

**PRESIDENT'S FISCAL YEAR 2005 BUDGET WITH AN
OFFICIAL OF THE U.S. DEPARTMENT OF THE
TREASURY**

HEARING

BEFORE THE

**COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES**

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

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FEBRUARY 11, 2004
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**PRESIDENT'S FISCAL YEAR 2005 BUDGET
WITH AN OFFICIAL OF THE U.S. DEPART-
MENT OF THE TREASURY**

WEDNESDAY, FEBRUARY 11, 2004

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

The Committee met, pursuant to notice, at 11:10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

[The advisory and revised advisory announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
February 04, 2004
FC-14

CONTACT: (202) 225-1721

Thomas Announces Hearing on President's Fiscal Year 2005 Budget with an Official of the U.S. Department of the Treasury

Congressman Bill Thomas (R-CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on President Bush's fiscal year 2005 budget tax proposals. **The hearing will take place on Wednesday, February 11, 2004, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:30 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. The witness will be an official of the U.S. Department of the Treasury. 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 20, 2004, President George W. Bush delivered his State of the Union address in which he outlined numerous budget and tax proposals. The details of these proposals were released on February 2, 2004, when the President submitted his fiscal year 2005 budget to the Congress.

FOCUS OF THE HEARING:

The Treasury official will discuss the details of the tax proposals in the President's budget.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person or organization wishing to submit written comments for the record must send it electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225-2610, by close of business Wednesday, February 25, 2004. In the immediate future, the Committee website will allow for electronic submissions to be included in the printed record. Before submitting your comments, check to see if this function is available. **Finally**, due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

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 electronically to *hearingclerks.waysandmeans@mail.house.gov*, along with a fax copy to (202) 225-2610, in WordPerfect or MS Word format and MUST 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. All statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers of each witness.

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.

* * * NOTICE—CHANGE IN TIME * * *

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
February 05, 2004
FC-14-Revised

CONTACT: (202) 225-1721

Change in Time for Hearing on President's Fiscal Year 2005 Budget with an Official of the U.S. Department of the Treasury

Congressman Bill Thomas (R-CA), Chairman of the Committee on Ways and Means, today announced that the Committee hearing on the President's fiscal year 2005 budget with an official of the U.S. Department of the Treasury, scheduled for Wednesday, February 11, 2004, at 10:30 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will now be held at 11:00 a.m.**

All other details for the hearing remain the same. (See full Committee Advisory No. FC-14, dated February 4, 2004.)

Chairman THOMAS. Good morning. We must not have any out-of-town visitors. As soon as I sat down, everybody rushed to their seat and quietly anticipated the beginning of the hearing. So, welcome, all you old-timers. Today we welcome Assistant Secretary for Tax Policy Pamela Olson, who is accompanied by Mr. Jenner.

I want to tell you how much I have appreciated your know-how, comprehension of tax policy, the way you have been open to the Committee when we have needed information.

I welcome Gregory Jenner, and let me say that oftentimes we often forget that public service, while it is important, is also something that is very difficult in today's society, one, because if you find someone competent and capable in that public service, the private sector can be very alluring, because they have the ability to

outbid us in every instance; but in addition to that we see each other as Members and witnesses, Assistant Secretary and Members, when, in fact, we are real people, we have families, loved ones, and responsibilities that are sometimes extremely difficult to juggle as we think our family is entitled to while we pursue sometimes very demanding, but almost always enormously time-consuming careers.

So, for all of those reasons, I believe Ms. Olson has decided to terminate her current activity in the public sector. I want to wish you well in the private sector and in your ongoing and growing teenage and preteen family responsibilities.

Once again, we are faced with the whole tax agenda, including several tax relief initiatives from the President in his budget for individuals and job creators. The President's aggressive economic policies have produced record growth, and I note unemployment now has dropped over the last 5 months faster than it has in the last 10 years.

A number of important tax relief measures are set to expire this year, and everyone says it is difficult to do things during an election year, but I do think not addressing some of these programs, not necessarily all of them, but some of these programs, would be a real disservice to the economy, to individual commercial sectors, to employees, and a number of other ramifications.

I know that we have not finished our business with corporate America. There may be some questions directed toward that area, Ms. Olson, in terms of studies that you have taken. The public has seen only the tip of the iceberg in terms of investigations of corporate misbehavior, and, as we wind our way through the justice system, it always seems to take longer than anyone realizes, but we are anxious to wait, if necessary, to get the kind of information necessary to pass good law, if law seems to be necessary in this particular area. Mr. Jenner will, in all probability, be involved as we move forward in looking at ways in which, in deed as well as word, people who assume significant fiduciary responsibilities, if they do not have the internal moral compass to drive them, can at least face an objective public one. It is going to be difficult, but I think it still needs to be done.

The other thing that I am very much concerned about is the fact that we are fast approaching March 1st, which is, I think, the last possible time the Europeans can back up in fulfilling the World Trade Organization (WTO) requirement that we deal with foreign sales corporation (FSC) language. I am concerned that we are running out of time, and that as we slip into exposure to retaliation for our failure to repeal this provision, it is absolutely the wrong time in our economic timing and certainly for the world's economic timing to not address this in a forthright way. Anything you can do to assist us in perhaps a packaging concern would be very helpful.

You have some loophole closing; other people call it tax increases. I am pleased to have you before us because, although we do appreciate the view of the President's budget and tax policies from 30,000 feet, we are, in essence, the House's foot soldiers, and we are on the ground, and we need to ask you some questions about both tactical and topography aspects as we move forward.

So, with that, I will recognize the gentleman from New York for any statement he may make.

[The opening statement of Chairman Thomas follows:]

Opening Statement of the Honorable Bill Thomas, Chairman, and a Representative in Congress from the State of California

Good morning. Today, we welcome the Treasury Department's Assistant Secretary for Tax Policy, Pamela Olson, for her final appearance before this Committee. Ms. Olson, we appreciate the know-how and comprehension of tax policy you brought to the Treasury Department and the insights you shared with this Committee. We wish you luck as you move forward. Also joining us is Gregory Jenner, who will serve as the acting Assistant Secretary for Tax Policy after Ms. Olson's departure. Welcome, we look forward to hearing your testimony.

Once again this year, we are faced with a full tax agenda, including several tax relief initiatives for individuals and job creators. The President's aggressive economic policies have produced record rates of growth, which in turn will channel increased federal revenues into the Treasury—helping to reduce the deficit and bring balance to our federal budget.

A number of important tax relief measures are set to expire in 2004. Congress must make these tax cuts permanent to prevent a tax hike on Americans and their families. This tax relief not only gave back American workers some of their hard-earned money, but also was impeccably timed to help get the U.S. economy back on track after facing recession, corporate scandals, and the horrific acts of terrorism on September 11, 2001. Allowing this tax relief to expire—when our economy is re-suming strong, steady growth—would reverse the positive economic changes tax relief has delivered.

We are also quickly approaching March 1st, the European Union's target date to begin billions of dollars worth of retaliation against some of America's most sensitive industries. Last year, the Committee passed legislation to not only prevent a trade war, but also create American jobs and make U.S. companies and workers more competitive. The House must now act to ensure U.S. farmers and manufacturers are not the brunt of this retaliation.

Ms. Olson, we look forward to discussing these proposals, as well as Treasury's initiatives to close loopholes and improve tax compliance. However, before we begin, I would like to recognize the gentleman from New York, Mr. Rangel, for any opening statement he has at this time.

Mr. RANGEL. Thank you, Mr. Chairman. Good luck to you, Secretary Olson, in whatever you do in the private sector. It is a little disappointing for me to hear that you are leaving, because Secretary Snow spoke in such broad general terms about how some of these problems would be handled. He said not to worry about the specifics, that you will be here to guide us through this, so that we have cut the budget in half, created more jobs, and have America back in line with the prosperity that we enjoyed in prior Administrations, but at least you can share with us in your testimony the direction in which you would like to see this Committee go.

Some of the problems that we had was with the alternative minimum tax (AMT) exemption. As you know, there has been no specifics as to how the Administration will handle this. The Secretary said he wanted revenue-neutral; I think the figures used were some \$700 billion. So, it helps us, especially in the Minority, to hear what the Administration would want, because it is sometimes very difficult to find out from the Majority. So, I know you have some specific ideas and guidance to give the Committee as to how we would raise this \$700 billion and where it would come from.

Another problem we have is the Administration's position in providing incentive for offshore jobs. There was something in the paper where the President's adviser is indicating that this is a good

thing to have jobs offshore, and that we should have even more incentives, which brings us around to the WTO ruling on the FSC and the extraterritorial income (ETI).

The Chairman has a proposal where it supports the President's belief, if indeed it is the President's belief, as shared by his economic adviser, that we have to provide more incentives overseas, and I think that is the proposal that came from the Majority.

As you well know, some of us believe that the savings we should have in revenue should be creating more jobs here on the mainland, but I do not think it has ever been clear to us where the President's office comes from in this tax policy, and it certainly should not be coming.

When I talked with the trade representative, he said this was a tax issue, so I think that would be in your shop.

We would have a lot of questions as to where we are going, and I do not know how long you are going to be with us so that you can guide us through these perilous political waters, but I am glad that you have been with us this far. I wish you luck for the future, and I do hope you will be able this morning to at least share with us what Secretary Snow could not, and that is specifically what will you be recommending in terms of making the tax cuts permanent, what happens with AMT, and where are we with the WTO problems that we have? I thank you very much.

[The opening statement of Mr. Rangel follows:]

Opening Statement of the Honorable Charles B. Rangel, a Representative in Congress from the State of New York

Last week, Secretary Snow had the luxury of speaking in broad generalities, leaving the specifics of the budget proposals for others.

Today's witnesses are faced with a more difficult job, actually helping this Committee understand the specifics of the tax proposals in the President's budget.

Secretary Snow's testimony left me with many questions.

For example, last week he testified that failure to extend a current tax benefit is, in effect, a tax increase. But he failed to explain why the President's budget did not extend the current level of the AMT exemption.

By Secretary Snow's definition, the President's own budget advocates a large tax increase that will hit families from high tax states such as New York, California, and many midwestern states the hardest.

Last week, Secretary Snow spoke of a revenue neutral solution to the problem of the expanding alternative minimum tax. I am hopeful that our witnesses today may help this Committee understand where the needed \$700 billion will come from.

I agree with Secretary Snow's testimony last week that we need to comply with the WTO ruling on our FSC/ETI international tax provisions. I am hopeful that the witnesses today will provide Treasury's position concerning the bill previously reported by this Committee and the bill reported by the Senate Finance Committee.

Last year, the President's budget recommended that all of the revenue from repeal of the current FSC/ETI benefits should be used to expand tax benefits for the offshore operations of U.S. multinationals. Essentially, the Bush Administration was recommending a tax increase on U.S. manufacturers in order to fund benefits for companies that have moved their manufacturing and other operations offshore.

Since this is now an election year, this year's Administration budget concerning FSC/ETI is not as clear. However, the President, in his budget, continues to argue that our companies need more tax benefits for their offshore operations. Last Week, Treasury Secretary Snow testified that enacting these offshore tax benefits remains an important goal for the Administration.

I was surprised to find that the Economic Report of the President, as reported by the L.A. Times, "endorses . . . outsourcing high-end, white-collar work to India and other countries." And the Chairman of Bush's Council of Economic Advisors says that "Outsourcing is just a new way of doing international trade" and that "More things are tradable than were tradable in the past. And that's a good thing."

If outsourcing is a result of natural economic forces, I hope you will explain why the Administration feels it is so important to give companies additional tax incentives encouraging outsourcing and the relocation of jobs off-shore.

I look forward to your testimony and your responses to questions on the specifics of the President's budget.

Chairman THOMAS. Thank the gentleman. Your written testimony will be made part of the record, and you can address us as you see fit in the time that you have.

STATEMENT OF THE HONORABLE PAMELA F. OLSON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY; ACCOMPANIED BY GREGORY F. JENNER, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY

Ms. OLSON. Thank you. Mr. Chairman, Mr. Rangel, distinguished Members of the Committee, I appreciate the opportunity to appear before you today to discuss the tax proposals included in the President's fiscal year 2005 budget. I am going to give a fairly brief statement, and then we will leave plenty of time for you for questions on some of the specific issues.

Over the last 3 years, the President and Congress have responded with courage to the recession and to external crises that put an extraordinary strain on our economy. The bursting of the high-tech bubble, the revelation of corporate accounting problems, September 11th, the uncertainties of the war on terror and global conflicts have contributed to the recession and prolonged the weakness in the economy. Those came on top of the remarkable global political, economic and technological changes that have occurred during the past 15 years.

Fiscal policy has played a crucial role in responding to these events. In 2001, many doubted that the legislative process could move fiscal policy rapidly enough for the effects to have an impact on an economic downturn. You have proved them wrong. The tax cuts enacted in 2001 were an important factor in making the downturn one of the shallowest on record, providing support to a weakening economy in a critical juncture.

The stimulus bill enacted in 2002 provided vital support to the economy in a key area of weakness, corporate investment. The temporary bonus depreciation provision, for example, provided the needed incentive for new corporate investment at just the right time.

The 2003 tax cut provided the needed lift to help the nascent recovery to continue and gain strength. Immediate support to the economy was provided through the acceleration of lower tax rates, expansion of the child credit, and marriage penalty relief.

Weakness in corporate investment was addressed by reducing the double tax on corporate income. This change lowered the cost of equity capital and provided an important stimulus to corporate investment. The increase in small business expensing and bonus depreciation provided additional stimulus to corporate investment.

These changes are leading to a robust economic recovery, and the recovery is beginning to put Americans back to work. Moreover, the tax cuts enacted will continue to spur economic growth. The tax changes have also laid the groundwork for strong economic growth

in the future. The lower tax rates improve incentives. After-tax rewards from working are now substantially higher. The rewards to innovation and risk-taking are greater. The cost of equity capital and investing has been reduced. More risk-taking, investment, and innovation mean higher productivity and greater capital accumulation. A larger capital stock translates into higher living standards for all in the future.

The tax cuts enacted have been fair and balanced, and now we must turn to eliminating the economic uncertainty created by their temporary nature by making them permanent.

In addition, we must take steps to address other national priorities: increasing the personal savings rate, making health care more affordable, reducing the barriers to home ownership, simplifying the tax laws, ensuring the integrity of the tax system by preventing abusive transactions, and responding to the WTO decision on the ETI provisions.

The savings provisions in the budget further promote an ownership society by removing barriers to savings, reducing complexity and improving fairness by providing the benefits of tax-preferred savings to everyone regardless of financial sophistication or capacity to save for the very long term. The single-family housing tax credit would similarly reduce the barrier to an ownership society by increasing construction or rehabilitation of affordable homes for lower-income individuals.

In addition, the President's budget reflects the importance of preserving defined benefit pension plans and the benefit they provide to workers and their families regarding this form of pension coverage.

We must address the rising costs of health care, and we must expand access to health insurance. These are complex issues for which there is no single solution. The President's proposal for a refundable, advanceable health insurance tax credit would help make insurance more affordable for lower-income individuals. The credit amount under the proposal would vary with family size, mirroring the relationship of actual health insurance premiums.

Health savings accounts (HSAs) are a significant step toward promoting cost-consciousness through greater reliance on individual choice and high-deductible plans. The President's budget includes above the line deductions to purchase the high-deductible health plans necessary to have an HSA, helping to level the playing field for a segment of the population that does not have employer-sponsored coverage.

The present tax system imposes compliance costs on taxpayers, estimated to range from \$70 billion to \$100 billion per year, just from the individual income tax. The complexity undermines confidence in the system, and the compliance costs represent a serious loss to the economy. For these reasons it is crucial that we begin efforts to simplify the tax laws. The President's budget includes several new simplification proposals that would address complexities borne by individuals and families. We look forward to working with the Committee on this effort.

Confidence in the tax system is also undermined by the use of abusive transactions to avoid taxes rightfully owed. For the past 3 years, the Administration has acted aggressively to restore con-

fidence in the tax system by halting the promotion of abusive transactions and bringing taxpayers back into compliance with the tax laws. The President's budget builds on these efforts and information gathered through the Internal Revenue Service (IRS) compliance programs. The new legislative proposals close loopholes and target identified abusive transactions and practices.

One proposal deserves particular mention. The Administration has proposed to limit certain types of abusive leasing transactions, known as sale-in, lease-outs (SILOs). These arrangements are entered into with tax-indifferent parties, such as foreign governments, domestic municipalities, and tax-exempt organizations. They purport to be leasing transactions, but, in substance, provide no financing to the tax-indifferent party aside from a fee for the claimed transfer of a tax benefit.

The SILOs represent a threat to the viability of the corporate tax base. It is essential that Congress address this issue promptly, but do so without interfering with leasing transactions that involve legitimate financing or refinancing of assets. We believe the proposal in the President's budget leaves legitimate transactions unscathed, while preventing abusive lease transactions from going forward.

Honoring our WTO obligations requires repeal of the ETI provisions. At the same time, meaningful changes to our tax law are required to preserve and enhance the competitiveness of U.S. businesses operating in the global marketplace. We look forward to continuing to work with the Congress on prompt enactment of legislation that brings our tax law into compliance with the WTO rules.

Thank you, again, Mr. Chairman, Members of the Committee, for the opportunity to appear before you today. I appreciate the opportunity that I have had to work with Committee Members and staff over the past 3 years, and I can assure you that I am leaving the Office of Tax Policy in very good hands and with a very talented staff. Thank you.

[The prepared statement of Ms. Olson follows:]

Statement of the Honorable Pamela F. Olson, Assistant Secretary for Tax Policy, U.S. Department of the Treasury; accompanied by Gregory F. Jenner, Deputy Assistant Secretary for Tax Policy

Mr. Chairman, Congressman Rangel, and distinguished members of the Committee:

Thank you for the opportunity to appear before you today to discuss the tax proposals included in the President's Fiscal Year 2005 Budget.

Over the last three years, the President and Congress have responded with courage to the recession and to a number of external crises that put additional, extraordinary, strain on that economy. The end of the high-tech bubble and its consequences for the stock market, the revelation of years of wrong-doing on the part of certain corporations and their executives, the impact of the September 11 attacks, and the uncertainties of the war on terror and the conflicts in Afghanistan and Iraq, are all at the root of the recent economic difficulties. These events worsened and prolonged the weaknesses in the economy.

Fiscal policy has played a crucial role in responding to these events. The tax cuts enacted in 2001 were an important factor in making the downturn one of the shallowest on record. Together with an expansionary monetary policy embodied in a series of deep interest rate cuts, the tax cuts provided support to a weakening economy at a critical juncture. The stimulus bill enacted in 2002 provided vital support to the economy in a key area of weakness—corporate investment. The temporary bonus depreciation provision, for example, provided the needed incentive for new corporate investment at just the right time.

While the tax cuts of 2001 were essential to keep the recession from deepening, the 2003 tax cut provided the needed lift to allow the nascent recovery to continue

and gain strength. Immediate support to the economy was provided through the acceleration of the lower tax rates, expansion of the child credit, and marriage penalty relief. Weakness in corporate investment was addressed by reducing the double tax on corporate income through the lower tax rate on dividends and capital gains. This change lowered the cost of equity capital and provided an important stimulus to corporate investment. The increase in small business expensing and bonus depreciation provided additional stimulus to corporate investment.

With these vital changes in tax policy, we now have a robust economic recovery with strong economic growth and tightening labor markets that are beginning to put Americans back to work. Moreover, the tax cuts already enacted will continue to spur economic growth. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) will put another \$146 billion into the economy this year with \$100 billion in the first half of the year.

The tax cuts have lowered the marginal effective tax rate on new investment

	Corporate Sector	Non-Corporate Business Sector	Business Sector
Without the Tax cuts	31.9%	20.8%	27.6%
With the Tax cuts	26.3%	18.9%	23.4%
% Change	-17.6%	-9.1%	-15.2%

But the tax changes enacted over the past three years have done much more than address and respond to the economic difficulties and crises we have faced. They also laid the ground work for strong economic growth in the future. The lower tax rates improve incentives. After-tax rewards from working are now substantially higher. The taxes paid by entrepreneurs, who tend to pay taxes through the individual income tax, are now lower. The rewards to their innovation and risk-taking are greater. The cost of equity capital and investing has been reduced. More risk-taking, investment, and innovation mean higher productivity and greater capital accumulation. A larger capital stock translates into higher living standards for all in the future.

Moreover, the tax changes enacted over the past several years have been fair and balanced. Without the tax cut, the bottom 50 percent of taxpayers would have paid slightly more than 4 percent of individual income taxes. As shown on the chart below, now they pay even less—3.6 percent. In contrast, the top 5 percent of taxpayers pay a larger share—52.8 percent of individual income taxes rather than 50.2 percent without the tax cuts. The same is true for the highest income taxpayers—the top 1 percent.

Higher income taxpayers pay a larger share of individual income taxes under the President's tax cuts

	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%	Bottom 50%
	Share of Individual Income Taxes [Share of Adjusted Gross Income]					
With the Tax Cuts	32.3	52.8	64.8	83	96.4	3.6
Without the Tax Cuts	30.5	50.2	62.6	81.8	95.9	4.1

Note: Calculations are for 2004. U.S. Treasury, Office of Tax Analysis.

This group now pays 32.3 percent of all individual income taxes, rather than 30.5 percent before the tax cuts were enacted.

Much remains to be done, however. Making the tax cuts enacted in 2001 and 2003 permanent, promoting savings, making health care more affordable, reducing the barriers to home ownership, simplifying the tax system, ensuring the integrity of

the tax system by preventing abusive transactions, and responding to the WTO decision on the extraterritorial income exclusion (ETI) provisions are all important priorities reflected in the President's budget proposals. I will focus on each of these priorities in turn.

Permanence: A Stable, Certain Tax Code

The tax reductions made in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and JGTRRA proved essential for promoting economic growth and will help to ensure higher living standards in the future. If these provisions are allowed to sunset, taxes will increase: for many individuals after 2004, for many small businesses in 2006; for investors beginning in 2009, and again for most taxpayers beginning in 2011.

An uncertain tax code imposes real costs on the economy. Uncertainty makes it difficult for workers and businesses to plan for the future and increases investment risk. The possibility of higher taxes increases the cost of equity capital to businesses and reduces individuals' after-tax rewards to working and investing. A higher cost of equity capital and lower rewards to workers and investors dampen long-run economic growth.

Permanent extension of the tax cuts enacted by the President and the Congress will provide a more certain tax environment for workers and businesses to plan and invest, both reducing complexity and continuing to support a growing economy. The revenue cost of making the tax cuts permanent (\$989 billion) is only a small percentage of the revenue of the federal government over the 10-year budget window. Moreover, the cost is only a tiny fraction of the United States economy over this same period.

In addition to uncertainty, failure to make the tax cuts permanent will inflict a real blow to the economy. Allowing the tax cuts to expire amounts to nothing more than a massive tax increase on the vast bulk of individual and business taxpayers.

Towards a Long-Term Solution to the AMT

The expected growth in the individual alternative minimum tax (AMT) is a major problem in the tax code that must be addressed. The AMT was first enacted in the late 1960s to target a small number of very high income taxpayers who paid little or no tax. The stage was set for the AMT's growth when the regular tax was indexed in the early 1980s but the AMT was not. Other changes throughout the 1980s and 1990s compounded the problem.

Now the AMT is a tax that is beginning and will continue to affect increasing millions of taxpayers. It will reach into the ranks of the middle class, potentially denying taxpayers the benefit of many of the deductions, credits and lower tax rates available under the regular tax system. The AMT also significantly increases the complexity of tax filing for taxpayers subject to the AMT and for millions of additional taxpayers who must complete AMT forms only to determine they are *not* subject to the AMT.

The AMT's future growth must be addressed. The President's budget extends through 2005 the temporary increase in the AMT exemption amounts and the provision that allows certain personal credits to offset the AMT. These temporary provisions will keep the number of taxpayers affected by the AMT from rising significantly in the near-term. More importantly, they will allow the Treasury Department the time necessary to develop a comprehensive set of proposals to deal with the AMT in the long-term. Because of the revenues involved and the number of taxpayers affected, any long-term solution to the AMT could well require significant changes to the regular income tax. The Treasury Department looks forward to its task and to working with this Committee to find a long-term solution.

Simpler Savings Options for All

Americans continue to save at a very low rate relative to historical standards and our major trading partners. The President has put forward in this year's Budget a modified version of his savings proposal to help address this low rate of saving. The proposal carefully balances the need for a simpler approach for providing accessible tax-preferred savings options to all Americans and preserving the employer-provided pension system, which has been the foundation for meeting the retirement savings needs for millions.

Saving is made simpler by replacing the existing web of tax-preferred saving options with two new savings vehicles: Retirement Savings Account (RSAs) and Lifetime Savings Accounts (LSAs). These savings vehicles allow everyone to contribute regardless of age or income. The simplicity of these new savings vehicles will help encourage individuals, especially lower income individuals, to save.

Lower income individuals often do not have the resources to save for the distant future and are unwilling to take the risk of locking up their savings in tightly restricted accounts. In addition, these individuals tend not to have access to the sophisticated advice needed to navigate the complex, and often conflicting, rules that govern the existing savings vehicles. LSAs have been designed to make the decision easy: it is a savings vehicle accessible for all, especially low and moderate income individuals. Any money contributed can be withdrawn at any time without penalty. Treasury believes that these more relaxed rules will encourage individuals to save who might otherwise not do so in targeted savings plans because of restrictions on and penalties for withdrawals. As individuals learn to save, and become comfortable doing so, they will do more of it. The lower \$5,000 contribution limit, as compared to the proposal in the FY 2004 Budget, will minimize the effect of these proposals on employer plans.

The proposal for RSAs would simplify the range of choices for taxpayers saving for retirement. The proposal takes the easy to understand Roth IRA and makes it available to all. Any taxpayer can contribute up to the lesser of \$5,000 or their earned income. Unlike current law, however, withdrawals could only be made for retirement, beginning at age 58. RSAs are the perfect complement to LSAs: targeted, tax-favored savings coupled with savings for any reason.

The proposal for Employer Retirement Savings Accounts (ERSAs) would consolidate six different types of employer contributory plans into a universal account. The proposal has been modified from the previous FY 2004 Budget proposal to enhance flexibility and encourage small businesses (10 or fewer employees) to fund an ERSA by contributing to a custodial account, which is similar to a current-law IRA.

A third proposal would credit Individual Development Accounts (IDAs) to encourage and assist lower-income individuals to save. This proposal would provide dollar-for-dollar matching contributions of up to \$500 targeted to lower income individuals. Matching contributions would be supported by a 100 percent credit to sponsoring financial institutions.

Together, these proposals further promote an ownership society by removing barriers to savings, reducing complexity, and improving fairness by providing the benefits of tax preferred savings to everyone, regardless of financial sophistication or capacity to save for the very long-term.

Reducing Barriers to Homeownership

A significant barrier to homeownership continues to be the supply of affordable housing for lower income individuals. To address that need, the President has proposed a \$2.4 billion (\$16 billion over 10 years), 5-year Single-Family Affordable Housing Tax Credit of up to 50 percent of the project costs of rehabilitation and construction of affordable homes, provided they are offered to homebuyers with incomes of not more than 80 percent of area median income. The tax credit would eventually result in an additional 200,000 affordable single-family homes becoming available through construction or rehabilitation.

Affordable Health Care is a Priority

Expanding access to health insurance remains an important goal of the President and is reflected by his continued commitment in this area. The lack of access to affordable health insurance is a complex problem that requires a comprehensive approach focusing on different segments of the uninsured with policies tailored to meet their needs. There is no one size fits all solution; a policy that excels in one dimension may do poorly in others. The high and rising cost of health insurance is a key factor that limits access. Policies that help control costs will make insurance more affordable through lower premiums.

Health Savings Accounts (HSAs), enacted as part of the recently-passed Medicare Reform legislation, are a significant step towards promoting cost consciousness through greater reliance on individual choice and high deductible plans. HSAs, now part of current law, are complemented by a new proposal in the President's Budget for an above-the-line deduction for premiums to purchase the high deductible health plans (HDHP) necessary in order to have an HSA. The proposal generally helps level the playing field for a segment of the population that does not have employer-sponsored coverage.

The proposal for a refundable, advanceable health insurance tax credit would help make insurance more affordable for lower income individuals. The credit amount under the proposal would vary with family size, mirroring the relationship of actual health insurance premiums. The credit is targeted to low-income individuals and families, who are the least likely to have employer-based health insurance, resulting in the efficient use of the subsidy. Together, these policies promote affordability and

access, and help encourage greater cost consciousness by giving individuals a greater stake in their health care choices.

Protecting Defined Benefit Plans and Promoting Fair Treatment for Older Workers in Conversions to Cash Balance Plans

The President's budget reflects the importance of preserving defined benefit pension plans and the benefits they provide to workers and their families. In addition to the proposal to fix the flawed interest rate used to determine the amount of contributions a plan sponsor must make to its defined benefit plan, the budget contains three interrelated proposals that recognize the importance of cash balance plans in providing retirement security to millions of Americans. The first proposal would ensure that companies converting from a traditional defined benefit plan to a cash balance pension include a fair transition for older workers. A five-year hold harmless provision would be required in a cash balance conversion, so that workers would continue to earn benefits under the greater of the prior plan formula or the cash balance formula for five years after the conversion. The second proposal would clarify that cash balance plans do not violate the age-discrimination rules that apply to pension plans as long as they treat older workers at least as well as younger workers. This would remove uncertainty created by inconsistent federal court decisions and would ensure the future of cash balance plans. The final proposal would eliminate the "whipsaw" effect, which acts as an effective cap on the interest credits that cash balance plans can provide to workers. This would permit companies to give higher interest credits, allowing larger retirement accumulations for workers.

Simplification of an Overly Complex Tax Code

In a sophisticated economy, a tax code with complex provisions may be unavoidable. It is the price we pay to ensure fairness, to limit government interference with personal and business decisions, and to prevent abuse. On the other hand, unnecessary complexity imposes tremendous burdens on honest taxpayers simply doing their best to comply with the law. The present tax system imposes compliance costs on taxpayers estimated to range from \$70 billion to \$100 billion per year from the individual income tax alone. Compliance costs also are onerous for business taxpayers, especially small businesses, while the typical Fortune 500 company spends almost \$4 million a year on tax matters.

For these reasons, it is crucial that we continue efforts to simplify the tax laws. The 2005 Budget includes several new simplification proposals. All of these proposals address complexities borne by individuals and families. They do not represent an exhaustive list; instead, they serve as examples of the many steps that can and should be taken to make the tax code easier to understand and comply with. The Treasury Department looks forward to working with this Committee to identify other areas where significant improvements can and should be made.

Stopping Abusive Transactions

Voluntary compliance with the tax laws is undermined when taxpayers use abusive transactions to avoid paying the taxes they rightfully owe. For the past three years, the Administration has acted aggressively to restore confidence in the tax system by halting the promotion of abusive transactions and bringing taxpayers back into compliance with the tax laws. The President's Budget builds on these efforts and information gathered through IRS compliance programs. The new legislative proposals close loopholes and target identified abusive transactions and practices. As other abusive transactions are identified, the IRS will challenge the transactions in audits, and the Treasury Department and the IRS will work with Congress to enact any legislation necessary to address such transactions.

One proposal deserves particular mention. The Administration has proposed to limit certain types of abusive leasing transactions, known as SILOs. These arrangements are entered into with tax-indifferent parties, such as foreign governments, domestic municipalities, and tax-exempt organizations. They purport to be leasing transactions but, in substance, provide no financing to the tax-indifferent party aside from a fee. These arrangements have no meaningful financial or economic utility other than the transfer of tax benefits to a U.S. taxpayer (by means of a purported "sale" of property) in exchange for the payment of an accommodation fee to the tax-indifferent party.

Although Treasury has been aware of SILOs for some time, the extent of the problem has only recently come to light. Our data indicates that as much as \$750 billion dollars of SILOs have been done in just the last four years. We have every reason to believe that, left unchecked, this trend will continue and grow. Because these transactions essentially involve no risk to either party, and require very little in the

way of actual cash investment, corporations seeking to reduce their U.S. tax liability will face no economic bar to seeking out these arrangements on an increasing basis.

SILOs represent a threat to the viability of the corporate tax base. They present a ready-made tool for self-help tax relief for large corporations and consortiums of smaller ones. Indeed, the magnitude of SILO transactions is such that the Treasury Department had to re-estimate and reduce its baseline estimate of corporate tax receipts over the ten-year budget window. It is essential that Congress deal with this issue. Otherwise, any corporation with the wherewithal to do so could plan itself out of the corporate income tax. The American citizenry rightfully expect their government to ensure that all taxpayers pay the taxes they owe, unreduced by artificial transactions. Congress should act promptly to ensure that SILOs are not permitted to continue.

At the same time, in addressing the SILO problem, it is not our goal to interfere with garden variety leasing transactions that have been entered into for many years and that involve legitimate financing or refinancing of assets. The detailed SILO proposal in the President's budget permits legitimate lease transactions to continue. We look forward to working with this Committee to ensure that legislation is enacted that leaves legitimate transactions unscathed while preventing abusive lease transactions from going forward.

Responding to WTO Decisions on ETI Provisions

The Extraterritorial Income ("ETI") provisions of our tax law, like the prior-law foreign sales corporation provisions, have been found to be inconsistent with World Trade Organization (WTO) rules. The WTO has authorized the imposition of trade sanctions against U.S. exports up to the level of \$4 billion per year, and the European Union has adopted a plan providing for sanctions to be phased in beginning next month if the ETI provisions remain in the law.

Honoring our WTO obligations requires repeal of the ETI provisions. At the same time, meaningful changes to our tax law are required to preserve and enhance the competitiveness of U.S. businesses operating in the global marketplace. Thus, the necessary repeal of the ETI provisions should be coupled with other tax changes that promote the competitiveness of American manufacturers and other job-creating sectors of the U.S. economy. Tax law changes that would provide a benefit to these vital contributors to the U.S. economy include across-the-board corporate tax rate reduction, expansion and permanence of the research credit, improvements in depreciation rules, extension of NOL carryback rules, AMT reform, business tax simplification, and rationalization of the international tax rules. The Administration intends to continue to work with this Committee and the Congress on prompt enactment of legislation that brings our tax law into compliance with WTO rules and makes changes to the tax law to enhance the global competitiveness of American businesses and the workers they employ.

Conclusion

Thank you again, Mr. Chairman and members of the Committee, for the opportunity to appear before you today. We look forward to working together with this Committee and others in the Congress to promote tax policies that continue to provide a sound foundation for economic growth.

Chairman THOMAS. I thank you very much. One of the reasons some of us like these sessions is so we can get into details quickly and expect answers.

On the leasing proposal that you outlined, pretty obviously, it is fairly broad and getting broader. Whenever I see more of something, it is because it is a good deal for somebody.

I am very much concerned about the idea that an indifferent party is able to do something with a, quote/unquote, benefit it cannot use in transferring it to someone else. We had a major internal debate over that very same concept in the energy bill when the term at that time was tradable credits, and I find it kind of interesting that you cannot use it, but if you can trade it to someone else, they get to use it, which, in a more fundamental sense, brings into question the whole concept of a tax credit as an appropriate

vehicle in which to make decisions. We will leave that for another day.

In some of these business transactions that I have looked at, one, it is very, very complicated and very clever. Everybody is a whole lot more familiar with leasing than they used to be 10 years ago. Most people are probably familiar with leasing of relatively expensive items like automobiles, where you get away from a significant front-end payment. Your monthly payments are lower, because you are not trying to amortize the cost over a period of time. Maintenance is usually thrown in, and if you are going to be making monthly payments anyway, why not walk away from a 3-year-old car in 3 years and get a new one and continue to make payments? The commitment, of course, is that you are going to continue making payments for the rest of your life.

So, I do think there are legitimate reasons to lease in your analysis you go through, and I think as we look at them in some details, some of them make sense. However, now you take the money, invest it for payback over a period of time, a 99-year lease is currently defined as ownership. Does that need to be changed?

There are just a whole lot of hinge points, I think, that we need to get into detail, because Members' first reactions from cities, counties, States, special districts are that we are into this up to our eyeballs, and please do not stop it.

The one, the fifth one, is the one that I do not fully understand. I want you to spend just a minute or two at least explaining how you would arrive at it, because the fifth criteria or test that you advocate is the lease is not identified as abusive in a U.S. Department of the Treasury regulation.

My first reaction is Potter Stewart's definition of obscenity: "I cannot define it, but I know it when I see it," so show me one of these, and then I will look at it to decide whether it's been abusive or not.

What can we hang onto in terms of more objective criteria that Treasury will begin to look at as to what is abusive or not? If I normally make a 15-percent profit on arm's-length business, leasing transactions, if I only make a 2-percent profit, is the amount of profit reaching an abusive point where it is not really a profit, but an attempt to show that I have met the letter of the law, certainly not the spirit? Where are we going to know when Treasury thinks the transaction is not abusive?

I guess ultimately what I am going to ask for is a continuum where I am sure that you could come up with leases that would be legitimate, and we could all come up with leasing arrangements that are not legitimate. The ones that are legitimate and the ones that are not legitimate on the far ends of the spectrum are obviously the ones we should be less concerned about. It is when you get to that point where there are a whole lot of new ones out there, and what is your observation; what are you going to use to decide that one is abusive, the other is not, notwithstanding these criteria which I am quite sure very clever corporate attorneys and others will begin to change the playingfield as we begin to examine it?

It is a little open-ended, but it is going to be a major point of controversy if for no other reason that you are laying, in a very difficult budgetary time, somewhere between \$25 and \$35 billion on

the table, which many people would like to take from the table, but they are concerned with the consequences of taking that concept from the table.

Ms. OLSON. Mr. Chairman, the leasing bar has been described by many as among the most creative group of attorneys in the country, and I concur in that assessment.

The fifth criteria that you refer to is merely authority for the Treasury Department and the IRS to address holes in the first four exceptions to the proposal; to the extent that the leasing bar finds ways to work around it, to achieve results that are similar to the results that they are achieving today, so that the effort would be focused on making sure that we do not inadvertently leave things out that are economically the same as the things that we propose to cover, and to make sure that the leasing bar does not find ways to work around it.

Chairman THOMAS. Well, that is another way of just saying trust us. Although I happen to say I may be more inclined to do that in an Administration of my own party than another one, I am not inclined to do that with anybody in which the results will go far afield from where we thought they were going to go based upon our discussions.

I just want to underscore this is an important area. If we do not lay down some kind of a bright line, it will only increase, in my opinion, the idea of going into a city and finding out that all of the municipal buildings and all of the vehicles and all of the assets of the city are not really owned by the city, but the city owned them and is leasing them back, and entered into more leasing arrangements; and then to find out it is not only domestic, but it is also international, and, given the complexity of tax rules, you may be able to lease the same item in three different countries three different ways is something of very great concern. In hard-pressed times, people do conduct, behavior, that would not ordinarily be assumed to be rational, and when you call them on it, who gets to do it and who does not is going to be a very, very sensitive political issue. How do you grandfather in some that are—how do you stop them if they are almost or just like something that has already occurred?

Those are all problems that we are going to have to address, and, Mr. Jenner, you are going to inherit some of this and whoever follows on. We have to be completely open, as honest as we can, using specific examples, so that Members can understand what you are talking about in today's world, because there is a lot of leasing going on that I believe is totally legitimate for good business reasons in not having to maintain capital employees and others to maintenance that leasing activities.

There are also, as this information comes to light, some amazing arrangements that are hard for somebody to say with a straight face are legitimate and appropriate, if not impossible to explain, except for the fact, quote/unquote, it happens to be my municipality or my major city, and so go somewhere else.

That is going to be a very difficult problem to resolve, so as you identify the problems and as you work on the solutions, you are going to have to work very closely with us so that we have a comfort level in going forward. Gentleman from New York?

Mr. RANGEL. Let me underscore: if you do not work very closely with us, then we Democrats have no one to work with at all, and so we are depending on the Administration to give us a little guidance so we know what is going on.

Now, the Secretary has indicated that this AMT problem will cost about \$700 billion in a tax increase if we do not do anything. Would you agree to that estimate?

Ms. OLSON. There are a fairly wide range of estimates.

Mr. RANGEL. What would yours be?

Ms. OLSON. It depends on what you think a tax—depends on what you think making a change or not making a change would mean.

Mr. RANGEL. Do you think we should make a change?

Ms. OLSON. Yes, Mr. Rangel, I think we do need to make a change because right now—

Mr. RANGEL. Do you know what that change would be?

Ms. OLSON. No. We are not in a position to recommend what that change should be. We have been studying the AMT.

Mr. RANGEL. Do you believe it should be revenue-neutral?

Ms. OLSON. There are ways in which the AMT problem can be addressed that would produce revenue-neutral results. You could make changes to produce almost any result you want, but there are ways in which it could be done.

Mr. RANGEL. Well, the Secretary suggested it should be revenue-neutral. Do you agree with the Secretary?

Ms. OLSON. I think what the Secretary is referring to was the fact it could be done on a revenue-neutral basis, and if he said it should be done, I think he probably just slipped a couple of words. It can be done on a revenue-neutral basis.

Mr. RANGEL. Well, if it is not done on a revenue-neutral basis, where would we raise the money to give the relief that I think you and I and the Congress believes that these people should get, because we are really talking about working families receiving a dramatic increase in taxes and also the fact that some of them come from high-tax States like New York and California, so that if we do not do anything, we are involved in increasing taxes, which I think we can agree that the Administration and the Congress would not want that to happen. If you are just saying that it is some way down the line we will find some answers to it, but we do not know what the Administration would want, then I will accept that, except that we have thought that your Department would be a little more specific.

What about the problem we have with the WTO? So far, I haven't gotten any direction from the Administration. You talk with the trade ambassador. He says he is not a tax expert, that that is Treasury's department, not a trade department. You talk with the Chairman of the Committee, and he does not talk with you, so you talk with people on the other side that will they come up with something, and that is rejected.

It might make it a lot easier for us if we found out where is the Administration; do you support the Chairman; do you support alternatives; are you involved in this at all? What do we say to our foreign friends when they threaten us with a \$4 billion increase in tariffs against our manufacturers? What do we say, that Treasury

hasn't made up their mind, trade hasn't made up their mind, and we have a political dispute on the Committee?

Ms. OLSON. Mr. Rangel, there are a number of things that could be done to address issues in the Tax Code with the revenues that will come from repealing FSC and ETI. We have outlined a number of those options in the budget. Many of those options would inure to the benefit of manufacturers in particular.

I would note the AMT changes that are discussed in there. Manufacturers bear a particular burden from the AMT because of the capital-intensive nature of the business and because of the cyclical nature of the business. The same is true with changes to the net operating loss rules.

There are a variety of things that we could do that would improve the tax system for manufacturers and make them more competitive.

Mr. RANGEL. Madam Secretary, there is a lot of controversy involved in whether or not we use the revenues that we save by correcting the FSC problem as to whether the incentive should be given to American businesses that are offshore, or whether we should have a more equal distribution of this tax benefit, because by removing it the way the WTO would want, you would agree with me that this would be a substantial increase for our exporters.

So, it is a very difficult political question, and I know there are many ways to do it, and, if you are saying that in the future, after you leave, somebody else has got to give us some guidance, I accept that. The Secretary was specific in saying that your shop was the one that dealt with these type of things, so we are not getting any answers from you on these sensitive questions.

It is a political year, and it would be very helpful if the President and his Cabinet at least say that this is what I want you to do, but you try to work it out, because, after all, you are the legislators; but, if you are just going to have us have a food fight over these things politically, I do not really think the country or the Administration benefits from not dealing with these specific questions because they are so difficult politically. Thank you.

Chairman THOMAS. I thank the gentleman. The gentleman from Illinois wish to inquire?

Mr. CRANE. Thank you Mr. Chairman.

Chairman THOMAS. Would the gentleman yield briefly?

Mr. CRANE. Yes, indeed.

Chairman THOMAS. One of the things I would hope we would all learn from the AMT situation was that in 1986, in the tax bill, there was an attempt to, quote/unquote, get a group of people, and then in the 1993 tax bill there was a failure to index the way in which we were going to get a certain group of people.

One of the lessons I would hope we would learn from this is that when we do not go back to fundamentals and we do not change the way in which we decide to define groups and tax them, you are going to find yourself in these kind of situations. We should have done it more fundamentally back in 1986 and indexed it in 1993, and the consequences of not doing so are the current situation that we are in.

I do want to remind people that we were not in charge at that time, and my hope is that whenever we do these kinds of tax

changes, that we deal with fundamentals and not be driven by the desire to, quote/unquote, get certain people.

Mr. RANGEL. Mr. Chairman, Mr. Chairman, I respect the prerogatives of the Chair, and I do not want to do anything to diminish it because I still believe that one day I will be Chair, but having said that, there should be some basic rules involved as to whether or not the Chair believes it has to politically respond to everything that the Minority says, because we have had some discussion on this subject matter, and that would give you about 20 much more times to pontificate than the rest of us. So, at some point, and perhaps not openly, we ought to agree on how we ought to handle that.

Chairman THOMAS. Tell the gentleman I recognized the gentleman from Illinois, asked for him to yield to me, and the time that the Chair was speaking was on the gentleman from Illinois' time. The Chair recognized the gentleman from New York, and it will not come out of the gentleman from Illinois's time.

Mr. RANGEL. I appreciate that.

Chairman THOMAS. If the gentleman or any other Member yields on a request for time and I will utilize that time, that is wholly within the rules, has been in the rules, and will be in the rules.

Mr. RANGEL. Well, let me apologize to the Chair, and I am sorry that both of us has utilized all of Mr. Crane's time.

Chairman THOMAS. I think you will find that all of Mr. Crane's time has not been utilized, and I want to thank the gentleman from Illinois for yielding to me.

Mr. CRANE. I most certainly appreciated the opportunity to yield some time, and I want to express my appreciation to Madam Secretary for your tour of duty. We think you have done an outstanding job, and we know that you look forward to going back to the real world for a change, too.

Ms. OLSON. Thank you, Mr. Crane.

Mr. CRANE. One of the things you mentioned in your testimony dealt with the leasing issue, and I just want to say, as a matter of my personal convictions, any retroactivity in taxes, to me, is totally unacceptable. If there are reforms that are called for, that is one thing, but there is no retroactivity being contemplated, is there?

Ms. OLSON. We have proposed that the provisions take effect the first of this year, so there is a little bit of retroactivity, about 2 weeks' worth.

Mr. CRANE. The first of this year?

Ms. OLSON. Yes.

Mr. CRANE. Okay. All right. One of the major issues to me, of course, is the repeal of the ETI and being WTO-compliant. We have that deadline that has been extended to March 1st, and starting March 1st, if we do not act, we are going to start taking a hit, the beginning of a hit, that could amount to on an annual basis over \$4 billion to our manufacturers that are trading abroad. One of the worrisome things is we are almost halfway through the month already now, and we are about to have a full week off during the President's break. I hope that the Administration is working to try and get action taken.

Action has been taken in Committees, both the Senate and the House, and while there are differences there, I think we can negotiate over the differences and hopefully get that reconciled. We really need a full court press by the Administration; otherwise, to me, there are some very serious concerns about what could happen after March 1st, and it is not just taxes. It is tariff protectionism.

Ms. OLSON. I certainly recognize that concern, Mr. Crane. We have been spending a lot of time on this issue. I think there are probably more similarities between the bills that have passed the Senate Finance Committee and the Committee on Ways and Means than differences, and I think we can get together to get them reconciled and get legislation passed. We are certainly encouraging Congress to do so and are certainly willing to do whatever we can to help move in that direction.

Mr. CRANE. Well, I appreciate that, and I would hope that we could make an outreach to some of our colleagues on the other side of the aisle who are basically on the right track, but need a little bit of encouragement.

The other thing, the provisions in the Tax Code that are scheduled to sunset, some as soon as the end of this year, what would likely happen if we failed to extend that 10-percent bracket, the marriage penalty, and other tax relief that is set to expire in 2004?

Ms. OLSON. Well, we would have a very quick increase in taxes on lower- and moderate-income folks; in particular, the ones who benefit from the child credit, the ones who would benefit particularly from expansion of the 10-percent bracket, and those who benefit from marriage penalty relief, which is a complete elimination of marriage penalty at the lower end, moderate-income levels. So, we would see increases across the board there.

Mr. CRANE. Thank you very much, and good luck to you, Madam Secretary.

Chairman THOMAS. Thank the gentleman, and thank him once again for his willingness to yield. Gentleman from Michigan wish to inquire?

Mr. LEVIN. Thank you, Mr. Chairman. Welcome. Just a minute on the earned income tax credit (EITC) changes. As I read the budget proposal, it includes some efforts to simplify the EITC for working—poor working families. Do you consider these simplification provisions important ones?

Ms. OLSON. Yes, we certainly do. We believe that a lot of the problems that we see with errors in the EITC area stem from the fact that the rules are complicated and difficult to follow, and that the changes that we propose would go some distance to eliminating those problems.

Mr. LEVIN. Thank you. On the AMT, you mention there was a range of estimates. Tell me what the range is. The Secretary—I do think Mr. Rangel is right—mentioned \$700 billion. What is the range?

Ms. OLSON. Dealing with the AMT issue, I think, is going to require us to take a very significant look at the underlying underpinnings of our tax system on the individual side, and that is what we are undertaking right now at the Treasury Department.

I believe that if we simply extended the patches and current law, that cost would be something north of \$400 billion over a 10-year

budget window. Depending on how you scale those things up, you could go higher; you could go lower.

Mr. LEVIN. So, \$400 billion is some figure that people could work with? We have to have some idea.

Ms. OLSON. It depends on what you want to do, Mr. Levin. Our recommendation would be that we not continue to patch the system, but rather that we take a more significant look at the tax system, because right now the fact that there are two separate tax systems adds considerably to the complexity of the system. It means a loss of transparency for people in terms of understanding how the system works, what their tax systems are, and for making plans for taking provisions for various things in the Tax Code that are intended to provide various things like education benefits. So, we would like to step back and take a very significant look, long-term look, at the system, not just to continue patching it, but rather to bring the two systems together.

Mr. LEVIN. Okay. So, patching it would cost at least \$400 billion, more or less?

Ms. OLSON. That is my recollection.

Mr. LEVIN. Okay, and a more basic set of reforms, what are the ranges of cost there?

Ms. OLSON. It depends on how far you want to go, Mr. Levin.

Mr. LEVIN. Well, give us some idea.

Ms. OLSON. We will be doing it on a revenue-neutral basis, as the Secretary suggested, to something far in excess of \$400 billion.

Mr. LEVIN. How long has the Treasury been working on this?

Ms. OLSON. We have been looking at the AMT issue for as long as I have been at the Treasury Department.

Mr. LEVIN. How long has that been?

Ms. OLSON. Three years, Mr. Levin, and so far we have proposed only patches, but we really do need to stop just patching the system and go back and take a harder look at it.

Mr. LEVIN. See, here is the problem: you have been working on this for 3 years. What is proposed in the budget is minimal, just a temporary addressing of it, and so it pushes the whole issue of cost off another year.

It is pretty clear to most people it is going to be costly to fix it. There is no provision for that in this budget, which already has huge deficits. It is that kind of failure to kind of come clear, if not clean, that leads people to be very skeptical about the candor.

I was reading a comment of former Treasury Secretary—someone who is not a Secretary, but in the Reagan Administration, William Niskanen, and he said this about this budget, “I despair”—this is in quotes—“I despair about this budget. I do not think Bush is being honest with the world. I am not sure he is being honest with himself.”

We need to tell the American people that changing the rules as to AMT is going to cost considerable moneys. You have already been working on this for 3 years. A patch is \$400 billion. There is no indication that we can go beyond that in the immediate future, and so there is that huge hole there that isn’t filled.

We have got to be sure that there isn’t an increased credibility gap, and this budget is just filled with gaps in terms of credibility, and the AMT is clearly one of them.

Ms. OLSON. Mr. Levin, we have been working on a lot of other things for the last 3 years as well. It has been a busy time—

Mr. LEVIN. I know.

Ms. OLSON. In the tax policy area, and I can assure you that we are going to continue to be working on it, and that we do intend to propose our level best.

Mr. LEVIN. When?

Ms. OLSON. Our goal is to have something ready for the budget next year.

Mr. LEVIN. Not this year.

Ms. OLSON. Well, we passed the budget for this year already, but we are looking forward to something—something in the budget next year, and we are looking forward to working with the Committee to finding a solution to the AMT issue that is fair and appropriate for all.

Chairman THOMAS. The gentleman from Louisiana, Mr. McCreery wish to inquire?

Mr. MCCRERY. Yes. Thank you, Mr. Chairman. Ms. Olson, I would like to add to the Chairman's comments that I very much appreciate the service you have given the Bush Administration and the American people. You have been very professional and forthright in your dealings with us, this Committee, both in your appearances and hearings and in meetings that we have had, and I want to add my commendation to that of the Chairman of your efforts on our behalf. So, thank you very much. We will miss you.

Ms. OLSON. Thank you, Mr. McCreery.

Mr. MCCRERY. I would like to get back to this leasing question. The retroactive date does concern me. This Committee has in the past, on occasion, stated unequivocally—in the case, for example, of a change in the capital gains rate, if we change the capital gains tax rate, then it will be effective as of this date, and we do that so that there will not be distortion in the capital markets. I think that is a very valid reason to set an arbitrary date, even without full legislative action.

In the case of the leasing provision, though, it seems to me we risk having just the reverse reaction in the market if you set an arbitrary date before any action is taken. It seems to me that could put a chill on the market and perhaps distort market activity, and perhaps even slow down or even prevent what you and I might regard as legitimate leasing activity that should be—have some tax advantages.

So, I am concerned about the retroactivity, and I hope the Chairman of the Committee on Ways and Means will join me in stating unequivocally that this Committee does not intend to enact a retroactive date of application. In fact, we will wait until at least this Committee takes some definitive action and crafts a proposal that does what the Chairman said, draws that bright line, so that we can distinguish the policing arrangements that we think are appropriate for favorable tax treatment and those that are not.

Chairman THOMAS. Gentleman yield on that point?

Mr. MCCRERY. Yes, sir, be glad to.

Chairman THOMAS. You clearly outlined a concern about chilling the marketplace, but I think there is some concern as well, since this is a bit amorphous in that we haven't been able to create

that spectrum and draw that line, that there will be a number of people who will rush to judgment in putting together a number of deals that may, in fact, fall on the abusive side of the spectrum and then argue they should not be reproached because that would be retroactive.

I do think, notwithstanding the leasing attorneys, it probably takes some time to put these deals together, that we have a window of opportunity, one of the reasons I urged we move fairly quickly on looking at the structure. I do want to support your argument. It makes no sense that we would draw some date from the previous year or January 1st as the date that we would operate with, but if the gentleman brings this subject matter up, my desire would be to act as contemporaneously as possible.

We have product and we indicate that henceforth that activity would not be allowed based upon the legislation that we draw, but it underscores the haste at which we need to come together on this legislation.

Mr. MCCRERY. I agree with the Chairman's assessment of what would be appropriate in terms of the timing of this.

Ms. OLSON. Mr. McCrery, we did give careful thought to the effective date on the market, and we did try to put within the scope of the changes we propose that had things that we think really are problems and that you would not want to go forward on any basis. There are certainly room on some of the changes as you look at them that you might conclude that what you need is a split effective date; that some of the provisions should be effective as of the first of this year, whereas others might be effective as you move forward with legislation.

Mr. MCCRERY. Thank you. One more question, it is switching subjects here, to the international tax reform. This Committee, as you know, passed out legislation last year that not only repealed FSC/ETI, but made a number of changes in our international tax provisions, and some critics of those changes have claimed that the effect of those changes would be to encourage jobs to move overseas. Would you comment on that? What is your opinion and Treasury's look, because you recommended some of those changes?

Ms. OLSON. Yes, we did recommend some of those changes, Mr. McCrery.

One of the concerns has been that we are taking the FSC/ETI benefits and we are giving them to people who are moving jobs offshore, which is sort of a line that has been used, but right now the current FSC/ETI beneficiaries are by and large in multinational companies. Those multinational companies have businesses offshore not because they are manufacturing over there and then shipping things back, but because it is important for them to be there to serve the local market.

A lot of their offshore activities that would be benefited by some of the international reforms that we have talked about and this Committee has considered would allow them to more efficiently market U.S.-made products. So, we do think that it is important for us to look at international reform. Right now, we are driving around in a 1960 Chevy pickup, and everybody else is working in virtual reality. We need to reconsider our rules.

Mr. MCCRERY. Thank you.

Chairman THOMAS. Thank the gentleman. The gentleman from Maryland, Mr. Cardin wish to inquire?

Mr. CARDIN. Thank you, Mr. Chairman, I do. First, let me thank Ms. Olson for your public service. We very much appreciate working with you and the Committee.

Ms. OLSON. Thank you.

Mr. CARDIN. Yesterday Secretary Thompson was before the Committee, and he made a statement that was rather dramatic, and that was that he believed the President's proposals would cut the number of uninsured for health insurance by 50 percent. The tools that the President has in his budget all fall within Treasury, so let me take a chance, if I might, to inquire as to Treasury, as to the numbers that you have; first of all, the number of people who currently do not have health insurance, at least your numbers in that regard, and how you believe the HSAs that were included in last year's medical bill would reduce those numbers. Then the additional tools that you have in this budget for the deductible savings accounts and the credits, how that will impact the number of uninsured?

Ms. OLSON. Thank you, Mr. Cardin. First I am pleased to say that there are some proposals that fall outside of Treasury's bailiwick. I think there are some proposals on the State Children's Health Insurance Program (SCHIP) and some proposals on associated health plans that are both outside of Treasury's bailiwick, and both of those I believe Secretary Thompson believes would contribute to reducing the number of uninsured.

There is a fairly wide variation in the estimated number of uninsured in this country. The number that we typically work with is something north of 40 million. The budget proposals that we put together, we believe, would reduce the number of uninsured on the tax side, the tax budget proposals, by something of 4 or 5 million. The low-income health insurance tax credit in particular would help a good segment of that part of the market be able to get health insurance which currently cannot.

The HSAs are targeted at a different problem, which is trying to introduce some more cost-consciousness into the health care market with the goal of making people consume less. So, that is the direction that the HSAs go, and the high-deductible health insurance premium deduction along with that; again, to try to put some of this back into the control of consumers to make them more sensitive about it.

Mr. CARDIN. I appreciate that. So, when you're dealing with the number of uninsured, the 4 to 5 million that you believe would be on the tax side would be in primarily the credit?

Ms. OLSON. That is correct.

Mr. CARDIN. I thank you for that, and we will question Secretary Thompson more how the SCHIP program and the others, the association plans, will, I guess, equal another 20 million somewhat.

Ms. OLSON. He does believe very strongly that those are the answers to that, and part of the answer to the health insurance tax credit allows people to work with the State pools, which again he believes very strongly there is a solution.

Mr. CARDIN. Those numbers do not seem credible, but we will go back and look at that. We have done a lot to advance these issues, and they have had minimal impact of reducing the number of uninsured in our health system.

I want to touch on the defined benefit comment that you made, that you are concerned about the defined benefit plans, as we are concerned about it. I personally believe it is the preferred source for retirement security because it is a guaranteed benefit for individuals, and it is one that is generally better managed than individuals' defined contribution plans.

So, what is the Administration's position on the replacement now, 30-year Treasury? We have a bill that is moving through the Senate and one through the House. We have a 2-year temporary bill that substituted a corporate bond mix. I saw that you issued a veto threat on the Senate bill. Is there a specific position that the Administration has now?

Ms. OLSON. We support the temporary fix that the House has passed. We would like to see that enacted into law, and that is an issue that has to be addressed fairly quickly for the corporate community. So, we would encourage you to move forward with that.

The bill that has passed the Senate side includes some deficit reduction contribution (DRC) relief for a couple of specific industries and then with a rather amorphous permission to the IRS to grant other relief. We are very concerned about the DRC relief just continuing to exacerbate the problem with underfunded plans, and that is what has caused the concern.

Mr. CARDIN. I share your concern, but I would point out the urgency to try to resolve this. Mr. Chairman, we are going to run into a situation where the well-funded plans are the ones that are going to be freezing or converting or leaving the defined benefit market, and we will be left with more and more plans that are underfunded because they have no opportunity to do much other than that. I wasn't happy with the 2-year fix, but it was a temporary fix, but it was a better option than doing nothing, and I would hope that we would be able to get the bill to the President's desk that he can sign as soon as possible.

Chairman THOMAS. I thank the gentleman. Gentleman from Pennsylvania, Mr. English wish to inquire?

Mr. ENGLISH. Thank you, Mr. Chairman. I do. I would also like to congratulate Secretary Olson on her extraordinary service and the activism that she has brought to this job, which is so refreshing.

Madam Secretary, I have heard concerns from companies in Pennsylvania about a proposal in the Senate Finance Committee ETI bill relating to what is called the economic substance doctrine. My constituents are concerned that this doctrine should be left to the courts, and attempting to write it into statute would interfere with ordinary business transactions. In a region that has seen, I dare say, more than its share of difficult economic times, we see this as another potential burden on the global competitiveness of certain companies. What is the Administration's view of this proposal?

Ms. OLSON. Thank you, Mr. English. We have had considerable concern about the attempts to codify the economic substance doc-

trine as well, because although we think there are very serious compliance issues out there that need to be addressed, we don't think the economic substance doctrine—the codification of the economic substance doctrine would be particularly effective in addressing those.

The statutory provisions that have been drafted are very complicated. I think it would be very difficult for the IRS to apply, which would mean they would not be particularly effective as a tool for the IRS, and they have the potential of hitting a number of transactions or chilling a number of transactions that really aren't the intended target of it. We spent a lot of time looking at this issue in trying to find ways to direct the effort into the things that actually cause us concern, and I think that is a more fruitful direction to go.

Mr. ENGLISH. Do you believe that the proposals in the President's new budget on combating abusive tax avoidance transactions will be sufficient to address the serious problem of abusive tax shelters?

Ms. OLSON. We believe that we have made a real dent in the marketing of abusive tax transactions over the course of the last 3 years with much more aggressive enforcement activities by the IRS and with the regulatory changes that we have made. What we could really use is some statutory changes that would allow us to complete the web of information that the IRS relies on in order to combat abusive transactions. The statutory provisions that we have requested changes for would allow us to do that, and we would urge the Committee to go forward with those.

Mr. ENGLISH. Thank you. Finally, I have noticed there have been discussions so far in this hearing about the individual AMT, which is certainly a very serious and growing problem that the Administration, I think, is clearly building some particular capital to deal with. Certainly your predecessors did not address this problem, and it has been out there since the eighties growing in force.

The issue that I wanted to finally ask you about is the corporate AMT, probably the most perverse provision, I think, in the entire corporate code. When I first came to Congress, I introduced a bill to repeal it because I think it is a dead drag on the competitiveness of the manufacturing economy. In your view, can you explain why the AMT might be, on the corporate side especially, stifling to manufacturing and how its repeal might boost manufacturing?

Ms. OLSON. Certainly. We did include in the budget discussion of the FSC/ETI repeal three specific items with respect to the corporate AMT that the Committee ought to consider if it wants to improve the climate for manufacturing in this country. One of them is the depreciation differential that exists between regular tax and the corporate AMT. The fact that that provision is in the AMT increases the cost of capital, which is a particularly significant item for manufacturers who tend to have high capital investment. So, getting rid of that provision would be a significant positive for manufacturing.

The other two items that we specifically refer to in the budget are the limitation on net operating losses and the limitation on foreign tax credits that exist in the AMT. Both of those, likewise, have a particularly bad effect on manufacturers. Manufacturers, because

of the cyclical nature of the industry, are more likely to get caught by the AMT because that is when the AMT tends to kick in—when the economy is down.

Mr. ENGLISH. It is the “kick them when they are down” tax.

Ms. OLSON. There you go. Anything we can do to reduce that effect would be a positive for manufacturers.

Mr. ENGLISH. As Co-Chairman of the Zero AMT Caucus, which is gearing up its efforts now, we really appreciate your suggestions on some incremental steps to begin to reduce the impact of the corporate AMT with an eye toward its eventual abolition.

Chairman THOMAS. Gentleman from Washington, Mr. McDermott wish to inquire?

Mr. MCDERMOTT. Thank you, Mr. Chairman. Ms. Olson, if I applied for a 501(c)(3) status for an organization that I created, and the public planning of that organization was a fundraising event which provided access to the Democratic leadership at the next Democratic convention, do you think that would fall within the guidelines for 501(c)(3)?

Ms. OLSON. Doesn't sound like it to me.

Mr. MCDERMOTT. Didn't sound like it to me when Mr. DeLay did it either. When I wrote a letter to them, they said that the IRS has not received—has not recognized—the children's fund is exempt from Federal income tax. We have no record of a Celebrations for Children, Inc. (CFC) filing on a Form 990. So, it sounds like he is telling people he is a tax-exempt organization, but, in fact, he has no status with the IRS.

Now I will enter into the record the brochure of the organization, but I assume that if the CFC has an application that is still pending, I have a question. Will the contributors that contribute to that organization be allowed to have a tax deduction this year for money they contributed to the organization under the belief that it was going to be a 501(c)(3)?

[The information is being retained in the Committee files.]

Ms. OLSON. I am sorry, Mr. McDermott, that is an area I am not familiar with, and I will be happy to take the question back and get you an answer.

Mr. MCDERMOTT. You can't tell me whether—you start an application for an organization, and you have an application in, and you start collecting money, you can't tell me whether people get the tax exemption or not?

Ms. OLSON. My guess is that the answer is no, you don't, but I believe there are some exceptions to that rule, and I don't want to answer the question without having the rules in front of me to be able to answer it definitively.

Mr. MCDERMOTT. I will tell you that the IRS liaison to the Congress says, yes, you do get the deduction. You can take the deduction even though it is pending. The question is, how does Treasury go back and get the taxes if they deny the 501(c)(3) status?

Ms. OLSON. I don't know the answer to that question either, Mr. McDermott. I would be happy to get you an answer to the question, but I can't answer it today.

Mr. MCDERMOTT. I think it is a question we really ought to look at. I think the Republican leadership setting up this shadow 501(c)(3) and going out and collecting and telling people they are

going to get a tax exemption and don't have to disclose who gives the money, no requirement for a 501(c)(3) to declare where they got the money from or how much, and it then could be denied after the election, and lo and behold, everybody would have taken the tax deduction. How will the Treasury go back and find them? Will they bill them, or will they audit these people if a tax deduction or if a tax organization loses its fight for an exemption?

Ms. OLSON. I don't know the answer off the top of my head. I will be happy to go and get one for you.

Mr. MCDERMOTT. Well, I think it is something that the Committee ought to take up, Mr. Chairman. I think when the leadership of the Republican party is setting up what I believe is an operation to use the Tax Code as was used by the previous Speaker and then—he collected money from Mr. Callaway, a former Member of Congress from Georgia, and then the exemption was taken away, and then the Department never went after the money. They reversed their decision a second time. So, they granted a tax exemption, took it away, and granted it back. There is nobody on this Committee that can get the papers from the IRS.

That is a travesty of the Tax Code, because it allows all kinds of foolishness and deception to go on. I really think this is an issue that ought to be taken up by this Committee. I yield back the balance of my time.

Chairman THOMAS. The gentlewoman from Connecticut, Mrs. Johnson wish to inquire?

Mrs. JOHNSON. Thank you, Mr. Chairman, and thank you, the Honorable Assistant Secretary Pam Olson, for your excellent service to the Treasury and also to this Committee. I appreciate the very clear presentation you just made of the impact of tax changes adopted in recent years on the recovery. It was clear and concise, and people need to understand how important tax policy is to the strength of our competitiveness and of our economy.

I am also pleased with the President's willingness to go ahead in very difficult times to address the problem of the uninsured. Indeed, the presence of so many uninsured is pulling down all of our provider organizations. So, it is important we move forward on that, and it is a suggestion we can build on.

The loophole closing and the AMT discussions are ones that I support, but I would have to say that I feel the Administration has been somewhat lackadaisical in their attitude with this problem with Europe. I know you talked about it, but this is big. There is \$14 billion in product that can be cycled through. For a soft economy, if this starts March 1st, this is a big issue. I am concerned that there hasn't been more emphasis on it; and furthermore, there hasn't been more willingness to say since the last time we made big changes in our tax law, we made our corporate rate the lowest in the world, we now are the second or third highest in the world in every avenue, whether it is research and development (R&D), corporate taxes, or capital gains or whatever, we are behind.

Not only do our business taxes not fall off our exports like they do from Europe, but the tax burden our products carry into the competitive world market is higher than most countries. If our global companies are to survive, and if we are to begin stemming

the offshoring of component parts to countries like China, we have to help them be competitive.

I think using this opportunity not only to address the FSC/ETI problem, but also to strengthen the competitive positions of our businesses is the biggest thing we can do to protect existing jobs and to bring jobs back to our country. It is just so bizarre that if you invest profits overseas, you don't get taxed. If you bring them back here, you do.

To me, jobs and the economy is the whole thing. If we don't deal with this, jobs and the economy—jobs are going to go, and the economy is going to suffer. I don't mean to be disrespectful, but I do feel a lack of urgency and the lack of sort of big picture thinking on this issue. I think this Committee—and I commend the Chairman on this, and Mr. Crane worked with him, and many Members did, on the comprehensiveness on this bill. It pains me to think that it is complicated, that we can't move forward. What it did for small manufacturers in America we never thought about doing. We never come close. We have to depreciate like the rest of the world does. So, we have to encourage investment and inventory and machinery and equipment.

I just needed to say that, and thank you for your good service and your testimony. I hope the Administration will get out there with us and push hard. To me that is much more important than making the tax changes permanent. I understand the need for some to be made permanent now, but this is the biggest issue, the job protection issue, I think, we face.

Ms. OLSON. We do have a couple of provisions in the budget that should be made permanent that definitely move in that direction for companies that are trying to produce more jobs here in the United States. Among them would be section 179. We need to make that permanent. Of course, the research and experimentation (R&E) credit, which expires on the 30th of June of this year.

Mrs. JOHNSON. How long do you extend that for?

Ms. OLSON. We would like to see it made permanent.

Mrs. JOHNSON. Do you fund making it permanent in your budget?

Ms. OLSON. No. We think it should just be extended.

Mrs. JOHNSON. For how long?

Ms. OLSON. We would like to see it made permanent. The point you are making is exactly right. There is a tremendous competition worldwide for R&E today, and R&E is our future, and we have to invest in R&E. If we don't make the credit permanent, then what we continue to do is leave companies uncertain about whether they should be making the R&E investments here or making them somewhere else. I think we need to move forward with that.

Mrs. JOHNSON. Thank you.

Chairman THOMAS. If you want to make something permanent that costs money, you have to show us where you are going to get the money. It is out there. Gentleman from Massachusetts, Mr. Neal wish to inquire?

Mr. NEAL. Thank you very much, Mr. Chairman. I am going to suggest where we can get \$5 billion pretty quickly. Again, as the other Members stated, thanks very much. You were particularly helpful on a couple of constituent issues that appeared to be lost

causes. You and your staff did a great job of really helping out on an individual basis, and I have not lost sight of that.

Ms. OLSON. Thank you, Mr. Neal.

Mr. NEAL. I still can't leave you off the hook on AMT. Isn't it fair to argue that the tax cuts over the last 3 years have exacerbated the AMT situation?

Ms. OLSON. The lower tax rates—because of the way the AMT functions, the lower tax rates have become a preference, but that has been the case since the rates increased back in 1993. I can recall meetings with my predecessors back in the nineties, and the complaint that we got at the time was that there were too many AMT forms being filed. We, at the time, said, this is your future. You need to do something to address the fact that the AMT is not indexed, and the problem is going to get worse because of the increase in the rates.

Chairman THOMAS. Would the gentleman yield briefly on that point? The reason I don't believe we have exacerbated the AMT is because every time we have passed a tax bill, we have vetted the hold harmless aspect of the AMT, and it has been tens of billions of dollars to try to not have the problem that you are concerned about happen. So, I believe we have held them harmless, but at an enormous cost to tread water. This won't come off the gentleman's time.

Mr. NEAL. There obviously is a difference of opinion as it relates to this issue between the Administration and the Chairman's perspective on this, but let me take this a step further and maybe make reference to the Chairman's opening comments as well.

I accept the responsibility on our side for what happened in 1986 and 1993, but can we not make the argument that the Majority has now been in charge of this institution for 10 years, and trying to get around to fixing this issue ought to have priority status? It strikes me it was so easy to proceed with tax cutting, but not to address the attending issue of what the tax cutting has done.

I heard Members speak earlier today of the notion of what we are going to take care of the marriage penalty down the road and other issues that had such sex appeal here, and the problem is that the taxpayers, as they begin to take advantage of these opportunities in the Tax Code, what we give to them on one hand with some tax preference we are going to ask back to the Treasury because of AMT. Is that a fair statement?

Ms. OLSON. For some part of the population, yes.

Mr. NEAL. Exactly, yes. That is the point I am trying to make. I would suggest that as much as we talk about this—and I understand the Chairman's sentiments that we do provide that patchwork, but it doesn't escape notice here that the problem still gets worse.

Ms. OLSON. It hasn't escaped notice at the Treasury Department either, and I can assure you we have been looking very long and very hard at this. That is why there is a another 1-year patch, as opposed to a permanent patch. We think that we need to look at more significant structural changes to the income tax, because we don't think leaving the AMT in place is necessarily the right thing to do. We are not sure that it serves the purpose for which

it was initially enacted. We need to take a harder structural look at the income tax, and then come to you with a proposed solution.

Mr. NEAL. I appreciate the sentiments you have offered, and you share my conclusion, if not some of the other information I put forward. If we continue down the road of making the Bush taxes permanent and don't do anything with the AMT, we end up with doubling the problem over the next decade. As sincere as you might be today, I think we are going to be back with another 1-year fix next year and the year after.

The Chairman talked about how we might raise some revenue from time to time. The most annoying problem I have had perhaps now in the 12 years I have been on this Committee is the whole issue of Bermuda. For us to have 134,000 troops in Iraq and to let these folks off the hook who, for a \$25,000 to \$27,000 post office box address, they are allowed to escape supporting these troops, men and women who have performed brilliantly, it strikes me as being odd that that would not be one of the things we could come up with a firm recommendation on. They should be paying their fair share. I have had estimates by the Joint Committee on Taxation and others here that suggested that we could pick up \$45 billion if we would simply close the Bermuda loophole.

Ms. OLSON. Well, we certainly agree with you that we need to take steps in that regard. I assume you are referring to the inversion activity in particular?

Mr. NEAL. Safe assumption.

Ms. OLSON. The issue that we saw when we did our inversion study 2 years ago that was really driving people offshore was the ability to reduce their U.S. taxes, taxes on U.S.-earned income, by leveraging those operations. We have taken—we have put forward a legislative proposal, and I know this Committee has passed a legislative proposal that would take the juice out of those transactions.

We have acted on the regulatory front in two different ways. We issued regulations providing for information reporting on these transactions because our belief was that some of the transactions were going forward without the shareholders recognizing that they had a tax liability as a result of the transaction, and that that tax liability may not have been paid. We have also gone forward with changes in section 482 regulations, which would be another way for companies to move intangibles offshore and then charge royalties back to the United States, which would again reduce the U.S. taxable income of these companies.

We have gone forward with changes in the section 482 regulations that begin to address those issues, and then we have been working hard on the treaty front as well. I think you know, there is one treaty in particular that has been used not to eliminate double taxation, but rather to eliminate all taxation. We have been working hard to get that treaty reformed as well.

Mr. NEAL. One last question. Do you believe that Tyco is a Bermuda-based company, or do you believe that Tyco is an American corporation?

Ms. OLSON. I am not sufficiently familiar with the Tyco structure to know where they belong.

Mr. NEAL. They are incorporated in Bermuda.

Ms. OLSON. I am aware they are incorporated in Bermuda, but don't know enough about the structure. One of the things we have to consider in these is that the transactions of moving offshore are taxable transactions. They are going to be taxed either at the corporate level or the shareholder level. If the transactions go forward on that basis, then we have to give some recognition to what has occurred, or we shouldn't be taxing the company or the shareholders. We shouldn't just be saying, you didn't leave, you are still here. I know some of the things that you have been thinking about are also some of the things we have been giving serious consideration to as well.

Chairman THOMAS. The gentlewoman from Washington, Ms. Dunn wish to inquire?

Ms. DUNN. Thank you very much, Mr. Chairman. I want to add my congratulations to Secretary Olson for a job well done. During our lives, those phases we go through every now and then, we see where attention needs to be directed in a new direction or different direction. I think you have picked up on that, and I congratulate you.

What I wanted to chat with you about today is the effects of the estate tax on the economy of the United States. The Economic Report of the President, the one that we saw on Monday, mentions that—it talks about the negative impact of the estate tax, and it says, quote, “it is likely to take the form of a reduction in capital accumulation.” Then it goes on to say that part of the long-run burden of the tax is likely to be shifted to workers through a reduction in wage rates. I wanted to ask you a couple of questions and listen to your response.

First of all, have the economists in Treasury attempted to evaluate the effect of the economy—of the depressing effect on the economy of the estate tax? Have you been able to estimate for this Committee the positive impact of eliminating the tax permanently? On the cost of repeal, lots has been discussed about the loss of the revenues from this tax, but none of the estimates that I have seen take into consideration the diversion of working capital to the costs involved in complying with producing this tax.

There was an economic report that was completed last year by the CONSAD Research Corporation that indicated that permanent repeal would free up capital. So, my additional question is: don't you think we need a more accurate picture of the actual effects of the repeal of this tax on our economy? Would you conclude as a result that this tax, if it were permanently repealed, could actually end up as budget-neutral?

Ms. OLSON. Thank you, Ms. Dunn. Treasury has spent a lot of time looking at the economic effects of the estate tax, and obviously now, as the Council of Economic Advisers has indicated by the report they released on Monday. We would certainly concur in their conclusion that the estate tax is an additional tax on capital, and as an additional tax on capital, the logical effect is that you end up with less of it, and it translates through to reduced capital for workers and reduced wages, a ripple effect through the economy.

The tax is also unfortunate because it is in many way a tax on virtue. It is a tax on those who are trying to leave a legacy to those

they leave behind, and that is another unfortunate feature of the tax.

One of the things that we analyze when we analyze the repeal of the estate tax was the income tax effect, because in some ways the estate tax and gift tax has served as a backstop to the income tax. So, that is one of the things we have to take into account as we look at what the costs of repeal are.

Ms. DUNN. What about my question on budget neutrality?

Ms. OLSON. That was my intended response to the question, that there are other effects besides just the revenues from the estate tax. It is the effect that it has on the backstop on the income tax that has produced some of the size in the revenue estimates.

Chairman THOMAS. Gentleman from Texas, Mr. Johnson wish to inquire?

Mr. JOHNSON. Pam, I just want to congratulate you on a job well done. You have been responsive to the Members on every occasion, and I just want wish you well in whatever endeavor you choose from here on.

Ms. OLSON. Thank you.

Chairman THOMAS. The gentleman from North Dakota wish to inquire?

Mr. POMEROY. Thank the Chairman. Let me add my best wishes to Secretary Olson. Been a pleasure for a North Dakota boy to work with a Minnesota girl in this position you have held.

Chairman THOMAS. You betcha?

Mr. POMEROY. You betcha. That isn't to say we ever quite agreed on several important matters, and I would say especially the savings issues. The Secretary, when he was here the other day, spoke of studies within the Treasury Department that supported the savings programs advanced in the budget. I have not read the studies. I have not been aware of studies in circulation. I asked the Secretary for them, and he indicated that you would be coming up to talk to me about those studies. Are there studies that have been reduced to writing that we can circulate for evaluation?

Ms. OLSON. We have done a lot of analysis. There is one study that is out on the Treasury website that has been out for a couple of years on the effect of complexity on savings. The others are not reduced to formal studies.

Mr. POMEROY. The lifetime savings account (LSA) proposal isn't 2 years old yet. I am interested in whatever study might be in support of this significant reform. I find it somewhat amazing a statement in your testimony on page 5, LSAs have been designed to make the decision easy. It is a savings vehicle accessible to all, especially low- and moderate-income individuals. Let us talk about that for a minute.

The LSA, as I understand, lets you put \$5,000 in every year per family member, correct?

Ms. OLSON. In every year, and every year that you can afford it, of course, and one of the things with low- and moderate-income folks is that they can't afford to every year. So, whenever they have the ability to sock money away, we would like make sure they have the ability.

Mr. POMEROY. Accessibility really relates to affordability. If you have wealth to invest, then you can access this savings vehicle. If you don't, then you can't.

Ms. OLSON. I don't think Mr. Gates cares about an LSA, but I think a lot of constituents would benefit greatly from it.

Mr. POMEROY. We will talk about that, but let us get to this accessibility versus affordability. If you don't have the money to put in it, you can't access it. If a family of four every year can put \$20,000 in an account and never be taxed on that money again, to suggest that that is going to be a vehicle principally used by moderate- and low-income people is, in my opinion, specious and false, because moderate- and low-income people don't even make \$20,000—low-income people, they don't have the aftertax money to put into these accounts.

Now it concerns me a lot that you have done away with savings incentives that have been in the marketplace and have proven themselves. You and I have a fundamental difference. You take the position complexity is a key bar to getting moderate- and low-income people to save. I went on the Internet and pulled down some individual retirement account (IRA) applications. Here is a 3-pager. Couldn't be more simple. There are 36 million households with traditional IRAs.

Ms. OLSON. Only 8.5 percent of the population participated in 2001.

Mr. POMEROY. Eight and a half percent is pretty good. You repealed this traditional IRA.

Ms. OLSON. That is 8.5 percent for all kinds of IRAs.

Mr. POMEROY. There are 36 million traditional IRAs, and you repealed them in the Tax Code.

Ms. OLSON. Many of those rollovers.

Mr. POMEROY. Madam Secretary, with respect, I have to finish my point here. I think what you need to get people to save when they are under very tight financial circumstances is some powerful incentives to save. The saver's credit is showing some strong early promise in that regard. It is on the books. It passed this Committee, and in the year 2002 we had 3.5 million people participating. You wiped that one out, too. The tax-deductible IRA is gone. The saver's credit, which matches savings by a partial credit for moderate- and low-income, gone. In exchange for that, you have got this account that disproportionately benefits those that can afford to put in up to \$20,000 a year for a family of four.

In my opinion, you have taken away the incentives that benefit low- and moderate-income. You have added a very substantial additional tax shelter. You seem to create a picture that when you talk about ownership society, essentially what you are talking about is taxes will be on wages, taxes will not be on investments. Is that where we are headed?

Ms. OLSON. Where we are headed is in the direction of rewarding people who say—this Minnesota girl is a farmer's daughter. My father was a sharecropper, and all of four of us went to college. Three of us have at least one advanced degree. We can save if we want to. What we want to do is encourage people to do more of it. That is the goal of this proposal, and complexity does get in the way.

Of those 36 million IRA accounts, we are not wiping any of them out. People will be able to keep that on a going-forward basis. We haven't looked at the saver's credit yet. As you know, it doesn't expire until 2006.

I want to point out to you last year when we were here, you complained to the Secretary that we hadn't done anything about the qualified tuition deduction, and in our simplification proposals we have taken that into account and making that permanent as part of the credit. We will continue to look at this and look forward to working with you on it because we have the same goals.

Mr. POMEROY. As always our conversations are always stimulating.

Chairman THOMAS. The Chair would recognize those individuals who may wish to make a brief statement rather than take their full 5 minutes, with the full understanding that the gentleman from Ohio will be recognized. The Chair is very cognizant of the time and the need to move to other activities and prepare for the Director of the Office of Management and Budget (OMB), who will testify at 2:00 p.m. Anyone who wishes not to go into a questioning at this time will be recognized at the beginning of the OMB Director's time rather than waiting for additional time. With that, anyone want to take me up on my offer? The gentleman from Florida.

Mr. SHAW. Thank you, Mr. Chairman. I just want to join and make a comment similar to Mr. Johnson's comment that you certainly are going to be missed. Been a pleasure to have before this Committee. You seem to bring civility into the room with you, and we wish you all the best. I understand you are taking a respite here for all the right reasons, and I compliment you for it.

Ms. OLSON. Thank you, Mr. Shaw.

Chairman THOMAS. Gentlewoman from Ohio.

Ms. TUBBS JONES. Ms. Olson, as much as I would like to ask you questions since you are leaving me, I would like to ask the next speaker more questions. I wish you success in your new position, and I will see you out in the street somewhere.

Chairman THOMAS. Any additional Members wish to take me up on the offer? You want to ask a question, don't you?

Mr. HOUGHTON. I will be very, very brief. Look, I have a question about the R&D tax credit, and the regulations are fine, they are doing a good job. However, there is the glitch here in terms of making progress in developing rules for service companies. The only thing I am going to ask is would the Treasury be willing to work with the Committee to clarify the internal software rules?

Ms. OLSON. Yes, Mr. Houghton, we would be delighted to, and that is a very complex area and have had a hard time dealing with it, and that is why we haven't been able to finalize that part of the regulations.

Chairman THOMAS. Software is hard. Gentleman from Illinois.

Mr. WELLER. Thank you, Mr. Chairman. As I understand, if we would like to ask a question now, we are deferring our opportunity to the next panel.

Chairman THOMAS. You will be taken in order at the next panel if you wish to inquire at this time.

Mr. WELLER. Based on that understanding, I do have a question I would like to ask Ms. Olson.

Chairman THOMAS. Gentleman from Illinois is recognized.

Mr. WELLER. Thank you, Mr. Chairman and Madam Secretary, and wish you well in your future endeavors. You have been a great asset for the Bush Administration as well as all of us in the Committee. Thank you for the assistance you have given each of us.

I would like to make a comment and then a question regarding a provision that we included in the jobs and economic growth package that the President signed into law last year. It is clear that the President's jobs and economic growth package is working. We are seeing economic growth and have seen 300,000 new jobs created. Unemployment is dropping, and we have seen record levels of capital investment; in fact, the highest level ever recorded in history. Much of the credit for that capital investment is given by the most pro-manufacturing provision that was in the jobs and economic growth package, and that was the bonus depreciation provision. Manufacturing sector, general aviation seen a 38-percent increase for demand for their products; electronics technology, over a 40-percent increase in demand for their products; and the credit, the bonus depreciation as not only being a contributing, but a deciding factor.

I noticed in the Administration's budget that you submitted the expiring provisions at the end of this year. Bonus depreciation was not one of them. Can you share with us the thinking? Here is something that is clearly working, it is driving the economy and providing an incentive for business to invest. It is pro-manufacturing, and it is a sensitive area for all of us, and I was wondering why the Administration did not include it as part of the tax provisions in the Administration budget?

Ms. OLSON. Thank you. It was included in the 2002 and 2003 legislation with the Administration's full support as a short-term stimulus, and we think some of the benefit from it has come from the short-term nature of the provision. That is why we have not proposed extending it.

Mr. WELLER. How would you feel, though, if we were to extend it? Would the Administration support or oppose that initiative?

Ms. OLSON. We have included in the budget a permanent extension of section 179, but our view at this point in time is that we would not be supporting—can't tell you this is a definite position that the Administration has taken—but I believe the view would be that we would not extend a portion of the 50 percent.

Mr. WELLER. I was wondering, like many of my colleagues, as an advocate of the bonus depreciation because it works and in driving economic growth, I feel that short-term economic stimulus, if you want to use that term, needs to be long-term economic growth. Clearly, reforming how we depreciate assets and moving toward expensing is a key part of that effort. I would like to work with your successor and our friends in the Administration to work toward that goal. I also would once again advocate extension of the bonus depreciation because, again, it is working, it is driving investments, and it is creating jobs.

Chairman THOMAS. Any other Member wish to curry favor with the Chairman with a brief farewell? The gentleman from Colorado.

Mr. MCINNIS. I have been quickly putting on my pad whether—the plusses and minuses of questioning now or later, but I would like to ask a question now. I will complete it before the yellow light goes on. First of all, Madam Secretary, I, too, join the rest of the people to thank you for the excellent job you have done.

Chairman THOMAS. The mike is not on. Use the one next to you. The Chair would like to convey the sincere appreciation of the gentleman from Colorado.

Mr. MCINNIS. I will make a brief statement and not even a question. The fact is, you have done an excellent job here. I have in my hands a report which greatly concerns me. The report indicates that a deal was recently done which allows the same assets to be depreciated on three separate continents and countries at the same time, Australia, the United States, and France. The report essentially brags about this fact. Have you heard about this, and if so, are you also concerned about these transactions?

I know you will have great success when you go.

Ms. OLSON. We are similarly concerned about the triple depreciation option.

Mr. MCINNIS. Thank you.

Chairman THOMAS. We all want to thank you for your service. I know that this isn't just a job for you, and that we will be able to work together on problems of common interest. I appreciate the service you have given the country.

If there are no further questions, the hearing is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[Additional questions submitted by Representative Wally Herger to the Honorable Pamela F. Olson, and the response follows:]

Washington, DC 20515
February 12, 2004

Ms. Pamela F. Olson
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, Room 3120
Washington, D.C. 20220

Dear Ms. Olson,

Thank you for taking the time to testify before the Committee on Ways and Means on February 11, 2004 regarding the tax proposals in the Administration's FY05 Budget. As a follow-up to your testimony, I would appreciate the Treasury Department's views on the issue of donated conservation easements.

The Administration's FY05 revenue proposals include efforts to ensure that patents, intellectual property and automobiles are valued correctly when donated to charity. I appreciate Treasury's willingness to address these important issues. However, I am concerned that there is potentially much greater fraud and abuse in the area of land conservation and specifically concerning the donation of conservation easements.

In 1976, Congress made donations of conservation easements tax deductible in an effort to encourage land conservation. Easement donors can claim Federal income tax deductions for any loss of property value caused by the restrictions on future development. The value of these tax deductions is generally established by appraisers hired by the land donor.

How do we know that these appraisals are accurate? The Washington Post, in a series of articles last year, cites a case in North Carolina 2 years ago where luxury home builders bought over 4,000 acres in the Great Smoky Mountains for \$10 million, developed less than a third of the land, and claimed a tax writeoff of \$20 million. So while I appreciate the Treasury Department's efforts to ensure that donated

patents and automobiles are valued correctly, I am concerned that you may be missing a much larger area of abuse.

A 1984 IRS study examined 42 deductions for easement donations and determined that all but one appeared inflated, resulting in overvaluations totaling nearly \$32 million. According to a General Accounting Office report on this study, taxpayers generally overvalued their conservation easement deductions by an average of about 220 percent. The revenue implications of this study are immense, considering that today there are an estimated 12,000 easements nationwide.

Has Treasury looked at this problem recently? What data does the federal government have on the amount of fraudulent deductions that are occurring?

Finally, Treasury's revenue proposals this year once again include a 50-percent exclusion of capital gains for land sales for conservation purposes. I continue to respectfully oppose this proposal as misguided tax policy. Already, more than 50 percent of my district is largely off limits to future development because it is owned by the Federal government.

I would appreciate an explanation as to why the federal income tax system is an appropriate mechanism by which to encourage land conservation, especially in light of the tax abuses that appear to be occurring in the area of donated conservation easements.

I sincerely hope that Treasury will be willing to work with me and other concerned Members of Congress to gather comprehensive data regarding conservation easements, and to formulate appropriate legislative proposals to address the tax abuses that are taking place.

Again, thank you for your testimony before the Committee and for your meritorious service as the assistant secretary for tax policy. I would appreciate answers to my questions at your earliest convenience.

Sincerely,

Wally Herger
Member of Congress

This is in response to your follow up questions regarding the issue of donated conservation easements. We share your concern about improper deductions being claimed for donations of conservation easements. We are reviewing valuation and compliance issues relating to donations of all types of property, including conservation easements. We are considering actions to ensure accurate valuation and compliance with applicable law.

Under current law, a charitable deduction is allowed for the donation of a conservation easement only if the donation is made to a qualified organization exclusively for statutorily defined purposes. As you know, the value of the donation is the fair market value of the easement at the time of the contribution, which may be measured by the difference in the value of the restricted property before and after the granting of the easement. Treasury regulations provide that these values should take into account not only the current use of the property but an objective assessment of how immediate or remote the likelihood is that the property, absent the easement, would in fact be developed, as well as any effect from zoning or conservation laws that already restrict the property's potential highest and best use. In addition, the amount of the deduction must be reduced by the amount of any financial or economic benefit to the donor or a related person, including any resulting increase in the value of other property (whether or not the property is contiguous) owned by the donor or a related person. It is the taxpayer's responsibility to obtain qualified appraisals as required to substantiate any deduction claimed. The Administration's Budget includes a proposal to require all taxpayers (including corporations)

to obtain a qualified appraisal for donated property worth over \$5,000, and to attach a copy of the appraisal to the taxpayer's return if the deduction claimed exceeds \$500,000. This proposal to require qualified appraisals would apply to donations of conservation easements, as well as other types of property.

Further, your letter notes that the Administration's Budget includes a proposal to exclude from income fifty percent of any capital gain from the voluntary sale of land for conservation purposes. The proposal defines conservation purposes in the same way as existing law, complementing the charitable contribution deduction by encouraging the sale of land to charitable organizations having conservation as their primary purpose. We believe this proposal will strengthen the ability of charitable organizations to compete with other buyers of appreciated, environmentally sensitive land. Conservation purposes would be served, under the proposal, by voluntary sales of property rather than by government regulation of land use.

Your letter asked for an explanation why the Federal income tax system is an appropriate mechanism by which to encourage land conservation. In enacting the charitable deduction relating to property preservation and conservation for a historical as well as ecological goal, "Congress believe[d] that the achievement of this goal is largely dependent upon whether private funds can be enlisted in the preservation movement." Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act 1976 (Pub. L. 94-455) at 643. This legislative history may explain Congressional intent in using the Federal income tax system as a mechanism by which to encourage land conservation.

Thank you for your expression of willingness to work with the Department of the Treasury in gathering data on conservation easements and in formulating responsive proposals. We look forward to working together to ensure that charitable deductions serve their intended purposes.

[Submissions for the record follow:]

Statement of Coalition for Fair International Taxation

The Coalition for Fair International Taxation ("C-FIT") is a group of over two-dozen U.S. employers representing a broad cross-section of industries that supports the modernization of the U.S. international tax law to ensure that U.S. companies can effectively compete at home and abroad. (Please see the attached list of companies.) We appreciate the opportunity to submit our views to the Committee.

Introduction

We applaud the Bush Administration's Fiscal Year 2005 Budget for its continued recognition of the necessity of reforming the nation's international tax provisions as an appropriate response to the World Trade Organization (WTO) rulings invalidating the Foreign Sales Corporation (FSC)/Extraterritorial Income Exclusion (ETI) provisions.

The WTO has now ruled definitively in a case initiated by the European Communities (EC) that the FSC/ETI rules violate U.S. international trade obligations, and has authorized the EC to impose up to \$4 billion in annual trade sanctions against U.S. exports. EC officials have announced their intention to begin imposing tariffs by March 1, 2004 if the United States does not comply with the WTO decision. The Administration again makes clear in its FY 2005 Budget its position that the United States should comply with the WTO ruling through the passage of legislation repealing ETI. It is imperative that the Congress pass ETI replacement legislation in order to avoid the crippling economic effects of a trans-Atlantic trade war.

As described in more detail below, C-FIT strongly supports legislation approved by the Ways and Means Committee, the American Jobs Creation Act (H.R. 2896). The legislation brings the United States into compliance with its international trade obligations as well as meets the charge laid out to Congress in the Administration's Budget that the "ETI provisions should be replaced with tax law changes that preserve and enhance the global competitiveness of U.S.-based businesses and American workers."¹

FSC/ETI Replacement Legislation Should Advance U.S. Economic Interests

- **In responding to the WTO FSC/ETI ruling, the Congress must take account of the vital role that U.S.-based multinational operations play in increasing U.S. exports.**

U.S. multinational corporations play a vital and leading role in the U.S. economy, and are responsible for:

- 23 million American jobs
- 9 million of the 16 million U.S. manufacturing workers
- 21% of U.S. GDP
- 56% of U.S. exports
- \$131 billion in annual U.S. R&D spending and
- 49% of U.S. corporate income tax payments

Moreover, foreign direct investment by U.S. businesses helps create markets for American products. This leads to sales in foreign markets that likely would not happen by simply exporting goods. For example, Wal-Mart, a member of C-FIT, has expanded its global reach by opening stores in foreign markets and providing additional markets for the U.S. products it sells. As a result, more U.S. products—most of them from small businesses—find their way onto foreign shelves. Small U.S. producers have a much tougher time getting onto the shelves of Wal-Mart's foreign competitors, like Carrefour, a French company.

A recent study by the Organization for Economic Cooperation and Development (OECD) found that each dollar of outward foreign direct investment led to two dollars of additional exports and a \$1.70 increase in the U.S. bilateral trade surplus. The Commerce Department's "Survey of Current Business" indicates that in 2000 (the most recent year for which data are available), U.S.-based multinationals accounted for about two-thirds of overall U.S. merchandise exports. Foreign affiliates of U.S.-based multinationals purchased \$203 billion of goods from U.S. sources, while domestic operations of U.S.-based multinationals exported \$236 billion to other foreign customers.

- **The nation's tax and trade policies should work in tandem to strengthen the U.S. economy, including by retaining headquarters of companies in the United States.**

In recent years, Congress and the Administration have recognized the economic importance of trade liberalization measures by enacting sweeping tariff reduction agreements. The domestic benefits of free trade are not only challenged by overseas trade barriers but are also being frustrated by an outdated U.S. international tax regime that acts as a trade barrier in its own right—however, this is a trade barrier we impose on ourselves.

The increasingly interdependent global economy has largely been a good thing for the U.S. economy. As the President's Council of Economic Advisors observed in 2003, "The U.S. economy is increasingly linked to the world economy through trade and investment. Domestically based multinational businesses and their foreign investment help bring the benefits of global markets back to the U.S. by providing jobs and income."²

U.S. international tax rules have been cited as a factor in the loss of U.S. headquarters jobs, one that may create an incentive for foreign multinationals to acquire the U.S. operations of American companies. These transactions are likely to result in the relocation of U.S. headquarters to foreign countries. A 2002 Treasury report on corporate inversions notes the growth in foreign acquisitions of U.S. businesses in recent years: \$90.9 billion in 1997, \$234 billion in 1998, \$266.5 billion in 1999, and \$340 billion in 2000. The relocation of headquarters abroad poses a serious long-term risk to the U.S. economy, to the extent that management functions move out of the United States and foreign overseers make future U.S. versus foreign in-

¹ General Explanation of the Administration's Fiscal Year 2005 Revenue Proposals, Dept. Treasury (February 2004), p. 187.

² U.S. Council of Economic Advisors, *Economic Report of the President*, 2003, p. 208.

vestment and employment decisions. Decisions made by companies regarding the location of their headquarters affect the creation and retention of jobs in management, marketing, R&D, information technology, and other high-wage, high-skill areas. It is therefore critical that we not adopt policies that encourage companies to locate their headquarters overseas.

- **Thousands of small U.S. businesses participate in the global economy as suppliers to U.S.-based multinational corporations.**

Thousands of small businesses support and depend on the global operations of U.S. firms. As the Small Business Administration found in a report discussing the role of small businesses in the global economy, “smaller firms can conduct international expansion on their own, or by collaborating with a multinational firm. The intermediated form of international expansion has certain advantages. The small firm benefits from having access to the multinational firm’s global market reach. From the large firm’s perspective, the arrangement enhances the value of its existing contributions to internationalization.”³

Accordingly, reforms that increase the international competitiveness of large U.S. based companies will have a positive impact on U.S. small businesses.

- **Congress must act to support the competitive efforts of American companies that operate in the global marketplace.**

The challenge for U.S. companies to remain competitive on an international basis has never been greater than it is today. One significant factor limiting our competitiveness is the basic structure of the U.S. international tax regime. That regime was enacted over 40 years ago when the U.S. economy dominated the world and 18 out of the top 20 global companies were headquartered here. At the time, the United States accounted for over half of the world’s multinational investment. Today, to remain competitive and fuel U.S. economic growth and jobs, domestic companies must compete against foreign-owned firms for clients and customers that are located around the globe.

Defects in the Subpart F and foreign tax credit regimes cause U.S. companies to face discriminatory tax burdens not borne by their foreign competitors. Present law, in general, allows the deferral of U.S. tax on foreign earnings of U.S. companies. The Subpart F rules inappropriately impose current U.S. taxation on many types of active business income earned by U.S. companies through their foreign subsidiaries. This premature U.S. tax places the U.S. owned foreign subsidiary at a disadvantage relative to its competitors. The U.S. rules should permit active business income of foreign operations to be taxed when the earnings are paid as dividends to the U.S. parent company.

Similarly, the FTC was enacted to prevent the double taxation of income earned by U.S. companies overseas—that is, by both a foreign country and the United States. Unfortunately, the FTC has numerous arcane rules that cause double taxation of foreign-source income. The improvements to the foreign tax credit rules in H.R. 2896 go a long way toward eliminating the prospect of double taxation of foreign source income. The goal of U.S. international tax policy should be to allow U.S. companies to pay roughly the same burden of income tax as their competitors do in markets both at home and abroad.

C-FIT Supports the American Jobs Creation Act (H.R. 2896)

Briefly, the Ways and Means bill would repeal ETI over three years and replace it with a host of business tax reforms that would provide crucial benefits to all sectors of the American economy, spur the economic recovery, and create new jobs.

- **Improves International Competitiveness.** To fuel U.S. economic growth and jobs here at home—H.R. 2896 would reform antiquated U.S. international tax rules that undermine the international competitiveness of domestic companies.
- **Provides crucial benefits for small businesses.** According to the National Federation of Independent Business (NFIB), several provisions of H.R. 2896 would prove extraordinarily helpful to America’s small businesses: reduced 32% rate for small employers; restaurant and leasehold depreciation shortened from 39 to 15 years; increased exemption from the corporate alternative minimum tax; reduced depreciation period for manufacturing equipment used in the United States; and extension of the 50% bonus depreciation for an additional

³SBA Office of Advocacy, “The New American Evolution: The Role and Impact of Small Firms” (June, 1998).

year. Importantly, these benefits would flow to all small businesses: firms that do and do not export.

- ***Delivers Immediate Relief.*** Small businesses would receive many of the benefits included in H.R. 2896—AMT relief and depreciation reform—as early as this year, providing a critical and timely boost to the economy.
- ***All Businesses Qualify.*** The Ways and Means Committee bill takes account of the full range of American employers that export and compete in the global marketplace for worldwide business. The bill does not limit its benefits to corporations and thus includes small manufacturers operating as sole proprietors or partnerships. H.R. 2896 provides all sectors of the U.S. economy—including the valuable services and manufacturing sectors—with needed job-creating incentives.

Conclusion

The United States must comply with the WTO's FSC/ETI ruling, taking into account the interests of *all* American businesses and their workers. ETI replacement legislation should also ensure that U.S. businesses and workers are not placed at a disadvantage in relation to their foreign competitors. The WTO-mandated changes to U.S. tax law should include much needed reforms to our outmoded international tax regime because these reforms will ensure that U.S.-based companies can continue to compete globally against foreign-based companies operating under more advantageous tax regimes.

C-FIT supports the Bush Administration in its efforts to replace the FSC/ETI provisions with reforms to the international tax laws of the United States. Accordingly, we enthusiastically support the American Jobs Creation Act (H.R. 2896) because it meets the high bar set by the Administration: honoring the nation's WTO obligations and enhancing the competitiveness of U.S.-based businesses and American workers. We stand ready to work with the Congress and the Administration to achieve passage of this important legislation.

LIST OF MEMBER COMPANIES

3M
 Agilent Technologies
 Cargill
 Cisco
 Citigroup
 Coca-Cola
 Coca-Cola Enterprises
 Deere & Company
 Dow Chemical
 EDS
 Exxon-Mobil
 Ford
 General Mills
 General Motors
 Georgia Pacific
 Hewlett-Packard
 International Business Machines Corporation
 Johnson & Johnson
 Kodak
 Mars, Inc.
 McDonald's
 Praxair
 Procter & Gamble
 Texas Instruments
 Wal-Mart

Statement of Credit Union National Association, Inc.

The President's 2005 Budget, which was transmitted to the Congress on February 2, 2004, contains a number of proposals that the Credit Union National Association (CUNA) supports. CUNA represents over 90 percent of the nation's approximately 10,000 state and federally chartered credit unions and their 84 million members. We

are pleased to provide comments for the record in connection with the February 11, 2004, hearing of the House Committee on Ways and Means on the "President's Fiscal Year 2005 Budget."

The Administration's FY 2005 budget plan would, among other things, create an Individual Development Account (IDA) tax credit and simplify personal saving by replacing existing tax-preferred saving options with Lifetime Savings Accounts (LSAs), Retirement Savings Accounts (RSAs) and Employer Retirement Savings Accounts (ERSAs).

IDAs are matched savings accounts that may be opened by persons who meet a net worth test and are eligible for the Earned Income Tax Credit or Temporary Assistance for Needy Families. The accounts are restricted to three uses: 1) buying a first home; 2) funding post-secondary education or training; or 3) starting or improving a small business. They were first authorized by the Personal Work and Responsibility Act of 1996 (P.L. 104-193). In 1998, the Assets for Independence Act (P.L. 105-285) established a five-year \$125 million demonstration program administered by the Department of Health and Human Services to evaluate the effects of savings incentives on persons of limited means.

Currently, contributions are not deductible but are matched by contributions from a program run by a state or a participating nonprofit organization. Matching contributions and their earnings are not taxed to the individual. The Administration's IDA proposal would provide dollar-for-dollar matching contributions of up to \$500 supported by a 100 percent transferable tax credit to sponsoring financial institutions. An additional \$50 per account per year would be available to offset administrative costs and expenses associated with providing financial literacy training.

In this connection, CUNA notes that H.R. 7, the "*Charitable Giving Act*," passed by the House on September 17, 2003, by a vote of 408-13 and S. 476, *The Charity, Aid, Recovery and Empowerment (CARE) Act of 2003*, passed by the Senate on April 9, 2003, by a vote of 95-5 both contain IDA expansion provisions and await further congressional action in conference. We urge you to include the transferable tax credit provision included in the Senate bill in the final agreement reached on this most important legislation.

Under the Administration's Lifetime Savings Accounts proposal, individuals of any age or income could contribute up to \$5,000 annually (nondeductible) to a LSA, regardless of whether they had any earnings that year. Investment earnings and distributions from the account would be tax-free. There would be no required distributions from LSAs during the account owner's lifetime. Coverdell Education Savings Accounts (ESAs) and Section 529 Qualified State Tuition Plans (QSTPs) could be converted to LSAs up to December 31, 2005.

We agree that these more relaxed rules could encourage individuals to save who might otherwise not do so in targeted savings plans because of restrictions on and penalties for withdrawals.

The Administration's Retirement Savings Account proposal would allow individuals of any age or income to contribute up to \$5,000 per year¹ (nondeductible) from earned income to a RSA. Qualified distributions² would be tax-free. All other distributions would be subject to tax on amounts exceeding contributions. Current "Roth IRAs" would be renamed RSAs and would be subject to the rules for RSAs. Owners of traditional IRAs could convert them to RSAs.

We agree that RSAs would simplify the range of choices for taxpayers saving for retirement by making the Roth IRA concept available to all taxpayers. Any taxpayer could contribute up to the lesser of \$5,000 or their earned income. Unlike current law, however, withdrawals could only be made for retirement, beginning at age 58. RSAs would address a key component of retirement—personal savings.

By eliminating income restrictions, the RSA could become a strong vehicle for retirement savings, particularly for those who are within a decade of beginning to retire.

The Employer Retirement Savings Accounts proposal would make many of the employer plans easier to understand. Beginning in 2005, § 401(k), § 403(b), Savings Incentive Match Plans for Employees (SIMPLE plans), Simplified Employee Pension (SEP) plans and governmental § 457 plans would be consolidated into ERSAs, which would be available to all employers. Qualification rules under the Internal Revenue Code would be simplified.

¹For a married couple, the maximum contribution would be the lesser of annual earned income or \$10,000.

²Qualified distributions would be those made after age 58 or if the account owner died or became disabled.

LSAs, RSAs and ERSAs could provide additional encouragement for all taxpayers to save. *However, we urge you to also include and expand the current law SAVER's tax credit in the provision.*

American's private savings rate remains low and many low—and middle-income individuals continue to have inadequate savings or no savings at all. Lower income families remain more likely to be more budget constrained with competing needs such as food, clothing, shelter, and medical care taking a larger portion of their income. Applying the SAVER's credit to RSA and ERSA contributions would provide a needed additional tax incentive that would enhance their ability to save adequately for retirement. *We believe the credit should also be made refundable to be available to individuals who might not have to pay tax in any particular year.*

CUNA urges Congress to pass tax legislation that would encourage all Americans to increase personal savings. We understand that Congress may address other tax matters, either as a part of this package or later in this session. Should such an opportunity arise, we request that you consider legislation that would:

- Simplify the Earned Income Tax Credit;
- Create Farm, Fish, and Ranch Risk Management Accounts (“FFARRM” accounts);
- Permanently extend the retirement and savings provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 EGTRRA;
- Permit tax free withdrawals from IRAs for charitable contributions;
- Provide a tax credit for developers of affordable single-family housing;
- Permanently extend the disclosure of tax return information for administration of student loans; and
- Extend the protections of section 7508 of the Code to all Armed Forces reservists and National Guardsmen called to active duty.

CONCLUSION

CUNA appreciates having this opportunity to present our views on the revenue provisions contained in the President's fiscal year 2005 budget proposal. We look forward to working with you in the future on these most important matters.

Statement of Equipment Leasing Association of America, Arlington, Virginia

This statement is submitted on behalf of the 800 member companies of the Equipment Leasing Association of America (ELA). ELA is a non-profit association representing the equipment leasing and finance industry.

Equipment leasing is used by eight of every ten organizations, including tax-exempt entities, to acquire productive assets and raise capital. In 2004, the leasing industry will provide over \$220 billion in equipment investment through lease products. Organizations of all types utilize leasing for all kinds of equipment and financing needs. In an econometric study released February 3, 2004, the preeminent research firm, Global Insight, determined that over the period 1997–2002, equipment leasing produced between \$100–\$300 billion additional real GDP. The study, *The Economic Contribution of the Equipment Leasing Industry to the U.S. Economy*, indicates that equipment leasing produced between \$227–\$229 billion in additional real equipment investment and created between 3–5 million additional jobs.

The ELA expresses its strong opposition to certain “anti leasing” tax proposals in the Administration's FY 2005 budget. The Administration is proposing a major tax increase on the leasing industry and constitutes a major policy change in this area. The ostensible policy justification for the proposals is to address “unintended” leasing transactions and practices. The tax principles involved in leasing, however, have been developed and reviewed by the Congress, successive Administrations and courts over decades in legislation, regulations and court decisions.

It has long been the policy of the Congress to use tax depreciation to incent investment in productive assets. Leasing has played an important role to insure that these incentives worked efficiently for private companies that were currently not profitable and for tax-exempt entities by more readily allowing them to acquire productive assets and raise capital.

In 1984 and 1986 Congress specifically addressed the use of leasing by tax-exempt entities.

- Congress spelled out the reduced rate of tax depreciation available for leases of tax-exempt use property—the so-called “Pickle rules”.
- Congress created an exception from the “Pickle rules” for short-term leases.

- Congress created an exception for Qualified Technological Equipment to promote acquisition and deployment of technology.
- Congress adopted special rules to encourage investment in a range of assets, including solid waste disposal through service contracts.

Current and historical public policy regarding leasing to tax-exempts has provided a reduced investment incentive for the lessor as a result of a lower rate of tax depreciation if the lessee is a tax-exempt customer such as a hospital, city, education facility, public transit authority or foreign entity. Congress has recognized that it is contrary to sound public policy for the cost of capital for cities, hospitals, public transit systems and other tax-exempts be substantially higher than that of private entities. The proposed policy changes would effectively take away the option of leasing for tax-exempt entities by changing this long held value of stimulating investment in capital goods.

Specifically, the Administration's proposals would remove the exemption for qualified technological equipment (QTE) from the "Pickle rules" for depreciation. There is no description in the Administration's proposal or any Treasury literature of any abuse associated with the exemption for QTE. Qualified technological equipment and computer software are essential to the productivity of any organization and the quality and cost of services provided. A tax-exempt hospital would have to pay \$38,000 more a year to lease a CAT scan machine. A newly mandated emergency communications systems would cost a city substantially more and a public transit authority that needs to upgrade its signaling and control systems would similarly incur higher costs.

No modern organization, whether private or tax-exempt, can operate efficiently and effectively without investment in technology. In addition, technology equipment and software are major sectors of the U.S. economy. Reducing demand conflicts with objectives to grow the economy and related jobs. Congress has a consistent history of encouraging and incenting research and the development and deployment of technology. While Treasury can properly define technology for QTE purposes it is poor public policy to impose a blanket penalty on all technology equipment acquired by a tax-exempt entity.

The Administration's proposals include aggregating potential subsequent service contract periods with initial lease periods for purposes of computing depreciation. The proposal has been rejected in prior Congresses and ignores the very real differences that exist among the parties in a service contract versus those that exist among the parties in a lease. The proposal also would undermine the policy considerations that led to the service contract distinction that currently exists in the Internal Revenue Code.

Treasury also proposes to limit deductions for leases to tax-indifferent parties. The proposal sets forth five "safe harbor" requirements from application of the proposed limits. The first four "safe harbor" requirements are too complex to address in this testimony. However, the association wishes to express its willingness to address the implications of each of the requirements with Treasury officials and the Congress. A central concern is that any regulation or policy take into account the realities of risk management and credit enhancement in today's capital markets. The fifth requirement is so broad that we are unable to comment. However, to unintentionally foreclose practices or structures commonly used in capital markets just because the customer, the lessee, is a municipality or a hospital or a water treatment authority or other tax-exempt entity would be unfair.

As a result of the Treasury's proposals in the FY 2005 budget, however, there will be at least three serious consequences for tax-exempt entities.

- The options available to tax-exempt organizations for acquiring equipment and raising capital are reduced. This loss of flexibility makes efficient management more difficult. Strategies such as privatization and public-private financings will be severely limited.
- The cost of acquiring equipment and raising capital will increase for tax-exempt entities. The results will include delayed or deferred capital expenditures, personnel layoffs and increases in fares/costs for services.
- Tax-exempt entities, organizations that make up a significant portion of the economy and provide needed services, will not have the necessary access to productive modern equipment.

CONCLUSION

As it has for over forty years, the association is prepared and willing to work with Congress as it considers legislation in the tax-exempt leasing area. No major policy change with broad effect should be made without careful consideration of the impact on a significant sector of the economy, the people who rely on tax-exempt organiza-

tions for quality service, on a major financial services industry and on the manufacturers of equipment and software.

The value of leasing is that it makes what Congress intended work—investment—productivity—growth—jobs. Congress has *never* said:

- “We want to incent investment, but not for tax-exempt organizations.”
- “We want a free market with business and financing options and alternatives, but not for tax-exempt organizations.”
- “We want to encourage the development and use of technology in our economy, but not for tax-exempt organizations.”
- “We want American businesses to be more global, to export what they make or do, but you cannot use the traditional elements of the tax code to do it.”
- “We want to encourage public-private partnerships, but let’s so unlevel the playing field they will not work.”
- “We want to encourage and even mandate upgrades and improvement in public safety systems, but increase the cost to the agencies who have to do it.”

The association wishes to express its appreciation to the Congress for its serious attention to these comments. For those who have an interest in greater information we recommend that they go to the following web sites.

<http://www.elaonline.com/GovtRelations/Federal/>
<http://www.elaonline.com/Leasing4USA/>

National Association of Realtors®
 Washington, DC 20001
February 26, 2004

Honorable Bill Thomas
 Chairman
 Committee on Ways and Means
 1100 Longworth House Office Building
 Washington, D. C. 20515

Dear Mr. Chairman:

Pursuant to your request for comments on the President’s FY 2005 Budget, the NATIONAL ASSOCIATION OF REALTORS® (NAR) wishes to draw your attention to two proposals of interest to our members. NAR represents nearly one million Realtors® who are engaged in real estate activities such as sales, leasing, property management, brokerage and commercial property investment. Realtors® also are active in their communities and seek to expand homeownership opportunities in them.

Affordable Housing

The President’s budget proposal recommends a tax incentive designed to spur the production of affordable housing. Despite the vigor of the housing market in recent years, one category of purchasers has been underserved. There is a shortage of housing stock available for purchase by individuals and families below the median income level for their communities. In many cases these individuals are the teachers, firemen and police officers who provide significant services to communities they cannot afford to live in. One Realtor® has characterized the problem succinctly: “We are losing our stock of entry level housing.”

President Bush has proposed a tax credit designed to attract housing capital to areas where, under current market conditions, the cost of constructing or rehabilitating properties exceeds the amount that could reasonably be charged as a fair market purchase price for the community. For example, in an older, inner-ring suburb, the cost to develop housing units might be \$130,000 per unit, but a fair market value purchase price might be \$105,000. The President’s proposal would provide a tax credit designed to cover the gap. The tax credit would be administered by state housing agencies. The pay-out period for the credit would be five years.

The President’s proposal follows the model of the very successful Low Income Housing Tax Credit (LIHTC) of Section 42. The General Accounting Office has audited many LIHTC projects and has found the program to be efficient, effective and, as a general matter, not susceptible to fraud. The President’s proposal provides significant safeguards to assure that housing is constructed where it is needed and where it will contribute to community renewal objectives.

A coalition of 40 groups has come together to seek enactment of this proposal, embodied in H.R. 839. This bill was originally introduced by Messrs. Portman and

Cardin and several other members of your Committee. As of February 20, 2004, the bill has 250 cosponsors that represent the full range of perspectives across the entire political spectrum. Companion bills in the Senate (S. 875 and S. 198) together have more than 40 cosponsors, again reflecting bipartisan support. Bipartisan majorities of the Ways and Means Committee, the Senate Finance Committee and of the House and Senate Committees with jurisdiction over housing programs are represented among that wide cosponsorship.

NAR recognizes that the President's proposal carries a substantial revenue estimate. An NAR representative serves on the steering committee of the coalition supporting the credit. NAR has discussed with other coalition members ways to reduce the cost of the proposal. NAR is eager to work with you, your staff and other coalition members to address revenue concerns. Our highest priority is to facilitate the prompt enactment of the President's proposal.

Under the terms of H.R. 839, projects could be undertaken in central cities, suburbs and rural areas. Projects in census tracts that satisfy certain demographic requirements are eligible to apply to the state housing agency for an allocation of the tax credit. The agencies would grant allocations based on statewide needs. The allocation requirements and numerous other features of the legislation are designed to prevent abuses. The goal is to provide a mechanism that has numerous safeguards that is nonetheless flexible enough to attract capital to neighborhoods where it is currently difficult to attract housing capital.

Realtors® have a significant stake in this legislation. For the past few years, Realtors® have found that it is easier for a family of modest means to qualify for a mortgage than it is for that family to find a suitable house to purchase. The financial marketplace has worked efficiently to design mortgage products that those of modest means can afford. The housing marketplace, however, has not provided sufficient amounts of housing, either newly-constructed or rehabilitated, to meet the needs of qualified lower-income buyers. Realtors® are committed to expanding homeownership opportunities for all Americans. The ideal of homeownership will remain out of reach for a substantial group of otherwise qualified Americans, however, if the available supply of decent, affordable housing is not increased.

Polling data demonstrate both the widespread concerns about the availability of affordable housing and the willingness of voters to support affordable housing initiatives for their communities. When asked "How concerned are you about the cost of housing in your area?" two-thirds of respondents said that they were very concerned or somewhat concerned. When asked to evaluate the statement "I would like to see government place a higher priority on making housing—both for renters and homeowners—more affordable in my area," a total of 71% agreed with the statement. Notably, 51% of respondents said that they *strongly* agreed with the statement. Two-thirds of respondents said that commitment to affordable housing would be an important determinant of their choices of candidates.¹

NAR urges the Committee to act on President Bush's proposal and H.R. 839. There is a great need for this tax incentive as a mechanism that would increase the available inventory of affordable and entry-level housing.

Capital Gains

President Bush recommends a change to the computation of depreciation recapture as a component of capital gains measurements. NAR wishes first to express its ongoing and fervent opposition to the depreciation recapture changes that were made in 1997. Prior to 1997, previously-allowed depreciation deductions on both residential and nonresidential property were treated as capital gains when a property was sold. The capital gains rate was applied to gain in excess of the adjusted basis. (Before 1986, when capital gains were partially excluded from income, the depreciation recapture amounts were eligible for the same exclusion as all other gain.) Since 1997, however, the depreciation deductions are treated as neither capital gains nor ordinary income and are taxed at a fixed rate of 25%. NAR continues to believe that the appropriate treatment of these amounts is to afford them capital gains treatment.

The President's proposal would reclassify the depreciation recapture amount. One-half would be treated as capital gains income and one-half would be treated as ordinary income. The effect of this change is that taxpayers in the top income tax bracket (currently 35%) would experience no change in the effective tax rate on the recapture amount. That rate would remain 25%. Taxpayers in brackets below 35% would experience a very modest reduction in the effective tax rate on their recapture amounts.

¹Survey conducted by Public Opinion Strategies, August 2003.

So far, so good. We note, however, that if, at any time, marginal tax rates on ordinary income exceed 35%, individuals who sell investment real estate will experience a *tax increase* on their recapture amounts. NAR is concerned about this possibility. Not only do we believe that current law related to depreciation recapture is incorrect, but we see the possibility under current law that the tax rate on recapture would increase should the Bush tax cuts expire. Moreover, we see the President's proposal as one that offers either a half-full or half-empty glass to real estate. In bifurcating the recapture amount into ordinary and capital gains amounts, the proposal presents an opportunity to future Congresses to either restore capital gains treatment to the full recapture amount (which we would eagerly support) or to treat the full recapture amount as ordinary income (which we would oppose).

NAR will not oppose the President's proposal. We do wish, however, to make the Committee aware of the long-term implications of the concept. Our members viewed the reduction of the capital gains rate to 15% as a positive development, but remained disappointed that the recapture tax rate was not reduced by a commensurate amount. This proposal would create the possibility of increased recapture burdens should tax rates change.

The NATIONAL ASSOCIATION OF REALTORS® appreciates this opportunity to present its views to the Committee. We look forward to working with you and your staff.

Sincerely,

Jerry Giovaniello
Sr. VP, Government Affairs

Statement of the R&D Coalition

Chairman Thomas, Ranking Member Rangel and members of the Committee:

The R&D Credit Coalition appreciates the opportunity to share its views with the committee on the provision in President Bush's proposed FY 2005 Budget that would make permanent the federal R&D tax credit.

The R&D tax credit is key to the ability of companies to continue creating jobs in the United States. Growth in jobs and in the economy depend on growth in U.S. R&D spending. This important tax credit, which encourages companies to create more R&D jobs in the U.S., should be permanent, and the Coalition applauds the President for again demonstrating a strong commitment to making the credit permanent. Many members of Congress share this commitment and a permanent extension of the R&D credit has long been championed on a bipartisan basis by members of this committee.

First, and foremost, it is imperative that Congress act to extend and strengthen the R&D credit before its scheduled June 30, 2004 expiration. Expiration of this credit, even with a retroactive extension, is extremely disruptive to businesses with research projects in the pipeline. Further, the effect of an expiration of the credit could be felt in the financial markets this year as companies adjust their financial statements to factor in a higher cost of their research projects.

The President's budget proposal, in addition to recommending the permanent extension of the credit, also acknowledges the need to assess whether modifications to the credit are necessary and directs the Treasury Department to study the credit and ways to improve its incentive effect. The Coalition looks forward to working with the Treasury Department and the Congress in this endeavor.

We submit for consideration in this regard the following recommendations that the hundreds of research-intensive businesses and organizations in the Coalition strongly support. We believe that an extension of the R&D credit coupled with the changes we recommend will address the most pressing concerns that face the business community now and will help ensure that as we continue to strive for the ideal research incentive we do not disrupt research projects already underway.

Recommendations

The Coalition's members—who are unified in support of a permanent and strengthened research tax credit—recommend that, first, the R&D tax credit be made permanent and that the current Alternative Incremental Research Credit (AIRC) rates be increased to improve the effectiveness of the AIRC. The Administration pointed out in its budget, and we want to underscore, that permanence is essential to the effectiveness of this credit.

Research and development projects typically take a number of years and may even last longer than a decade. The continued uncertainty surrounding the credit

has induced businesses to allocate significantly less to research than they otherwise would if they were assured the tax credit would be available. This uncertainty undermines the purpose of the credit and has stifled its full potential for inducing research spending. For the government and the American people to maximize the return on their investment in U.S.-based research spending, this credit must be made permanent.

In addition, we recommend a new alternative simplified credit that will allow taxpayers to elect to calculate the R&D credit under computational rules. Although the current-law regular R&D tax credit is still an effective incentive for many companies, the combination of the base period and business cycle changes, has resulted in many companies that incur significant research expenditures being unable to claim any credit. To help solve part of this problem Congress enacted the AIRC in 1996 and our recommended alternative elective credit will help address the rest of that problem.

Under current law, both the regular credit and the AIRC are calculated by reference to a taxpayer's gross receipts, a benchmark that could produce certain anomalous results. For example, many taxpayers are no longer able to qualify for the regular credit, despite substantial R&D investments, because their R&D spending relative to gross receipts has not kept pace with the ratio set in the 1984-88 base period, which governs calculation of the regular credit. This can happen, for example, simply where a company's sales increase significantly in the intervening years, where a company enters into a new line of business that generates additional gross receipts but involves little R&D, or where a company becomes more efficient in its R&D processes.

We recommend that taxpayers be permitted to elect, in lieu of the regular credit or the AIRC, a credit that would equal 12 percent of the excess of the taxpayer's current year qualified research expenditures ("QREs") over 50 percent of the taxpayer's average QREs for the 3 preceding years. Unlike the regular credit and the AIRC, this credit calculation does not involve gross receipts.

The R&D Credit Coalition is committed to working with the Bush Administration and the Congress to achieve the important goal of growth in the economy that comes from growth in R&D spending and the high-wage jobs that are created in the United States.

