek legitimate minimization of tax liabilities, i.e., to pay no more in taxes than the tax law demands.[2] Indeed, corporate executives have a fiduciary duty to preserve and increase the value of a corporation for its shareholders. Some commentators decry this responsibility, termed "profit center activity" in current management parlance. We disagree. Responsible minimization of taxes in conjunction with the business activity of a corporation is an important function of corporate executives and one that long has been viewed as consistent with sound policy objectives.[3]

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[1] The Problem of Corporate Tax Shelters, Department of the Treasury, July 1999.

[2] Individual taxpayers often undertake actions to obtain favorable tax treatment, but this alone is not considered a reason simply to disallow the benefits. For example, an individual holding an appreciated security may decide to hold it for sale until a particular date solely to obtain long-term capital gain treatment. Also, an individual may take out a home-equity loan to pay off credit-card debt because interest on the home loan can be tax deductible. As another example, an individual renting a home may decide to purchase it, viewing the tax benefits as a principal purpose for entering into the transaction. In such cases, Congress has not been concerned that the taxpayer acted out of tax motivations; the tax benefits still are allowed.

[3] Judge Learned Hand wrote: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich

The following are our specific comments on the Administration's proposals.

A. INCREASE DISCLOSURE WITH RESPECT TO CERTAIN REPORTABLE TRANSACTIONS

Summary

The proposal would require a corporation to disclose a transaction that has "significant tax benefits" if it has some combination of the following "filters": (1) a book/tax difference in excess of a certain amount; (2) a rescission clause, unwind clause, insurance, or similar arrangement; (3) involvement with a tax-indifferent party; (4) contingent advisor fees in excess of a certain amount; (5) the offering of the transaction to multiple taxpayers; and (6) a difference between the form of the transaction and how it is reported. Disclosure would be made on a short form or statement filed with the return; the form or statement would have to be signed by a corporate officer who has, or should have, knowledge of the transaction. Failure to disclose would subject the taxpayer to a penalty of $100,000 per failure.

Comment

This proposal would create considerable uncertainties for taxpayers seeking to determine whether disclosure is required. Consider, for example, the proposed requirement to disclose transactions that are reported differently from their form. Does "form" refer to the label given to the transaction or instrument, or does it refer to the rights and liabilities set forth in the documentation? For example, if an instrument is labeled debt, but has features in the documentation typically associated with an equity interest, is the form debt or equity? What if the taxpayer reasonably believed that it was reporting the transaction in accordance with its "form," but later interpretations of "form" suggested that it had not so reported the transaction? Furthermore, it is unclear how a company would know whether the tax consequences of a transaction constitute a "significant tax benefit," a term that is not defined by Treasury.

The disclosure requirement would be redundant in a number of respects. First, companies already are required to account for book/tax differences on Schedule M of the corporate income tax return. Treasury has not indicated why a second level of reporting of these differences is necessary. Second, the disclosure requirements would overlap with tax shelter reporting requirements enacted by Congress in 1997.[4] More than two years later, the Treasury Department has yet to take the steps necessary to implement the new tax shelter reporting rules.

The proposed disclosure requirement would add significantly and unnecessarily to the burdens already shouldered by corporate tax officials.[5] Companies would be forced to report thousands of transactions and arrangements in order to guard against the $100,000 penalty for failure to report. Remarkably, this penalty would be imposed on the taxpayer regardless of whether the the taxpayer's treatment of the unreported transaction is sustained. Examples of commonplace transactions that presumably would have to be reported would include purchases of equipment that qualifies for accelerated depreciation, thus creating a book-tax difference, and transactions with foreign companies—hardly a rarity in today's global economy -and other "tax-indifferent parties." It would be patently unfair to assess a tax shelter penalty for nondisclosure of legitimate transactions.

The utility to the IRS of this flood of information is questionable. By point of reference, the United Kingdom last year dropped a proposal made by the Labor Party in 1997 that would have imposed a "general anti-avoidance rule" to counter perceived tax avoidance in the corporate sector. The proposal was dropped, in part, because of concerns that arose over Inland Revenue's ability to process reports that UK corporate taxpayers would have been forced to file with respect to transactions in order to have any certainty that the tax treatment would be respected. Similar difficulties surely would arise for the IRS if the Administration's proposals were enacted.

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or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions." *Comm'r v. Newman,* 159 F.2d 848, 850–851 (2d Cir. 1946) (dissenting opinion).

[4] Taxpayer Relief Act of 1997, P.L. 105–34.

[5] Of the $1.7 trillion in tax revenue collected by the federal government in FY 1998, corporate tax officials were responsible for remitting more than 50 percent.

B. MODIFY SUBSTANTIAL UNDERSTATEMENT PENALTY FOR CORPORATE TAX SHELTERS

Summary

The substantial understatement penalty imposed on corporate tax shelter items generally would be increased to 40 percent (reduced to 20 percent if the taxpayer discloses). The reasonable cause exception would be retained, but narrowed with respect to transactions deemed to constitute a corporate tax shelter—for these transactions, taxpayers would have to have a "strong" probability of success on the merits and to make disclosure.

For this purpose, a "corporate tax shelter" would be defined as any entity, plan, or arrangement in which a corporate participant attempts to obtain a tax benefit (other than those clearly contemplated in the Tax Code) in a "tax avoidance transaction." A "tax avoidance transaction" would be defined generally as any transaction in which the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits. A financing transaction would be considered a tax avoidance transaction if the present value of the tax benefits of the taxpayer to whom the financing is provided significantly exceed the present value of the pre-tax profit or return of the person providing the financing.

Comment

This proposal is inconsistent with the goals of rationalizing penalty administration. If the proposal were enacted, an IRS agent proposing a different treatment of a tax shelter item than on the taxpayer's return would feel compelled to impose a penalty even if the agent determines that (1) there is substantial authority supporting the return position taken by the taxpayer, and (2) the taxpayer reasonably believed (based, for example, on the opinion or advice of a qualified tax professional) that its tax treatment of the item was more likely than not the proper treatment. It is doubtful that the agent would decline to impose the penalty based on the taxpayer's arguing that its position had had a "strong probability of success," an undefined term setting an unrealistically high threshold. Indeed, one might question how a return position that was challenged successfully could ever be shown to have had a strong probability of success.

The near-automatic nature of the proposed increased penalty would alter substantially the dynamics of the current process by which the vast majority of disputes between the IRS and corporate taxpayers are resolved administratively. Today, even where a corporation and the IRS agree that there is a substantial understatement of tax attributable to a tax shelter item, the determination as to whether the substantial understatement penalty should be waived for reasonable cause continues to focus on the merits of the transaction and the reasonableness of the taxpayer's beliefs regarding those merits. If, however, the reasonable cause exception no longer were effectively available, the parties necessarily would have to focus on whether the transaction in question was a "tax avoidance transaction" and other definitional issues unrelated to the underlying merits of the transaction.

The proposal also runs directly counter to the goal of maintaining transparency (i.e., the ability for a taxpayer to determine the tax rules applicable to transactions) in our tax system. The inclusion of so many subjective concepts in the definition of "tax-avoidance transaction" precludes it from being an objective test. As an initial matter, what constitutes the "transaction" for purposes of this test? Next, what are the parameters for "reasonable expectation" in terms of both pre-tax economic profit and tax benefits? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits? Given these ambiguities, this definition would threaten to sweep in legitimate transactions undertaken in the ordinary course of business, such as financing transactions, capital restructuring transactions, and corporate reorganizations. It also could sweep in many start-up ventures—how many "dot coms" can be said to have a reasonable expectation of profit? It is safe to say that it is highly unlikely that this definition would be applied uniformly by IRS agents.

The difficulty of defining "corporate tax shelter" is highlighted when one compares Treasury's FY 2000 and FY 2001 "Green Book" descriptions of the Administration's revenue proposals. Some proposals (e.g., a proposal to modify the treatment of "built-in losses") that were characterized as targeting "corporate tax shelter" transactions in Treasury's FY 2000 Green Book no longer are characterized as such in Treasury's FY 2001 Green Book. Conversely, some proposals (e.g., a proposal to amend the "80/20" company rules) that were not characterized as targeting "corporate tax shelter" transactions in the FY 2000 Green Book are now characterized as such in the FY 2001 Green Book. This inconsistency illustrates the inherent difficulties in the Administration's proposed definition.

Finally, it should be noted that the proposed 40-percent penalty rate is out of line with other penalty rates in the tax code.

C. Codify the Economic Substance Doctrine

Summary

The proposal would disallow tax benefits from any "tax avoidance transaction," as defined in B., above.

Comment

While couched as merely codifying an existing common-law doctrine, the proposal would have the plain effect of encouraging IRS agents to challenge taxpayer positions that meet the objective rules provided by Congress and set forth in the tax code. Given the loose definition of "tax avoidance transaction," the proposal essentially would grant IRS agents unfettered authority to disallow deductions, credits, exclusions, or other allowances where they see fit. This power could be invoked without regard to the legitimacy of the taxpayer's business purposes for entering into the transaction. If a transaction is viewed as too tax efficient, it could be challenged on those grounds alone. As a result, audits would become more protracted, and corporate tax officials would find it impossible to rely on the statute in planning transactions.

The proposed disallowance rule strongly resembles a test that was included in the new U.S.-Italy Income Tax Treaty and the new U.S.-Slovenia Income Tax Treaty that drew strong criticism last year from the staff of the Joint Committee on Taxation ("JCT"). "Main purpose" tests in the treaties as proposed would have denied treaty benefits (e.g., reduced withholding rates on dividends) if the main purpose of a taxpayer's transaction is to take advantage of treaty benefits. The JCT staff correctly raised policy objections to this proposed test:

The new main purpose tests in the proposed treaty present several issues. The tests are subjective, vague and add uncertainty to the treaty. It is unclear how the provisions are to be applied. . . This uncertainty can create planning difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty.. . . This is a subjective standard, dependent on the intent of the taxpayer, that is difficult to evaluate.. . . It is also unclear how the rule would be administered.. . .In any event, it may be difficult for a U.S. company to evaluate whether its transaction may be subject to Italian main purpose standards.[6]

These very same objections—"vague," "subjective," "difficulties for legitimate business transactions"—apply equally to Treasury's proposed definition of "tax-avoidance transaction." In light of concerns raised by the JCT staff and the Senate Foreign Relations Committee, the Senate last year approved the treaties subject to a "reservation" that has the effect of eliminating the "main purpose" test.

It would be inappropriate for the Congress to hand the IRS this authority to deny tax benefits at this time, less than two years after Congress enacted significant new limitations[7] on the authority of IRS agents in audit situations. Congress also should note that Treasury and the IRS could use the authority that would be provided under this proposal to make changes administratively that Congress has not seen fit to make legislatively. For example, Treasury in its FY 1999 budget proposals asked for expansive authority to "set forth the appropriate tax results" and "deny tax benefits" in hybrid transactions.[8] Congress dismissed this proposal. The FY 2001 budget proposals now ask for authority of the same type but significantly broader than the authorization that Congress rejected. The Treasury's new proposals thus can be seen as an attempted end run around earlier failed initiatives—this time accompanied by the shibboleth of "stopping tax shelters."

D. Impose a Penalty Excise Tax on Certain Fees Received from Corporate Tax Shelters

Summary

The proposal would impose a 25-percent excise tax on fees received in connection with promoting or rendering tax advice related to corporate tax shelters.

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[6] "Explanation of Proposed Income Tax Treaty and Proposed Protocol between the United States and the Italian Republic," October 8, 1999 (JCS–9–99); see also, "Testimony of the Staff of the Joint Committee on Taxation before the Senate Committee on Foreign Relations Hearing on Tax Treaties and Protocols with Eight Countries," October 27, 1999 (JCX–76–99).

[7] Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105–208.

[8] *General Explanation of the Administration's Revenue Proposals,* Department of the Treasury, February 1998, p. 144.

Comment

The imprecise definition of a corporate tax shelter transaction would make it difficult for professional tax advisers to determine the circumstances under which this provision would apply. The substantive burdens of interpreting and complying with the statute and the administrative problems that taxpayers and the IRS would face cannot be overstated.

Further aggravating the complexity and burdens that are imbedded in this proposal is the fact that the ultimate determination that a particular transaction was a corporate tax shelter may not be made until several years after the fees are paid. In that situation, issues arise as to when the excise tax is due, whether the applicable statute of limitations has expired, and whether and upon what date interest would be owed on the liability.

More fundamentally, the creation of the proposed excise tax subjects tax advisors to an entirely new and burdensome tax regime, a regime that again shifts the focus away from the substantive tax aspects of the transaction to unrelated definitional and computational issues. It is also unclear who would administer or enforce this new tax regime. For instance, if the existence of a tax shelter is determined as a result of an income tax examination of a corporation, would the revenue agents conducting that examination have jurisdiction over a resulting excise tax examination of the taxpayer's tax adviser? Would the income tax and excise tax examinations be conducted concurrently? How would conflicts of interest between the taxpayer and the adviser be identified and handled? These are only a few of the serious real-world issues that would have to be resolved to administer an inherently vague and cumbersome proposal.

Finally, the real possibility exists that the effect of the proposal may be to deter certain taxpayers from seeking and obtaining necessary advice and guidance from a qualified tax professional in many transactions where the broad and vague scope of the prohibition calls into question the ultimate deductibility of fees. In many such cases, it is likely that qualified tax advice would have either convinced the taxpayer that it would be unwise or improper to enter into the transaction, or resulted in the restructuring of the transaction so as to bring it within full compliance with the letter and spirit of the internal revenue laws.

E. Tax Income from Corporate Tax Shelters Involving Tax-Indifferent Parties

Summary

Any income allocable to a "tax-indifferent party" (e.g., a foreign person; a foreign, State, or local government; a Native American tribal organization; a tax-exempt organization) with respect to a corporate tax shelter would be taxable to that party. The corporate participants in the transaction would be jointly and severally liable for the tax.

Comment

Treasury itself has conceded that this proposal "may be difficult to administer."[9]

This overreaching Treasury proposal cannot be justified on any tax policy grounds. The proposal ignores the fact that many businesses operating in the global economy are not U.S. taxpayers, and that in the global economy it is increasingly necessary and common for U.S. companies to enter into transactions with such entities. The fact that a tax-exempt person earns income that would be taxable if instead it had been earned by a taxable entity surely cannot in and of itself be viewed as objectionable.

Moreover, as it applies to foreign persons in particular, the proposal is overbroad in two significant respects. First, treating foreign persons as tax-indifferent ignores the fact that in many circumstances they may be subject to significant U.S. tax, either because they are subject to the withholding tax rules, because they are engaged in a U.S. trade or business, or because their income is taxable currently to their U.S. shareholders. Second, limiting the collection of the tax to parties other than treaty-protected foreign persons does not hide the fact that the tax-indifferent party tax would constitute a significant treaty override.

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[9] *The Problem of Corporate Tax Shelters, supra* n.1, at 114.

III. ARGUMENTS AGAINST SWEEPING CHANGES

A. The Myth of the Eroding Corporate Income Tax Base

The Treasury Department has cited as justification for its proposals a possible erosion of corporate income tax revenues attributable to "corporate tax shelters," but has not presented any evidence to support this concern. Rather, Treasury has cited statements made Joseph Bankman of Stanford University that "corporate tax shelters" are responsible for $10 billion in lost corporate income tax revenues each year. Bankman essentially admits he has no data supporting his $10 billion figure in his Internet tax policy chatroom,[10] where he answers a question from a reader as to the references for his $10 billion figure as follows: "The $10 billion figure that I am quoted on is obviously just an estimate." This unsubstantiated claim hardly represents the type of serious economic analysis that should be undertaken before adopting sweeping tax policy changes of the scope envisioned by Treasury.

An analysis of actual data shows no evidence of a loss of corporate income tax revenues attributable to shelter activities. Since 1992, corporate federal income tax payments have grown by more than 80 percent, from $100.3 billion in fiscal 1992 to $184.7 billion in fiscal 1999 (see Appendix 1). By point of comparison, GDP has grown by 44 percent over this period. Over the fiscal 1993–1999 period, corporate tax payments averaged 2.1 percent of GDP; only once in the preceding 1980–1992 period were corporate income tax payments higher in percentage terms (in 1980).

Despite the high level of tax payments in the post–1992 period, some commentators have pointed to a two-percent drop in federal corporate tax payments in fiscal 1999, as compared to the prior year, as possibly indicating corporate tax shelter activity.[11] This claim has been made despite the fact that corporate tax payments as a percentage of GDP in fiscal 1999 were higher than the average for the 1980–1999 period.

A possible explanation for this drop is a relative decline in corporate profits attributable to depreciation deductions associated with increased equipment investment and the increase in employee compensation relative to corporate profits.[12] The Congressional Budget Office in its January 2000 budget outlook noted depreciation as among the factors putting downward pressure on corporate profits.[13] It also should be noted that the slight falloff in corporate profits was not unforeseen—the Office of Management and Budget (OMB) last year projected that corporate income tax payments would fall in FY 1999, before rising again in FY 2000.[14] It should be further noted that actual corporate income tax payments for FY 1999 ultimately exceeded the OMB forecast by more than $2 billion.

In this section, we examine whether the recent dip in corporate income tax payments provides any evidence that "corporate tax shelter" activity is proliferating. After a thorough review of the data, including data from the IRS, the Bureau of Economic Analysis (BEA), and corporate financial statements, we find no basis for assertions that increased shelter activity has caused corporate tax burdens to fall.

1. Corporate tax liability and the timing of tax payments

Corporate tax payments received by the IRS during a given year fail to reflect that year's tax liability for several reasons. First, large corporate taxpayers frequently have five to ten "open" years for which final tax liability has not been determined. Thus, current corporate tax payments may include deficiencies (plus interest and penalties) for a number of prior tax years. Similarly, current corporate tax payments may be reduced by refunds arising from overpayments of corporate tax in a number of prior tax years. In addition, current tax payments may be reduced by previously unused net operating losses and tax credits that are carried forward from prior years. Thus, current data on corporate income tax payments received by the IRS are not a reliable indicator of current year tax liability; rather, current year

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[10] http://www.law.nyu.edu/bankmanj/federalincometax

[11] See, Martin A Sullivan, "Despite September Surge, Corporate Tax Receipts Fall Short," 85 Tax Notes 565 (Nov. 1, 1999).

[12] See, *New York Times,* September 21, 1999, "When an Expense is Not an Expense." This article points to rising compensation paid in the form of stock options as a possible explanation. An increase in employee compensation increases personal income tax (at the employee level) at the expense of corporate income tax, because employee compensation generally is deductible in computing corporate income tax and includable in computing personal income tax.

[13] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2001–2010,* January 2000, p. 60.

[14] The Administration's FY 2000 budget projected that corporate income revenues would total $182.2 billion in FY 1999, or $2.5 billion less than actual.

tax receipts reflect a blend of current and past year tax liabilities, and are reduced by carryforwards of unused losses and credits from prior years.

Corporate tax payments

Monthly information on receipts of corporate income taxes by the U.S. Government is published by the Financial Management Service of the U.S. Treasury Department.[15]

The Treasury defines net corporate tax receipts in any month as gross receipts less refunds. Net corporate tax receipts were $185.0 billion in calendar year 1998 and $185.9 billion in 1999. Gross corporate tax receipts were $213.5 billion in 1998 and $217.0 billion in 1999. Net corporate tax receipts increased by a smaller amount than gross corporate tax receipts due to an increase in corporate tax refunds, from $28.5 billion in 1998 to $31.1 billion in 1999. Refunds can increase as a result of overpayments of estimated tax (which may occur when profits turn out to be lower than expected) or as a result of amendments to prior year tax returns (for example, when current year losses or credits are carried back to a prior tax year). Until the IRS tabulates tax return data for 1998 and 1999, it is not possible to determine the reason for the recent increase in refunds.

Corporate tax liability

For purposes of the National Income and Product Accounts, BEA makes current estimates of corporate tax liability based on IRS and other data. The IRS calculates annual corporate income tax liability by tabulating corporate tax returns (before audit). The most recent publicly available corporate income tax return information is for IRS years 1996 (i.e., tax years ending after June 1996 and before July 1997).[16]

In summary, it is important to distinguish between corporate tax liability and corporate tax receipts. Because corporate tax receipts are a mix of estimated tax payments for the current year as well as adjustments (both up and down) to taxes paid with respect to prior years, a drop in corporate tax receipts does not imply a drop in corporate tax liability. For example, in 1985, corporate tax receipts increased over the prior year at the same time that corporate tax liability decreased (see Appendix 2).

2. Effective tax rates: Commerce Department data

Corporate tax liability can be broken down into two components: (1) a reference measure of profits arising in the corporate sector; multiplied by (2) the effective tax rate (which is equal to corporate tax divided by reference profits). A decline in corporate tax liability can occur as a result of lower profits or, alternatively, as a result of a lower effective tax rate. A decline in corporate tax liability due to a fall in real corporate income is not, of course, evidence of tax shelter activity. By contrast, a decline in the effective tax rate may warrant investigation to determine if there is tax avoidance not intended by lawmakers.

Calculation of the effective corporate tax rate requires a measure of corporate income tax liability as well as a reference measure of corporate profits. Two data sources are used in this analysis: (1) the National Income and Product Accounts (NIPA) published by the U.S. Commerce Department; and (2) data from audited financial statements of public companies filed with the Securities and Exchange Commission (SEC) on Form 10K. Effective tax rate calculations based on NIPA data are described in this section; calculations based on SEC data are described in the following section.

One of the items used by BEA to calculate GDP is "corporate profits before tax."[17] This concept of profits includes income earned in the United States (whether by U.S. or foreign corporations) and excludes income earned outside the United States. For purposes of calculating an effective tax rate, several adjustments are made to "corporate profits before tax": (1) profits of the Federal Reserve Banks are subtracted; (2) profits of subchapter S corporations are subtracted; (3) payments of State and local income tax are subtracted; and (4) corporate capital gains are added. These adjustments follow the methodology developed by CBO to estimate "taxable corporate

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[15] U.S. Dept. of the Treasury, *Monthly Treasury Statement of Receipts and Outlays of the United States Government.*

[16] See, IRS, *Statistics of Income Bulletin,* Winter 1998/1999.

[17] BEA makes two adjustments to this measure of corporate profits in determining GDP: (1) BEA uses an "economic" measure of depreciation rather than tax depreciation (i.e., the "capital consumption adjustment"); and (2) BEA removes inventory profits attributable to changes in price (i.e., the "inventory valuation adjustment"). Note that the BEA data uses in this report are based on information available as of October 1999 and do not reflect the subsequently released comprehensive revision of the National Income and Product Accounts (NIPA).

profits."[18] BEA estimates that corporate profits before tax, as adjusted, increased from $587 billion in calendar 1998 to $603 billion in 1999 (see Appendix 3).[19] As a percent of GDP, pre-tax corporate profits are estimated to have reached a post–1980 high of 7.0 percent in 1996, with a dip to 6.9 percent in 1997–1998, and a further dip to 6.8 percent in the first half of calendar 1999 on an annualized basis.

Based on adjusted NIPA data, the effective corporate tax rate, measured as federal corporate tax liability divided by corporate profits before federal income tax, is projected to be 32.7 percent in 1999, higher than the 31.2 percent rate in 1998 and higher than the 32.6 percent average for the 1993–1999 period (see Appendix 3). Thus, based on the National Income and Product Accounts, there is no evidence of a decline in the effective rate of corporate income tax.

3. Effective tax rates: SEC data

Corporate effective tax rates also can be estimated from the audited financial statements that publicly traded companies are required to file with the SEC. This method was used by the General Accounting Office in its 1992 study of corporate effective tax rates.[20] Following the GAO methodology, the effective corporate tax rate is measured by dividing the current provision for federal income tax into reported U.S. operating income, reduced by the current provision for State and local income tax. U.S. operating income is determined by subtracting foreign operating income from total operating income net of depreciation, based on geographic segment reporting.

Standard & Poors publishes SEC 10K data in its Compustat database, which is updated monthly.[21] Based on the August 1999 Compustat data release, effective corporate tax rates were calculated for the 1988–1998 period using information from every corporation in the database that supplied all of the necessary data items. Recognizing that the results for 1998 might not be comparable to prior years due to the limited sample size, the effective tax rates for 1996 and 1997 were recomputed using information from the same companies as in the 1998 sample.

For purposes of this analysis we excluded publicly traded corporations and partnerships that are not generally taxable at the corporate level (i.e., mutual funds and real estate investment trusts). Separate calculations were made for companies that reported foreign activity (multinationals) and for companies that reported no foreign activity (domestics). A multinational's current provision for U.S. tax may include U.S. tax on foreign source income; consequently, measured relative to domestic income, the effective tax rate of U.S. multinationals may be higher than for comparable domestic firms. In theory, U.S. tax on foreign source income should be removed from the numerator of a domestic effective tax rate calculation; however, this adjustment cannot accurately be made with financial statement data.

The results of this analysis are shown in Appendix 4. For 1997, the most recent year for which annual reporting is complete, companies included in the Compustat sample report $78 billion of current federal income tax liability, accounting for over 40 percent of federal corporate tax liability in the National Income and Product Accounts. The Compustat sample of firms excludes private companies and public companies that do not report all of the items necessary to calculate the effective tax rate. While the average firm in Compustat is much larger than the average corporate taxpayer, the main purpose of our analysis is to examine the trend in effective corporate tax rates over time. We have no reason to believe that there is a systematic difference in trend effective tax rates between companies in Compustat and other corporate taxpayers. Indeed, if there were a proliferation of corporate tax shelter activity, we might expect to see indications of this first among the largest and most sophisticated corporations, of the type included in the Compustat sample.

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[18] *See,* Congressional Budget Office, *The Shortfall in Corporate Tax Receipts Since the Tax Reform Act of 1986*, CBO Papers, May 1992. The first adjustment reflects the fact that the Federal Reserve system is not subject to corporate income tax; the second adjustment is made because S corporations generally do not pay corporate level tax (rather the income is flowed through to the shareholders); the third adjustment is made because state and local income taxes are deductible in computing federal income tax; and the fourth adjustment is necessary because corporations are taxed on capital gains while GDP excludes capital gains.

[19] 1999 data are annualized based on the first six months of the year, seasonally adjusted.

[20] See, General Accounting Office, "1988 and 1989 Company Effective Tax Rates Higher Than in Prior Years," GAO/GGD–92–11, August 1992.

[21] Financial statements for companies with fiscal years ending after May of 1998, and before June of 1999, are classified as 1998 statements in Compustat. Because there is a lag between the end of a company's fiscal year and the time it files Form 10K, and another lag between the time the form is filed and the time it is processed by Standard & Poors, information for Compustat's 1998 year was incomplete as of August 1999.

In general, we find that the effective tax rates calculated from financial statement data are lower than those calculated from the National Income and Product Accounts. One reason for this is that the profit definition used for the NIPA calculations is based on tax depreciation, while the profit definition used for the financial statement calculations is based on book depreciation. Another reason is that the income element of nonqualified stock options is deductible for tax purposes when the option is excercised (and included in the employee's income), but is not treated as an expense against income for financial statement purposes. We also find that, on average, over the 1988–1998 period, effective federal tax rates are higher for multinational corporation than for domestic corporations.

Based on financial statement data, the corporate effective tax rate for all corporations (domestic and multinational) was higher in 1997 (19.9 percent) than the average over the ten-year period 1988–1997 (18.5) percent, and for the sample of companies reporting financial results for 1998, the effective tax rate increased between 1997 (19.4 percent) and 1998 (20.7 percent).[22]

In summary, based on audited financial statements, there is no evidence for a decline in the effective corporate tax rate. This is consistent with our findings using National Income and Product Account data.

4. Corporate capital gains

One category of corporate "tax shelter" that has received recent attention is the use of transactions designed to avoid tax on capital gains. Indeed, one commentator believes these transactions are so prevalent that the tax on corporate capital gains has essentially been rendered "elective."[23] If this assessment of the corporate income tax system were accurate, we would expect to see a marked decline in corporate capital gain realizations in recent years.

The IRS data, however, do not support the view that corporations easily can avoid tax on capital gains. Excluding mutual funds, net corporate gain on capital assets increased by 54 percent from $53 billion in 1992 to $82 billion in 1996 (the most recent year for which IRS data is available)—an average annual increase of 11.5 percent per year (see Appendix 5). In short, notices of the death of the corporate capital gains tax are premature.

5. Conclusion

If unusually high levels of corporate tax shelter activity have been occurring over the last few years, we would expect to see a drop in corporate tax liability relative to normative measures of pre-tax corporate income. To test this hypothesis, we measure corporate effective tax rates using data from the National Income and Product Accounts and audited financial statements. Neither measure shows a suspicious drop in tax liabilities relative to corporate income; to the contrary, both measures show flat or rising corporate effective tax rates over the last five years. Moreover, if corporate capital gains tax was easily avoidable using tax shelter techniques, we would expect to see little or no growth in net capital gains reported on corporate tax returns. Again, the data disprove this hypothesis, showing instead a robust rate of increase over the most recent four-year period for which data are available.

B. Efficacy of Current-Law Tools

Proponents of extensive new legislation to address "corporate tax shelters" overlook the formidable array of tools currently available to the government to deter and attack transactions considered as abusive. In our view, the tools described below are more than sufficient to achieve compliance with the corporate income tax. That is, these tools enable the IRS and courts to ensure that corporations pay the corporate income tax liability that results from application of the Internal Revenue Code.

1. Threat of penalties

As an initial matter, the tax Code includes significant disincentives to engage in potentially abusive behavior. Present law imposes 20-percent accuracy-related penalties under section 6662 in the case of negligence, substantial understatements of

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[22] These results also generally hold up when effective tax rates are measured relative to U.S. assets or U.S. revenues. Among domestic-only firms, however, income has grown more slowly than either assets or revenues since 1995, with the result that the ratio of tax liability to either assets or revenues has declined slightly for companies without foreign operations.

[23] Michael Schler, as quoted in the September 1, 1999, *Wall Street Journal "Tax Report,"* A1.

tax liability, and certain other cases. In considering a proposed transaction that may turn on a debatable reading of the tax law, a corporate tax executive must weigh the potential for imposition of these penalties, which could have a negative impact on shareholder value and on the corporation.

Furthermore, it should be noted that Congress, in the 1997 Taxpayer Relief Act, strengthened the substantial understatement penalty as it applies to "tax shelters." Under this change, which was supported and encouraged by the Treasury Department, an entity, plan, or arrangement is treated as a tax shelter if it has tax avoidance or evasion as just one of its significant purposes.[24] The Congress believed that this change, coupled with new reporting requirements that Treasury has failed to activate, would "improve compliance by discouraging taxpayers from entering into questionable transactions."[25] Although this change is effective for current transactions, the IRS and Treasury have not yet issued regulations providing guidance on the term "significant purpose."

The 1997 Act changes have made it even more important for chief tax executives to weigh carefully the risks of penalties and even more difficult to determine which transactions might trigger penalties. At this time, there is no demonstrated justification for making these penalties even harsher.

2. ANTI-ABUSE RULES

The Code includes numerous provisions that arm Treasury and the IRS with broad authority to prevent tax avoidance, to reallocate income and deductions, to deny tax benefits, and to ensure taxpayers clearly report income.

These rules long have provided powerful ammunition for challenging tax avoidance transactions. For example, section 482 authorizes the IRS to reallocate income, deductions, credits, or allowances between controlled taxpayers to prevent evasion of taxes or to clearly reflect income. While much attention has been focused in recent years on the application of section 482 in the international context, section 482 also applies broadly in purely domestic situations. Further, the IRS also has the authority to disregard a taxpayer's method of accounting if it does not clearly reflect income under section 446(b).

In the partnership context, the IRS has issued regulations under subchapter K aimed at arrangements the IRS considers as abusive.[26] The IRS states that these rules authorize it to disregard the existence of a partnership, to adjust a partnership's methods of accounting, to reallocate items of income, gain, loss, deduction, or credit, or otherwise to adjust a partnership's or partner's tax treatment in situations where a transaction meets the literal requirements of a statutory or regulatory provision, but where the IRS believes the results are inconsistent with the intent of the Code's partnership tax rules.

The IRS also has issued a series of far-reaching anti-abuse rules under its legislative grant of regulatory authority in the consolidated return area. For example, under Treas. Reg. Sec. 1.1502–20, a parent corporation is severely limited in its ability to deduct any loss on the sale of a consolidated subsidiary's stock. The consolidated return investment basis adjustment rules also contain an anti-avoidance rule.[27] The rule provides that the IRS may make adjustments "as necessary" if a person acts with "a principal purpose" of avoiding the requirements of the consolidated return rules. The consolidated return rules feature several other anti-abuse rules as well.[28]

3. COMMON-LAW DOCTRINES

Pursuant to several "common-law" tax doctrines, Treasury and the IRS can challenge a taxpayer's treatment of a transaction if they believe the treatment is inconsistent with statutory rules and the underlying Congressional intent. For example, these doctrines may be invoked where the IRS believes that (1) the taxpayer has sought to circumvent statutory requirements by casting the transaction in a form designed to disguise its substance, (2) the taxpayer has divided the transaction into separate steps that have little or no independent life or rationale, (3) the taxpayer

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[24] Section 6662(d)(2)(C)(iii). Prior law defined tax shelter activity as an entity, plan, or arrangement only if it had tax avoidance or evasion as the principal purpose.

[25] *General Explanation of Tax Legislation Enacted in 1997,* Staff of the Joint Committee on Taxation, December 17, 1997 (JCS 23–97).

[26] Treas. Reg. § 1.701–2.

[27] Treas. Reg. § 1.1502–32(e).

[28] See, e.g., Treas. Reg. § 1.1502–13(h) (anti-avoidance rules with respect to the intercompany transaction provisions) and Treas. Reg. § 1.1502–17(c) (anti-avoidance rules with respect to the consolidated return accounting methods).

has engaged in "trafficking" in tax attributes, or (4) the taxpayer improperly has accelerated deductions or deferred income recognition.

These broadly applicable doctrines—known as the business purpose doctrine, the substance over form doctrine, the step transaction doctrine, and the sham transaction and economic substance doctrine—give the IRS considerable leeway to recast transactions based on economic substance, to treat apparently separate steps as one transaction, and to disregard transactions that lack business purpose or economic substance. Recent applications of those doctrines have demonstrated their effectiveness and cast doubt on Treasury's asserted need for additional tools.

The recent decisions in *ACM v. Commissioner*[29] and *ASA Investerings v. Commissioner*[30] illustrate the continuing force of these long-standing judicial doctrines. In *ACM,* the Third Circuit, affirming the Tax Court, relied on the sham transaction and economic substance doctrines to disallow losses generated by a partnership's purchase and resale of notes. The Tax Court similarly invoked those doctrines in *ASA Investerings* to disallow losses on the purchase and resale of private placement notes. Both cases involved complex, highly sophisticated transactions, yet the IRS successfully used common-law principles to prevent the taxpayers from realizing tax benefits from the transactions.

More recent examples of use of common-law doctrines by the IRS are the Tax Court's decisions in *United Parcel Service v. Commissioner*[31] (8/9/99), *Compaq Computer Corp. v. Commissioner*[32] (9/21/99), and *Winn-Dixie v. Commissioner*[33] (10/19/99). *In United Parcel Service,* the court agreed with the IRS's position that the arrangement at issue—involving the taxpayer, a third-party U.S. insurance company acting as an intermediary, and an offshore company acting as a reinsurer—lacked business purpose and economic substance. In *Compaq,* the court agreed with the IRS's contention that the taxpayer's purchase and resale of certain financial instruments lacked economic substance and imposed accuracy-related penalties under section 6662(a). In *Winn-Dixie,* the court held that an employer's leveraged corporate-owned life insurance program lacked business purpose and economic substance.

This recent line of cases and the IRS's increasingly successful use of common-law doctrines in these cases argue against any need for expanding the IRS's tools at this time or (as the Treasury Department has suggested) for codifying the doctrines.

4. TREASURY ACTION

Treasury on numerous occasions has issued IRS Notices stating an intention to publish regulations that would preclude favorable tax treatment for certain transactions. Thus, a Notice allows the government (assuming that the particular action is within Treasury's rulemaking authority) to move quickly, without having to await development of the regulations themselves—often a time-consuming process—that provide more detailed rules concerning a particular transaction.

Examples of the use of this authority include Notice 97–21, in which the IRS addressed multiple-party financing transactions that used a special type of preferred stock; Notice 95–53, in which the IRS addressed the tax consequences of "lease strip" or "stripping transactions" separating income from deductions; and Notices 94–46 and 94–93, addressing so-called "corporate inversion" transactions viewed as avoiding the 1986 Act's repeal of the *General Utilities* doctrine.[34]

Moreover, section 7805(b) of the Code expressly gives the IRS authority to issue regulations that have retroactive effect "to prevent abuse." Although many Notices have set the date of Notice issuance as the effective date for forthcoming regulations,[35] Treasury has used its authority to announce regulations that would be effective for periods prior to the date the Notice was issued.[36] Alternatively, Treasury in Notices has announced that it will rely on existing law to challenge abusive transactions that already have occurred.[37]

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[29] 157 F.3d 231 (3d Cir. 1998). See also *Saba Partnership,* T.C.M. 1999–359 (10/27/99).
[30] T.C.M. 1998–305.
[31] T.C.M. 1999–268.
[32] 113. T.C. No. 17.
[33] 113. T.C. No. 21.
[34] The *General Utilities* doctrine generally provided for nonrecognition of gain or loss on a corporation's distribution of property to its shareholders with respect to their stock. See, *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935). The *General Utilities* doctrine was repealed in 1986 out of concern that the doctrine tended to undermine the application of the corporate-level income tax. H.R. Rep. No. 426, 99th Cong., 1st Sess. 282 (1985).
[35] *See, e.g.,* Notice 95–53, 1995–2 CB 334, and Notice 89–37, 1989–1 CB 679.
[36] *See, e.g.,* Notice 97–21, 1997–1 CB 407.
[37] Notice 96–39, I.R.B. 1996–32.

5. Targeted legislation

To the extent that Treasury and the IRS may lack rulemaking or administrative authority to challenge a particular type of transaction, one other highly effective avenue remains open—that is, enactment of legislation. In this regard, over the past 30 years dozens upon dozens of changes to the tax code have been enacted to address perceived abuses. For example, Congress last year enacted legislation (H.R. 435) addressing "basis-shifting" transactions involving transfers of assets subject to liabilities under section 357(c).

These targeted legislative changes often have immediate, or even retroactive, application. The section 357(c) provision, for example, was made effective for transfers on or after October 19, 1998—the date House Ways and Means Committee Chairman Bill Archer introduced the proposal in the form of legislation. Chairman Archer took this action, in part, to stop these transactions earlier than would have been accomplished under the effective date originally proposed by Treasury (the date of enactment).

C. IRS National Office Activities Regarding "Corporate Tax Shelters"

The question whether broad legislative action regarding "corporate tax shelters" is warranted at this time should be considered in view of current administrative initiatives now being undertaken at the IRS. Larry Langdon, Commissioner of the IRS's new Large and Mid-Size Business Division, has announced that the IRS is establishing a special office to coordinate IRS efforts to address corporate tax shelter issues.[38] The new office will allow for quick communication between IRS examiners, the IRS Chief Counsel, and the Treasury Department in identifying and addressing abuses. These IRS efforts will serve as a strong deterrent to abusive transactions and further call into question the need for legislative action at this time.

IV. CONCLUSION

Congress should reject the broad legislative proposals regarding "corporate tax shelters" that have been advanced by the Treasury Department. The revenue and economic data indicate no need for these radical changes. Further, the proposals are completely unnecessary in light of the array of legislative, regulatory, administrative, and judicial tools available to curtail perceived abuses. Finally, these proposals would create an unacceptably high level of uncertainty and burdens for corporate tax officials while potentially imposing penalties on legitimate transactions undertaken in the ordinary course of business.

Appendix 1

Corporate Income Tax Receipts, FY 1980–1999

[Billions of current dollars]

Fiscal year	GDP (dollars)	Federal corporate income tax receipts (dollars)	Corporate tax receipts as a percent of GDP (percent)
1980	2,719	64.6	2.4
1981	3,048	61.1	2.0
1982	3,214	49.2	1.5
1983	3,423	37.0	1.1
1984	3,819	56.9	1.5
1985	4,109	61.3	1.5
1986	4,368	63.1	1.4
1987	4,609	83.9	1.8
1988	4,957	94.5	1.9
1989	5,356	103.3	1.9
1990	5,683	93.5	1.6
1991	5,862	98.1	1.7
1992	6,149	100.3	1.6
1993	6,478	117.5	1.8

[38] GNA *Daily Tax Report,* January 18, 2000, G–4.

Corporate Income Tax Receipts, FY 1980–1999—Continued

[Billions of current dollars]

Fiscal year	GDP (dollars)	Federal corporate income tax receipts (dollars)	Corporate tax receipts as a percent of GDP (percent)
1994	6,849	140.4	2.1
1995	7,194	157.0	2.2
1996	7,533	171.8	2.3
1997	7,972	182.3	2.3
1998	8,404	188.7	2.2
1999	8,851	184.7	2.1
Period averages:			
1980–99	5,529.9	105.5	1.9
1980–82	2,993.7	58.3	1.9
1983–85	3,783.7	51.7	1.4
1986–89	4,822.5	86.2	1.8
1990–92	5,898.0	97.3	1.6
1993–99	7,611.6	163.2	2.1

Sources: Congressional Budget Office, Historical Budget Data, The Economic and Budget Outlook: Fiscal Years 2000–2009, released January 1999.

Congressional Budget Office, The Economic and Budget Outlook: An Update, July 1999. U.S. Treasury Department, Monthly Treasury Statement, October 1999 and earlier issues.

US Treasury Department, Monthly Treasury Statement, October 1999 and earlier issues.

Appendix 2

Federal Corporate Tax Liability and Receipts, 1980–1999

[Billions of dollars]

Calendar year	Federal corp. tax liability [1]	Federal corp. income tax receipts		
		Gross	Refunds	Net
1980	58.6	72.0	8.6	63.4
1981	51.7	75.1	13.4	61.7
1982	33.9	63.5	19.5	44.0
1983	47.1	64.6	22.7	41.9
1984	59.1	75.5	16.9	58.6
1985	58.5	78.7	16.1	62.6
1986	66.0	84.1	17.8	66.3
1987	85.5	105.2	18.0	87.2
1988	93.6	114.4	16.0	98.5
1989	95.5	113.9	14.1	99.8
1990	94.4	112.9	15.9	96.9
1991	89.0	112.9	16.6	96.4
1992	101.8	119.7	16.6	103.1
1993	122.3	137.3	13.7	123.6
1994	136.2	158.9	14.7	144.2
1995	155.9	180.4	17.9	162.5
1996	172.9	191.8	19.8	172.1
1997	189.5	211.1	19.8	191.3
1998	183.2	213.5	28.5	185.0
1999	197.0 [2]	217.0	31.1	185.9

[1] Determined from the National Income and Product Accounts as profits before tax (domestic basis) minus profits of the Federal Reserve Banks minus state and local income taxes. See text for details.

[2] Federal corp. tax liability is seasonally adjusted at an annual rate based on first six months of the year.

Sources:

1. U.S. Commerce Department, Bureau of Economic Analysis, Survey of Current, October 1999. Note that the data do not reflect changes in the most recent comprehensive revision of the National Income and Product Accounts (NIPA), which came out after our study was completed.

U.S. Treasury Department, Monthly Treasury Summary, January 2000 and earlier issues.

PwC calculations.

APPENDIX 3

Effective Corporate Tax Rate, NIPA, 1980–1999

[Billions of dollars]

Calendar year	GDP (dollars)	Corp. profits before tax (BEA adj.[1] (dollars)	Federal corp. tax liability (BEA adj.) (dollars)	Federal corp. tax liability (BEA adj.) as a percent of corp. profits before tax (percent)	Corp. profits before tax (BEA adj.) as a percent of GDP (percent)
1980	2,784.2	200.8	58.6	29.2	7.2
1981	3,115.9	193.6	51.7	26.7	6.2
1982	3,242.1	142.9	33.9	23.7	4.4
1983	3,514.5	181.1	47.1	26.0	5.2
1984	3,902.4	212.3	59.1	27.8	5.4
1985	4,180.7	215.4	58.5	27.2	5.2
1986	4,422.2	238.0	66.0	27.7	5.4
1987	4,692.3	255.9	85.5	33.4	5.5
1988	5,049.6	305.2	93.6	30.7	6.0
1989	5,438.7	290.0	95.5	32.9	5.3
1990	5,743.8	281.1	94.4	33.6	4.9
1991	5,916.7	287.3	89.0	31.0	4.9
1992	6,244.4	317.8	101.8	32.0	5.1
1993	6,558.1	369.5	122.3	33.1	5.6
1994	6,947.0	399.5	136.2	34.1	5.8
1995	7,269.6	499.9	155.9	31.2	6.9
1996	7,661.6	537.6	172.9	32.2	7.0
1997	8,110.9	559.7	189.5	33.9	6.9
1998	8,511.0	587.3	183.2	31.2	6.9
1999[2]	8,873.4	603.4	197.5	32.7	6.8
Period averages:					
1980–99	5,609.0	333.9	104.6	31.3	6.0
1980–82	3,047.4	179.1	48.1	26.8	5.9
1983–85	3,865.9	203.0	54.9	27.1	5.2
1986–86	4,900.7	272.3	85.1	31.3	5.6
1990–92	5,968.3	295.4	95.1	32.2	4.9
1993–99	7,704.5	508.1	165.4	32.5	6.6

[1] Figures for 1997–1999 are based on CBO fiscal year projections. Because actual corporate capital gains data were not available for 1980–82, imputations were used.

[2] Figures for 1999 are annualized based on first six months, seasonally adjusted.

Sources:

1. U.S. Commerce Department, Bureau of Economic Analysis, Survey of Current Business, October 1999. Note that the data are based on information available as of October 1999 and do not reflect the subsequently released comprehensive revision of the National Income and Product Accounts (NIPA).
2 U.S. Treasury Department, Monthly Treasury Summary, October 1999.
3. PwC Calculations

Appendix 4

U.S. Corporate Income Tax Liability per Audited Financial Statements, 1988–1998

[Dollar amounts in billions; Tax years ending after May of indicated year, and before July of following year]

Item	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	96Aug	97Aug	98Aug	Avg '88–97
A. Companies with foreign operations														
U.S. fed. inc. tax liability[1]	$25	$24	$25	$23	$23	$27	$34	$41	$42	$48	$19	$22	$24	$31
U.S. oper. inc. after state inc. tax	$127	$144	$138	$123	$128	$149	$181	$222	$231	$234	$89	$103	$105	$168
U.S. assets	$1,408	$1,587	$1,753	$1,904	$1,996	$1,988	$2,310	$2,433	$2,595	$2,494	$905	$1,050	$1,071	$2,047
U.S. revenues	$1,063	$1,212	$1,313	$1,371	$1,423	$1,373	$1,529	$1,745	$1,794	$1,770	$736	$817	$841	$1,459
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	19.9%	16.6%	18.2%	19.1%	18.3%	18.2%	19.0%	18.3%	18.4%	20.7%	21.7%	21.4%	22.6%	18.7%
U.S. assets	1.8%	1.5%	1.4%	1.2%	1.2%	1.4%	1.5%	1.7%	1.6%	1.9%	2.1%	2.1%	2.2%	1.5%
U.S. revenues	2.4%	2.0%	1.9%	1.7%	1.6%	2.0%	2.2%	2.3%	2.4%	2.7%	2.6%	2.7%	2.8%	2.2%
Number of corps.	700	746	806	886	963	820	934	1,057	1,159	1,178	633	633	633	925
B. Companies without foreign operations														
U.S. fed. inc. tax liability[1]	$17	$19	$20	$23	$24	$22	$25	$27	$29	$29	$24	$26	$29	$24
U.S. oper. inc. after state inc. tax	$106	$116	$118	$123	$136	$115	$130	$149	$157	$157	$131	$144	$150	$131
U.S. assets	$1,332	$1,488	$1,570	$1,658	$1,825	$1,627	$2,061	$2,295	$2,526	$2,676	$2,124	$2,493	$2,907	$1,906
U.S. revenues	$913	$1,016	$1,117	$1,182	$1,286	$1,079	$1,252	$1,398	$1,509	$1,564	$1,214	$1,403	$1,593	$1,232
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	15.7%	16.3%	17.3%	18.4%	18.0%	19.2%	19.6%	18.2%	18.7%	18.6%	18.1%	18.0%	19.4%	18.1%
U.S. assets	1.2%	1.3%	1.3%	1.4%	1.3%	1.4%	1.2%	1.2%	1.2%	1.1%	1.1%	1.0%	1.0%	1.2%
U.S. revenues	1.8%	1.9%	1.8%	1.9%	1.9%	2.1%	2.0%	1.9%	1.9%	1.9%	2.0%	1.9%	1.8%	1.9%
Number of corps.	3,681%	3,573%	3,646%	3,731%	3,945%	3,696%	3,847%	4,209%	4,249%	4,052%	3,357%	3,357%	3,357%	3,863
C. Companies with and without foreign operations														
U.S. fed. inc. tax liability[1]	$42	$43	$45	$46	$48	$49	$60	$68	$72	$78	$43	$48	$53	$55
U.S. oper. inc. after state inc. tax	$233	$261	$256	$246	$264	$264	$310	$372	$387	$391	$220	$247	$256	$298
U.S. assets	$2,740	$3,075	$3,323	$3,562	$3,821	$3,615	$4,371	$4,727	$5,120	$5,171	$3,030	$3,543	$3,978	$3,952
U.S. revenues	$1,976	$2,228	$2,430	$2,553	$2,709	$2,452	$2,781	$3,143	$3,302	$3,333	$1,950	$2,220	$2,434	$2,691
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	18.0	16.5%	17.8%	18.8%	18.2%	18.7%	19.2%	18.3%	18.5%	19.9%	19.6%	19.4%	20.7%	18.5%
U.S. assets	1.5%	1.4%	1.4%	1.3%	1.3%	1.4%	1.4%	1.4%	1.4%	1.5%	1.4%	1.4%	1.3%	1.4%
U.S. revenues	2.1%	1.9%	1.9%	1.8%	1.8%	2.0%	2.1%	2.2%	2.2%	2.3%	2.2%	2.2%	2.2%	2.0%
Number of corps.	4,381	4,319	4,452	4,617	4,908	4,516	4,781	5,266	5,408	5,230	3,990	3,990	3,990	4,788

1. Current provision for tax.

Source: Standard and Poors, Compustat, September 1999; PwC calculations.

APPENDIX 5

Net Capital Gains for All Active Corporations, 1980–1996

[Excluding RICs in Billions of dollars]

Year	Net gain on capital assets		
	Net short-term gain less net long-term loss	Net long-term gain less net short-term loss	Subtotal
1980	11.4	22.1	23.5
1981	1.7	25.6	27.3
1982	1.9	24.1	26.0
1983	2.7	28.4	31.1
1984	2.4	35.1	37.6
1985	4.3	45.9	50.2
1986	8.2	74.2	82.4
1987	4.4	54.5	58.9
1988	4.0	56.7	60.7
1989	6.0	62.5	68.5
1990	2.9	43.4	46.3
1991	7.1	41.1	48.2
1992	7.9	45.1	53.0
1993	10.8	53.3	64.1
1994	2.4	47.9	50.3
1995	10.0	60.9	70.8
1996	6.6	75.2	81.8

Source: IRS. Corporate Source Book, various issues.

Statement of the Real Estate Roundtable

The Real Estate Roundtable [1] appreciates the opportunity to submit comments for the record of the February 9, 2000 hearing of the House Committee on Ways and Means regarding the revenue provisions of the Administration's fiscal year 2001 budget proposal.

Background

The Administration's budget contains proposals that could significantly affect the real estate industry, both positively and negatively, and we look forward to working with the Committee as it deliberates on these proposals. We welcome those proposals in the Administration's budget intended to be favorable to real estate, however, we oppose a number of proposals that are detrimental. Furthermore, we favor a comprehensive and related approach to real estate tax policy. In this testimony we will comment briefly on some of the real estate tax policies we believe the Committee should consider. If these tax policies were enacted, current tax impediments that otherwise discourage sound economic real estate decisions would be removed from the Internal Revenue Code and bring about fairer tax treatment and a more productive flow of real estate capital and credit.

Overall State of the Commercial Real Estate Industry

Real estate represents about 12 percent of America's gross domestic product and accounts for nearly 9 million jobs. About $293 billion in tax revenues is generated annually by real estate and almost 70 percent of all tax revenues raised by local governments come from real property taxes. Unquestionably, real estate is a direct, vital and major contributor to the nation's economy.

Today's real estate markets, as a whole, are in overall good health. Interest rates, although rising are relatively low, inflation is in check, availability of capital and credit is good; and demand for work and shopping space, in most regions, is rel-

[1] The Real Estate Roundtable is a Washington based policy organization comprised of America's leading public and private real estate owners, investors, lenders and managers as well as the leaders of major national real estate trade associations actively involved in shaping federal policies affecting income producing real estate. The Real Estate Roundtable is engaged in a range of important policy issues in the areas of tax, capital and credit, telecommunications and technology and the environment.

atively strong. Nevertheless, the financial markets on which real estate depends are quite sensitive and volatile. The financial crisis that erupted during the summer of 1998 in Japan and Russia demonstrated how quickly things can change in the credit markets. This crisis seriously impacted the real estate industry despite the underlying fundamentals of real estate investment being strong.

Real estate is similarly sensitive to changes in tax treatment. The turmoil in the industry created by the whipsaw effect of the tax changes of the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986 is evidence of this. Real estate tax policy changes should be implemented through a carefully thought through and deliberative course of action that brings about a rational relationship between the economics of a transaction and its taxation.

The Real Estate Roundtable Tax Agenda

The Real Estate Roundtable recommends the Committee adopt, (in addition to those provisions in the President's budget we support) the following tax proposals:

• *10 year depreciation recovery period for leasehold improvements.* Today's depreciation rules do not differentiate between the economic useful life of building improvements, (i.e. internal walls, ceilings, partitions, plumbing, lighting, floor coverings, electrical and communication outlets and computer data ports), and the life of the overall building structure. The result is that current tax law dictates a depreciable life for leasehold improvement of 39 years—the depreciable life of the entire building—even though most commercial lease terms average between 7–10 years.

As a result, the after-tax cost of reconfiguring or building out space to accommodate new tenants, modernize the space or upgrade technology is artificially high and out of step with the economics of the transaction. The tax implication of this could negatively impact decisions relating to leasehold improvements—particularly when extensive improvements are involved. Providing a depreciation life for leasehold improvements that more closely matches the lease terms, (typically about ten years), would more closely align the tax treatment for these assets and better reflect economic reality.

Current law provides a tax obstacle to reinvesting in existing properties. Without proper reinvestment, tenants will leave older buildings for more modern buildings that offer desired amenities and efficiencies. This would enhance new development demand and contribute to a deterioration of existing property. H.R. 844 (Shaw) provides a 10-year depreciation period for leasehold improvements and currently has 122 bipartisan cosponsors. Its companion bill S. 879 (Conrad, Nickles) has 15 bipartisan cosponsors.

• *Expensing or Rapid Amortization of Environmental Cleanup Costs.* Costs to cleanup land purchased in a contaminated state must be capitalized and added to the basis of the non-depreciable land. These contaminated sites are known as "brownfields" and are less toxic than Superfund sites but still must be remediated prior to redevelopment. The U.S. Conference of Mayors estimates that there are approximately 400,000 brownfield properties across the country.

The 1997 Taxpayer Relief Act provided immediate expensing of brownfield cleanup costs in empowerment zones and other high poverty targeted areas (Section 198). The President's budget proposes to make this provision permanent. Section 198 should be extended to brownfields located in non-targeted areas as well and the definition of "hazardous substance" expanded to include common contaminants such as petroleum and pesticides. Also, if not immediate deductibility, then a rapid amortization period such as 60 months would be appropriate. The expansion of Section 198 beyond targeted areas, (H.R. 2264-Johnson, R–CT), was included in the Taxpayer Refund and Relief Act of 1999 and should be included in the community renewal legislation the Committee intends to mark up this year.

• *At-Risk Rules:* The definition of qualified nonrecourse financing in the at-risk rules needs to be modified to allow for the inclusion of publicly traded real estate debt (general obligation bonds issued by public real estate companies). Qualified nonrecourse financing is nonrecourse financing provided by a person in the business of lending (i.e. banks, insurance companies, pension funds) that is secured by the real property. This exception was adequate for the type of real estate lending that existed in 1986 -property specific financing from traditional lending institutions. Since 1986, however, real estate financing has undergone significant changes. The most significant being the use of publicly traded debt to finance real estate.

Currently, publicly traded debt does not meet the technical requirements of the qualified nonrecourse financing because the lender—in this case the public—is not in the business of lending. Furthermore, the debt is a general obligation of the company and is not secured by a specific property interest as is a typical mortgage loan. The failure of the at-risk rules to be updated as real estate financing has evolved

is creating unfair potential tax liabilities for many real estate owners and serious compliance headaches. The Real Estate Roundtable worked closely with the Joint Committee On Taxation to develop an modification was included in the Taxpayer Refund and Relief Act.

• *Amortization of Demolition Costs.* Current law (Code Section 280B) requires that demolition expense and the unrecovered basis of the demolished structure must be capitalized and added to the basis of the land rather than deducted. This tends to discourage redevelopment of land that includes a structure which must be demolished, because the costs of demolition are not recovered until the underlying land is sold. A more appropriate tax result would permit these expenses to be added to the tax basis of the replacement structure and depreciated.

• *Update the Placed in Service Date for Properties Eligible for the Rehabilitation Tax Credit.* The 1986 Tax Reform Act provided that the only properties eligible for the rehabilitation tax credit are those placed in service before 1936. Prior to 1986, a 10% tax credit was allowed for rehabilitation of properties placed in service at least 20 years prior to the rehabilitation activity. Qualifying a building for the rehabilitation credit based on its age, rather than a fixed placed in service date, is a preferable approach because it continually adds buildings to the credit eligibility pool as they reached the required age. The pre–1936 placed in service requirement excludes all buildings placed in service from 1936 on—regardless of age. Allowing buildings of a minimum age to be eligible for the credit would update the pool of eligible buildings and help achieve the social, economic and aesthetic goals brought about by rehabilitating and preserving older structures.

We believe the above-proposed policies, (with the exception of the at-risk rules), comprise a related package of tax changes aimed at promoting smart growth through redevelopment. In communities across the nation, rapid land development -often called "sprawl" -is having unwanted side effects such as traffic congestion, higher taxes, loss of open spaces and parks and overcrowded schools. Although the problems and solutions are primarily at the state and local level, the Federal government can help provide solutions, particularly through tax policy.

Current federal tax law discourages redevelopment of existing property through its uneconomic tax treatment of leasehold improvement depreciation, demolition costs and brownfield cleanup expenses. Enacting the changes proposed above would mitigate these tax impediments and level the tax implications associated with new versus re development decisions, thus making redevelopment more viable. Renewing the viability of the rehabilitation tax credit by allowing more buildings to be eligible also would promote redevelopment and, in turn, ease pressure to develop new space. We look forward to working with the Committee to shape and implement these real estate tax policies.

REAL ESTATE RELATED REVENUE INCREASES IN PRESIDENT'S BUDGET PROPOSAL

• *Modify the treatment of closely held REITs.* The Administration proposal would impose an additional requirement for REIT qualification that no person can own stock of a REIT possessing 50 percent or more of the total combined voting power of all classes of voting stock or 50 percent or more of the total value of all shares of all classes of stock. The stated reason supporting this proposal is that "[a] number of tax avoidance transactions involve the use of closely held REITs."

Recommendation: We believe the Administration's proposed prohibition on almost all closely held REITs is overly broad and unnecessary. We are concerned with the impact the Administration's closely held proposal could have on capital flows to real estate and the potential resulting negative effect on asset values and jobs. The capitalization of real estate through REITs that has occurred in the 1990s has been an important factor in the recovery of the real estate industry which itself is making a significant contribution to the strength of the overall economy.

We are pleased that the Administration has revised this proposal over the last three years to provide look through rules for certain entities owning interests in REITs in determining whether the REIT is closely held. These rules include a look through for a REIT or a domestic pension fund owning another REIT. A limited look through rule for partnerships is included in this year's budget. We believe, however, that these exceptions need to be broadened as follows:

Pass-through entities. Allow an unlimited look-through of all pass through entities -domestic and foreign. The lack of such a look-through would undercut the recently negotiated treaty with the Netherlands that is designed to improve foreign investment in REITs. The treaty allows up to 80 percent ownership of a U.S. REIT by a Dutch pension fund without dividend withholding. In the absence of the treaty,

foreign pension funds and investors are also subject to 30 percent withholding tax. The Netherlands treaty has facilitated a significant amount of capital to flow to U.S. real estate. Similarly, the treaty allows U.S. pension funds to own up to 80 percent of a Dutch venture without dividend withholding. This is a significant benefit to outbound international investment. The failure to allow the closely held private REIT structure for foreign investors would dampen foreign investment interest cause a significant amount of capital that is presently flowing into U.S. real estate to dry up.

Incubator REITs. Any closely held proposal must provide for the use of "incubator REITs." Incubator REITs sometimes have a majority shareholder corporation for a transition period in order to prepare the REIT for going public by allowing it to develop a track record. Corporate majority shareholders of private REITs are also used for legitimate state and local income and real property tax planning purposes and as a vehicle for legitimate foreign investment in real estate.

Joint Ventures with Publicly traded REITs. Public REITs benefit from being able to joint venture with third parties that often take the form of closely held private REITs. In present market conditions, depressed stock prices can hamper the ability of some public REITs to go back to the stock market to raise equity capital. Many of these same REITs want to limit borrowings under their lines of credit to maintain, or improve, their investment grade ratings. They, therefore, are relying on privately structured joint ventures with closely held REITs to raise equity in order to complete new transactions and to grow.

In many cases, a third party investor owns a majority share of the closely held REIT. Although the Administration's proposal would allow a REIT to own another REIT, such ownership effectively would be limited to REITs that meet the ownership requirements of the proposal. This would have a material adverse impact on the ability of public REITs to tap into the much needed alternative source of capital provided by joint ventures with closely held private REITs.

• *Eliminate non-business valuation discounts (for family limited partnerships).* The budget proposal asserts that family limited partnerships are being used to take "illusory" valuation discounts on marketable assets. The proposal contends that taxpayers are making contributions of these assets to limited partnerships, gifting minority interests in the partnerships to family members, and then claiming valuation discounts based on the interest being a minority interest of a non-publicly traded business. The proposal would eliminate such valuation discounts except as they apply to "active" businesses.

Recommendation: The Real Estate Roundtable opposes this proposal in concept because it increases the estate tax burden and specifically because it defines non-business assets as including "real property." The reference to real property, which lacks any elaboration, could be interpreted broadly to include much of the nation's directly or indirectly family-owned real estate. In all events, further clarification by the Administration is needed to determine the definition of "real property" and whether it is considered part of an active business.

Nevertheless, The Real Estate Roundtable does not believe that real property or interests in real property should be included in a proposal targeted at truly passive investments, such as publicly traded stocks and bonds. We applaud the Committee for its continuing effort to reduce the estate and gift tax burden. This proposal would take a number of steps backward and increase the estate tax burden. As a result, successors in family-owned real estate businesses could be faced with the troubling scenario of having to sell real property in the estate (often at distressed value prices) in order to pay death taxes.

• *Disallow interest on debt allocable to tax-exempt investments.* The President's proposal would expand the definition of "financial institution" in Section 265(b) of the Code to include "any person engaged in the active conduct of banking, financing, or similar business, such as securities dealers and other financial intermediaries." As a result, a "financial institution" that invests in tax-exempt obligations would not be allowed to deduct a portion of its interest expense in proportion to its tax-exempt investments. Under current law, (Revenue Procedure 72–18) taxpayers, other than financial institutions, are not subject to such limitations provided the average amount of the tax exempt obligations does not exceed 2 percent of the average total assets of the taxpayer.

Recommendation: The Real Estate Roundtable opposed a similar proposal last year and opposes this proposal because it would reduce corporate demand for tax-exempt securities, such as industrial development and housing bonds. Reducing corporate demand for these important investment vehicles would increase the borrowing costs of municipalities throughout the country—thus, hindering urban rein-

vestment activity—and it would discourage corporate investment in state and local housing bonds issued to finance housing for low and middle income families.

• *Limit Inappropriate Tax Benefits For Lessors of Tax Exempt Use Property.* Under current law, certain property leased to governments, tax-exempt organizations, or foreign persons is considered to be "tax-exempt use property." There are a number of restrictions on the ability of lessors of tax-exempt use property to claim tax benefits from transactions related to the property. For example, such property must be depreciated using the straight-line method over a period equal to the greater of the property's class life (40 years for non-residential real property) or 125 percent of the lease term. The Administration contends that certain leasing transactions involving tax-exempt use property are being structured using a short-term lease and optional service contracts to avoid the special depreciation rules for tax-exempt use property. Therefore, the budget proposes to require lessors of tax-exempt property to include the term of optional service contracts and other similar arrangements in the lease term for purposes of determining the recovery period.

Recommendation: We stand ready to work with the Committee and the Administration on this proposal to determine the extent and nature of any potential tax abuse in lease arrangements for tax-exempt use property. Until that time, we must oppose the proposal due to a concern that it may be overly broad. Should the transactions prove to be without economic justification and solely tax motivated, we would be pleased to work with the Committee and the Administration on an appropriate and targeted remedy.

• *RIC excise tax application to undistributed REIT profits.* The Administration is proposing that REIT distribution rules conform to the Regulated Investment Company (RIC) distribution rules. Therefore, it is proposing that a REIT distribute 98 percent of its ordinary income and capital gain net income for a calendar year in that year in order to avoid the four percent excise tax that applies to insufficient RIC distributions. Currently REITs are only required to distribute 85 percent of the REITs ordinary income for the calendar year and 95 percent of its capital gain income.

Recommendation. The current differentiation between the RIC and REIT distribution rules exists for a reason. RICs are mutual funds that own stocks and bonds. This allows them to determine relatively easily by the end of a calendar year the amount of ordinary and capital gain income for that year. As a consequence, RICs are able to distribute in such year a very high percentage (98%) of its income. REITs derive their income primarily from rents -in the retail sector the rents are based on a percentage of sales. Year-end holiday shopping accounts for a significant amount of these sales. As a result, it is more difficult for REITs to determine their income for a calendar year and distribute it in such year. Current law requires a lower distribution level for that reason. This is logical and relates to the economics of leases. Therefore, we oppose the Administration's conforming proposal since it does not take into the account that the assets of RICs and REITs are different and this difference affects their respective ability to determine and distribute income in a calendar year.

• *Start-up Cost Amortization.* Currently, start-up and organizational expenditures for a new trade or business can be amortized over 60 months. Acquired intangible assets, such as goodwill and trademarks, may be amortized over 15 years. The Administration proposes to allow a taxpayer to elect to deduct up to $5,000 of start-up expenditures and up to $5,000 of organizational expenditures. However, these amounts would be reduced by the amount cumulative costs exceed $50,000. Any amount of expenditures that is not deductible must be amortized over 15 years.

Recommendation. Real Estate Roundtable opposes this proposal. Start-up and organizational costs are a significant cost for real estate—particularly because many real estate assets are now held in single purpose entities. Single purpose limited liability companies (LLCs) are widely used because they allow for the pass-through tax advantages of a partnership and the limited liability of a corporation. In fact, lenders often require their use. Real estate companies can hold dozens, even hundreds, of properties in separate LLCs. This results in significant amounts of start -up expenses. For many real estate companies, the Administration's proposal would result in most start-up expenses being amortized over 15 years as opposed to the current 60 months. We do not believe such a tax increase is warranted or justified and we strongly oppose the proposal.

REAL ESTATE RELATED TAX INCENTIVES IN THE BUDGET PROPOSAL

• *Energy-efficient building equipment tax credit.* The Administration's budget proposes a 20 percent tax credit for the purchase of certain highly-efficient building equipment, including fuel cells, electric heat pump water heaters, advanced natural gas and residential size electric heat pumps, and advanced central air conditioners. Specific technology criteria would have to be met to be eligible for the credit. The credit would apply to purchases made after December 31, 2000 and before January 1, 2005.

Recommendation: The Real Estate Roundtable believes the immediate objective of this proposal—encouraging energy efficiency in buildings—is appropriate. In preparing for the 21st century, the real estate industry, like other major industries, is looking for ways to improve its overall performance from an economic and environmental perspective. The Real Estate Roundtable has taken notice of statistics from the Department of Energy identifying office buildings as consuming about 27% of the nation's electrical supply. If this is an accurate assessment, we are surprised that, of the six specific tax credit proposals for energy efficient building equipment, only one (fuel cells) has any practical application to commercial office buildings. More specifically on the matter of the fuel cell credit, while the amount of the incentive is not insignificant, it is not yet sufficient to encourage the use of this technology except in limited circumstances.

Furthermore, because of the December 31, 2000 effective date, the credit provides no incentive to taxpayers considering making energy efficient building equipment decisions this year. Optimally, the credit should be available for purchases made in 2000. Postponing the credit until 2001 could affect negatively decisions to purchase certain energy efficient building equipment this year resulting in a missed opportunity for the new building stock coming on line.

• *Expensing of brownfield remediation costs.* The Administration proposes to make permanent the deduction for brownfield remediation costs. This sunset date for this provision was extended to December 31, 2001 as part of last year's tax bill.

Recommendation: The Real Estate Roundtable has supported making section 198 permanent since its enactment in 1997 and is pleased the Administration is seeking to take this important step. However, further broadening of the provision's scope is warranted and necessary.

The deductibility of clean-up expenses applies only to brownfields in specifically targeted areas, such as empowerment zones. We understand the need to revitalize these acutely distressed communities. However, there are almost 400,000 brownfields across the nation, most of which are outside of these targeted areas. Many brownfields are located in prime business locations near critical infrastructure, including transportation, and close to a productive workforce. These sites need to be put back into productive use, contributing to the economy and producing good paying jobs where they are need most. Allowing the expensing or amortization of clean-up costs for all of these brownfields would help restore brownfields across America to viable and productive use.

• *Fifteen year depreciable life for distributed power property.* The budget proposes to assign a 15 year depreciation recovery period and a 22-year class life for distributed power property. Distributed power property is property used to generate electricity and/or heat and can be more energy efficient and generate fewer greenhouse gases than convention generation methods. Typically, it is used in an industrial manufacturing setting and is depreciated using the 150 percent declining balance method over 15 years. Technological advancements have made it possible to place electrical generation assets in or adjacent to commercial and residential rental properties as well as industrial sites. Distributed power property used in commercial or rental residential buildings, however, is likely to be classified as a building component and currently depreciated over 39 years.

Recommendation: The Real Estate Roundtable supports this proposal because it would simplify current law by clarifying and rationalizing the assignment of recovery periods to distributed power property. It would reduce taxpayer uncertainty and controversy and promote the use of more efficient technologies. Further, this provision is consistent with our position that certain building components should be treated separately from the structure for depreciation purposes.

• *Increase limit on charitable donations of appreciated property.* This proposal would repeal the special lower contribution limits for gifts to charity of capital gain property. As a result, both cash and non-cash contributions would be subject to the general 50 percent deductibility limit for gifts to public charities and the 30 percent

deductibility limit for gifts to private foundations. It would be effective for contributions made after December 31, 2000.

Recommendation. The Real Estate Roundtable supports this provision as philanthropists often contribute appreciated real property to charities. The special lower contribution limits that apply to contributions of capital gain property create added complexity and could discourage gifts of valuable real property to charitable organizations. Contributions of conservation easements and open spaces are often gifted to charitable organizations with the intent of promoting more livable communities. This provision would facilitate such contributions.

• *Low-income housing tax credit expansion.* The budget proposes a major expansion of the low-income housing tax credit, which could facilitate the construction of 150,000–180,000 new affordable housing units over five years. Under the Administration's proposal, the annual state low-income housing credit limitation would be raised from $1.25 per capita to $1.75 per capita for calendar year 2001and indexed for inflation for each year thereafter.

Recommendation: The Real Estate Roundtable supports this proposal. We also support related legislation, H.R. 175 introduced by Representative Nancy Johnson (CT) and cosponsored by several other Members of the Committee on a bipartisan basis. We are encouraged by the consensus developing between the Administration and Members of Congress on the need for increasing the amount of low income housing tax credits allocated to the states.

• *Tax credits for holders of Better America Bonds.* The Administration is proposing a tax credit for holders of certain bonds issued by state and local governments for the purpose of protecting open spaces; creating forest preserves near urban areas; rehabilitating brownfields; improving parks and reestablishing wetlands.

Recommendation: Although we have no specific comment on how the Better America Bonds would, or should, function from a tax perspective, we believe the Committee should consider tax policies that would improve the livability of our communities by encouraging redevelopment, protection of open spaces and clean up of contaminated sites. The Real Estate Roundtable tax agenda described in this testimony is intended to achieve a similar goal and we welcome the opportunity to work with the Committee on these proposals.

Conclusion

Again, we thank Chairman Archer and the Committee for the opportunity to comment regarding the revenue proposals in the President's fiscal 2001 budget. We are encouraged by the proposals to make permanent the deductibility of brownfield clean-up costs and implement credits for energy-efficient improvements for buildings. We are also pleased that the Administration is again seeking an increase in the low-income housing tax credit and simplifying the charitable contribution limits for appreciated property.

We are concerned, however, about the proposals for closely held REITs ownership and the application of the RIC excise tax to undistributed profits by REITs. We also object to the proposals to amortize start-up costs over 15 years, eliminate valuation discounts for non-business, family limited partnerships and disallow interest on debt allocable to tax exempt investments.

Finally, we encourage you to adopt the tax agenda we outlined in the beginning of our comments. A 10 year depreciation life for leasehold improvements is our top priority and is strongly justified by the economics of typical leases. Allowing the expensing of brownfield clean up costs for any brownfield site would remove a significant tax impediment to community revitalization. Modification of the "at-risk" rules to incorporate publicly traded real estate debt within the definition of qualified nonrecourse financing is an important updating of these rules that would free real estate owners from an unintended and unfair tax liability.

VANGUARD CHARITABLE ENDOWMENT
SOUTHEASTERN, PA 19398–9917
February 22, 2000

A.L. Singleton, Chief of Staff
Committee on Ways and Means
1102 Longworth Building
Washington, D.C. 20515

Dear Mr. Singleton:

The purpose of this letter is to comment on a provision contained in the Administration's Fiscal Year 2001 Revenue Proposals, to "clarify public charity status of donor advised funds." In this regard, we note that one commentator has characterized the recent surge in the creation of donor-advised funds as a form of "democratization of endowment giving," with "exciting prospects for the future of philanthropy." [1]

By way of background, the Vanguard Charitable Endowment Program (the "Endowment Program") was founded by The Vanguard Group, Inc. It is an independent public charity that was recognized by the Internal Revenue Service as exempt from federal income tax under Section 501(c)(3), and as a public charity under Sections 509(a)(1) and 170(b)(1)(A)(vi), on December 8, 1997.

We are writing to observe that the Administration's proposal concerning donor-advised funds is generally consistent with the Endowment Program's current operations, and in our view would codify some "best practices" for charitable organizations maintaining donor-advised funds. For example, the Endowment Program has adopted a policy of making minimum annual distributions of at least 5% of the aggregate average net asset value on a five year rolling basis. We believe this requirement, which is included in the Administration's proposal, provides an important assurance that there will be an immediate charitable benefit for the beneficiaries of donor-advised fund organizations. Similarly, the Endowment Program maintains a prohibition against the use of funds in donor-advised accounts for the personal benefit of the donors and/or advisors of those accounts. This is an important safeguard to ensure that funds are used for the proper and intended charitable purposes, and the Administration's proposal would further this objective by imposing a penalty on donors and/or advisors who violate this prohibition.

Our only question about the Administration's proposal relates to its reliance on the "no material restriction" test under Section 507. We believe that test is complicated and subjective, and that it could be replaced by a simple and explicit requirement that donors and/or their advisors have only the right to recommend grants and no legal right to direct the use of funds in the donor-advised accounts.

The Endowment Program is proud to be at the forefront of the movement to expand the accessibility of philanthropy, and we believe that legislation along the lines described in the Administration's proposals will help to ensure that the intended philanthropic objectives are achieved.

Sincerely,

BENJAMIN R. PIERCE
Executive Director

cc: Timothy L. Hanford
Susan D. Brown

Statement of LaBrenda Garrett-Nelson, Gary Gasper, Nicholas Giordano, and Mark Weinberger, Wahsington Counsel, P.C.

Washington Counsel, P.C. is a law firm based in the District of Columbia that represents a variety of clients on tax legislative and policy matters.

[1] Steuerle, "Charitable Endowments, Advised Funds & the Mutual Fund Industry," *The Exempt Organization Tax Review,* Vol. 23, No. 2 (February 1999) at 299.

THE ADMINISTRATION'S BUDGET PROPOSAL TO TAX SHAREHOLDERS ON THE RECEIPT OF TRACKING STOCK SHOULD BE REJECTED

INTRODUCTION

Although 28 of the 39 members of the Committee on Ways and Means opposed the Administration's proposal to tax the issuance of tracking stock in the President's Budget for FY2000, and the Congress did not enact that proposal, Treasury has proposed yet another attack on tracking stock in the form of a proposal to tax shareholders on the receipt of "tracking stock." In effect, this proposal would increase the cost of capital to corporations by inhibiting the use of "tracking stock" as a financing option. Apart from proposing a new tax and granting broad regulatory authority to Treasury, the Administration's proposal represents an arbitrary departure from established tax principles and fails to offer any tax policy reason for the change. Moreover, it is not at all clear that the issuance of tracking stock is an appropriate time to impose a tax, because there is no bail out of corporate earnings. For these and other reasons set forth below, the "tracking stock" proposal should be rejected.

SUMMARY OF THE ADMINISTRATION'S "TRACKING STOCK" PROPOSAL

The Administration's proposal would impose a new tax on a shareholder's receipt of tracking stock as a distribution or in a recapitalization or similar exchange of stock or securities for tracking stock. Under the proposal, tracking stock would be treated as "property" other than stock in the issuing corporation. As a result, a shareholder who receives a distribution of tracking stock would be subject to tax on the entire value of the tracking stock received. Similarly, a shareholder who exchanges stock in the issuing corporation for tracking stock would be treated as having engaged in a taxable disposition of the stock surrendered in the exchange (and subject to tax on any gain, determined by reference to the excess of the fair market value of the tracking stock over the tax basis of the stock surrendered). "Tracking stock" would be defined generally as "stock that relates to, and tracks the economic performance of, less than all of the assets of the issuing corporation (including the stock of a subsidiary)." Two characteristics are identified as factors to be taken into account in applying this definition: (1) whether dividends are "directly or indirectly determined by reference to the value or performance of the tracked entity or assets," and (2) whether liquidation rights are "directly or indirectly determined by reference to the value of the tracked entity or assets." Treasury would be authorized to prescribe regulations treating "tracking stock as nonstock (e.g., debt, a notional principal contract, etc.) or as stock of another entity as appropriate to prevent tax avoidance. The provision would be effective for "tracking stock" issued on or after the date of enactment.

I. The Administration's Proposal Would Inhibit The Use Of A Valuable Corporate Financing Tool

Over the last 16 years, corporations have utilized "tracking stock" as a vehicle for raising capital and to meet a variety of non-tax, business needs. By limiting the financing options of U.S. corporations, the Administration's "tracking stock" proposal would impinge on the ability of corporations to raise low-cost capital in an efficient manner, and thereby have an adverse impact on economic growth, job creation, and the international competitiveness of U.S. businesses. The "tracking stock" proposal would also inhibit the ability of businesses to use "tracking stock" in several other beneficial situations, such as issuing the stock to better align management and shareholders interests.

A. Corporations Have Issued Tracking Stock For a Variety of Business Reasons

"Tracking stock" is issued by corporations that have multiple lines of business that the marketplace would value at different prices if each line of business were held by a separate corporation. By issuing "tracking stock," a corporation can raise capital in a manner that improves the attractiveness of the issuer's stock to the public. The valuation of the entire enterprise increases, because "tracking stock" provides a mechanism for "tracking" the performance of individual businesses. There is, however, no actual separation of a tracked subsidiary or other asset. The corporate issuer continues to benefit from operating efficiencies that would be lost if different lines of business became independent. These efficiencies include economies of scale, sharing of administrative costs, and reduced borrowing rates based on the issuing corporation's overall credit rating. Thus, it is clear that corporations issue

"tracking stock" for the business purpose of obtaining the highest values for the separate tracked businesses, while maintaining legal ownership and other operating synergies.

B. The Essential Elements of "Tracking Stock" Are Consistent With the Form of the Transaction as A Class of Common Stock of The Issuer

Typically, "tracking stock" is issued as a class of common stock, the return on which is determined by reference to less than all of the issuer's assets. The "tracked" asset can take a variety of forms (e.g., a line of business, a separate subsidiary, or a specified percentage of a separable business). There is no legal separation of corporate assets, and thus an investor's return remains subject to the economic risks of the issuer's entire operation: (1) the holder of tracking stock retains voting rights in the issuer (not, for example, a "tracked" subsidiary); (2) dividend rights, although based on the earnings of a tracked subsidiary or other asset, are subject to whether the parent/issuer's board of directors declares a dividend, as well as state law limitations on the parent/issuer's ability to pay (without regard to a "tracked" subsidiary's ability to pay); and (3) liquidation rights might be determined by reference to the value of tracked assets, but investors in tracking stock have no special right to those assets; rather they are entitled to share in all of the issuer's assets on a pro rata basis.

II. The Administration's Tracking Stock Proposal Presents Serious Tax Policy Concerns, in Addition to Technical Issues

A. Unjustified and Radical Departure From the Normal Treatment of the Receipt of Common Stock

Sections 305 [1] provides tax-free treatment to a shareholder who receives a proportional distribution of common stock on common stock. This treatment is based on the fact that a common shareholder already owns all the corporate assets that are not devoted to preferred shareholders, and they do not receive anything more by a common stock dividend that re-divides the same "pie." Similarly, tax-free treatment is provided to a shareholder who surrenders common stock for common stock by either Section 1036 or Section 354 (where the exchange is a reorganization in the form of a recapitalization). In the case of an exchange, tax-free treatment is justified on the ground that the transaction represents a mere reshuffling of an existing corporation's capital structure. The Administration's proposal represents a radical departure from these established tax principles, and inappropriately relies on the typical features of tracking stock to justify the result.

Consistent with the theory that underlies the tax-free treatment of stock dividends and recapitalizations, the issuance of tracking stock is not an appropriate time to impose a tax on a shareholder, to the extent that a taxpayer's investment remains in corporate solution, and the stock represents merely a new form of participation in a continuing enterprise.[2]

Nevertheless, the Administration's proposal would trigger a tax on receipt of tracking stock, even in a case where a distribution of the tracked subsidiary would satisfy the strict requirements for tax-free distribution.

B. Technical Issues

Circular Definition Of Tracking Stock. The proposed definition of "tracking stock" could include stock that has no tracking-stock features. For example, consider a corporation with one class of common stock outstanding, which then issues a new class of tracking stock, dividends on which are based on the operating results of one of the corporation's two subsidiaries. In such a case, by definition, the pre-existing common will constitute "stock that relates to—less than all of the assets of the issuing corporation;" similarly, dividends on the pre-existing common will (effectively) track the results of only one of the two subsidiaries. (Note that last year's Treasury proposal included a specific statement that the "issuance of tracking stock will not result in another class of the stock becoming tracking stock if the a—rights of such other class are determined by reference to the corporation's general asset. . .")

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[1] Except as provided, references to "Sections" are to the Internal Revenue Code of 1986, as amended (referred to herein as the "Code").

[2] See generally Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, par. 12.01[3] regarding the theory underlying tax-free treatment.

Failure To Provide Any Substantive Guidance. Apart from the imposition of a new tax, the Administration's proposal fails to provide any substantive guidance on the treatment of tracking stock under the Code. Rather than providing operating rules to deal with identified issues, the Administration proposes to grant new and exceedingly broad regulatory authority for Treasury to prescribe rules treating tracking stock as nonstock, etc. Note that the effect of the Budget proposal is to treat tracking stock as nonstock for purposes of the rules regarding stock dividends and recapitalizations. Thus, it is unclear what other circumstances Treasury might identify as candidates for an exercise of this regulatory authority. Presumably, regulatory guidance would be applied prospectively; however, it is not at all clear whether Treasury contemplates a grant of authority to recast a transaction on a retroactive basis.

III. The Administration Has Failed To Establish A Reason To Single Out Tracking Stock for Congressional Action

The Administration has failed to set forth a basis for either legislative action or the delegation of additional regulatory authority to Treasury. Tracking stock is not a new concept in the tax law. Moreover, the enactment of the proposal would effectively put an end to the market for tracking stock, and thus little if any revenue would be raised.

A. Over Fifty Years of Tax Law Contradicts the Administration's Statement that "Tracking Stock is. . .Outside the Contemplation of Subchapter C and Other Sections of the. . .Code."

The stated rationale for the Administration's proposal includes the statement that the "use of tracking stock is clearly outside the contemplation of subchapter C and others sections of the. . .Code." It is quite clear, however, that present law is adequate to the task, particularly in view of the existence of case law that pre-dates the Internal Revenue Code of 1954,[3] as well as numerous grants of specific regulatory authority relating to tracking stock.[4]

B. It is Questionable Whether the Administration's Proposal Would Increase Tax Revenues

It is arguable that the use of tracking stock increases tax revenues. This view is based on the availability of financing options such as the issuance of debt, an alternative that would generate interest deductions and thereby eliminate tax on corporate earnings. By comparison, the issuance of tracking stock does not reduce a corporation's tax liability because dividends are paid out of after-tax income. In any case, one likely consequence of the Administration's proposal is that few (if any) corporations will issue tracking stock.

IV. A Similar Proposal Was Rejected By The Congress Last Year

The tracking stock proposal in this year's Budget is a reiteration of a proposal that was considered but not acted upon by Congress last session. Last year, the Administration's budget contained a "tracking stock" proposal that taxed the issuing corporation on the issuance of tracking stock, or a recapitalization of stock or securities into tracking stock. This year's proposal changes the point of taxation from a

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[3] As early as 1947, the U.S. Tax Court had occasion to consider the federal income tax consequences of the issuance of tracking stock in the case of Union Trusteed Funds, Inc. v. Commissioner. Similarly, the Congress has taken account of the existence of tracking stock, as appropriate for purposes of particular tax provisions. For example, in 1986 the Congress reversed the result in the Union Trusteed Funds case; as another example, in the original enactment of the Passive Foreign Investment Company ("PFIC") regime, the Congress included regulatory authority to treat "separate classes of stock. . .in a corporation. . .as interests in separate corporations." Interestingly, the Congress did not suggest that all tracking stock should be so treated, thus allowing for circumstances in which the form of an issuance of tracking stock should be respected.

[4] For example, in 1990, the Congress specifically addressed a tracking stock issue in the legislative history of Section 355(d), a provision added to deny tax-free treatment to a "disguised sale" of a subsidiary. Very generally, section 355(d) triggers a tax on the distributing corporation in a divisive reorganization where 50 percent or more of the corporation's stock was acquired by purchase during the preceding five years. In measuring the five-year window, section 355(d)(6) reduces the holding period for stock for any period during which the holder's risk of loss is substantially diminished by any device or transaction. In this regard, the Conference Report on the 1990 legislation specifically cites the use of "so-called 'tracking stock' that grants particular rights to the holder or the issuer with respect to the earnings, assets, or other attributes of less than all the activities of a corporation or any of its subsidiaries." H.R. Conf. Rep. No. 5835 p. 87.

tax on the issuing corporation to a tax on a shareholder who receives tracking stock in a distribution or in exchange for other stock. While the point of taxation has changed the underlying tax policy concerns presented by the proposal (described above) remain the same.