HEARING ON CORPORATE TAX REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

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HEARING ON CORPORATE TAX REFORM

TUESDAY, MAY 9, 2006

U.S. House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:05 p.m., in room 1100, Longworth House Office Building, Hon. Dave Camp (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
April 19, 2006
SRM–8

CONTACT: (202) 226–5911

Camp Announces Hearing on Corporate Tax Reform

Congressman Dave Camp (R–MI), Chairman, Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on corporate tax reform. **The hearing will take place on Tuesday, May 9, 2006, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 p.m.**

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

BACKGROUND:

A recent Congressional Budget Office (CBO) study shows that in 2003 the United States has the third-highest statutory corporate tax rate among members of the Organization for Economic Co-operation and Development (OECD). Overall, the U.S. corporate tax system raised $278 billion in 2005 (representing 2.3% of U.S. GDP). Despite this high tax rate, the amount of revenue as a percentage of GDP raised by the U.S. system is modest in comparison to other countries that employ *lower* corporate tax rates. In comparison to the U.S. model, corporate tax regimes in other OECD countries raise, on average, tax revenue equal to 3.4% of their country's GDP.

Further, it is observed that reporting requirements for income taxes are rapidly diverging from parallel requirements for purposes of financial reporting. This divergence greatly increases complexity for corporations. A large number of these book-tax differences can be attributed to specific tax-preference items which benefit narrow classes of taxpayer.

In sum, critics argue that the U.S. corporate tax system taxes more, raises less revenue, and imposes significantly more complexity upon taxpayers than the tax code of competing countries.

In announcing the hearing, Chairman Camp states, "This hearing provides us with an opportunity to examine the current U.S. corporate tax system and the base upon which taxes are imposed. We seek to reform business taxation in a way which increases fairness, decreases complexity and improves the U.S. competitiveness on a global basis."

FOCUS OF THE HEARING:

The purpose of this hearing is to understand how tax-preference items within the corporate tax code reallocate the tax burden and whether these shifts are beneficial or detrimental to the U.S. economy. Of specific interest is to understand how the current system affects a company's decision of where and how to invest in technology, equipment and people.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Tuesday, May 23, 2006. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item 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 submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies 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 submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission 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.

Chairman CAMP. The hearing will come to order.

Today's hearing continues our examination of tax reform issues. In this case, we seek to explore the role tax laws may play in influencing corporate investment and business development in the United States. The way we tax business activity, I think we all agree, impacts, how, in what quantity, and where jobs are created. We have an extremely distinguished group of witnesses from both the academic and business worlds with us today, and I am sure my colleagues join me in saying how much we appreciate their time.

This hearing is simply to gather information. There is no predetermined or preferred outcome. Instead, we have asked our guests to examine certain influences business taxes provide. We can all agree that the Tax Code has grown more complex over the years, and making sure our tax system does not choke off economic growth requires us to explore how businesses react to tax law in today's economy.

Our first panel includes distinguished academics and professionals from around the country, who will provide perspectives on subjects such as the effect of differences in tax and financial accounting, the importance of corporate rates, and incentives to expand investment. This is an opportunity to explore points of view on broad topics we will need to consider in any kind of reform program.

Our second panel is comprised of businesspeople, who will give us insights on influences they see and face in making decisions about how and where to invest. This is a chance for us to ask questions about what really makes a difference when it comes to growth in jobs.

This hearing is a chance to learn about what influences the economy. Every Member of this Subcommittee shares a desire for a smart tax system that will give this country a sustainable, robust economy. Our guests are well situated to help us in that quest, and with that, I turn to our Ranking Member, Mr. McNulty, for any remarks he may wish to make.

Mr. MCNULTY. Thank you, Mr. Chairman. I also thank the panels.

Reform of our corporate tax structure is an issue that has been discussed for years with little substantive progress. In January 2005, President Bush created the bipartisan President's Advisory Panel on Federal Tax Reform. On November 1, 2005, after 10 months of meetings and studies, the Panel issued its report to the Department of the Treasury for its consideration. I had hoped that Treasury would be our lead witness at the hearing today, to discuss the Department's views on the viability and appropriateness of the President's panel recommendations. Their decision not to testify today is disappointing.

As we discuss corporate tax reform today, I must emphasize that our country continues to face record Federal deficits and that the national debt has ballooned to more than $8.3 billion. The Committee on the Budget has estimated that the deficit for fiscal year 2006 will be $372 billion and for fiscal year 2007 will be $348 billion. For the sake of our children and grandchildren, this practice of deficit spending cannot be allowed to continue.

I hope that this hearing and any future tax reform plan will not serve as platform for more tax cuts for corporations. We have an obligation to future generations to reduce the Federal deficit, not increase it. Finally, I want to thank Chairman Camp for working with me and the Democratic staff of the Subcommittee, on a bipartisan basis, to develop an excellent list of witnesses for this hearing. I look forward to our discussion of issues that must be considered in any future corporate tax reform package. Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman CAMP. Thank you very much, and now, we will go to our first panel. We have Mihir Desai, Ph.D. Associate Professor from Harvard Business School; Ronald Pearlman, Professor of Law at Georgetown University Law Center; Thomas Neubig, National

Director of Quantitative Economics and Statistics at Ernst & Young; Douglas Shackelford, Professor of Taxation of Accounting, University of North Carolina; Samuel Thompson, Jr., Professor of Law and Director, Law Center, University of California, Los Angeles.

Each of you will have 5 minutes to summarize your testimony. Your full testimony will be a part of the record. I want to thank you for taking the time out of your busy schedules to be with us today and want to welcome you to the Committee and look forward very much to hearing your testimony. Dr. Desai, why don't you begin?

STATEMENT OF MIHIR A. DESAI, ASSOCIATE PROFESSOR OF FINANCE, HARVARD BUSINESS SCHOOL

Dr. DESAI. Chairman Camp and Members of the Subcommittee, it is a pleasure to appear before you today to discuss reform alternatives for the corporate tax. I am an associate professor of finance at Harvard Business School and a faculty research fellow of the National Bureau of Economic Research.

In these comments, I want to emphasize possibilities for corporate tax reform that do not involve fundamental tax reform or significant marginal tax rate reductions. While both fundamental tax reform and lower marginal rates are laudable for various, well understood reasons, I want to highlight three reforms to the corporate tax that are somewhat more piecemeal but still can yield significant economic benefits to the country. I believe that reforming the corporate tax as outlined in my comments will generate significant efficiency gains, would improve the competitive position of American firms in the worldwide markets in which they operate, and would create a more transparent and cost-effective reporting system for American firms and investors.

Three changes to the corporate tax are discussed at length in my written testimony, and I briefly summarize them here. First, capital gains earned by corporations are currently penalized in an anomalous way relative to intercompany dividends and relative to individual capital gains. Effectively, the current system of corporate capital gains taxation creates a third layer of taxation on capital.

While intercompany dividends are afforded relief through the dividends received through deductions, puzzlingly, no such relief exists for capital gains earned by corporations. For companies with large gains, this creates a significant disincentive to reinvest these gains in new projects, effectively locking up this capital. This system significantly influences business investment, as estimates indicate that American corporations hold over $800 billion in unrealized corporate capital gains.

This anomalous treatment also stands in contrast to the approach adopted by several other countries. Unlocking these gains through even partial tax relief would result in reallocations of capital toward more productive uses that would generate efficiency gains that are estimated to be as high as $20 billion a year.

Second, the system of taxing foreign source income, or the income earned by multinational firms abroad, should be reconsidered. Foreign operations are increasingly important to American firms, with more than 30 to 40 percent of corporate profits coming from their tightly integrated global operations. With the growth of markets abroad, these shares will only rise further.

The annual burden of the current worldwide system of taxation on American firms is conservatively estimated in my research at $50 billion a year. The current worldwide system of taxation conforms neither to traditional efficiency benchmarks or to more recent measures grounded in modern notions of multinational decisionmaking. In particular, recent research highlights that international tax rules distort which companies own what assets and that these distortions matter for productivity and efficiency. For example, assets that should be owned by the most productive owner are not because of tax distortions associated with the country of origin of that owner. Something that should be owned by Wal-Mart because of tax considerations is instead owned by a French company, Carfour. An emphasis on these distortions to ownership patterns provides a rationale for a move toward a territorial system of taxation that would bring the United States closer to the system employed by many other countries.

Finally, the reporting system used in corporate taxation should be restructured to bring reporting to tax authorities in line with reporting to capital markets. Currently, corporations must characterize their income in two distinct ways to tax authorities and capital markets, the so-called dual books system. Reconciliation of these reports is only available to tax authorities. Unsurprisingly, this has resulted in two completely different portraits of profitability.

This dual system creates significant confusion, as it is impossible to infer corporate tax payments from public financial statements or, for that matter, to truly understand corporate profitability. Imagine if something that represented one-third of a company's costs was hidden to investors. This is what the current system effectively does. This system also creates latitude for opportunistic managers to take advantage of the discrepancy in a way that does not advance the interests of shareholders.

At a minimum, reporting taxes paid in public financial statements is advisable. More ambitiously, corporations could simply pay taxes on income reported according to GAAP. Significant compliance costs currently incurred would be nearly eliminated. The top marginal corporate tax rate could be reduced significantly to 15 percent without a loss of revenue, and actions designed to exploit differences between these two different reporting systems would be eliminated.

Significant opportunities for corporate tax reform exist by reconsidering the base of corporate taxation; in particular, the treatment of corporate capital gains and foreign source income, and by reconsidering the curious reporting practices for corporate profits. These changes, while piecemeal relative to fundamental tax reform, still have sizeable consequences for economic efficiency that will be manifest in more productive allocations of capital, reduced compliance costs, and ultimately in greater incomes for American workers.

Thank you for this opportunity, and my written testimony elaborates these points with references to the underlying research.

[The prepared statement of Dr. Desai follows:]

Statement of Mihir Desai, Ph.D., Associate Professor, Harvard Business School, Cambridge, Massachusetts

Chairman Camp and members of the Subcommittee, it is a pleasure to appear before you today to discuss reform alternatives for the corporate tax. I am an Associate Professor of Finance at Harvard Business School and a Faculty Research Fellow of the National Bureau of Economic Research.

In these comments, I want to emphasize possibilities for corporate tax reform that do not involve fundamental tax reform or significant marginal tax rate reductions. While both fundamental tax reform and lower marginal rates are laudable for various well-understood reasons, I want to highlight three reforms to the corporate tax that are somewhat more piecemeal but still can yield significant economic benefits to the country. I believe that reforming the corporate tax as outlined below would generate significant efficiency gains, would improve the competitive position of American firms in the worldwide markets in which they operate, and would create a more transparent and cost-effective reporting system for American firms and investors.

Three changes to the corporate tax are discussed at length below and I briefly summarize them here.

First, capital gains earned by corporations are currently penalized in an anomalous way relative to intercompany dividends and relative to individual capital gains. Effectively, the current system of corporate capital gains taxation creates a third layer of taxation on capital. This system significantly influences business investment as estimates indicate that American corporations hold over $800 billion in unrealized corporate capital gains. This anomalous treatment also stands in contrast to the approach adopted by several other countries. Unlocking these gains through even partial tax relief would result in reallocations of capital toward more productive uses that would generate efficiency gains that are estimated to be as high as $20 billion a year.

Second, the worldwide system of taxing foreign source income—or the income earned by multinational firms abroad—should be reconsidered. Foreign operations are increasingly important to American firms with more than thirty percent of profits coming from their global operations. The annual burden of the current system on American firms is conservatively estimated in our research at $50 billion a year. The current system conforms neither to traditional efficiency benchmarks nor to more recent measures grounded in modern notions of multinational decision-making. In particular, recent research highlights that international tax rules distort which companies own what assets and that these distortions matter for productivity and efficiency. An emphasis on these distortions to ownership patterns provides a rationale for a move toward a territorial system of taxation that would bring the U.S. closer to the system employed by many other countries.

Finally, the reporting system used in corporate taxation should be restructured to bring reporting to tax authorities in line with reporting to capital markets. Currently, corporations must characterize their income in two significantly different ways to tax authorities and capital markets. Unsurprisingly, this has resulted in two completely different portraits of profitability. This dual system creates significant confusion as it is impossible to infer corporate tax payments from public financial statements or to truly understand corporate profitability. This system also creates latitude for opportunistic managers to take advantage of this discrepancy in a way that does not advance the interests of shareholders. At a minimum, reporting taxes paid in public financial statements is advisable. More ambitiously, if corporations simply paid taxes on reported GAAP income, significant compliance costs would be nearly eliminated, the top marginal corporate tax rate could be reduced significantly to 15% without a loss of revenue, and actions designed to exploit differences between these two reporting systems would be eliminated.

Significant opportunities for corporate tax reform exist by reconsidering the base of corporate taxation—in particular, the treatment of corporate capital gains and foreign source income—and by reconsidering the curious reporting practices for corporate profits. These changes, while piecemeal relative to fundamental tax reform, still have sizable consequences for economic efficiency that would be manifest in more productive allocations of capital, reduced compliance costs, and, ultimately, in greater incomes for American workers.

I. Fixing the anomalous treatment of corporate capital gains [1]

The appropriate taxation of capital income has preoccupied policy makers and scholars for the last half century. Within this debate, the taxation of capital gains has been a central topic. Surprisingly, this emphasis on capital gains has been limited to the role of capital gains at the individual level rather than at the corporate level. This asymmetry may have arisen due to a perception, unsupported by the evidence, that corporate capital gains were of a small magnitude relative to other sources of corporate income or relative to individual capital gains. In fact, reviewing the magnitude of corporate capital gains, the distortionary effects of corporate capital gains taxation, and the efficiency and revenue consequences of alternative treatments of corporate capital gains recommends a reconsideration of this aspect of the tax code.

Corporate capital gains make up an increasingly large portion of corporate income, now comprising approximately 20% of corporate income subject to tax, and one third of the dollar amount of taxable individual capital gains. The late 1990s and early 2000s saw a significant increase in the level of unrealized corporate capital gains. A modest estimate of unrealized corporate capital gains exceeds $800 billion.

When considered within the broader nature of capital taxation, the current system of taxing corporate capital gains appears anomalous. In particular, dividends and capital gains earned by corporations are treated asymmetrically, and the absence of relief for corporate capital gains results in a third level of taxation on capital income. Individual capital gains are taxed at preferential rates, in recognition of the importance of encouraging corporate investment and mitigating the impact of situations in which investors are "locked into" investments they would prefer to sell were it not for the associated capital gains taxes. Despite both considerations applying with equal or greater force to corporate investments, corporate capital gains are currently taxed at ordinary income rates. Many other countries exempt from tax corporate capital gains or tax them at preferential rates, further contributing to the anomalous nature of current U.S. tax policies.

The corporate capital gains tax has a variety of distortionary effects in addition to those usually considered with respect to the individual capital gains tax. For example, foreign and domestic investors are taxed differently, thereby affecting the pattern of asset ownership. Additionally, corporations respond to the corporate capital gains tax with a variety of tax planning activities that have distortionary effects.

A variety of alternatives exist to the current practice of taxing corporate capital gains at the same rate as ordinary income. The efficacy of any alternative depends on the responsiveness of corporate capital gains realizations to tax rates. Measured elasticities of corporate capital gains realizations to tax rates are higher than individual elasticities, giving rise to greater potential efficiency gains associated with reduced tax rates. The reduced "lock-in effect" associated with a reduction in the corporate capital gains tax rate to 15% would produce annual efficiency gains of $16.7 billion a year. Repealing the corporate capital gains tax entirely would eliminate the "lock-in effect" and thereby produce an efficiency gain of $20.4 billion a year. In addition, these reduced corporate capital gains tax rates would generally reduce the tax burden on corporations, improving efficiency by encouraging greater corporate investment.

While seemingly abstract, these large efficiency gains can be understood as a measure of economic surplus or income that is currently foregone because of the presence of this taxation. These improvements in economic efficiency correspond to increases in national income and corresponding increases in wages. Tax relief of various stripes has the potential to generate sizable efficiency gains relative to lost tax revenue. Several features of corporate capital gains taxes suggest that corporate capital gains tax relief has the potential to produce significant efficiency gains. The greater responsiveness of corporations to taxation, interactions with other financing frictions, and the preexisting distortions in the taxation of capital income suggest that alternative, less onerous treatments of corporate capital gains have the potential to yield greater efficiency gains, relative to revenue consequences, than other sources of tax relief.

II. Reconsidering the worldwide system of taxation [2]

Markets and economies evolve continuously, making yesterday's tax solutions possibly much less efficient or desirable today. Time also brings changes in our under-

[1] See Desai and Gentry (2003) and Desai (2006) for more details.

[2] This section draws on Desai and Hines (2004) and the details of the efficiency calculations can be found there. Other arguments for reconsidering the tax treatment of foreign source in-

standing of the impact, and wisdom, of different tax choices, again carrying the message that what might have seemed to work for yesterday may not be sensible today. A rapidly integrating world and a wave of recent scholarship on multinational firms combine to suggest that the mismatch between yesterday's tax policy and today's reality is particularly pronounced with respect to international taxation.

The rising economic importance of international transactions has put increasing pressure on corporate tax systems to accommodate foreign considerations. This accommodation has not been an easy or simple process. In many countries, particularly high-income countries such as the United States, corporate tax provisions are designed on the basis of domestic considerations. Subsequently, modifications intended to address problems and opportunities that arise due to global capital and goods markets are incorporated, often as afterthoughts. While such a method of policy development has the potential to arrive at sensible outcomes, doing so requires greater degrees of luck and patience than most would care to attribute to existing political systems.

Several recent developments have contributed to a growing sense of unease over the structure of U.S. corporate taxation, particularly its international provisions, and have prompted calls for reform. The European Union successfully challenged export subsidies embedded in the U.S. corporate income tax, leading the World Trade Organization to authorize tariffs on American exports. Reported cases of corporate malfeasance and the aggressive use of tax shelters have drawn attention to the tax avoidance activities of many corporations, with particular attention on the role of tax havens. The difficulty of spurring investment through traditional channels has frustrated policymakers intent on reversing the large loss in manufacturing jobs in the early 2000s. These events have each contributed to an increasing dissatisfaction with the structure of corporate taxation, and at the same time reflect the insufficiency of evaluating corporate taxes on the basis of strictly domestic considerations. The international tax provisions at the center of the trade dispute are emblematic of immensely complex international rules appended to a corporate tax system designed primarily with domestic activity in mind.

Successful corporate tax reform requires the corporate income tax to be placed firmly in an international setting, which is not currently the case in the United States. To be sure, the U.S. corporate income tax includes many provisions concerning the taxation of foreign income, but these provisions largely reflect attempts to apply the logic of domestic taxation to foreign circumstances. As a consequence, the current U.S. corporate income tax includes foreign provisions that distort taxpayer behavior and impose significant burdens on international business activity, particularly given the greater mobility of international business activity. A simple framework for considering the burden of this tax system indicates that the current system imposes a burden of approximately $50 billion a year.

Assessing the burden of the current system is useful but does not provide guidance on how international considerations might be better incorporated into a reform of corporate taxation. Incorporating realistic assumptions about the nature of multinational firm activity yields some novel analyses of what constitutes efficient systems. These analyses imply that efficiency requires that foreign investment income face no residual tax upon repatriation. From the standpoint of countries (such as the United States) that employ a worldwide regime and impose residual repatriation taxes, a reduction in the tax burden on foreign income would not only improve national welfare but also improve world welfare. Consequently, a movement to reform corporate taxation in the direction of exempting foreign income has a compelling logic. Of course, the history of taxation in the United States and elsewhere offers many examples of persistent differences between what countries do and what they should do. Nonetheless, thinking clearly about the burden of the current system and the appropriate efficiency benchmarks provides the foundation for closing the gap between old rules and new realities.

In order to evaluate the wisdom of current U.S. taxation of foreign income it is necessary to consider appropriate welfare standards. While there is a timeless quality to the economic principles that form the basis of efficient tax policy design, the application of these principles to the taxation of foreign income has varied over time, and in particular, has undergone a significant recent change. Until recently, three benchmarks were commonly used to evaluate the efficiency of international tax systems: capital export neutrality (CEN), national neutrality (NN) and capital import neutrality (CIN).

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come can also be found at Desai (2004) and the slides entitled "Taxation and Global Competitiveness" prepared for the President's Advisory Panel on Federal Taxation available at www.taxreformpanel.gov/meetings/docs/desai.ppt.

CEN is the doctrine that the return to capital should be taxed at the same total rate regardless of investment location, with the idea that adherence to CEN promotes world welfare. A system of worldwide taxation with unlimited foreign tax credits satisfies CEN, since then foreign and domestic investments are all effectively subject to the same (home country) tax rate, and firms that maximize after-tax returns under such a system thereby also maximize pretax returns. NN is the doctrine that foreign investment income should be subject to home country taxation with only a deduction for foreign taxes paid. The idea behind NN is that home countries promote their own welfare by subjecting foreign income to double taxation, thereby discouraging all but the most productive foreign investments, and retaining investment capital for use at home. Thirdly, CIN emphasizes that the return to capital should be taxed at the same total rate regardless of the residence of the investor. Pure source-based taxation is consistent with CIN, as long as individual income tax rates are harmonized to ensure that the combined tax burden on saving and investment does not differ among investors residing in different countries.

These traditional welfare benchmarks suffer from a number of shortcomings. CIN offers little guidance for the design of a single country's system of taxing foreign income, since its application requires simultaneous consideration and coordination of corporate and personal taxes in all countries in the world. While CEN and NN do not suffer from this shortcoming, they have other worrisome features. Tax policies adopted by other countries matter not at all in determining whether a country's tax system conforms to CEN, which seems an unlikely feature of a benchmark that is intended to characterize policies that promote global efficiency. Tax policies that implement NN would subject foreign investment income to punishing home country taxation, thereby discouraging multinational business operations and, as a realistic matter, more likely reduce rather than advance home country welfare. As an empirical matter, such policies have not been adopted by any major capital-exporting nation. Moreover, a very common policy approach—exempting foreign income from taxation—is incongruent with any of these welfare benchmarks.

CEN, NN, and CIN rely on the intuition that FDI represents the transfer of net savings between countries. This characterization of FDI was discarded long ago by the scholarly community that studies multinational firms. Instead, modern scholars view FDI as arising from differential capabilities, and consequently differential productivity, among firms, and the extension of intangible assets across borders. This intuition squares well with empirical FDI patterns, which include the fact that most of the world's FDI represents investment from one high-income country into another, and the fact that a very high fraction of such investment takes the form of acquiring existing businesses. Consequently, most FDI represents transfers of control and ownership, and need not involve transfers of net savings. This emphasis on transfers of ownership, and the productivity differences that drive ownership patterns, implies that CEN, NN, and CIN do not characterize optimal tax systems, whereas other welfare benchmarks do. The modern view of FDI as arising from productivity differences among firms, with ownership changes taking the form of FDI, raises the possibility that greater outbound FDI need not be associated with reduced domestic investment. Indeed, it is conceivable that greater outbound FDI is associated with greater domestic investment, either by home country firms undertaking the FDI or by unrelated foreign investors. Under this view, in short, multinational firms are not engaged in the reallocation of the capital stock as much as they are engaged in the reallocation of ownership and control of existing capital stocks.

This emphasis on ownership suggests that tax policies should be evaluated on the basis of their effects on the allocation of ownership of productive assets. Global efficiency is characterized by ownership arrangements that maximize total world output, whereas national welfare (taking the tax policies of other countries as given) is characterized by tax policies that maximize home country incomes. This perspective yields the welfare benchmarks of capital ownership neutrality (CON) and national ownership neutrality (NON), in which CON is a direct analogue to CEN, and NON a direct analogue to NN. CON requires that tax rules not distort ownership patterns, which is equivalent to ownership of an asset residing with the potential buyer who has the highest reservation price in the absence of tax differences. As a practical matter, CON is satisfied by conformity among tax systems, including situations in which all countries exempt foreign income from taxation, and situations in which all countries tax foreign incomes while providing complete foreign tax credits. The national welfare considerations that form the basis of NON suggest, much as is evident in practice, that countries should want to exempt foreign income from taxation. This policy prescription stems from the observation that outbound foreign investment need not be accompanied by reduced domestic investment in a world of shifting ownership patterns. As a result, countries have incentives to select tax rules that maximize the productivity of foreign and domestic investment, since doing so improves tax collections as well as private incomes. When both capital stocks and ownership claims are affected by tax rules, then NON need not correspond exactly to maximizing national welfare, and home countries might benefit from imposing modest taxes on foreign investment.

The CON/NON framework places productivity differences among multinational owners, and the transfers of control induced by tax rules, front and center in analyzing the efficiency of taxation. The relevance of such a framework depends on the degree to which such differences matter relative to the actual transfers of net saving emphasized in the CEN/NN/CIN framework. That scholars who study multinationals have dismissed the view of FDI as transfers of net savings as neither satisfying theoretically nor confirmed empirically suggests that employing welfare frameworks that rely exclusively on such notions is incomplete at best. That incorporation of modern interpretations of FDI produces tax policies that countries actually use further suggests the importance of these alternative frameworks.

The CON/NON paradigms carry direct implications for U.S. taxation of foreign income. The NON logic implies that the United States would improve its own welfare by exempting foreign income from taxation, rather than, as it does now, subjecting foreign income to taxation imposing significant burdens on American firms. In addition, should it be relevant to American policy, CON implies that a reduction of U.S. taxation of foreign income would improve world welfare by moving U.S. taxation more in the direction of other countries that currently subject foreign income to little or no taxation.

Improving the taxation of foreign investment income requires abandoning the notion of international tax provisions as appendages to a domestic corporate tax. At first glance it is perfectly logical to posit that, given that the U.S. tax system requires American companies to remit 35 percent of their taxable incomes to the U.S. government, the same type of taxation should apply to foreign income. Unfortunately, the realities of a competitive world capital market suggest otherwise. U.S. taxation of foreign income impairs the productivity of American firms in the global marketplace, and interestingly, impairs the productivity of investments located in the United States, since it distorts ownership patterns by foreign investors as well as Americans.

It would appear that the current taxation of foreign income, a product of many complex appendages to the domestic corporate tax, imposes significant burdens on U.S. firms. The simple framework developed above suggests that the annual burden on American firms is conservatively estimated at $50 billion a year. The current U.S. tax regime conforms neither to traditional efficiency benchmarks nor to more recent measures grounded in modern notions of multinational decision-making. Ownership based concepts of efficiency imply that national and world welfare would be advanced by reducing U.S. taxation of foreign income, thereby permitting taxpayers and the country to benefit from greater market-based allocation of resources to the most productive owners.

III. Revisiting the Dual Reporting System [3]

IRS Commissioner Mark Everson and SEC Chairman Christopher Cox have advanced a remarkably simple, but controversial, proposal. Discussions are underway to have companies publicly disclose how much they pay in taxes. Remarkably, the amount corporations pay in taxes is impossible to decipher from annual reports. Their proposal, which will likely meet fierce opposition from accountants, lawyers and managers, is a laudable first step in restoring some sanity to the way corporate profits are reported to tax authorities and the capital markets.

Given that thirty-five cents of every pretax dollar is supposed to go the government, one would think that this figure would be easily deduced or that it would be clearly reported. Leading accounting scholars have reviewed the intricacies of tax footnotes of leading companies and cannot answer a simple question: how much did this company pay in taxes? This raises a much larger question: How did we end up in a world where something as important as the amount of taxes paid was obscured from investors?

When the corporate tax was introduced, making reporting profits more credible was a central goal. Indeed, the profits reported to tax authorities and capital markets were essentially the same. As the corporate tax evolved, well-considered exceptions—such as the way investment was expensed—were introduced to permit fiscal policy goals. An investment stimulus might involve accelerating those expenses to

[3] For a more detailed discussion of the dual book system and the gaps between profits reported to capital markets and tax authorities, see Desai (2003, 2005). For a discussion of the ways in which earnings manipulation and tax avoidance are related, Desai and Dharmapala (2005, 2006a, 2006b). For international evidence on these links, see Desai, Dyck and Zingales (2005).

make investment more attractive while accounting standards wouldn't permit such a treatment.

In the last decade, the two reporting systems have developed into parallel universes. Large, unexplained gaps—more than $100 billion—have developed between the profits reported to capital markets and tax authorities that can no longer be explained by accepted differences between the two reporting systems.

In fact, we shouldn't be surprised by these developments. Imagine if you were allowed to represent your income to the IRS on your 1040 in one way and on your credit application to your mortgage lender in another way. You might, in a moment of weakness, account for your income in a particularly favorable light to your prospective lender and go to fewer pains to do so with the IRS. Indeed, you might take great liberties to portray your economic situation in two divergent ways that would serve your best interests. You might find yourself coming up with all kinds of curious rationalizations for why something is income (to the lender) or an expense (to the tax authorities).

In fact, you don't have this opportunity and for good reason. Your lender can rest assured that the 1040 they review in deciding whether you are credit-worthy would not overly inflate your earnings given your desire to minimize taxes. Similarly, tax authorities can rely on the use of the 1040 for other purposes to limit the degree of income understatement given your need for capital. In that sense, the uniformity with which you are forced to characterize your economic situation provides a natural limit on opportunistic behavior.

While individuals are not faced with this perplexing choice of how to characterize your income depending on the audience, corporations do find themselves in this curious situation. Dual books for accounting and tax purposes are standard in corporate America and, judging from recent analysis, are the province of much creative decision-making. Indeed, something as simple as interest expense on debt can be engineered to appear as an expense to tax authorities and a dividend to the capital markets.

This confusing state of affairs has naturally drawn the attention of tax authorities, given the loss of tax revenues, but why is the SEC interested? Indeed, investors might be thought to benefit from lower taxes paid to the government. This simple logic doesn't account for the fact that managers don't always do the right thing for shareholders. If managers are opportunistic, then the extra latitude afforded by the dual reporting system can be costly to investors.

Indeed, research shows just that—actions associated with corporate tax avoidance are not valued by the market unless the firms are well-governed. And, the actors in various corporate scandals—including Enron and Tyco—were expert in exploiting the dual tax system to manufacture accounting earnings. No corporate tax shelter was ever undertaken that reduced book income and, often, the primary benefit of a corporate tax shelter is the reported income it produces.[4]

The proposal to publicly report taxes paid is an eminently sensible idea. More ambitious alternatives should also be considered. Corporate tax returns could be made public so shareholders could benefit from the additional information. More ambitiously still, we could junk the dual book system and simply allow corporations to pay taxes, at a lower rate, on the profits they report to capital markets. Such a change would save corporations and the governments the considerable resources now dedicated to compliance and allow for a lower marginal rate. Rough estimates, elaborated on in Desai (2005), suggest that a 15% tax on reported profits would generate the same revenues as the corporate tax does now. Such a change would embody a central lesson of economics—the virtues of tax with a lower rate on a more sensible base.

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Chairman CAMP. Thank you very much, Dr. Desai. Mr. Pearlman, you have 5 minutes.

STATEMENT OF RONALD A. PEARLMAN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER

Mr. PEARLMAN. Thank you, Mr. Chairman, Members of the Subcommittee. I want to address a couple of topics briefly during my oral comments. The first relates to the seemingly age-old question of whether Congress should improve the business tax system through targeted tax preferences or by means of a reduction in the corporate tax rate. My instinct is that the corporate tax rate reduction most often is preferable to an industry-specific or activity-specific tax preference, or, put another way I think the legislative default should be to eliminate tax preferences and lower corporate tax rates.

I think most tax preferences suffer from three deficiencies. First, they disregard signals the market sends to a business and thus distorts business decisionmaking. Second, tax preferences tilt the playingfield in favor of the beneficiaries of the preference, thereby potentially disadvantaging others, including entrepreneurs in emerging industries or new technologies in the fierce competition for capital. Third, enactment of a new or a continuation of an existing tax preference implies that the preference provides a sufficient quantity of the desired behavior to justify the resulting reduction in tax revenues.

Unfortunately, our collective knowledge of the effectiveness of targeted tax preferences is not well developed. Except for the usual ad hoc advantages offered by supporters, there is not much in the way of impartial empirical analysis supporting the incentive effects. One thing is certain: a tax preference that simply rewards behavior that would occur anyway is a waste of money.

I encourage the Subcommittee to use the occasion of corporate tax reform to question existing tax preferences. Call it zero-based tax reform. Continuation of existing preferences would not be presumed; rather, supporters would have to explain why the alternative of a corporate rate reduction is not in the best interests of U.S. tax and economic policy.

My second topic relates to the deductibility of interest expense on debt incurred by business taxpayers to finance the purchase of capital investment. I decided to discuss this topic because of the relationship between interest deductibility and the cost recovery rules that likely will be an important part of corporate tax reform projects.

A pure income tax subjects a business to tax on its net economic income. It would include a depreciation system that enables a business taxpayer to properly recover its cost in an asset and would allow the taxpayer to deduct interest expense on debt incurred to finance the purchase of the asset. On the other hand, a pure consumption tax exempts income from capital from tax. The exemption is implemented in part by allowing business taxpayers to fully deduct the cost of a capital investment when incurred, a cost recovery approach known as expensing.

The effect of expensing is to exempt income generated by the business asset from tax on a present value basis, assuming a constant rate of return and constant tax rates. Because of this tax exemption, it is inappropriate to permit the business taxpayer to deduct interest expense on debt incurred to finance the acquisition of the expensed asset.

The Growth and Investment Tax Plan recently proposed by the President's Tax Reform Panel provides for the immediate expensing of new business investment, but importantly, it also would deny the deductibility of business interest. The panel report, indeed, refers to the disallowance of interest as an essential component of the plan.

I expect cost recovery alternatives, including forms of accelerated depreciation and expensing, to be prime topics in a corporate tax reform discussion. Permit me to be speculate: expensing will be seen as good and the disallowance of interest as bad, leading to the possible enactment of a business tax package that contains a tax subsidy to which the President's panel referred. The result will be the emergence of a variety of tax shelters and other tax motivated activities that will pose a significant threat to the U.S. tax base.

Distortions from tax preferences and the tax arbitrage for a combination of interest deductibility and accelerated depreciation or expensing encourage business taxpayers that do not have sufficient income to fully utilize the resulting tax benefits to transfer those benefits or at least to attempt to transfer those benefits to other taxpayers who can use them to reduce their tax liabilities or to merge with other taxpayers that are able to use them.

I hope that tax reform of the business tax system will lead us in a more productive direction. Thank you.

[The prepared statement of Mr. Pearlman follows:]

Statement of Ronald Pearlman, Professor of Law, Georgetown University Law Center

Mr. Chairman and Members of the Subcommittee:

My name is Ronald A. Pearlman. I am a Professor of Law at the Georgetown University Law Center, where I teach courses in Federal income taxation.

It is a great privilege to appear before the Subcommittee today. I appear on my own behalf. My comments represent my personal views and not necessarily those of Georgetown University or any other organization with whom I am associated.

I have appeared before the Subcommittee on two prior occasions to address issues relating to corporate tax reform. In 1983, as a representative of the Treasury Department, I discussed problems with the carryover of corporate net operating losses and other tax attributes, and in 1985, I discussed factors relating to the then-current wave of corporate mergers. Today, I would like to comment on two tax reform topics that, at least on the surface, appear to be quite different than the subjects of my prior testimony.

Business Tax Preferences

The first topic that I wish to address involves the recurring question whether Congress should provide tax relief to corporate taxpayers, by which I mean to include all business taxpayers regardless of their form of organization, through targeted tax preferences or by means of periodic reductions in the corporate tax rate.

My instinct, informed by 27 years of experience as a practicing tax lawyer advising clients in many different industries, and ranging in size from small closely-held businesses to large multinational corporations, and by 10 years of assorted tax-related government service, is that corporate tax rate reduction most often is preferable to the enactment of industry-specific or activity-specific tax preferences. Put another way, I think the legislative default policy should be to eliminate tax preferences and lower corporate tax rates.

In May 1985, President Reagan transmitted to the Congress the recommendations that served as the impetus for enactment of the Tax Reform Act of 1986. The summary of President Reagan's proposals stated, "The tax system should, insofar as possible, foster economic growth by . . . allowing resources to be allocated efficiently on the basis of economic rather than tax considerations." In furtherance of this efficiency objective, the Report went onto say, "Special subsidies or preferences for specific industries or sectors should be curtailed except where there is a clear national security interest that argues to the contrary." [1]

Why was efficiency so important to President Reagan? I think it was because he understood that by altering incentives, an industry-specific or an activity-specific tax preference will cause business taxpayers to disregard market forces—or at least alter the influence of market competition on their decisions—thereby adversely affecting the allocation of resources of the particular business and of the Nation.

Not only is a distortion in the business decision making process likely to impose costs on the economy, it also tilts the playing field in favor of one group of businesses over another. The financial advantage of a narrow tax preference may influence how third parties—lenders and equity investors, for example—evaluate competing businesses. The tax preference thereby may create an inappropriate advantage in the marketplace that discourages entrepreneurs in emerging industries or technologies who do not enjoy a comparable tax advantage from successfully competing for capital, thereby stifling U.S. economic growth.

While I admit to a bias in favor of President Reagan's approach to tax reform because of my involvement in the development of the Administration's proposals and my advocacy for their enactment before the Ways and Means Committee, I think our tax system would be much improved if the tax law today more fully reflected his philosophy. However, one does not have to accept a market efficiency analysis to question the appropriateness of narrow business tax preferences.

We might tolerate the economic distortion resulting from a particular preference if we could be reasonably certain that it produces a sufficient quantity of the desired behavior over and above the behavior that would occur absent the existence of the preference. To the extent a tax preference provides a tax subsidy for behavior that would occur anyway, the subsidy is a waste of money that could be expended more productively on new or existing programs, to reduce the deficit, or to provide broad-based tax relief.

Unfortunately, our collective knowledge of the effectiveness of targeted tax preferences is not well developed. Recently, the Director of Strategic Issues for the Government Accountability Office was reported to have bemoaned the lack of research on the true effect of tax incentives.[2] Supporters of a tax preference typically point to an assortment of *ad hoc* examples of the positive impact of the preference and to self-serving supportive assertions by executives about the incentive effect. In the absence of a body of unbiased research regarding the effectiveness of tax preferences or a negative analysis by opponents of a particular preference, Members of Congress, under the pressure of the tax legislative process, understandably tend to accept supportive information as a validation of the preference's effectiveness.

The U.S. business tax system is replete with targeted tax preferences. Some are narrowly targeted, some more broadly. However, in every case, one class of business taxpayers is preferred over another. In the aggregate, the revenue effects of these preferences are substantial. Take for example a small group of tax credits: the credit

[1] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* 5–6 (Gov't Printing Office, May 1985).

[2] Allen Kenney & Dustin Stamper, "Panelists Debate Role, Value of Tax Incentives," 2006 TNT 68–3 (April 10, 2006).

for increasing research activities, popularly known as the research and development or "R&D" tax credit (Section 41 of the Internal Revenue Code); the low-income housing credit (§ 42); the renewable electricity production credit (§ 45); and the nonconventional source fuel credit, more commonly referred to as the Section 29 credit even though the section reference is out of date (§ 45K). Assuming extension of the R&D credit, the combined projected revenue effect of these four credits for a single year (F/Y 2007) is approximately $13.7 billion, and the five-year effect is approximately $81.6 billion.[3]

Why would it not be appropriate to compare the potential economic effects of retaining the credits or alternatively financing a reduction in the corporate tax rate with the revenues generated by repeal of the credits? I am not so naïve to assume that there is any realistic chance repeal will occur. Nevertheless, supporters of existing, as well as proposed, business tax preferences should be forced to justify why the alternative of a corporate rate reduction is not in the best interests of U.S. tax and economic policy. This Subcommittee is an ideal venue for carefully considering the continuing utility of these and other tax preferences. To those who say that $13.7 billion is not sufficient revenue to effect a meaningful reduction in the corporate tax rate, I am confident that in response to the Subcommittee's request, the Staff of the Joint Committee on Taxation will provide a list of additional repeal candidates that would finance meaningful corporate tax rate reduction.

There are two occasions in the tax legislative process when advocates of existing tax preferences may realistically be pressured to justify continuation of their preferences. One arises when Congress needs to increase tax revenues to reduce the deficit or offset other tax reductions. The other is when Congress undertakes a comprehensive review of present law in connection with broad-based tax reform. In anticipation of any corporate tax reform project in the Ways and Means Committee, I encourage the Subcommittee to seek the assistance of the Joint Committee on Taxation, the Congressional Budget Office, the Congressional Research Service, and General Accountability Office, as well as academic and private sector analysts, in carefully and, might I suggest boldly, reevaluating the appropriateness of existing business tax preferences. This exercise will not, and probably should not, result in the repeal of all of them. However, with Member support, it should serve to identify those provisions that no longer can be justified and assist in improving the effectiveness of those provisions that remain in the law.

Deductibility of Business Interest

The second topic that I wish to discuss relates to the deductibility of interest expense on debt incurred by business taxpayers to finance the purchase of capital investment, including not only real and tangible property (plant, machinery and equipment), but also intangible property, such as patents, copyrights, and know-how.

One important reason to consider the relevance of the deductibility of interest expense in the context of corporate tax reform relates to the problems under present law that result from characterization of corporate investment as debt or equity. However, I am motivated to discuss business interest expense today for a different reason, namely, because of the relationship between the deductibility of interest expense and the tax law cost recovery rules relating to debt-financed investments that I assume will be an important part of any corporate tax reform debate.

"Cost recovery" refers to mechanisms by which a business taxpayer is entitled to reduce or offset otherwise taxable income by its investment in a business asset. Depreciation is an important form of cost recovery, as is the right of a taxpayer to offset its undepreciated investment, referred to as the asset's adjusted tax basis, against the consideration the taxpayer receives on the sale or other disposition of a business asset in calculating the gain or loss on the disposition. Other provisions of the Internal Revenue Code that might not appear to be cost recovery mechanisms are best analyzed as if they were. In particular, certain business tax credits, such as the R&D credit and the low-income housing tax credit, are calculated as a percentage of a taxpayer's relevant expenditures and, therefore, afford the taxpayer an added means of recovering a portion of its investment in property associated with the tax-preferred activity.

[3] These numbers are based on the revenue effects of §§ 41, 45, and 45K reported in Joint Committee on Taxation, Estimates Of Federal Tax Expenditures For Fiscal Years 2006–2010 (JCS–2–06) (April 26, 2006), and my rough guess of annual and five-year revenue effects based on the Joint Committee on Taxation's $3.2 billion estimated effect in 2007 of a one-year extension of the R&D credit as passed by the House in H.R. 4297, the Tax Relief Extension Reconciliation Act of 2005 (JCX–10–06) (February 9, 2006).

A pure, or idealized, income tax subjects a business taxpayer to tax on its (net) economic income. In theory, a properly designed depreciation system under a pure income tax, known as "economic depreciation," would enable a business taxpayer to recover its cost in a business asset by properly matching periodic depreciation deductions with income generated by the asset during the same period. Depreciation deductions would be calculated based on the economic useful life of the asset (that is, the period over which the asset is expected to be productive) and the actual decline in value of the asset in each period.[4] To properly calculate the taxpayer's economic income, it also is appropriate under a pure income tax to allow the taxpayer to deduct interest expense related to debt incurred to finance the purchase of the asset, because the interest expense is an added cost of earning the income generated by the asset.

Under a pure consumption tax that is calculated by reference to sales or other income of a business (a cash-flow consumption tax; a subtraction-method value-added tax, such as the so-called Flat Tax or the Bradford X Tax; or an invoice-credit form of value-added tax), the cost of capital investments would be fully recovered at the time incurred either through a deduction equal to 100 percent of the asset's cost or, in the case of an invoice-credit value added tax, by means of a credit for prior taxes paid.

Unlike a pure income tax, a consumption tax exempts income from capital from tax. This exemption is implemented at the business level of a consumption tax by allowing business taxpayers to fully deduct the cost of a capital investment when incurred, a cost recovery mechanism known as "expensing." The effect of expensing is to exempt the income generated by the business asset from tax on a present value basis, assuming a constant rate of return and constant tax rates. This is so even if it appears that income generated by the asset is taxable because the taxpayer makes nominal tax payments to the government over the productive life of the asset. This analysis is know as the "immediate deduction-yield exemption equivalence" and is based on work postulated in 1942 by an economist named E. Cary Brown.[5]

Because income from business assets is deemed to be exempt from tax under a consumption tax by reason of the expensing of capital investment, it is inappropriate to also permit the business taxpayer to deduct interest expense on debt incurred to finance the purchase or development of the expensed asset. To do so would create a negative tax that would provide an improper government subsidy to the taxpayer. Consistent with this analysis, the Growth and Investment Tax Plan recently proposed by the President's Tax Reform Advisory Panel would allow immediate expensing of all new business investment, but also would eliminate the deductibility of business interest. The Panel's Report describes the proposal to deny the deduction of business interest as "an essential component" of the Plan.[6] "Allowing both expensing of new investments *and* an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity."[7]

Present law is not a pure income tax but, rather, a hybrid tax system that has both income tax and consumption tax characteristics. I will be surprised if a fundamental reform of present law will result in a new tax law that one could describe as "pure." It is for this reason that I chose to raise the interest expense issue in my comments today.

We have seen a trend in U.S. tax policy toward liberalized cost recovery. Depreciation under present law is accelerated, that is, it is faster than economic depreciation, and in some instances, the statute provides for immediate expensing of capital investment, a prominent example being the so-called small business expensing (§ 179). Consumption tax proponents understandably identify expensing as a key element of any reform of the current tax system, and I would expect expensing or some form of accelerated depreciation would be considered as part of a reform of the business tax system.

I am concerned that in the legislative sausage factory, expensing will be perceived as an attractive component of a business tax package but the disallowance of interest expense will not, leading to the possible enactment of the tax subsidy to which

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[4] In the purest of pure economic depreciation systems, depreciation deductions also would be adjusted to account for inflation.

[5] See Alvin W. Warren, Jr., "How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash Flow Tax?," 52 Tax L. Rev. 1 (1996).

[6] The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 164 (Gov't Printing Office, November 2005).

[7] President's Advisory Panel Report, p. 164.

the President's Panel referred. This subsidy will encourage a variety of tax shelters and other tax-motivated activities that will pose a very significant threat to the tax base.

If we could be certain that the interest income paid by business taxpayers would be subject to tax in the hands of the recipients, the revenue effect of the continued deductibility of interest expense would be of less concern, even though the distortive effects to which the President's Panel refers would continue to be troubling. However, we know that a sizeable portion of interest income is exempt from U.S. tax because corporate debt is owned by so-called tax-indifferent parties, including foreign lenders that are not subject to U.S. tax. In 1989, the Joint Committee on Taxation reported that, based on 1987 data, foreign investors owned 13.3 percent of U.S. corporate bonds and an additional 62.2 percent were owned by insurance companies and pension funds, resulting in the current exemption from tax of a sizeable portion of the interest income received on corporate debt in their portfolios.[8] I presume the percentages reported in 1989 are larger today.

The relationship between expensing and the deductibility of business interest expense, in my view, is a very significant issue. If I am correct, it will be important for the Subcommittee to analyze specific cost recovery proposals with this issue in mind.

As a final point, it is worth noting that the subsidy to which the President's Tax Reform Panel referred exists under present law, because interest expense frequently is incurred in connection with debt-financed business investments that are eligible for accelerated depreciation or expensing under Section 179. Thus, the tax treatment of business interest expense under present law also is an appropriate topic for examination.

Conclusion

At the beginning of my remarks, I mentioned that I had previously appeared before the Subcommittee to comment on two corporate tax reform topics, the transferability of corporate tax attributes and corporate mergers and acquisitions. References to those two previous appearances might seem merely evidence of my nostalgia, having no relevance to my comments today. I do value my interactions with the Subcommittee over the years, but I also I think the prior appearances to which I referred are relevant.

To the extent the tax law creates distortions, as do industry-specific or activity-specific tax preferences, and to the extent the tax law creates discontinuities, as does the deductibility of interest by a business taxpayer who is entitled to recover the cost of a capital investment faster that economic depreciation, there exist increased incentives to structure transactions to enable business taxpayers that do not have sufficient income to fully use the tax preferences or interest deductions to directly or indirectly transfer those preferences to another taxpayer who can use them to reduce its tax liability or to merge with another business taxpayer that is able to use the tax benefit. As the Subcommittee considers corporate tax reform proposals, I encourage you to keep in mind the possible implications of these distortions and discontinuities.

Thank you very much. I will be pleased to attempt to answer any questions.

Chairman CAMP. Thank you very much, Mr. Pearlman. Dr. Neubig, you have 5 minutes.

STATEMENT OF THOMAS S. NEUBIG, NATIONAL DIRECTOR OF QUANTITATIVE ECONOMICS AND STATISTICS, ERNST & YOUNG

Dr. NEUBIG. Thank you, Mr. Chairman and Members of the Subcommittee. I am the national director of the quantitative economics and statistics practice at Ernst and Young. I am the former director and chief economist of the U.S. Department of the Treasury and worked for Ron Pearlman during the 1986 tax reform. I am happy to be part of this academic panel, since in my different

[8] Staff of the Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures* (JCS–1–89) (Gov't Printing Office, Jan. 18, 1989).

roles, I have been trying to teach policy makers, non-economists, and younger staff members.

The breadth of the Subcommittee hearing on corporate tax reform is quite large, so I am going to restrict my comments to reasons why many corporations prefer a lower corporate marginal tax rate to more targeted tax reductions, specifically expensing of capital equipment. The President's Advisory Panel outlined a growth and investment tax plan for a business cash flow tax which included expensing, first-year, 100 percent writeoff of capital equipment, structures and inventory. One might have expected that this plan would have received a standing ovation from the business community, because many economists say it is the equivalent of a zero effective tax rate on new capital investment. Instead, there really has been silence.

So, why this tepid response from the corporate community? Why this disconnect between the corporate community and what academic economists are saying? I think if we look at the Tax Council Policy Institute's Survey of Multinational Corporations, where they were asked to rank a range of alternative tax reform options, the clear favorite was lowering the corporate tax rate to 25 percent, compared to both fundamental as well as incremental tax reforms.

I would like to highlight four reasons why many corporations prefer a lower corporate tax rate to the proposed option of expensing. First is that expensing offers only a timing benefit and does not reduce corporations' book effective tax rate. If you lower the corporate marginal tax rate, that would lower corporations' book effective tax rates and increase their reported profits for most corporations.

Expensing accelerates corporate deductions from future years into the first year, providing only a timing benefit, and with expensing, public corporations would continue to have a high book effective tax rate on their current income, plus they would buildup large deferred book tax liabilities. In contrast, reducing the corporate marginal tax rate would lower book effective tax rates, increase their reported after-tax profits, and it would also reduce corporations' deferred book tax liabilities and assets, and that would be a very welcome development in a world where two-thirds of the largest companies report deferred tax liabilities. Ohio recently began phasing out its corporate income tax, and a number of companies immediately began reporting higher book profits as a result.

The second reason is that corporations already expense a large fraction of their capital investment. A lower tax rate would benefit both their tangible investments and their intangible investments. A recent study showed that about the same amount of intangible investments are made as tangible capital investments. Intangible investments include research and development, copyrights, computerized databases, and brand equity.

Through the deduction of wages associated with the creation of self-constructed intangible assets, many investments or most investments in intangible assets are already deducted in the year that the expense is incurred, and so, a lower corporate tax rate would help both tangible and intangible assets.

The third reason is expensing is unlikely to occur without a counterbalancing loss of interest deductibility, as Ron said. A lower corporate marginal tax rate could occur with continued interest deductibility.

The fourth reason is expensing reduces the tax wedge at just one margin in terms of reducing the tax rate on tangible capital investment. If you reduce the corporate marginal tax rate, you are going to be reducing the margin at which people make decisions in a whole host of dimensions. Currently, the United States has one of the highest statutory corporate tax rates. The Organization for Economic Cooperation and Development (OECD) calculates the U.S. combined Federal and State corporate tax rate to be over 39 percent. That compares to an OECD average of just 31 percent, and a number of our major trading partners have significantly lower corporate marginal tax rates.

A lower corporate marginal tax rate would reduce the tax wedge for all corporate decisions, including location decisions between the United States and foreign investments. It would reduce the corporate versus non-corporate decision, debt-equity financing decisions, and transfer pricing planning.

While there is a wide range of views among the corporate tax community, many of them would prefer to see the United States join other countries in lowering the U.S. corporate marginal income tax rate rather than moving to a business cash flow tax.

[The prepared statement of Mr. Neubig follows:]

Statement of Thomas Neubig, Ph.D., National Director of Quantitative Economics and Statistics, Ernst & Young

Mr. Chairman and Members of the Subcommittee: *

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

I appreciate the invitation to testify before the Subcommittee on the issue of corporate tax reform. Given the breadth of the topic of corporate tax reform, I will restrict my comments to the issue of reasons why many corporations prefer a lower corporate tax rate to more targeted tax reductions. My testimony is based on a recent Tax Notes article, entitled "Where's the Applause? Why Most Corporations Prefer a Lower Tax Rate." **

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

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

With economists and the business community differing so widely in their response to the Advisory Panel's expensing option, many observers wonder why the dis-

* Thomas S. Neubig, Ernst & Young LLP, 1225 Connecticut Avenue, N.W., Washington, DC 20036. E-mail Tom.Neubig@ey.com The views expressed in this testimony are my own, and don't necessarily reflect the views of my firm or clients.

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

[1] See Desai and Gentry (2003) and Desai (2006) for more details.

[2] This section draws on Desai and Hines (2004) and the details of the efficiency calculations can be found there. Other arguments for reconsidering the tax treatment of foreign source income can also be found at Desai (2004) and the slides entitled "Taxation and Global Competitiveness" prepared for the President's Advisory Panel on Federal Taxation available at www.taxreformpanel.gov/meetings/docs/desai.ppt.

connect. Here are seven reasons why many corporations prefer a lower corporate tax rate to the proposed option of expensing capital investments.

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

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

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

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

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

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

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

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

3) Expensing is unlikely to occur without a counterbalancing loss of interest deductibility. A lower corporate marginal tax rate could occur with continued interest deductibility.

The Advisory Panel's report emphasizes the necessity of combining expensing with repeal of interest deductibility to prevent negative economic effective tax rates. "Eliminating the business interest deduction for non-financial firms is an essential component of the Growth and Investment Tax Plan. Allowing both expensing of new investments and an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity." (Advisory Panel, p. 164)

As a result, the valid comparison isn't just expensing versus a lower corporate tax rate, it is expensing combined with loss of interest deductions versus a lower corporate tax rate with interest deductions.

It should be noted that debt-financed capital investment is already calculated as having an economic effective corporate tax rate of zero with economic depreciation, and a negative economic effective tax rate with the current accelerated depreciation. "By contrast, the average tax rate on debt-financed investment is negative (–15%), as deductions for interest, together with deductions of items such as accelerated depreciation, more than offset the income generated from debt-financed investment." (Advisory Panel, p. 100)

So, expensing would really only help a small fraction of corporate investment: equity-financed tangible investments. Because of the loss of the interest deduction, debt-financed tangible and intangible investment would be worse off under the business cash-flow tax. For this reason, a lower corporate marginal tax rate on top of the current interest deduction and accelerated depreciation for tangible capital would be more advantageous for many corporations compared to expensing or business cash-flow tax.

4) Corporations invest to earn above-normal returns, not just the "normal" or risk-free return. While expensing reduces the tax rate on only the risk-free return, a lower marginal tax rate applies to the entire return to capital.

Economists distinguish between four different returns to investors: 1) a "normal" or risk-free return for deferring consumption, or a "return to waiting"; 2) an expected risk premium; 3) a return due to entrepreneurial skill, a unique idea, a patent or other specific factors; and 4) an unexpected return from good or bad luck where the actual return differs from the expected return. The Advisory Panel report (p. 150) states "Removing the tax on the first component, the return to waiting, is the key to removing taxes from influencing savings and investment decisions." The Panel report stresses that both an income tax and a "post-paid" consumption tax (expensing) fall on the other three components, which they say has "important implications for the distributional effects" of reform.

Academic economists argue that in competitive markets businesses can only earn the "normal" or risk-free return to capital on their last (marginal) dollar of investment. By this reasoning, expensing will provide an incentive for additional investment. However, the Growth and Investment Tax Plan with expensing but without an interest deduction would impose a tax on returns in excess of the "normal" or risk-free return arising from risk-taking, entrepreneurial effort or innovation. Consequently, the academic economists' zero tax rate argument only applies to a very small fraction of a company's total investment—just to that last dollar of investment, and only to the portion equivalent to a risk-free return. But, the reality is that companies don't invest just to earn a risk-free return; they expect to earn returns to justify their risk-taking, specialized factors and competitive positioning.

Economic proponents of expensing like to point out that under a business cash flow tax profits above the risk-free return would be taxed. They argue that taxing "rents" is equivalent to a lump-sum tax, causing no economic distortions. Again, we are reminded that the economists and the corporate tax officers are two very different audiences.

While most economists are focused at the "margin", businesses make investments that are large, discrete, finite, risky and also include substantial entrepreneurial and innovative efforts. When entering a market with a sizeable investment, a company looks at its total after-tax return. While a company might earn a risk-free return from the time-value of money from accelerating depreciation deductions, companies invest to earn a significantly higher return on their total investment. On the other hand, a lower corporate tax rate would reduce the tax on all corporate income—both the normal risk-free return income as well as the return to risk-taking, entrepreneurial skill and innovation.

5) Many companies would not receive the full benefit of expensing without also being able to receive immediate refunds.

Many companies, especially while transitioning to the business cash flow tax model, would not benefit from the full effect of expensing, because expensing would eliminate all taxable business cash flow for many companies. Unless the government provided immediate cash refunds, they would only realize a fraction of the potential benefits that expensing might offer. Many more companies would find themselves in a net operating loss (NOL) carry forward position with expensing.

The Advisory Panel did propose that the business cash flow tax with expensing would also include NOL deductions with interest. And, economists' present value calculations would show that corporations are made whole with an interest adjustment to NOLs. However, corporations don't normally choose to invest in Treasury securities earning a risk-free return. Deferring the tax benefits of expensing beyond the initial year, even with a risk-free interest rate, is not the equivalent of a zero economic effective tax rate when a corporation considers the other, more potentially rewarding, opportunities available for its investments or payments to shareholders.

6) Expensing reduces the tax wedge on one margin, but a lower tax rate would reduce the tax wedge on all margins.

The Advisory Panel notes that its Simplified Income Tax proposal for a territorial system of international taxation would put increased pressure on transfer pricing. (Advisory Panel, p. 242) Indeed, transfer pricing issues are important when marginal tax rates differ across countries, and currently the U.S. has one of the highest statutory corporate tax rates. The Organization for Economic Cooperation and Development (OECD) calculates the U.S. combined federal/state corporate tax rate to be 39.3% compared to an OECD average of 31.2 %. Other marginal decisions, such as debt versus equity financing, are influenced by the statutory marginal tax rate. Marginal and average tax rates also influence location decisions.

While expensing would eliminate the differential tax treatment of tangible and intangible investments, a lower corporate marginal tax rate would reduce the tax wedge for all corporate decisions, including location decisions, the corporate non-corporate decision, debt equity financing decisions, transfer pricing, etc.

7) Corporate tax rates could increase in the future. Expensing leaves large deferred tax liabilities that could be subject to significant future tax increases.

The economists' assertion that expensing creates a zero effective tax rate on the risk-free return only holds if tax rates remain unchanged over the life of the investment. If tax rates increase in the future, then the effective tax rate would be higher. Of course, if tax rates were to decrease in the future, then the economists' effective tax rate could fall below zero.

If tax rates increase in the future, then public corporations' large deferred tax liability from expensing would become even larger on prior investments. In addition, a higher tax rate and increased deferred tax liability would reduce reported book income in the year of the change. Academic economists might think that corporations would be indifferent to the possibility of future tax changes, or at least treat the possibility of a tax rate increase as offsetting the possibility of a tax rate decrease. In reality, though, many corporate officers and tax directors would see a much larger downside from a tax rate increase than benefit from a tax rate decrease. Negative surprises seem to have a larger adverse effect than the positive effect from positive surprises. In today's business environment, jobs and options can be lost with negative surprises; a positive surprise, on the other hand, might elicit a one-time bonus.

Expensing would create large deferred tax liabilities. And, many theoretical economists might argue that these could later be taxed at higher rates without adverse economic effects since the investments had already been made. This is the same argument that many economists use for estimating the future economic benefits of moving to a consumption tax (either a value-added tax or business cash flow tax), since the shift can be financed by imposing taxes on old capital (existing investments). This is another reason why corporate officers are skeptical of expensing and also economic arguments of efficiency.

Conclusion

Given the very different perspectives and day-to-day challenges of the academic economists and the business community, it is unlikely that the Growth and Investment Tax Plan—or any tax reform proposal that resembles a consumption tax—will draw raves from both audiences. And, while the Advisory Panel's business cash-flow tax proposal retains the appearance of the current corporate income tax—with expensing and a repeal of interest deductibility added to the mix—it is still, at its core, a variant of a consumption tax. Part of the explanation for the disconnect between academic economists and the business community is what might be called the "Red Riding Hood disguise"—hiding a consumption tax in income tax clothing.

Expensing capital investment would provide significant tax benefit to many corporations. But still, most corporations—even many of those who would benefit from expensing—are likely to favor lower marginal rates as part of any incremental tax reform. And, while expensing would significantly reduce the taxation of equity-financed depreciable property, the business cash-flow tax (with repeal of interest deductibility) would increase the tax burden on debt-financed tangible and all intangible assets. Plus, expensing would not lower book effective tax rates.

Academic economists are correct when they say that expensing can result in a zero effective tax rate on the risk-free return to marginal investment. However, the underlying assumptions and limited focus of their analysis (marginal investment, equity-financed tangible investments, no financial statement effects, no principal-agent incentive effects) neglect the fact that businesses are seeking high total after-tax returns to their investments, including the return to risk-taking, innovation, and entrepreneurship.

These seven reasons seem to be why many corporate tax directors and officers have not stood up with many economists to applaud expensing and the proposed business cash-flow tax. Most of the corporate tax community would prefer to see the U.S. join other countries in lowering the corporate marginal income tax rate.

That concludes my testimony. I would be happy to answer any questions about my testimony.

Chairman CAMP. Thank you very much, Dr. Neubig. Dr. Shackelford, you also have 5 minutes.

STATEMENT OF DOUGLAS A. SHACKELFORD, MEADE H. WILLIS DISTINGUISHED PROFESSOR OF TAXATION, KENAN-FLAGLER BUSINESS SCHOOL, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

Dr. SHACKELFORD. Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to testify. I have been asked to comment on suggestions that we tax the accounting profits that companies report to their shareholders, a practice known as book-tax conformity.

I oppose conformity. I believe it would damage our capital markets and our tax system. I believe it disregards the importance of financial reporting in our economy. Let me start with a practical reason: conformity is not sustainable. Suppose we did tax book income. The accounting rules would remain the same, and the net income reported to shareholders would become the new tax base.

Generally accepted accounting principles (GAAP), those guidelines that have evolved over time to guide the judgments underlying accounting would replace the Internal Revenue Code. The Financial Accounting Standards Board and other accounting standard setters would replace Congress as the body that determines the corporate tax base. In other words, conformity would force Congress to yield its authority to write the tax law. Imagine pressure on these unelected standard setters to set tax-advantaged accounting standards.

Let us consider depreciation under conformity. The current accounting rules permit companies to depreciate equipment in a manner that best reflects its economic deterioration. Thus, if the same plant uses identical forklifts differently, management may depreciate them differently. On the other hand, the current tax law provides specific rules for the depreciation of equipment; for example, a percentage of the cost of the equipment is depreciated in the first year, regardless of the actual decline in the value of the equipment.

Under conformity, judgments about the decline in the usefulness of the equipment would replace the certainty of current tax depreciation roles. Besides the impossibility of basing the tax system on the judgments of the taxpayer and the possibility that taxpayers would make tax-favorable judgments, suppose the economy slows, and Congress decides that more rapid depreciation would encourage firms to expand. What would Congress do? Would Congress exclude depreciation from conformity, or would Congress mandate that accelerated depreciation is the only depreciation method acceptable for both book and tax?

If Congress provides the conformity exception for depreciation, then, soon, we are back to where we are today. In fact, this path brought us to where we are today. The corporate income tax was originally based on GAAP. Over time, Congress found reasons why Congress should differ from book. The decoupling is understandable. Book and tax reporting exists for different reasons. There is no reason to think that the most useful measure of a firm's profitability to its shareholders is also the most useful measure of profitability for the taxing authorities.

Accounting exists because management needs to provide information to outside investors. Without this information, shareholders would be apprehensive about turning their money over to managers that they do not know. For example, consider research and development about a new drug at a pharmaceutical company. Insiders know the probability of success far better than outside investors do. Through financial reports, managers convey some of the knowledge to the outside investing community. This accounting information enables outsiders to better forecast the profitability of the drug, reducing their uncertainty about the future of the firm and increasing their willingness to invest in the company.

In other words, the demand for financial reporting comes from the need to reduce differences in knowledge between inside management and outside suppliers of capital, and to provide the most informative financial reports requires extensive judgment about the current activity and future expectations of the firm.

Conversely, the purpose of taxable income is to provide a verifiable measure for collecting revenue. The taxing authorities need information rooted in law, not in judgments. An important quality of the tax law is that taxable income can be measured the same by both the taxpayer and the government. As an aside, when book and tax treatment are the same, widely held public corporations will often care more about their accounting earnings than their taxable income. This is understandable, because investors can see the financial reports but not the tax returns. So, sometimes, firms choose to report higher earnings, even at the cost of higher taxes.

To continue our depreciation example, when Congress provides accelerated depreciation for tax purposes, suppose it decides to maintain conformity? If so, when Congress changes the tax law, it will also change the reporting methods for book purposes. In other words, Congress will set the tax law and then force the book rules to conform. This option is far more dangerous than providing different treatment for book and tax, because it will erode the quality of information that managers can provide to external investors.

If Congress begins to restrict the means by which managers can communicate to their investors, then, investors will fear that they do not have the information that they need to evaluate companies. Furthermore, legislating conformity will not conform taxes to the information that firms communicate to investors. Managers will continue to need to provide investors with information to attract their capital. If the financial reports are constrained in their ability to communicate, managers will find other means.

In conclusion, conformity is naive and bad policy. I encourage you to reject it. I look forward to your questions.

[The prepared statement of Dr. Shackelford follows:]

Statement of Douglas Shackelford, Ph.D., Professor of Taxation of Accounting, University of North Carolina, Chapel Hill, North Carolina

Introduction

Mr. Chairman and distinguished members of this subcommittee, I appreciate the invitation to comment on corporate tax reform. My comments will address the interplay of financial reporting and taxation and proposals for conforming book and taxable income. I applaud this subcommittee for studying these issues. They reflect the growing appreciation for the impact of financial reporting on tax policy.

The Demand for Financial Reporting

Many (investors, creditors, customers, suppliers, regulators, rating services and the government, among others) need financial information from firms. For purposes of this testimony, I will limit my focus to current and potential shareholders.

Managers report financial information to shareholders to reduce the asymmetric information problems that otherwise would limit their ability to attract external capital. Asymmetric information exists when one party knows more than another party does. For example, in the equity markets, managers know more about the firm than outside investors know. Problems arise for managers when the external investors fear that the differences in information enable the managers to take advantage of them. The accounting information provided in financial reports allows managers to reduce the asymmetry and thus attract capital from outside investors.

For example, consider research and development about a new drug at a pharmaceutical company. Insiders know the probability of success far better than outside investors do. Through financial reports, managers can convey some of their knowledge to the outside investing community. This accounting information enables outsiders to better forecast the profitability of the drug, reducing their uncertainty about the future of the firm and increasing their willingness to invest in the company. In brief, the demand for financial reporting comes from the need to reduce differences in knowledge between inside management and outside supplies of capital.

Accounting Standard Setters

Generally Accepted Accounting Principles (GAAP) provides guidance about the information that firms can provide through their financial reports to shareholders. GAAP has evolved over decades into accounting conventions that provide a structure for identifying, evaluating, and reporting the firm's activities. The Financial Accounting Standards Board (FASB), with oversight from the Security and Exchange Commission (SEC), is the primary standard setter of GAAP. The American Institute of Certified Public Accountants, the Emerging Issues Task Force, and the SEC itself also contribute to GAAP. Each body promulgates statements to guide the accountants who produce the financial reports. Some standards mandate specific accounting treatment for a transaction. Other pronouncements suggest an approach or a structure for reporting transactions. The goal is financial reports that present relevant, reliable, comparable, and consistent information about the affairs of the company.

At the same time, the standard setters recognize the impossibility of specifying the precise treatment for every transaction, and they rely heavily on firms to judge the appropriate approach within bounds for specific transactions. As a result, two firms with identical activities could produce different financial reports without violating GAAP. For example, suppose the same customers bought the same goods on credit from two retailers. One retailer might expect higher collections than the other retailer does. Consequently, the first retailer would report higher net income than the second retailer does—the sole difference being a judgment about future collections. Neither retailer violates GAAP. They simply disagree about future collections.

This element of discretion enables managers to better communicate their expectations to investors. However, this flexibility also enables managers to manage their reports in a manner that reflects well on them. Continuing the example, the first retailer's expectations may not differ from the same retailer's expectations. However, the imprecision of financial reporting enables the first to report higher accounting profits. Of course, the markets are aware of this potential for earnings management. However, the evidence is mixed about whether investors can fully adjust their forecasts for earnings management. Nonetheless, managers behave as though they believe that investors cannot fully adjust for earnings management

The Demand for Tax Information

Compared with financial reporting, the demand for tax information is relatively simple. The government needs each firm to report its taxable income in accordance with the existing tax law because self-reporting is an efficient means of gathering the information to compute the tax liability. By comparison with accounting standards, the tax law is intentionally rigid and, to the extent possible, attempts to specify the appropriate treatment for every transaction.

Whereas standard setters intend financial accounting to be a flexible, evolving, conceptual framework that guides accountants in their judgments, Congress writes the tax law to provide as much certainty as possible about the tax treatment of a transaction. The Treasury Department adds to this certainty with regulations that interpret the law. The courts add to this certainty when they resolve differences between the government and the taxpayers. Although GAAP itself is becoming more rules-oriented over time, it remains far less certain and binding than the tax law. In the starkest terms, financial accountants use judgments to report a firm's profitability while tax accountants apply the law to compute taxable income.

Of course, since the taxpayer and the government take adversarial positions in the interpretation of the law, conflicts arise continually about the tax treatment of specific transactions. However, if tax rules were based on the guidelines, approaches, discretion, and judgments that underlie financial accounting, the differences in opinions would be far more extensive than we currently observe in the tax arena. In fact, if the tax law had the flexibility of GAAP, administration of the tax law would be impossible as tax cases flooded the courts. Instead, under the current tax system, both taxpayers and the government benefit from "bright-line" provisions in the tax law that specify the treatment of particular transactions as precisely as possible, reducing the uncertainty about the ultimate resolution of an event's tax treatment.

The Interplay of Financial Reporting and Tax Disclosures

Many transactions are treated the same for financial reporting (or book) and tax purposes. Transactions receiving the same treatment create a tension between book and tax considerations. For book purposes, managers may wish to present the event to investors in a favorable light, e.g., in a manner that increases accounting earnings or lowers earnings volatility. For tax purposes, managers wish to present the event in a manner that reduces the firm's tax liability.

For example, if a firm uses LIFO (last-in, first-out) to compute the costs of its inventory for tax purposes, it also must use LIFO for book purposes. During inflationary times, LIFO reduces both book and taxable income. Thus, when firms choose LIFO, they are demonstrating a willingness to sacrifice the profitability that they report to outside investors in order to lower their tax liability. Conversely, when firms choose other inventory costing methods, e.g., FIFO (first-in, first-out), they are choosing to report higher earnings at the expense of higher taxes.

Researchers have studied the trade-offs between book and tax reporting extensively.[1] To the surprise of those who are unfamiliar with the importance of financial reporting, many studies find that book considerations dominate tax considerations. In other words, some firms structure their activities in a way that boosts earnings, even though they have to pay for the higher earnings through higher taxes. For example, many firms in inflationary times used FIFO. As expected, the companies that rely most heavily on outsiders for their capital (and thus face the greatest asymmetric information problems) are the ones that are most likely to enhance earnings at the cost of higher taxes.

To demonstrate, suppose you are the sole shareholder, lender, and employee in your business. You have no need to provide information to outside investors. Thus, there is no tension between your financial reporting considerations and your tax choices. You will always report your affairs in a tax-minimizing manner.

Conversely, suppose you are the CEO of a company owned by outside investors. The shareholders observe your financial reports, but not your tax return, and have access to little financial information about the firm, except the information that you provide them. In that case, the financial reports play a critical role in the firm's ability to raise capital.

For example, suppose the market uses a simple price-earnings ratio to value stock. If a firm's price-earnings ratio is 20, then every dollar of (permanent) accounting earnings boosts the firm's capitalization by $20. Conversely, if saving one dollar of taxes does not increase the firm's book earnings, and thus cannot be observed by outside investors, then the tax savings have no effect on the stock price. In such an environment, it is entirely rational that a firm would forgo tax savings to communicate a more favorable message about its future profitability.

Consequently, managers of widely held public companies are very concerned with the book considerations of transactions. In fact, managers in these types of firms often forgo tax opportunities because they have adverse book effects or even because they have no favorable impact on book earnings. On the other hand, managers may undertake a tax strategy that has minimal reduction in their tax liability, but provides a boost to earnings. In short, financial reporting considerations often dominate tax concerns for managers of public corporations with asymmetric information problems.

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[1] For a review of the literature, see Shackelford, Douglas, and Terry Shevlin, "Empirical Tax Research in Accounting," *Journal of Accounting and Economics* 31:1–3, September 2001, 321–387.

The importance that corporations place on the financial reporting considerations of changes in tax policy can puzzle policymakers. If the policymakers underestimate the importance of financial reporting in allaying asymmetric information problems, they may be surprised when widely held public companies show little interest in tax reductions that adversely affect their financial reports. They sometimes even have limited interest in tax reductions that do not benefit accounting earnings.

One example of the importance placed on accounting earnings concerns recent proposals for replacing depreciation with immediate expensing. Immediate expensing likely would reduce the tax bill for many firms and certainly would reduce taxes in the short-run. However, expensing would have no effect on accounting profits. The reason is that the timing of the deductions for tax purposes (up front with expensing versus over time with depreciation) is irrelevant for computing accounting earnings. Because expensing carries no book benefit, many managers of widely held public companies likely will have little interest in switching the tax law from depreciation to immediate expensing.

Book-tax Conformity

Recently some have suggested adoption of book-tax conformity. By book-tax conformity, I mean taxing the accounting earnings that companies report to their shareholders. On the surface, conformity makes sense. Companies report income to their shareholders, and companies report income to the taxing authorities. Conformity simplifies the process by having companies report the same amount of income to both shareholders and the government. Furthermore, with conformity, the tendency to overstate income to shareholders would offset the tendency to understate income to the government, providing better measures for both shareholders and the government.

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

Different Users need Different Information

The first problem with conformity is that it ignores the different purposes for book and tax reporting. It assumes that the most useful measure of a firm's profitability for shareholders is also the most useful measure of profitability for the taxing authorities.

To demonstrate that different measures are appropriate for different users, compare the information demands of bondholders and shareholders. Bondholders need information to assess the likelihood that the firm will be able to service its debt. For example, they may want to know the value of the firm under liquidation. Shareholders need information to assess the value of their residual claims. Thus, they need information that assumes that the firm is a going concern, i.e., not facing liquidation.

Similarly, shareholders and the taxing authorities need different information. As mentioned above, shareholders need information from the financial reports about their residual interests. Conversely, the taxing authorities need verifiable information, rooted in law, rather than the judgments. No one would expect two financial accountants to reach the same book earnings for a firm because the process involves extensive judgment. Conversely, an important quality of tax law is that taxable income can be measured the same by both the taxpayer and the government.

Lack of Sustainability

The second problem with conformity is that it is not sustainable. Suppose we did set taxable income equal to book income. The accounting rules would remain the same, and the net income reported to shareholders would be the new tax base. GAAP, those guidelines that have evolved over time to guide the judgments underlying accounting, would replace the rigid Internal Revenue Code. The seven, unelected members of the FASB and other accounting standard setting bodies would replace Congress as the body that determines the corporate tax base. In short, a consequence of conformity is that Congress would abrogate its authority to write the tax laws.

Consider depreciation under conformity. The current accounting rules permit companies to depreciate equipment in a manner that best reflects its economic deterioration. Thus, if the same plant uses identical forklifts differently, management may depreciate them differently. On the other hand, the current tax law provides specific rules for the depreciation of equipment. For example, a percentage of the cost of the equipment is depreciated in the first year, regardless of the actual decline in the value of the equipment. Under conformity, judgments about the decline in the usefulness of the equipment would replace the certainty of the current tax depreciation rules.

Besides the impossibility of basing a tax system on the judgments of the taxpayer, suppose the economy slows and Congress believes that more rapid depreciation would encourage firms to expand. What would Congress do? Would Congress provide an exception to conformity for depreciation? Would Congress mandate that accelerated depreciation is the only depreciation method acceptable for book and tax? Would Congress pressure the SEC and the FASB to change the accounting rules to mandate accelerated depreciation? Would Congress sit idly by, recognizing that it has delegated taxing authority to the accounting standard setters?

First, let us reject the possibility that Congress will do nothing or leave responsibility of the economy to an unelected body of accounting standard setters. Thus, Congress has two choices. Change depreciation for tax purposes only or mandate that accelerated depreciations is required for both book and tax.

If Congress provides a conformity exception for depreciation, then soon we are back to where we are today. In fact, this path brought us to where we are today. The corporate income tax was originally based on GAAP. Therefore, taxable income began closely linked to book income. Over time, Congress found reasons why tax should differ from book. The reasons include the need to provide incentives, improve efficiency, simplify the tax rules, provide certainty to taxpayers and the taxing authorities, address inequities, aid administration of the law, and raise revenue.

Therefore, over time, book and tax drifted apart. The decoupling is understandable. The purpose of accounting earnings is to provide information to external investors. The purpose of taxable income is to provide a verifiable measure for collecting revenue. It is unreasonable to think that one measure of profitability can achieve both purposes. Naturally, changes that narrow the gap between book and tax without adversely affecting financial reporting or the tax system are desirable, but complete conformity reflects a naivety about the purposes of book and tax information.

Alternatively, to continue our example, when Congress provides accelerated depreciation for tax purposes, suppose it decides to maintain conformity. If so, when Congress changes the tax law, it also will change the reporting methods for book purposes. In other words, Congress will set the tax law and force the book rules to conform.

This option is far more dangerous than providing different treatment for book and tax because it will erode the quality of the information that managers provide to external investors. Congress has a long history of rarely interfering with the evolution of accounting standards. This has enabled accounting to change naturally with economic developments and ensure that managers can best communicate private information about their companies to external investors. The standards provide a delicate balance of certainty (e.g., equipment is depreciated and land is not) and judgment (e.g., companies decide the rate of depreciation). If Congress interferes with this balance, it will have major adverse affects on our economy.

Financial accounting has contributed mightily to our enjoying the largest and most efficient capital markets in the world. Domestic and foreign investors pour trillions of dollars into American firms led by managers whom they do not know. They invest because they trust the accounting information that the managers communicate about their companies. If Congress begins to restrict the means by which managers can communicate to their investors, e.g., by setting book depreciation methods, then investors will fear that they do not have the information that they need to evaluate companies. Contracting costs will rise. Stock prices will tumble. The damage to the capital markets alone will far exceed any benefits to conformity.

Germany's Experience with Conformity

Some advocates for conformity point to forms of conformity among our trading partners. It is true that some countries, such as Germany, have used conformity. However, these companies are increasingly abandoning conformity, providing further evidence that it would be bad policy for the United States.

Germany historically mandated book-tax conformity. The reason that conformity could exist in Germany was that their corporations raised little capital from external investors and thus had little or no asymmetric information problems. Instead, large banks supplied the capital for German corporations. Through extensive stock cross-holdings, the banks were insiders (using serving on the board of directors) and privy to the private knowledge of management. In other words, conformity could exist in a debt-centered economy, which relied on few external investors.

In contrast, America has equity-centered capital markets with widespread external ownership. Germany is now attempting to build an equity-centered economy. To facilitate the transition from a debt-centered economy to an equity-centered economy, Germany has discontinued conformity for consolidated financial statements, enabling managers to communicate more freely and thoroughly with their external investors. In other words, Germany is leaving conformity in an attempt to create the external capital markets that we already enjoy. Germany recognizes that book-tax conformity is inappropriate in an economy that relies on the equity markets to raise capital from external shareholders. Thus, Germany's abandonment of conformity provides enough further evidence that the U.S. should not adopt conformity as policy.

Unintended Consequences

Let me close with a warning about unintended consequences. Corporate behavior will change with any changes to the tax law or the financial accounting rules. If Congress were to establish book-tax conformity, then firms would begin to alter their behavior in ways that may be unanticipated at the inception of conformity.

For example, legislating conformity will not eliminate the need for information to address asymmetric information problems between insiders and outside investors. Thus, managers in widely held public companies will find other means to communicate private information to outside capital sources. Some firms may go private, but most will continue to rely on the equity markets to supply their capital. External investors will continue to demand information—and firms will find a way to supply that information—because their survival and prosperity depend on attracting external investors. If firms are unable to provide that information through their financial reports without adversely affecting their tax liabilities, then they will find other means of communication. Those other channels likely will be more costly and less effective than the current financial reporting system, but in the end, firms will find a way to communicate information to investors, which reduces the problems associated with asymmetric information. In short, managers will find a way to decouple any legislated link between financial reporting and taxes.

Closing Remarks

In conclusion, I applaud these hearings and your interest in the coordination of financial and tax reporting. This is an important and often overlooked area of tax policy. Any attempts at corporate tax reform will require a thorough understanding of the effects of financial reporting on tax policy.

As far as book-tax conformity, I strongly oppose it. It is a naïve proposal that fails to appreciate the complex role of financial accounting in our economy. If we adopt conformity, we will inevitably abandon it (albeit after considerable damage to the economy) because Congress will not and should not cede its authority to set tax law. In the meantime, conformity will adversely affect the capital markets for public corporations and force managers to find alternative methods for addressing their inherent asymmetric information problems with external capital suppliers. Doubtlessly some differences between book and tax can be narrowed, but widespread book-tax conformity is bad tax and financial policy.

Chairman CAMP. Thank you very much, Dr. Shackelford. Mr. Thompson.

STATEMENT OF SAMUEL C. THOMPSON, JR., PROFESSOR OF LAW AND DIRECTOR, LAW CENTER, UNIVERSITY OF CALIFORNIA, LOS ANGELES, LOS ANGELES, CALIFORNIA

Mr. THOMPSON. Thank you, Mr. Chairman. I urge Congress to eliminate deferral for foreign source income, thereby rejecting the recommendation of the President's tax reform panel that we adopt a territorial system. The recent increase in oil prices is yet another reason for Congress to eliminate deferral. Finally, I will point out that dividends for higher bracket taxpayers are significantly undertaxed, and therefore, Congress should reinstate the taxation of dividends at the ordinary individual rates for these taxpayers.

Codification of the economic substance doctrine (ESD) has been opposed by the Treasury Department, the American Bar Association (ABA) Tax section, the American Institute of Certified Public Accountants (AICPA), and the Tax Executive Institute (TEI). My testimony today critically examines the rationales given by these organizations in opposition to codification. The arguments against codification made by the former Assistant Secretary of the Treasury for Tax Policy, Pamela Olson, reveal four principal themes: first, codification would make the ESD more wooden and less flexible. Second, codification has the potential for creating a rule that is both too broad and too narrow. Third, codification would add complexity for the Internal Revenue Service (IRS) in its enforcement of the laws. Finally, codification would slow IRS audits.

Although Olson uses the term wooden and rigid in a negative connotation, the principal argument for codification is the lack of woodenness or rigidity in the current state of the law, which gives sophisticated taxpayers too much wiggle room. Olson's argument that codification would lead to a rule that is too broad is also vigorously made by several tax organizations and will be discussed shortly. Olson's argument that codification would create a rule that is too narrow assumes that, currently, courts have the flexibility to prevent tax shelters that codification may not contemplate. However, the language of the statute remains sufficiently broad to allow flexibility in determining what constitutes an abusive, tax motivated transaction.

Even a brief review of the cases attempting to interpret the current ESD undermines Olson's argument that codification would add complexity for the IRS in enforcement. Also, rather than slowing audits, as Olson argues, a more uniform standard provided by codification would enable the IRS to increase the speed of its audits.

A close experience of the positions of the tax organizations against codification revealed the following basic rationales: codification would interfere with bona fide business transactions; two, codification would hurt small businesses and average taxpayers; three, these concerns have already been addressed by the 2004 act; and four, the 40 percent penalty is too high.

The ABA and the TEI argue that codification of the ESD may have significant ramifications for bona fide business transactions. It is highly unlikely that bona fide business transactions such as the organization of a corporation or the sale or reorganization of a corporation would be adversely affected by the ESD. The ESD would act as a speed bump for problematic transactions that would have virtually no impact on bona fide transactions.

The AICPA argues that codification would present traps for small businesses in a broad cross-section of taxpayers. It is unlikely that ordinary business activities of small businesses and ordinary taxpayers will, in any way, be touched by the codification of ESD. These taxpayers generally cannot engage in the type of transactions that would raise issues under a codified ESD.

All the organizations argue that the concerns with tax motivated transactions have already been addressed by the 2004 act. However, the revenue estimates associated with ESD show that it is likely to have a much greater bite than the 2004 act. Each of the organizations argues that the 40 percent penalty for nondisclosed, noneconomic substance transactions is too high. These organizations want to have it both ways. On the other hand, they oppose a 40 percent penalty that can be avoided by disclosure. Codification of the ESD would be good for business, the economy, and the tax system.

I turn to the territorial regime proposed by the panel. The principal reason the panel gives for moving to a territorial system is competitiveness. However, there is a serious competitive problem in that a territorial regime would attract capital overseas. This would be bad for U.S. businesses. Congress should tax on a current basis all the income of foreign corporations controlled by U.S. taxpayers, which would produce significant tax revenues and eliminate much of the complexity under our current deferral system.

Finally, my research shows that dividends for ordinary taxpayers, low bracket taxpayers, are indeed overtaxed, but dividends for high bracket taxpayers are undertaxed. I therefore urge Congress to reinstate the taxation of dividends at ordinary income rates for high income tax payers. Thank you.

[The prepared statement of Mr. Thompson follows:]

Statement of Samuel Thompson, Jr., Professor of Law and Director, Law Center, University of California, Los Angeles, Los Angeles, California

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I. Introduction

Thank you for giving me the opportunity to share my views with you today. The views I express are my own, are not supported by any organization or client, and are motivated only by my interest in the U.S. tax system.

Because of the limited time, I will focus my remarks on two issues: (1) codification of the economic substance doctrine (ESD), and (2) ending deferral for foreign source income of controlled foreign corporations. Most of the presentation focuses on the need for Congress in the ongoing fight against tax shelters to codify the ESD, currently reflected in Senate bill 2020, the Tax Relief Act of 2005. The current House bill has no similar provision. I then will provide some brief remarks on why I think Congress should reject the recommendation of the President's Tax Reform Panel that we adopt a territorial system for taxing foreign source income of U.S. controlled foreign corporations. I believe Congress should move in the opposite direction and completely eliminate deferral for foreign source income. The recent increase in oil prices is another good reason for Congress to take a careful look at eliminating deferral.

My testimony today on the ESD follows themes set out in articles I have published urging Congress to codify the ESD,[1] and my presentation on deferral is based on a published speech I gave in March 2006 at the Penn State Forum dealing with tax reform.[2]

II. Background on the ESD

The Senate bill sets out a conjunctive test for determining if a transaction satisfies the ESD. First, the transaction must change in a meaningful way (apart from federal income tax consequences) the taxpayer's economic position. Second, the taxpayer must have a substantial non-tax purpose (*i.e.,* business purpose) for entering into such transaction, and the transaction must be a reasonable means of accomplishing such purpose. This conjunctive test would act as a significant barrier to tax shelter activity and eliminate the different approaches courts have been taking when applying (or even questioning the validity of) the ESD under current law. In addition, the Senate bill would impose a 40 percent penalty on understatements attributable to a non-economic substance transaction, unless the transaction is disclosed, in which case the penalty would be 20 percent.

Codification has been opposed by the Treasury Department, the ABA Tax Section, the AICPA, and the Tax Executives Institute (TEI), an association of in-house business tax professionals.[3] My testimony today critically examines the rationales given by the Treasury and these tax organizations in opposition to codification. I first set out the basic case for codification and address the revenue estimates behind it.

III. The Basic Case for Codification of the ESD

Obviously there are many reasons for strong action against tax shelters and other non-economic tax-motivated transactions. For example, such transactions undermine the structure of the tax system by (1) allowing similarly situated taxpayers to pay different amounts of tax, that is, undermining horizontal equity, and (2) allowing certain taxpayers in higher brackets to pay less than taxpayers in lower brackets, that is, undermining the vertical equity inherent in our progressive tax system.

From a macroeconomic perspective, non-economic, tax-driven transactions are a drag on the economy, because, among other things, time of corporate officers and their tax advisers is diverted to the pursuit of transactions that have little or no economic merit. Thus, it could be expected that codification of the ESD would have the effect of channeling business people and their advisers in the direction of real, rather than tax-motivated, transactions. Also, the self-policing nature of the ESD may in time allow the IRS and courts to devote less time and effort on these transactions.

Certainly, codification would not end all tax shelter activity or tax driven transactions, but it would put a large "speed bump" in the way of non-economic transactions. The speed bump effect would help to level the playing field between (1) those aggressive tax advisers who seek financial rewards by playing close to (and in some cases over) the line, and (2) those more responsible advisers intent on playing within the rules. To be specific, codification of the ESD would reduce some of the competitive advantage aggressive tax planners have over their more responsible competitors in attracting clients. This is a real problem for tax advisers. Indeed, I experienced this problem first hand during my many years as the head of the tax department at a major Chicago law firm.

If non-economic transactions are developed that are not prohibited by the ESD, the Treasury and Congress should stand ready to enact targeted legislation to shut such transactions down. This is what Congress did with the enactment of the passive loss provision, Section 469, which has been very effective in shutting down many real estate and similar tax shelters.

In this regard, I urge that a provision be added to the Senate bill requiring the Treasury to annually report to the Congress on (1) the effectiveness of the ESD, and

[1] Thompson, *Despite Widespread Opposition, Congress Should Codify the ESD*, Tax Notes 781 (February 13, 2006), and Thompson and Clary, *Coming in from the "Cold": The Case for ESD Codification*, Tax Notes 1270 (May 26, 2003).

[2] Thompson, *Federal Tax Reform and Reducing the Bush Deficit by $800 Billion*, 110 Tax Notes 1486 (March 21, 2006).

[3] ABA Tax Section, Letter of January 4, 2006 to Congressional Tax Writers on Three Revenue Provisions, Including Codification of Economic Substance Doctrine, in Tax Relief Act of 2005 (S. 2020) as Passed by Senate, BNA TaxCore®—Congressional Documents Correspondence(January 5, 2006) ABA Letter]; AICPA, Comments of December 23, 2006 to Congressional Tax Leaders on Several Revenue Provisions, Including Codification of Economic Substance Doctrine, in Tax Relief Act of 2005 (S. 2020) as Passed by Senate, BNA TaxCore®—Congressional Documents Correspondence (January 5, 2006) AICPA Letter]; TEI, Letter of January 10, 2006 to Chairmen of House, Senate Tax Committees Commenting on S. 2020, Tax Relief Act of 2005, BNA TaxCore® Congressional Documents (January 12, 2006) TEI Letter].

(2) the need for targeted legislation addressing any tax shelter transactions that may not be clearly caught by the statute. This would keep Congress abreast of new tax shelter developments.

IV. Projected Revenues from Codification of the ESD

The projected tax revenue from codification of the ESD is substantial, with the Staff of the Joint Committee on Taxation estimating that the ESD and the associated provisions would generate approximately $15 billion over the ten year period from fiscal year 2006 through fiscal year 2015.[4] The revenue from codification of the ESD is by far the largest single item of the many "Revenue Offsets" included in the 2005 Senate Bill.[5] Thus, this is a big ticket item. Indeed, it is much larger than the revenue projected from the package of tax shelter provisions enacted by the Jobs Creation Act of 2004 (the 2004 Act). The Joint Committee Staff estimated that those anti-shelter provisions, which related principally to disclosure and penalties, would raise approximately $1.5 billion over a ten year period.[6]

V. Why is the Treasury against Codification of the ESD?

A. The Rationale Given by Former Assistant Secretary for Tax Policy Olson

The Treasury has opposed codification of the ESD for many years. For example, in her nomination hearings in 2002 before the Senate Finance Committee, former Assistant Secretary of the Treasury for Tax Policy Pamela Olson made the following comments concerning codification:

I do not think that codification of the economic substance doctrine will help. I do not think it will help for several reasons, but I would like to maybe mention a couple of them.

One, is that the doctrine right now is a very flexible doctrine that is applied by the courts as needed. I think any codification of it even if in codifying it we say that we do not intend to override any other doctrines, I think it is going to make it more wooden and less flexible than it currently is.

If that happens, then it has the potential for being both too broad and too narrow. So, that is a real danger. A more serious danger I see with it, is I think it adds to the complexity for the IRS in its enforcement of the laws and assertion of penalties in appropriate cases because it is yet another set of things that they need to consider, work through, and look at in doing an audit of a taxpayer. So I think that it has the potential to slow IRS audits, and anything that slows IRS audits is not a good thing. I think what we need at this point is more enforcement, and the IRS being able to complete more audits as rapidly as possible.[7]

Assistant Secretary Olson's opposition to ESD codification remained constant during her tenure as Assistant Secretary for Tax Policy, and her views were shared by others in Treasury.

Olson's statement reveals four principal arguments against codification. First, codification would make the ESD "more wooden" and "less flexible." Second, codification has the potential for creating a rule that is both "too broad" and "too narrow." Third, codification would add "complexity for the IRS in its enforcement of the laws." Finally, codification would "slow IRS audits." The next section explores each of Assistant Secretary Olson's arguments and identifies how each is flawed.

B. Analysis of Secretary Olson's Arguments

1. "More Wooden" and "Less Flexible"

Assistant Secretary Olson argues that codifying the ESD would create a rule that is "more wooden" and "less flexible," and former Deputy Assistant Secretary for Tax Policy Greg Jenner has argued that the legislative proposals would move away from an inherently flexible doctrine to a "rigid rule."[8] There are two significant criticisms of these arguments.

First, both Olson and Jenner use the terms "wooden" and "rigid" in a negative connotation, as if a rule is less effective because it is labeled as such. To the con-

[4] Joint Committee on Taxation, JCX–82–05, *Estimated Revenue Effects of the Tax Provisions Contained in S. 2020, the Tax Relief Act of 2005, as passed by the Senate on November 18, 2005* (November 29, 2005).

[5] *Id*. at Section V.

[6] Joint Committee on Taxation, JCX–95–03, *Estimated Revenue Effects of Chairman's Amendment to H.R. 2896 the AJCR* (October 24, 2004).

[7] Nomination of Pamela F. Olson, Hearing Before the Senate Finance Committee (Aug. 1, 2002).

[8] Sheryl Stratton, *Shelter Disclosure, Doctrine Codification Debated*, Tax Notes, Apr. 7, 2003, p. 25 (quoting the then Deputy Assistant Secretary for Tax Policy Greg Jenner as saying that codification of the ESD is "an incredibly bad idea" that would move away from an inherently flexible doctrine to a "rigid rule.")

trary, the principal argument for codification is the lack of "woodenness" or "rigidity" in the current state of the law. Look where the current "flexible" approach has left the state of the law concerning tax shelters. Courts are applying various standards, and it seems unlikely that the Supreme Court will soon clarify the law in such a way as to significantly curtail the use of aggressive corporate tax shelters. The current state of the law gives sophisticated taxpayers too much wiggle room, that is, too many opportunities to convince the IRS or a court that a purely tax-motivated transaction should be recognized. On the other hand, codification would give courts two guideposts for determining if a transaction has economic substance—the "objective" meaningful change in economic position test and the "subjective" business purpose test. The transaction would not be recognized if either test were not satisfied, that is, if either (1) there were no change in the taxpayer's economic position, or (2) the taxpayer did not have a meaningful nontax purpose for entering the transaction.

Second, both Olson and Jenner have overstated the degree to which codification would produce a "wooden" rule. First, the two-prong test, which is central to the codification proposal, is inherently flexible. Both prongs are open to interpretation and will afford courts latitude in determining what constitutes a "meaningful change" or "nontax purpose." Finally, Treasury would be given significant rulemaking authority to clarify the provision and, therefore, would have substantial power to insure that the rule is applied flexibly.

2. "Too Broad" and "Too Narrow"

Assistant Secretary Olson's second argument against codification of the ESD is that codification would produce a rule that is both "too broad" and "too narrow." Olson's argument that codification would lead to a rule that is "too broad" is based on the proposition that codification would result in findings that common transactions lack economic substance, and therefore, the desired tax consequences of these transactions would be denied. This argument, also vigorously made by several tax organizations, has several flaws, which will be discussed shortly.

Assistant Secretary Olson's argument that codification would create a rule that is "too narrow" is also flawed. While the argument is not expressly made, presumably Olson is arguing that currently courts have the flexibility to prevent current and future tax shelters that the statute may not contemplate, and by codifying the doctrine, tax professionals will be able to "plan around" the statute, thus narrowing the doctrine's reach.

Four points illustrate the flaws in this argument. First, the Treasury's authority to issue regulations under the provision will aid in the fight against such "aggressive planning." Second, the language of the statute remains sufficiently broad (as Olson herself argues) to allow flexibility in determining what constitutes an abusive tax-motivated transaction that does not result in a meaningful economic change or have a business purpose.

Third, the "too narrow" argument assumes that codification is the final and only tool in the fight against abusive tax shelters. It is possible that clever tax planners will formulate transactions that skirt around the literal language of the statute. Such is the case with any statute. However, codification of the ESD does not foreclose future legislation addressing specific tax shelters, and as suggested above, the Treasury should provide Congress with reports on the effectiveness of the statute and recommendations for any needed targeted anti-shelter legislation.

Finally, under proposed section 7701(o)(4), prior law continues as a supplement to codification. Under the language of (o)(4), other common law doctrines, such as the business purpose doctrine, would continue to operate as they did before codification. That being the case, it seems unlikely that codification would do anything to "narrow" the ability the Service or the courts have in combating abusive tax shelters.

3. "Complexity" for the IRS

Assistant Secretary Olson's third argument against codification of the ESD is that codification would add "complexity for the IRS in enforcement." After even a brief review of the cases attempting to interpret and apply the current economic substance and related doctrines, it is hard to understand how matters could be any more complex for the IRS in terms of enforcement. In making enforcement decisions and outlining strategies, the IRS is left with a variety of cases that apply a multitude of standards in a seemingly ad hoc fashion. This leaves the IRS at a significant disadvantage when challenging transactions entered into by enormous global companies with sophisticated tax planners on their side.

On the contrary, it would seem that codification and subsequent regulations would significantly decrease complexity for the IRS. Codification would give the IRS a much-needed tool in combating these abusive transactions. This tool is one of uniformity that would allow the IRS to apply a single standard and set of regulations in making decisions on enforcement, instead of basing those decisions on unsettled doctrines applied in disparate ways by the courts.

4. "Slow Audits"

Finally, Assistant Secretary Olson argues that the ESD should not be codified because codification would "slow IRS audits." There is no evidence to indicate that such a slowdown would occur. On the contrary, a more uniform standard coupled with clear and concise Treasury regulations would enable the IRS to increase the speed of its audits.

VI. Why are the ABA, AICPA, and TEI against Codification of the ESD?

A. Introduction

A close examination of the positions of the ABA, AICPA, and TEI against codification, reveals the following basic rationales: (1) codification would lead to increased complexity for taxpayers and would interfere with bona fide business transactions, (2) codification would hurt small businesses and average taxpayers and would decrease flexibility in the tax system, (3) there is no need for codification because the concerns with non-economic transactions have already been addressed by the 2004 Act and otherwise, and (4) the 40% penalty provision is too high. Each of these points is addressed in turn.

B. Complexity and Interference with Bona Fide Transactions

Along the lines of the concerns expressed by Assistant Secretary Olson, the ABA Letter argues that codification of the ESD may have "significant ramifications for bona fide business transactions that are far removed from the tax shelter transactions that are the intended target of the legislation." The TEI Letter makes a similar claim:

Indeed, codifying the economic substance doctrine would further complicate the system, confuse taxpayers and revenue agents, raise significant issues of statutory construction, impede the courts' ability to rely on existing precedent, and interfere with legitimate commercial transactions. Thus, adding a complex, subjective anti-abuse rule like [ESD] to the Internal Revenue Code might well be counterproductive and even frustrate IRS efforts to combat abusive transactions.

These arguments are unconvincing; it is highly unlikely that bona fide business transactions, such as the organization of a corporation, partnership, or limited liability company, or the sale or reorganization of such an entity would be adversely affected by the ESD. Certainly, tax advisers would be more cautious in planning transactions that came close to the line, and this is a good thing. The ESD would act as a speed bump for problematic transactions but would have virtually no impact on standard economically motivated transactions.

The current judicial ESD is difficult to understand, and courts take different approaches in applying the doctrine. Thus, there is a substantial degree of complexity and uncertainty with the current state of the law. Rather than increasing complexity and uncertainty, codification of the ESD would lead to a uniform application of the doctrine.

C. Hurting Small Business and Taxpayers Generally and Denying Flexibility

The AICPA Letter argues: "In addition to introducing statutory complexity and traps for small businesses and a broad cross section of taxpayers, codifying economic substance would deprive the tax system of the flexibility needed to keep pace with the changing economic environment." First, it is unlikely that the ordinary business activities of small businesses and of ordinary taxpayers will in any way be touched by the codification of the ESD. Certainly, the ESD will act as a speed bump for any small business owner considering entering into a tax shelter transaction to shelter her business income or capital gain on the sale of the business, but that is as it should be.

Second, small businesses and ordinary taxpayers generally cannot engage in the type of transactions that would raise issues under a codified ESD, either because the Code does not allow for such planning by such taxpayers, or such persons typically do not have the financial capacity to pay the fees of the sophisticated tax professionals who create and defend such transactions. Thus, without a strong mechanism for curtailing abusive transactions by wealthy individuals and large corporations, small businesses and ordinary taxpayers would be saddled with a greater portion of the tax burden. Consequently, by promoting greater horizontal and vertical equity in the tax system, codification of the ESD will help not hurt small businesses and ordinary taxpayers.

D. Concerns Have Already Been Addressed

The ABA Letter argues that the concerns with tax-motivated transactions have already been addressed by the 2004 Act. The AICPA Letter makes a similar point: "In our view, deterrence and the eventual eradication of abusive transactions are best accomplished through targeted disclosure; reasonably high non-disclosure penalties; clearer standards for opinion letters and reasonable cause penalty relief; aggressive enforcement; and continued evolution of appropriate solutions by an informed judiciary." The TEI Letter elaborates extensively on the point:

Moreover, TEI has consistently urged the Congress and the Treasury Department to focus on and enhance disclosure-based approaches to address tax shelters. In response, the Treasury and IRS developed regulations under section 6011 requiring extensive disclosures of reportable transactions that might be indicative of tax shelter transactions; Congress, for its part, enacted sections 6662A and 6707A, which penalize taxpayers for tax understatements attributable to reportable transactions and for failing to disclose reportable transactions, respectively. In addition, the IRS has developed a new Schedule M–3 as part of the Form 1120 U.S. Corporation Income Tax Return (among other returns) that dramatically expands the disclosure and reconciliation of financial and tax accounting differences. Finally, the Treasury Department and IRS have issued rules to restrict tax-shelter promoter activities and have substantially revised the standards of professional conduct for practice before the IRS (the Circular 230 rules), including the rules governing the issuance of opinions on transactions. TEI believes that these actions have already substantially curbed tax shelter activities, especially by large companies.

Thus, each of these organizations thinks that the anti-shelter provisions currently in place are effective. But, the revenue estimate associated with the ESD shows that it is likely to have a much greater bite than the current provisions. Thus, the assertion by these organizations is not consistent with the judgment of the revenue estimating professionals on the Staff of the Joint Committee on Taxation. Further, even if these organizations are correct in their view that the current provisions are effective, the addition of the ESD, as an additional speed bump, should not have an adverse effect.

E. Penalty too High

Each of the organizations argues that the 40% penalty for non-disclosed non-economic substance transactions is too high. For example, the ABA says: "[We] believe that a 40-percent penalty is too high, is likely to be administered inconsistently by the IRS and may affect a court's decision as to whether to apply the ESD in a given case." And the TEI says: "[W]e believe that a 40-percent penalty is too high and may affect the decisions of the IRS to assert the penalty or the courts to uphold them."

These organizations seem to want to have it both ways. On the one hand, they argue that a disclosure regime is effective, but on the other hand, they oppose a 40% penalty that can be avoided by disclosure, in which case the penalty is reduced to 20%. It seems eminently reasonable to impose a 40% penalty on a taxpayer who has entered into a non-economic transaction and decided not to disclose the transaction on its return.

Further, the argument of these organizations that the courts and IRS will be reluctant to impose the penalty seems to acknowledge that the ESD provision is likely to apply only in rare cases. Indeed, taxpayers and their advisers will have a tendency to avoid those transactions that might give rise to the penalty; again, the ESD provision would act as an appropriate speed bump.

VII. Conclusion on the ESD

Codification of the ESD will not bring business to a halt; rather, through its speed bump effect, codification will tend to deter business people from pursuing transactions that have no economic substance. This will be good for business, the economy, and the tax system.

One final point! Codification of the ESD should be a non-partisan issue, and there is bipartisan support for the provision in the Senate. Although the principal opponents to codification in the House are Republicans, it should be remembered that in the 1980s strong action was taken against tax straddle and real estate tax shelters by the Reagan Administration, which led the successful legislative effort to shut those shelters down. Now is the time for the Republicans and Democrats in the House to come together with their colleagues in the Senate and enact the ESD.

VIII. Congress Should Adopt an Imputation System Rather than a Territorial System as Proposed by the Tax Reform Panel

A. Introduction to a Territorial Regime and the Current Deferral System

I turn now to the question of whether Congress should replace our current deferral system for taxing foreign source income with the "territorial" or "exemption" system proposed by the President's Tax Reform Panel.

Under a territorial system, U.S. corporations would be exempt from paying Federal income taxes on business income they earned in foreign countries. For example, assume that a corporation headquartered in State College, Pennsylvania, let's call it State Oil Corp, sets up a subsidiary corporation in China, let's call it China Oil Sub. State Oil Corp would not be taxed on the income earned by China Oil Sub either at the time the income was earned or at the time the income was brought back (that is, repatriated) to the U.S. in the form of dividends paid by China Oil Sub to State Oil Corporation.

Under our current deferral system, State Oil Corp is not taxed at the time China Oil Sub earns the income but is taxed at the time China Oil Sub pays dividends to State Oil Corp, and at that time State Oil Corp receives, within limits, a foreign tax credit against its U.S. tax liability for China taxes paid by China Oil Sub.

To summarize, under our current deferral system, the business income of China Oil Sub gets taxed when the income comes home, with a credit for taxes paid to China; under the proposed territorial system, the business income of China Oil Sub is completely free of U.S. tax even when it comes home.

B. Tax Reform Panel's Reason for Moving to a Territorial Regime

The principal reason the President's Tax Reform Panel gives for moving to a territorial system is "competitiveness." In other words, a territorial system is designed to make U.S. firms competitive with other firms doing business in China by subjecting the U.S. firm to the tax rate that applies to other companies doing business in China.

Although a territorial regime addresses this aspect of competitiveness, it also creates another competitiveness issue, that is, it creates an unlevel playing field between business conducted in the U.S., for example in State College, and business conducted in China. The President's Tax Reform Panel does not address this competitiveness problem.

To illustrate, assume that the corporate tax rate in China is 15%, which is 20 percentage points lower than the 35% U.S. corporate tax rate. Assume that State Oil Corp is faced with the following investment decision: (1) invest $50 million in oil exploration and refining in State College, which is expected to produce $10 million in annual taxable income, or (2) invest $50 million in oil exploration and refining in China, which is also expected to produce $10 million in annual taxable income. Thus, the pre-tax return of both investments is $10 million. Other things being equal, with a territorial system, what investment decision would State Oil Corp make?

The answer is clear: State Oil Corp will invest in China because although the pre-tax returns of the two investments are the same, the after-tax return with the China investment is $8.5 million, that is, $10 million less the $1.5 million China tax, while the after tax return for the State College investment is only $6.5 million, that is $10 million minus the $3.5 million U.S. tax.

Thus, in purporting to solve a potential competitiveness problem for U.S. companies doing business in foreign countries, a territorial system would create a very real competitiveness problem for the people of State College in that it would give U.S. corporations an incentive to invest capital in foreign markets with lower tax rates, rather than investing that capital here at home. Also, such an incentive would only exacerbate the problem of the job outsourcing.

There are many other problems with a territorial system. For example, there is an enhanced incentive for companies to deflect what would otherwise be high taxed U.S. income into low taxed foreign subs through the use of related party transfer pricing that is not arm's length pricing, as Section 482 of the Code requires. Also, in the case of businesses where costs of operating in foreign markets are less than in the U.S., there is a basic financial incentive (in addition to the tax incentive inherent in a territorial system) for foreign as opposed to U.S. investment. For example, suppose China Oil Sub can produce and refine oil for the China market more cheaply than it can in the U.S. Assuming the ultimate price to consumers is the same in China and the U.S., China Oil Sub will have greater profits on its China sales than on comparable U.S. sales, and this is an additional incentive for investing in China rather than the U.S.

C. My Proposal for an Imputation System

My bottom line is that Congress should not adopt a territorial regime. In thinking about this issue for many years, I have come to the conclusion that Congress should tax on a current basis all the income of foreign corporations controlled by U.S. taxpayers. Thus, under this system, which has been proposed by, among others, Stephen Shay, the International Tax Counsel in the first Bush Administration,[9] State Oil Corp would be taxed currently on the income earned by China Oil Sub; in other words, the income of China Oil Sub would be imputed to State Oil Corp as the income is earned. Also, State Oil Corp would within limits receive a foreign tax credit for the China tax paid by China Oil Sub.

Therefore, under the above example, State Oil Corp would be taxed in the U.S. on the $10 million of income earned by China Oil Sub, which would produce a tentative U.S. tax of $3.5 million. However, State Oil Corp would receive a credit of $1.5 million against this tax for the China taxes paid by China Oil Sub, producing a final U.S. tax liability of $2.0 million. Thus, the total of the U.S. and China taxes would be $3.5 million. Under this system, the after tax return from investing in the U.S. and China is the same; in other words, the playing field is level.

Leveling the field in this way would also produce significant tax revenues. For example, the Office of Management and Budget estimates that the tax cost of our current deferral system is $69 billion over the period 2007 through 2011. This type of imputation system would also eliminate much of the complexity with our current deferral system and significantly reduce the ability of firms to engage in abusive transfer pricing schemes.

Let me make one final point. I am not suggesting that we penalize investments by China Oil Sub. I am only proposing that the China profits of China Oil Sub be taxed at the same rate as U.S. profits.

Chairman CAMP. Thank you very much, Mr. Thompson. I want to thank the entire panel. Now, we will go into a question period, and each Member will have 5 minutes to ask questions. I will begin. Dr. Desai, I believe you testified that we have seen increased global operations, and many businesses are receiving more of their income from their global operations. What, then, are the tax trends in other countries. We are not alone in terms of dealing with these issues. What do you see as the trends around the world?

Dr. DESAI. I would highlight two things that are apparent. First, we have seen declining marginal rates around the world so, the idea that people have in their heads that the United States is relatively competitive on tax rates is no longer true; It was true 20 years ago, but now is no longer true. Second, I think we see, and just to flesh that out a little bit, Tom mentioned some numbers, but the OECD averages are now well below U.S. numbers, and major competitors, both developed countries and developing countries have significantly lower marginal rates.

Second, we see our comparable countries employing tax regimes for their foreign income which are territorial, and as a consequence, American firms that are using this worldwide system can be placed at a significant disadvantage relative to those foreign firms that are living in an international tax regime which is far more friendly.

Then, finally, just on this point of how we as American companies or how American companies compete with those firms, I think

[9] *See e.g.*, Peroni, Flemming, and Shay, *Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 55 (1999). *See also* Flemming and Peroni, *Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System*, 109 Tax Notes 1557 (December 19, 2005) (analyzing the territorial proposal of the Tax Reform Report and a similar proposal by the Joint Committee on Taxation; concluding that we should move to an imputation system).

it is important to note that when firms grow abroad, that is good for the United States. Research shows that firms that grow abroad grow domestically, and it makes sense; which is to say this is not a zero sum game. If it is not a zero sum game, if we make American firms more competitive abroad, they are going to do more activities in the United States as well. So, we should not view this as a zero sum game where, you know, if some investment goes abroad, somehow it is lost. In fact, the exact opposite is true.

Chairman CAMP. Thank you. Mr. Pearlman and Dr. Neubig, if you could just comment: not all businesses are C Corporations. Tell me how you feel expensing and accelerated depreciation, how do passthrough entities like partnerships and Subchapter S companies, how important are those items to them in your opinion?

Mr. PEARLMAN. I think the tax cost recovery system is important to every business. Indeed, in this context, as I noted in my written statement, I think you cannot just think about corporations. This is really a business tax system issue. Therefore, the sole proprietor, the business being operated in partnership form, the corporate enterprise, whether it is in a passthrough form like a Subchapter S corporation or a regular C Corporation, all are affected by the cost recovery system. Therefore, I think you have to think about all of those forms as you think about changes to any aspect of the cost recovery system.

Chairman CAMP. Dr. Neubig?

Dr. NEUBIG. I would agree with Ron Pearlman, that accelerated depreciation is important for all businesses. Although it is a timing difference, there are positive reductions in the cost of capital. The question is, for corporations and for noncorporations, if you have a choice, an explicit choice, between accelerated depreciation or expensing and a lower rate, what would work best, and for many noncorporations, they are also earning a lot of income from their hard work, their entrepreneurial efforts, their risk-taking in addition to from their equipment and their property.

Chairman CAMP. Thank you. For Mr. Pearlman and Dr. Shackelford, we heard from the panel a recommendation that we should look at the corporate rates. If those were reduced, what effect would that have on taxpayers with deferred liabilities, those that are heavily in debt, if you could both just take a chance to answer that? Dr. Shackelford, if you want to begin.

Dr. SHACKELFORD. Let me make sure I understood your question. You asked about deferred tax liability?

Chairman CAMP. Yes, and how would a change in the rate affect those companies or businesses with deferred tax liabilities or those that are heavily in debt?

Dr. SHACKELFORD. Deferred tax liabilities are taxes that you have to pay in the future. Since the rate would be lower in the future, this would create current income to companies on their books. Obviously, companies would be pleased by that.

Conversely, if you had deferred tax assets, in other words, you have deductions coming in the future; those deductions just became smaller. So, for companies in that situation, and there are a lot of companies with very large tax assets, surprisingly, reducing the tax rate from their perspective will not be good.

I am not sure that that has a direct implication to leverage, except that the stronger your balance sheet, the more easily you can raise capital.

Chairman CAMP. All right; thank you. Mr. Pearlman?

Mr. PEARLMAN. Mr. Chairman, the only thing I would add to that is actually a more general comment. Dr. Shackelford is the world's expert on this topic, so I do not think I can add very much. More generally, I think the book effects, the financial accounting effects of tax law changes are obviously critically important to businesses, particularly to public companies, and I think at least as tax professionals, we tend to deemphasize or not pay attention to those, and obviously, in the tax policy process, it is critically important to at least be aware of what those effects will be.

Chairman CAMP. All right; thank you very much. Now, Mr. McNulty may inquire.

Mr. MCNULTY. Thank you, Mr. Chairman. Since our time is so limited, I am going to harken back to what I said in my opening statement. I come from New York. We had a Governor years ago, Al Smith, who used to say let us look at the record. I have been here since the eighties, and I note that in the nineties, we had the longest sustained period of economic growth in the history of the country. We also had the only four budget surpluses in the last generation.

Then, in the year 2001, we started on this era of multitrillion dollar tax cuts. We have since had the largest budget deficit in the history of the country, and the national debt is now exceeding $8.3 trillion. Now, people that are my age are going to get through the rest of their life okay. I have got four children and five grandchildren, and I think more and more each day about what we are leaving them. Frankly, I do not like the picture right now.

I guess I would like to ask each of you to comment briefly on, not the reasons for what has happened in the last few years, but based upon the recommendations that you have just made, how do you see your recommendations ameliorating that situation, if, indeed, you think they would? Yes.

Dr. DESAI. Congressman, I share your concern about both large deficits, both for future generations, with the value of the dollar, for a variety of reasons. As it relates to recommendations I put forward, the key concern is that we continue to grow as an economy, and unlocking these corporate capital gains so they can be reinvested productively, as opposed to being held on in the way they are now, would stimulate new investment domestically.

Second, making our firms more competitive and allowing them to compete against other corporations that have different tax regimes that they face again I think would help the economic growth picture here.

Finally, on book tax conformity, which I advocate, and Doug disagrees with, there is the potential for a much simpler system which has much lower compliance costs and effectively could be revenue neutral.

So, I think those are savings, and I think those allow us to grow further. There is an interesting question you raise about how we think about financing ourselves going forward. In my proposals today, I have emphasized and really focused on the growth effects of these proposals, which I believe are substantial and would help us ultimately grow out of these deficits.

Mr. MCNULTY. Thank you.

Mr. PEARLMAN. Mr. McNulty, as it relates to the topics I discussed today, I think the primary focus is my concern, frankly, that tax reform is viewed just another opportunity to reduce taxes, either on individuals or businesses or both. What I was simply trying to convey in my comments is that tax reform can be an opportunity to improve the efficiency of the tax system, but it has to be under a very severe discipline.

The thing that I think was the hallmark of the 1986 effort, with which I was somewhat involved, was that it was done on a strict revenue neutrality basis that forced a recognition that there would be, as best people could determine, no revenue loss. Absent that, tax reform could just contribute to the serious economic condition of the country, and I am worried about that, and that is what prompted a lot of what I tried to address today.

Mr. MCNULTY. Thank you.

Dr. NEUBIG. I think I have worked too long with Ron and have shared the experience of the 1986 tax act. There clearly is improvement for meaningful reform in the corporate tax area that will improve our economy, increase the personal incomes of our kids and grandkids, and in many ways, we have to make hard decisions between choices such as narrowing the base versus lowering the rate, and whether or not Congress can choose what will be best for the economy on an industry by industry basis or trying to reduce rates for all industries is something you should be deciding.

Dr. SHACKELFORD. I think my comments with regard to conformity have really very little to do with what you are asking. My comments raise the concern that as you move forward in considering corporate tax reform, you take into consideration that the financial reporting system is closely linked, and in improving the tax system, we want to be careful not to harm our capital markets.

Mr. THOMPSON. If Congress were to follow my suggestions on dividends, the deficit would be $109 billion less over the next 10 years. With respect to the imputation system I have suggested, revenues would go up significantly, and a bias in favor of foreign investment vis-a-vis U.S. investment would be eliminated. The enactment of ESD would generate significant revenues, according to the JCT revenue estimates.

Mr. MCNULTY. I thank you all, and thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Linder may inquire.

Mr. LINDER. Mr. Thompson, do you think the taxing on various assets is a zero sum game? Are people going to have the same dividends paid out if you tax them higher as they do today?

Mr. THOMPSON. I think the evidence is ambiguous as to whether the reduction in the rate of taxation on dividends has generated an increase in dividend payouts. There are some basic disputes among the economists——

Mr. LINDER. Do you think Microsoft would have finally paid dividends even if we did not change the taxes?

Mr. THOMPSON. Pardon me?

Mr. LINDER. Do you think Microsoft would have made the decision to pay dividends even if we did not have a tax——

Mr. THOMPSON. I do not know about Microsoft as a company. I am simply talking about it on an aggregate basis. I think the evidence is in dispute as to whether it has generated. Even if it has generated, that does not necessarily mean that it is better for the economy, because where are those dividends going to go? Are they necessarily going to be plowed back into other companies or plowed back into other investment? Is it more efficient to have dividends than to have retained earnings? I think that——

Mr. LINDER. I got your idea. Dr. Shackelford, how much do we spend in corporate America on compliance costs?

Dr. SHACKELFORD. I do not have a figure. I am sure it is extraordinarily high.

Mr. LINDER. What percentage of all income taxes are paid by corporations or businesses?

Dr. SHACKELFORD. I do not have that percentage in front of me either.

Mr. LINDER. Ten or 11 percent.

Dr. SHACKELFORD. It is not a particularly large number in corporate taxes. It is difficult to make that statement, because S corps and other things would flow through to individual tax returns. So, if you look at the tax return data, that becomes a hard question to answer.

Mr. LINDER. Is it fair—the Tax Foundation says that we spent $265 billion last year filling out IRS paperwork. Is that a fair number?

Dr. SHACKELFORD. I cannot verify that, but as I said, I am sure it is a large number.

Mr. LINDER. Is it also fair to assume that we also spend almost that much or at least half that much calculating the tax implications of a business decision?

Dr. SHACKELFORD. Again, I do not have that number, but that number also is high.

Mr. LINDER. Mr. Pearlman, if corporate America is paying about 10 percent of the income tax burden, and they used to pay about a third, who is actually paying those taxes?

Mr. PEARLMAN. Well, that is a question that is probably unanswerable. The economic literature suggests that the corporate tax is borne by wage earners, by investors, and by consumers. In what proportions? You talk to three economists, they will give you different answers.

Mr. LINDER. Have you ever started a business?

Mr. PEARLMAN. I am sorry?

Mr. LINDER. Have you ever started your own corporation?

Mr. PEARLMAN. I have never started my own corporation. I have started lots of corporations but never my own.

Mr. LINDER. I have started six in which I was the only shareholder. You put as much money as you can into it, and then you go to the bank and borrow. Guess who paid my taxes when I made profits? My customers, my clients, my patients. I could not go back to my pocket again.

Mr. PEARLMAN. As I said, the economic literature suggests that corporate taxes are borne by all of them: some in the form of adjustments to wages; some in the form of prices to consumers; some are borne by shareholders, and I do not think there is any definitive response that anyone can give to your question.

Mr. LINDER. Well, if you start that company, and you are the only shareholders, you know you cannot go back to that pocket again. It comes from your customers. If we are spending as much to comply with the Code and calculate the tax implications of a business decision as we are submitting to the government, is it reasonable to assume that if we eliminated all business taxes entirely, we might have more revenues to the Federal Government?

Mr. PEARLMAN. I do not know the answer to that question. Clearly, I mean, clearly, you are correct, Mr. Linder, that the financial cost of tax compliance is very high in this country, and presumably, tax reform could contribute to a meaningful reduction in that cost. Would that be good for the tax system or the economy? I am confident it would be.

Mr. LINDER. If we are spending $300 billion to $400 billion a year to comply with the Code and submit $1.5 trillion in income taxes, that is not just inefficient; that is stupid. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Doggett may inquire.

Mr. DOGGETT. Mr. Chairman, thank you. I genuinely appreciate you having this hearing, and my remarks about what I consider to be the scandalous role of the Committee on Ways and Means in its failure to address corporate tax abuses are in no way directed at you as the new Subcommittee Chairman on a personal level, but I do think——

Chairman CAMP. Well, I certainly appreciate that.

[Laughter.]

Mr. DOGGETT. —it is very important to put this in proper perspective, and I do not think it has been put in proper perspective.

I do agree with you fully that all Members of the Committee want a tax system that does not choke off economic growth, but when you look at the ongoing abuses that this Committee has disregarded through the years, it really is enough to make you choke. Citizens for Tax Justice did a study of corporate income taxes in the Bush years that was published in 2004 and found that about a third of the 275 major companies they surveyed paid nothing or less in Federal income taxes in at least 1 year from 2001 to 2004. There were 28 companies that enjoyed a Federal income tax rate of zero or negative for the entire period, 2001 to 2003.

I think that it is not realistic to compare statutory rates with the OECD. The main thing we have in common with the Europeans is Swiss cheese, and we have a Swiss cheese corporate Tax Code, except that it is mostly hole and not very much cheese. This hearing in a way is the nearest thing that the Committee on Ways and Means has done to continue any hearing or investigation of corporate tax abuse since Chairman Archer reluctantly convened this Committee in this room on November 10, 1999, and in the intervening half a dozen years. During that period, the proportion of the national tax burden that is borne by corporations has steadily declined, and the use of abusive tax dodging techniques has cost Americans billions and billions in revenue.

On that day, November 10, 1999, the discussion focused on recommendations of the Joint Committee on Taxation and on legislation that I had introduced to close at least a few of the most abusive corporate tax shelters. Since then, the U.S. Senate, even when it had a Republican majority, has on at least three occasions overwhelmingly approved legislation to address this matter of abusive corporate tax shelters.

The issue continues even to this moment, as Chairman Grassley has attempted, even in the tax reconciliation conference Committee, to address the problem of corporate tax avoidance. Senator Levin brought in the tax returns from Enron. This Committee was even afraid to look under a rock to see what was under there with the kinds of abuses that led not only to the defrauding of shareholders but to the conduct that was to the great detriment of the U.S. Treasury.

Throughout this period, the House Committee on Ways and Means has been the obstacle. It has been the major enabler of corporate tax shelters. It simply would not have been possible for KPMG, other major accounting firms, investment banks, and assorted law firms to rip off the U.S. Treasury without this Committee blocking reform.

What was the kind of conduct that this Committee was permitting to continue? Well, one of those who testified as a former KPMG employee over in the Senate described having personally witnessed in his large accounting firm tax shelter promoters openly proclaiming their disregard as the law by making statements to clients such as, "it is like stealing candy from a baby;" "you will never pay taxes again;" "our clients do not pay income taxes." Paying tax is optional—kind of the Leona Helmsley approach to corporate taxes.

So, as we look at how to restructure our corporate tax system, the first thing we need to look at is how to shut down some of the abuses. There may well be more commonality than my comments indicate in that to the extent that we simplify the system, the opportunities for corporate tax abuse will be reduced.

Let me ask you, Professor Thompson, the comparison to the OECD, if you actually compare instead of the statutory rate, the amount versus gross domestic product (GDP) of U.S. domestic tax revenues with the amount of corporate tax revenues versus GDP in those other countries, how do we come out comparing? Do we look like we are the most negative toward corporations or overdemanding to them in what they provide, or are we behind the European countries in that regard?

Chairman CAMP. Mr. Thompson, the Gentleman's time has expired, but we would like to hear your answer.

Mr. DOGGETT. Thank you.

Mr. THOMPSON. Thank you, sir. It so happens, Congressman, that I had an opportunity to look at that very question. The Tax Foundation came out with this report that follows the Professor's statement here about statutory rates, and the statutory rate in the United States is 39.4 percent, according to the OECD; for example, the statutory rate in the U.K. is now 30 percent. As of 2000, the year 2000, note the difference in the percentage of GDP produced by those two statutory rates.

In the United States, the 39.4 percent statutory rate came out to 2.5 percent of U.S. GDP. The 30 percent statutory rate in the

United Kingdom (U.K.) comes out to 3.7 percent of U.K. GDP, and the average percentage of corporate tax to GDP is 3.6 percent among OECD countries, which indicates that our corporate tax system is full of holes. We have a high statutory rate and a very low effective rate. Other countries have lower statutory rates and higher effective rates.

Chairman CAMP. Thank you very much. Ms. Hart may inquire.

Ms. HART. Thank you, Mr. Chairman. I have too many questions, so I am going to pick one.

I had a forum with about eight different corporate financial people on Friday to get an opportunity to hear from them and their everyday lives and the decisions they make basically as a result of the Tax Code, not necessarily because they are the best decisions for the business but because they are the best decisions for the business because of the Tax Code, which I think we all agree is really strange and undesirable.

One thing I left the meeting with, one point, and I believe Professor Pearlman made it, is just the idea of getting rid of the different unique little exemptions and other special provisions and just having an effective across the board lower rate. If Congress actually did decide to broaden the corporate base and then reduce rates, I would like to hear first from Mr. Pearlman and then anybody who we have time for, what effect you think that might have on taxpayers and the deferred tax liabilities and other decisions that they have made and the suggestion of timeframe that it would take, actually, to change the system that drastically.

Mr. PEARLMAN. Well, Ms. Hart, I will try to be very brief so that others have a chance to comment. I think overall, it would be an extraordinarily positive thing to do. Very candidly, however, it is going to differ depending on taxpayers. Taxpayers who currently enjoy the benefits of very targeted tax preferences are not going to be happy. Taxpayers who have higher effective tax rates are going to be delighted.

I think the financial accounting impacts in the aggregate should be positive, although again, I would leave it to Professor Shackelford to react authoritatively to that. It is a difficult process; I lived through that during the 1986 act, and it is a difficult process. If one were to make a judgment that it were desirable to reduce the marginal tax rate, as I believe it would be, and you are willing to take on the burden of getting there, that is, identifying the losers that are necessary to do that, I think ultimately, that would be good for this country, both from a tax policy and an economic policy standpoint.

Ms. HART. Thanks. I guess, Dr. Shackelford, since you have been called upon.

Dr. SHACKELFORD. I wholeheartedly agree with a broader base and lower rates. One thing that it would cost you is, if you move the corporate rates, you also need to move the individual rates. If you move the corporate base, you need to move the individual base. An example of this is the opportunity between having a C corporation and an S corporation. You do not want a situation where, basically, individuals can either game the system by being a corporation and getting a more favorable tax system or remaining as an individual for tax purposes and gaining a more favorable situation.

So, I fully endorse broader base, lower rates, but I would say it needs to be further than just corporate reform.

Ms. HART. Okay; thank you for that. Anybody else care to comment? Yes, I would run from that one screaming, too. The one thing you all did not give me, and I will see if I can get it, is a timeframe to get there. Should it be, you know, here is the law now, and in 10 years, this is going to be the new law, or how do we get there?

Mr. PEARLMAN. Well, to some extent, frankly, it depends on how you get there. My assumption has always been that reasonable transition from the existing law to a desired future goal makes a lot of sense, and while there are academics who disagree with that and say you should just go cold turkey, change the law, let people just suffer with the change, I think that is not realistic either from a business perspective or in a realistic political world.

How long depends on what the changes are. For example, if you made massive changes to the depreciation system, presumably, you would do that over a longer period of time. If you merely cut out a couple of very targeted, narrow tax shelters, perhaps you could do that more quickly.

Ms. HART. The more things we offer from 1 year to the next, the harder it gets.

Mr. PEARLMAN. Exactly.

Ms. HART. It obviously makes delay a problem.

Mr. Thompson.

Mr. THOMPSON. Let me say, I am a Democrat, but I have the utmost admiration for Ron Pearlman and what he and others did in the Reagan Treasury Department in 1986, and I think that if we could start, if we could go back to the 1986 code right now, we would have one hell of an improvement over what we have.

Ms. HART. Okay; that gets us at least 20 years back—by the way, I was in law school in 1986, learned all the tax law, and then, it was all different, which was really helpful. I think that is the only question I have for now, because I see my time has gone. I yield back, Mr. Chairman.

Chairman CAMP. Thank you very much. Ms. Tubbs Jones may inquire.

Ms. TUBBS JONES. Thank you, Mr. Chairman. Good afternoon, gentlemen. Thank you for appearing here today. I want to start with, if I can read this, Dr. Neubig, seeing how you decided to talk about my State having recently—I am from Ohio, by the way; there are a lot of things going on in Ohio, like a loss of 160,000 jobs, and so forth, but I want to focus in on where you said when the State of Ohio enacted legislation phasing down its corporate tax rate on June 30, 2005, a number of public corporations reported higher profits due to the future tax rate reductions and their second quarter financial results. Have you followed that since June of 2005, sir?

Dr. NEUBIG. Well, I guess this goes to the question that Congressman Hart also asked in terms of the timing of the transition, that the Ohio Legislature and the Governor signed a 5-year phasedown of the corporate franchise or income tax, completely eliminating the corporate income tax 5 years out, and the way the accounting works—and again, I would defer to Professor Shackelford, is that when you have deferred tax liabilities, oftentimes, those deferred liabilities are going to be going out, 5, 10, even 20 years.

To the extent that there are lower rates, because, as taxes might have been paid 10 years from now, they are currently measured at, in the case of Ohio, it might have been 5 percent, but now, it will be at zero; they were able to report higher book profits. So, there is almost an immediate effect in terms of some of the book changes.

Ms. TUBBS JONES. If I understand the discussion about a book change and a real change, what impact—was there a real change for growth of business in Ohio as a result of this tax change?

Dr. NEUBIG. Well, I certainly think the Ohio Legislature thought that was true. The Ohio Business Roundtable was supportive of the——

Ms. TUBBS JONES. I did not ask you that question, sir. I asked you was there a real change.

Dr. NEUBIG. My colleague, Bob Cline, has done analysis of it. I mean, it has only been in effect for 9 months. It is being phased in over——

Ms. TUBBS JONES. Sir, I do not have but 5 minutes. Either it did, or it did not. Was there an improvement?

Dr. NEUBIG. Well, we certainly believe it will have a positive effect on Ohio's economy; absolutely.

Ms. TUBBS JONES. So, do you think if individuals had the ability to defer their taxes over 5 or 10 years, they would have an opportunity to improve upon their economic situations?

Dr. NEUBIG. Well, I think marginal tax rates matter. High marginal tax rates discourage activity, and if we can have broader bases with lower marginal tax rates, I think that is positive for State economies and also the U.S. economy.

Ms. TUBBS JONES. Let me go to the Democrat. Mr. Thompson, tell me, are you familiar with the change in Ohio tax laws with regard to corporations?

Mr. THOMPSON. I do not know anything about State taxes.

Ms. TUBBS JONES. Got you. Got you. Got you. Let me ask you something else, then. It was a great answer. From what I am hearing, as I recall some of the things you said, Mr. Thompson, there could be improvements in the income for the United States if there were some changes in the corporate tax structure. That is a good summary of what you said.

Mr. THOMPSON. Yes.

Ms. TUBBS JONES. Can you give us some specific examples of changes that you would suggest would assist us in improving the income of the United States or the deficit? Maybe that is a better question to ask.

Mr. THOMPSON. Well, as I said, I think that this idea that dividends are undertaxed is just flat out false for high bracket taxpayers. I think that the case—I think the conservative Republicans ought to be strongly supportive of moving to tax dividends of high bracket taxpayers at regular marginal rates that would eliminate a huge subsidy that those taxpayers are receiving and would give you some revenue to begin to focus on the idea of bringing down corporate rates.

If you have a tax system that is just full of loopholes, you are going to be bound to have these high statutory rates to make up for the deficits that arise from the loopholes. So, the dividend problem is a major problem.

Ms. TUBBS JONES. The argument that is made for reducing the capital gains and dividends is that hundreds and millions of Americans depend on their dividends for their retirement and the like. Are you able to compare, in the work that you have done, how much income comes from dividends for these poorer people who live on their dividends as opposed to the reduced rate for the high income folks?

Chairman CAMP. Mr. Thompson, the time has expired, but please complete your answer.

Ms. TUBBS JONES. Thank you, Mr. Chairman.

Mr. THOMPSON. Clearly, high bracket taxpayers get most of the benefit from the dividend cut. I believe that if you move back to taxing dividends at the regular, ordinary rate, there ought to be some targeted relief for low bracket taxpayers.

Ms. TUBBS JONES. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Chocola may inquire.

Mr. CHOCOLA. Thank you, Mr. Chairman. Thank you all for being here. Obviously, we are here to talk about potential tax reform, and a lofty goal or a reasonable goal for any tax reform is to increase our competitiveness, U.S. companies, and our standard of living as a country. So, with that in mind, just to review some of the economic data that we have had recently: we have had 18 straight quarters of economic growth; unemployment is at a historic low of 4.7 percent. We have had 5.3 million new jobs since August of '03 created in this country. After-tax personal income has grown about 4.1 percent in the last 12 month. The Dow Jones is at historic highs. Tax receipts grew by 15 percent in 2005, one of the largest increases, I think, in over 20 years. Capital gains receipts alone grew by over 50 percent from 2003 to 2005. The deficit, the annual deficit last year, was reduced by about $100 billion, and receipts in the first quarter of '06 are up 10 percent, and the deficit is down about $11 billion.

What lessons do you think we learned in the tax bill that we passed in 2003, which is right, after I was elected in 2002? Are there any lessons that we can learn from that? Do you think the dividends rate, the cap gains rate, 179 expensing, had anything to do with that growth?

Dr. DESAI. I am going to take a shot at that. I think that experience illustrates two things: first, it illustrates that reduced marginal rates on capital gains and dividends have the potential to impact the cost of capital and increase investment.

Mr. CHOCOLA. So, reduced rates could actually lead to increased tax receipts?

Dr. DESAI. Increased investment, and then, following down the chain, ultimately to higher wage levels and to higher tax receipts.

I think it also illustrates the fact that we came out of a recession at that simultaneous time. What is very hard to disentangle is what those relative two effects are: what is the natural bounceback, and what is the effect of those tax changes? The economic studies on that subject suggest that, A, it improved dividend payouts for sure; and B, there is competing evidence on whether or not it actually influenced investment, in large part, because it is hard to tell the timing of the tax act versus just a natural bounceback.

Mr. CHOCOLA. Anybody else? Mr. Thompson?

Mr. THOMPSON. Congressman, it is attractive to say we reduced the capital gains rate; we reduced the dividend rate, and the economy has been doing well, and therefore, the economy has been doing well for those reasons, but think back to 1993. In 1993, we increased taxes, and yet, there was a significant period of growth, and indeed, a period of growth that far eclipsed the period of growth that we have seen recently, so that is it fair to say that all of the 1993 and thereafter growth was attributable to the tax increase? I think some people believe that it probably was.

I do not think that we can say that a significant portion of the current growth that we have seen is attributable to the tax break for capital gains and dividends. Also, I think that by extending the dividend rate, the current dividend rate and the current capital gains rate is going to have a significant adverse budgetary effect going into the future. There may have been a decrease in the budget recently, but if there is a continuation of the cuts for dividends and capital gains, it will be a significant adverse budgetary effect.

Mr. CHOCOLA. Well, I am certainly not a history professor or an economist, but one of the things that I have learned is that when you have lower marginal rates, be they individual or corporate rates, it seems to me that history has proven that tax receipts actually increase because of economic growth, with the Kennedy tax cuts, the Reagan tax cuts, and now, the tax cuts that we have enacted over the last few years. You said that you would raise dividend rates on high income earners. How do you define high income earners?

Mr. THOMPSON. My research shows that if you move back to taxing dividends as ordinary income, taxpayers in the 28 percent bracket and lower would be overtaxed on dividends, and you ought to have some kind of relief for those taxpayers. But taxpayers in the 33 percent and higher tax brackets would not be overtaxed on dividends, and they should be subject to taxation at regular rates.

Mr. CHOCOLA. What about, and I should probably know this, but how are mutual funds taxed? If I am a teacher, and I am part of a pension plan that has investments, that pays dividends, how are those mutual funds taxed, and how is the individual teacher in the pension plan taxed?

Mr. THOMPSON. Well, the mutual fund is not subject to taxation, and the dividends that are distributed to the retirement plan are exempt from taxation. The teacher is exempt from taxation until he or she retires, in which case, the distributions from the pension plan would be taxable to the teacher.

Mr. CHOCOLA. Okay; thank you. Thank you, Mr. Chairman.

Mr. FOLEY. [Presiding.] The time of the gentleman has expired. The gentleman from California may inquire.

Mr. THOMPSON OF CALIFORNIA. Thank you, Mr. Chairman. I thank all of you for being here today. I just want to go back to something that two of my colleagues mentioned. Mr. McNulty talked about the size of the problem, particularly the debt and the deficit. Mr. Thompson, I appreciate your proposal that would save $109 billion over 10 years, and just for the record, though, it is important to note that the debt is $8.3 trillion, so we would have to do about 81 times those savings in order to have an effect on that, and we learned here in this very hearing by the Comptroller that by 2041, the Federal Government is going to take in enough revenue to pay the interest on the national debt. As a matter of fact, just in the little bit of time that we have been here today, the interest payments have been about $21 million, so this is a pretty substantial problem.

Then, we see that competing interest, because later, Mr. Thompson, you mentioned that we could then use those savings to bring down the corporate rate, so those savings did not even go down to pay the debt of the $400 billion deficit. They are already in the hunt for how to spend those.

The other issue was abuse that Mr. Doggett talked about, and being that this is a hearing to get ideas on how to fix the tax structure, do any of you have ideas on how we can go after this abuse issue, and what sort of changes in the law could we put in place to close those abuse loopholes?

Dr. DESAI. I would go back to my third proposal, which is to link book and tax income more carefully. As Congressman Doggett alluded to, we are living in this world where we have two completely different notions of income: what people report to capital markets and what they report to tax authorities. So, that gives them license to do a lot of different things, and they take advantage of that. So, that is the world that we are living in today.

If we lived in a system where marginal rates were lower, where income was defined according to the principles that have been developed by accountants, that would be much more preferable to a system where income was defined according to transitory legislative needs or tinkering, legislative tinkering; no disrespect intended. So, in that sense, I think conformity would allow for that kind of shelter abuse to stop. In fact, we know that corporate tax shelters are never undertaken to reduce book income, and in fact, they are often undertaken to produce book income. So, eliminating that distinction between the two, I think, could actually help a lot of the corporate tax abuse that we see.

Mr. THOMPSON OF CALIFORNIA. Thank you. Any other ideas on how to stop the abuses? Yes, sir.

Dr. SHACKELFORD. I would recommend increasing funding for the IRS.

Mr. THOMPSON OF CALIFORNIA. Create——

Dr. SHACKELFORD. Increased funding for the IRS. Some years ago, corporations were audited in a much higher proportion than they are now. I think that reductions in funding contributed to some of the things in recent years that occurred.

Mr. THOMPSON OF CALIFORNIA. So, better enforcement.

Dr. SHACKELFORD. Yes.

Mr. THOMPSON OF CALIFORNIA. Any other ideas? Mr. Neubig, you mentioned the issue of capital expensing, and could you talk a little bit about how this helps to influence purchasing choices? It seems to me that that is one way to stimulate the economy, one way to generate more business here at home. Is that what happens? I was not certain on your testimony whether you were critical of that or——

Dr. NEUBIG. I am not being critical of having depreciation rules that are set by Congress in terms of achieving the optimal investment incentives, but there are tradeoffs, and depreciation is a large part of the corporate and total business income tax base. To the extent that there is a deficit, to the extent that you were doing revenue neutral tax reform, there are choices that have to be made in terms of do you want to have accelerated or more accelerated depreciation versus the alternative of having a lower rate for corporations or for individuals?

When people do their cost of capital calculations, it is not only the treatment of depreciation, but it is also the tax rate that goes into those calculations. So, both of them, both lower rates and accelerated depreciation, can have favorable effects in terms of the investment decisions. There are an awful lot of other margins that are important that businesses are making besides just making investments in equipment and property. They are making decisions in terms of where they are going to be doing business in the world; they are going to be making decisions about their debt-equity choice, whether or not they are going to choose to operate in corporate form versus noncorporate form. They are making decisions about transfer pricing. All of those other decisions are affected by the statutory tax rate.

So, that is why I think I would agree with Ron that there might be a presumption of having lower rates over more targeted changes. Again, those should be evaluated. The Treasury Department has established this dynamic analysis group. It would be very useful if they looked at individual provisions in terms of the dynamic analysis.

Mr. THOMPSON OF CALIFORNIA. Thank you.

Mr. FOLEY. The time of the gentleman has expired. The gentleman from Connecticut, Mr. Larson.

Mr. LARSON. Thank you, Mr. Chairman. I thank all the panelists for their expert testimony. I want to join with the sentiments expressed by Mr. McNulty in terms of our disappointment that the Treasury Department is not here, because I do think that these are important and timely issues to be taken up, and I also regret that we have not heard from the President's commission as well.

I further want to commend a colleague of ours, Mr. Linder, both in terms of his robust questioning, and I realize that this is not about consumptive taxation, and while not an endorsement, I think that he has written an intriguing book and raises some very important issues along with other Members like Chaka Fattah, who is also exploring many avenues as it relates to our Tax Code and all the more disappointing that the Treasury Department is not here and that we do not have a chance to look at that stuff, but again, I thank Chairman Camp for this.

I was told when I first came on this Committee that it would be instructive if I read *Showdown at Gucci Gulch.* I had the opportunity to do so, and it allowed me to trace the history, the very storied history of this Committee including proposals that were put forward by Senator Bradley and then Representative Gephardt and then ultimately from 1982, when they first introduced it, to passage in 1986 with Dan Rostenkowski working almost—well, I cannot say quite hand in glove with President Reagan but nonetheless, an interesting read and it raised a lot of questions.

My questions are twofold to the panelists: number one, how would you categorize the influence of K Street or undue influence of K Street, and then, philosophically, as experts in the field of our Tax Code, are we at odds in terms of corporate interests versus citizen interests? We used to say that what is good for GM is good to the country. Can we say that today? Or is that in this era of globalization, with continued outsourcing and people fearing for loss of their pensions and health benefits that corporate interests, with their own set of fiduciary responsibilities to the shareholder, run counter to the interests of citizens and their work force? Start with Mr. Thompson and move—or whoever else would like to join in.

Mr. THOMPSON. Let me pass.

Mr. LARSON. All right.

Dr. DESAI. I will not comment on the K Street part of the question. On the philosophical part of the question, I am happy to comment, which is that I do not think globalization has outmoded that logic. I think people have come to that conclusion wrongly. I think it is the case that if we make our firms competitive, and they go abroad, the evidence is they grow domestically.

So, it is very easy to think this is zero sum, but there is no reason to think markets are zero sum. If firms are able to do something, one part of their production process more efficiently somewhere else——

Mr. LARSON. Well, that is good in theory, but can you give me an example?

Dr. DESAI. I will give you——

Mr. LARSON. I look right in my hometown, at Augie and Ray's, when I go there and talk to the people, and they say that they are out of work, and they see their jobs outsourced overseas, and they do not see anything in return for them. Some companies are farsighted, like United Technologies; they provide educational training. Thomas Friedman has written extensively about a trampoline. Where is the trampoline? Where do they spring to the next job after their job has been outsourced? Can you give me any concrete examples?

Dr. DESAI. I think that is a fair point. It is certainly the case that education and training programs are critical for workers who are displaced. I was speaking to, in some sense, the aggregate evidence, which is that firms that grow abroad grow domestically in other ways, and that, there are plenty of examples, and there is empirical evidence on. I share your sentiments though, that education and training programs for those workers who are displaced are critical.

Mr. LARSON. Mr. Thompson?

Mr. THOMPSON. Yes, I think again—I do not think that we want to have a system that penalizes our companies from going overseas, but I also do not think that we should have a system that gives them a tax benefit for going overseas. It is clear that a territorial system would give U.S. companies a tax benefit, a tax saving for going overseas.

As the President's Panel points out, our current deferral system is a quasi-self help territorial system. So, if the territorial system has this defect, our current deferral system has this defect, and the only way that I can see to solve it, that is, to eliminate the incentive to move overseas, tax incentive, is to move to a straight-out imputation system, to put investment, whether it is in the United States or in China, on the same tax footing.

Mr. LARSON. Interesting.

Mr. FOLEY. The time of the Gentleman has expired. On behalf of the Committee, we thank Dr. Desai, Mr. Pearlman, Dr. Neubig, Dr. Shackelford, and Mr. Thompson for your appearance before the Committee today. We will now call our second panel and ask them to take their place at the table. Our next panel includes James Tisch, President and CEO (chief executive officer) of Loews Corporation, headquartered in New York; Matthew McKenna, Senior Vice President of Finance at PepsiCo, Inc., also from New York; and John Castellani, President of the Business Roundtable.

Let me thank the gentlemen for appearing today before the panel. I will reserve the time for Chairman Camp upon his return so he may ask questions under his own time allocation. I will first turn to Ranking Member McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. I think all of you were in the room when I made my opening statement, so I am going to stick with that theme. I recounted that during the nineties, under the tax structure which existed at the time. We had the longest sustained period of economic growth in the history of the country. We had four budget surpluses, the only ones in the last generation, and since 2001, things have gone in the other direction. We have had the largest budget deficit in the history of the country, a national debt of $8.3 trillion and growing, and I just want to emphasize that that is a great concern to me and I think to all Americans now, and I hope that when we get to the question and answer period that we can discuss that a little bit among the other items that will be brought forward.

I thank you all for being here, and I want to assure John that Union and RPI (Rensselaer Polytechnic Institute) are doing just great back in the 21st District of New York.

Chairman CAMP. [Presiding.] All right; thank you. Just a moment, please. All right; again, welcome. Sorry I had to step out, but when the Chairman calls, you show up, so I want to thank you for coming today and for testifying. I look forward to hearing what you have to say. I have looked at the submitted statements. Your full statements will be included in the record. You each have 5 minutes, and so, why do we not begin with Mr. Tisch? Welcome.

STATEMENT OF JAMES S. TISCH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, LOEWS CORPORATION

Mr. TISCH. Thank you, Chairman Camp, Ranking Member McNulty, and distinguished Members of the Subcommittee on Select Revenue Measures, my name is Jim Tisch, and I am the President and CEO of Loews Corporation.

Loews, with a market capitalization in excess of $20 billion, is one of the largest diversified financial companies in the United States. We either own or are a minority shareholder in six separate and unique businesses, including commercial property and casualty insurance, tobacco, offshore drilling services, interstate natural gas pipelines, hotels, and watches.

My fellow panelists will address the impact of our high rates on our competitive taxes. My testimony, however, is from a domestic perspective. The issue of reducing the cost of capital for U.S. corporations, specifically the high rate of tax on long-term capital gains, has been absent from the debate on tax reform thusfar.

I believe that a significant reduction in the current 35 percent tax rate on long-term capital gains would enhance the competitiveness of U.S. corporations by enabling them to redeploy capital more efficiently. More freedom of capital redeployment would improve international competitiveness, would enhance economic growth and job creation, increase shareholder value, and possibly result in greater revenue for the U.S. Treasury.

We are presenting a proposal that has historical precedent. In fact, from 1942 to 1986, for 44 years, there existed lower rates on U.S. capital gains as a means to stimulate investment in the United States and to attract foreign investment to the United States. As I said, the current 35-percent rate on corporate capital gains is one of the highest rates in the world.

The 35 percent corporate capital gains tax rate has resulted in a lock-in effect of corporate investment capital. Corporate taxpayers oftentimes do not sell appreciated assets, because the tax cost severely reduces the after-tax proceeds for reinvestment from that asset sale. Faced with the prospect of a large tax wedge in the form of a 35 percent toll charge for redeploying capital, companies either do not sell or are tempted to borrow on their appreciated assets instead of selling them.

Our current corporate capital gains tax reflects a policy of imposing triple taxation on U.S. corporate investment. First, when the regular corporate tax is imposed on income generated by the investment; a second time when the capital gains taxes are imposed, when the investment is sold, and the proceeds are redeployed to other uses; and a third time when dividends are paid to shareholders.

A decision to reduce the corporate long-term capital gains tax rate will foster greater economic productivity in U.S. corporations. Companies will be able to convert from one form of capital to another more productive form, since the prohibitively harsh and stifling tax consequences will have been removed. Additionally, the transfer of capital assets from stale to newer, more dynamic hands will result in greater economic growth and job creation, as the asset's worth is maximized by the new holder.

I am currently soliciting the support of like-minded executives and their companies to form a Committee, which we have named America Gains. Once this coalition is in place, our goal will be to educate policy makers, business leaders, and interested media about this issue, with the objective of bringing corporate long-term capital gains tax reform to the forefront of the tax reform debate.

Mr. Chairman, I again applaud you for your interest and for having this hearing today, and I hope that you will use our coalition as a resource as you and the Committee develop Federal tax reform legislation.

Thank you.

[The prepared statement of Mr. Tisch follows:]

Statement of James Tisch, President and Chief Executive Officer, Loews Corporation, New York, New York

Chairman Camp, Ranking Member McNulty, and distinguished members of the Subcommittee on Select Revenue Measures, my name is Jim Tisch and I serve as the President and CEO of Loews Corporation. Loews is one of the largest diversified financial companies in the United States and we either own or are a majority shareholder in six separate and unique businesses, including commercial property & casualty insurance, tobacco, offshore oil drilling services, natural gas interstate pipeline transmission, hotels, and watches. I thank you for the opportunity to present my views regarding the excessively high rate of tax on U.S. corporate capital investment.

The 35-percent corporate capital gains tax rate needs to be reduced. Reducing the rate of corporate capital gains tax will foster greater economic productivity of U.S. corporations by enabling them to convert one form of capital to a more productive form, without incurring unduly harsh tax consequences

We presently have the highest rate of tax on corporate capital investment in the history of the United States, with the exception of two years during World War II. This historically high rate is creating economic distortions both at home and abroad. The 35-percent capital gains rate induces a "lock-in" effect under which corporate taxpayers often times do not sell appreciated assets because the tax cost severely reduces the after-tax reinvestment proceeds from that asset's sale. This "lock-in" effect impedes corporate investment within the United States and carries grave implications for the future of America's domestic growth and employment prosperity.

It is important to note what a capital gain represents in the corporate context. It represents the proceeds, after-tax, that are retained by a company for future investment in a new business venture or for pay-out as a dividend to its shareholders. These proceeds are derived from the long-term investment of capital in assets that create jobs and taxable income.

Corporate investment in assets that produce capital gains occur in many ways, but three are most prominent: (1) controlling ownership interests in active business entities, (2) equity investments in business entities, and (3) acquisition of the corporation's own plant, equipment or intellectual property.

In asking the Committee to consider reducing the rate of tax on corporate capital investment, we want to emphasize that we are not asking Congress to do something it has never done before. For 44 years, from 1942 to 1986, Congress imposed lower rates of tax on U.S. capital investment as a means to stimulate investments in the United States, and to attract foreign investment in the United States. We would like to see the current 35-percent rated reduced to match the individual capital gains rate or to its historically lower rates.

It is important to point out that neither integration of the individual and corporate tax regimes or the 15-percent individual capital gains and dividends tax rate will solve this problem. None of the recommendations of the President's Advisory Panel on Federal Tax Reform correct this problem. Only a reduction of the rates imposed on corporate capital gains will "unlock" the "lock-in" effect.

I will now turn to a more detailed explanation of our position, beginning with a detailed history of the corporate capital gains tax rate.

History of the Corporate Capital Gains Tax Rate

The current corporate capital gains rate is 35-percent. With the exception of the years 1940 and 1941, the current 35-percent rate surpasses any capital gains rates imposed on corporations in the history of the Internal Revenue Code.

The Revenue Act of 1942 adopted the first capital gains preference for corporate taxpayers in the form of a 25-percent maximum rate. Against the backdrop of World War II, the 1942 Act also increased the combined corporate normal and surtax rates from 31-percent to 40-percent. The 1942 Act's 25-percent corporate capital gains tax rate changed very little between the years 1942 to 1986.

The maximum rate on a corporation's net capital gains was increased to 26-percent for a very short time in the early 1950's, but by 1954, the rate was returned to its historical 25-percent rate.

It was increased to 30% in 1969, but was again reduced in 1978 to 28-percent. The corporate capital gains tax rate remained at 28-percent until 1986.

The Tax Reform Act of 1986 effectively eliminated the 28-percent rate for corporate capital gains by subjecting capital gains to the same rate of tax as ordinary income. It set the rate for both capital and ordinary corporate income at 34-percent.

The Tax Reform Act of 1986 also eliminated lower capital gains tax rates for individuals. As enacted in 1986, the capital gains tax rate for individuals and corporations would not exceed 28% and 34%, respectively. The 1986 elimination of the capital gains preference for individuals and corporations appears to have been part of an overall simplification measure. There is no evidence that Congress intended to disfavor capital gains generally, or corporate capital gains in particular.

After 1986, Congress enacted several measures to reduce capital gains taxes, but those measures only affected individuals, not corporations.

The Omnibus Budget Reconciliation Act of 1990 increased the maximum individual ordinary income tax rate to 33-percent, but left the individual capital gains rate at 28-percent. This rate differential between individual ordinary and capital gains rates was not the result of a new choice to prefer individual capital gains over corporate capital gains, but rather, reflected a decision not to increase the rate of tax on capital gains above the rates enacted in the Tax Reform Act of 1986.

In the Omnibus Budget Reconciliation Act of 1993, the maximum corporate ordinary tax rate was increased from 34-percent to 35-percent, and the corporate capital gains tax also was increased from 34-percent to 35-percent.

As a result of the 1993 tax increase, which was the largest tax increase in the history of the United States, U.S. corporations are now subjected to the highest capital gains rate since World War II.

The House passed the Contract with America Tax Relief Act of 1995, which sought to reverse the 1993 tax increases on capital gains. That bill contained a maximum 25-percent corporate capital gains tax rate.

Congress later passed the Balanced Budget Reconciliation Act of 1995, which reduced the maximum corporate capital gains tax rate to 28-percent. President Clinton vetoed that bill.

The Taxpayer Relief Act of 1997 enacted the first capital gain tax reduction after the Tax Reform Act of 1986. The Taxpayer Relief Act of 1997 reduced the maximum rate on individual net capital gains to 20-percent. The House Report for that bill, in its "Reasons for Change," stated that reduced taxation of capital gains promotes economic growth for four principal reasons:

- Reduced capital gains taxes would increase the return to individual savings and cause an increase in savings by individuals, which in turn, would help increase business investment in equipment and research.
- Reduced capital gains taxes would reward risk taking and the pursuit of new technologies.
- Reduced capital gains taxes would encourage investors to dispose of assets and allow the proceeds to flow to the segments of the economy where they would be most productive, thus offsetting the "lock-in" effect that high taxes on capital income have on the willingness of the owner to divest.
- Such an "unlocking" effect would increase government revenue in the short and long run; both due to current reduced taxes collected on sales and to improved economic activity resulting from the freer flow of capital.

The most recent Congressional action on capital gains occurred in 2003, with the passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003. This bill reduced the individual capital gains tax rate from 20-percent to 15-percent. This reduction expires in the year 2008, when the individual capital gains rate will revert back to 20-percent. Because the Jobs and Growth Tax Relief Reconciliation Act of 2003 was primarily a bill for individuals and small businesses, there was no consideration of reducing the corporate capital gains tax rate in that bill.

The Economic Rationale for Reducing Capital Gains Tax Rates Are Even More Compelling for a Corporation

Our current corporate capital gains tax reflects a policy of imposing triple taxation on U.S. corporate investment: first when regular corporate tax is imposed on income generated by the investment, a second time when dividends are paid to corporate shareholders, and a third time when the capital gains taxes are imposed when the investment is sold and the proceeds are redeployed to other uses.

As I noted earlier, the 35-percent corporate capital gains tax rate has resulted in a "lock-in" of corporate investment capital, under which corporate taxpayers often times do not sell appreciated assets because the tax cost severely reduces the after-tax proceeds for reinvestment from that asset's sale. Companies should be allowed to convert one form of capital investment to a more productive form, without incurring a 35-percent "toll charge" for doing so. Congress referred to this "lock-in" effect in 1997 and 2003,[1] so the term we use in this testimony is not unknown to Washington's tax policymakers.

Mihir Desai, an associate professor with the Harvard Business School, confirms this "lock-in" effect in an article published in the March 7, 2006 edition of Tax Analysts. I would note at the outset that Professor Desai was *not* retained by the America Gains coalition to produce that article.

Professor Desai states that it is surprising that the emphasis on capital gains has been limited to the individual level, rather than the corporate level. He states that greater efficiency gains can be achieved by reducing corporate capital gains rates as compared to individual capital gains rates, because corporations are more sensitive to tax rates in their decision-making. Professors Desai and Gentry published a study in 2003 which confirmed that a high rate of corporate capital gains rate does influence the decisions of firms to dispose of assets and realize the capital gains and losses.[2]

Professor Desai notes that many policymakers assume capital gains are a minor piece of overall corporate income, but in fact, quite the opposite is true. He estimates that capital gains constitute, on average, around 20% of the taxable income reported by U.S. corporations, and during the last 5 years of available information they averaged $128 billion a year. That amount, however, is greatly reduced by the lock-in effect.

Professor Desai conservatively estimates that nearly $800 billion of corporate capital gains remain unrealized and untaxed because of the lock-in effect. This $800 billion amount is approximately one-third of the value of realized and taxable individual capital gains. The $800 billion amount, however, is based on the historical asset values shown in a company's financial statements for minority interests in investments. Professor Desai and I suspect that unrealized corporate capital gains greatly exceed $800 billion.

I ask the distinguished members of this Committee to consider the stimulus to both the U.S. economy and the Federal Treasuries if even $800 billion of corporate capital is freed up for reinvestment, redeployment, and made available for Federal tax collection. I must tell you that at the current historically high 35% rate, those corporate capital gains will not be realized as taxable income by the Federal government. The current 35% rate is impeding U.S. capital deployment, which in turn, impedes U.S. collection of corporate capital gains taxes.

The economic consequences of the lock-in effect are particularly undesirable because the impetus for a sale of assets by a corporation is often a desire to convert those assets to other uses that would be more economically productive for the corporation, consequently creating more jobs and economic growth. Another owner, in turn, who has made a significant investment in the asset, would certainly be incentivized to put the divested assets to their highest and best use, better managing them and creating yet more jobs and economic growth.

Faced with the prospect of a large "tax wedge" in the form of a 35-percent "toll charge" for redeploying capital, corporate managements either refrain from selling or are tempted to borrow on existing appreciated assets instead of selling them, thus increasing the corporation's debt burden and reducing its economic stability and flexibility. The cost of losing 35-percent of an asset's appreciated value often exceeds the cost and risk of incurring additional debt. As a consequence, these unsold, newly leveraged assets are not likely to realize their greatest economic value.

The impact of the capital gains tax on the international competitiveness of U.S. companies is equally troubling. Several European countries have, in certain cir-

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[1] H.R. Rep. No. 108–93, 108th Cong., 1st Sess. III.A. The lock-in effect is further exacerbated by Code provisions that are hostile to redeployment of capital asset investment. For example, under section 1245 certain gains on sale of depreciable property used in a trade or business are "recaptured" as ordinary income. Similarly, restrictions on capital losses increase the tax cost of capital redeployment. Section 1212 of the Code provides that corporate capital losses can be carried back 3 years and forward 5 years. The ability of a corporation filing consolidated returns to deduct a loss on the stock of a group member is heavily restricted by various consolidated return regulations, including Regs. § 1.1502–19(c) and –35T, and § 1.337(d)–2.

[2] Desai and Gentry, The Character and Determinants of Corporate Capital Gains, NBER Working Paper No. 10153, p. 26 (Dec. 2003). The Working Paper supports many other points submitted in this testimony, including: if reallocation of assets among firms raises their productivity, then corporate capital gains realizations can have a positive effect on productivity that individual capital gains realizations do not have; the logic of the corporate dividends received deductions also supports some tax relief for corporate capital gains; the "lock-in" effect can result in social costs from a mismatch of assets with a more productive owner; the "lock-in" effect also can prevent the corporate owner of an asset from redeploying its value to a more productive use.

cumstances, substantially reduced corporate capital gains rates or eliminated them altogether.

Professor Desai notes that Hong Kong, Singapore, New Zealand, and several other countries do not tax capital gains at all. For example, starting next year France will exempt 95% of qualifying capital gains from taxation. Professor Desai's study also shows that Germany, Greece, the Philippines, Austria, Luxembourg, the Netherlands, Sweden, Switzerland, Mexico, Canada, Israel, Zimbabwe, South African, and even Pakistan have some form of corporate capital gains tax relief, but not the United States.

Not only does the United States impose the highest rate on corporate investment in its history, but we also prohibit corporations from claiming losses to the extent they have no capital gains to offset those losses, and those losses may expire unused. Current law allows capital losses to only offset capital gains. Those losses may be carried back three years to offset net capital gains in those years, or carried forward to offset net capital gains in the next five years. If the losses are not used within that framework, they simply disappear from the tax return, as if they never actually happened. The tax deduction for the losses is denied, even though the taxpayer suffered a real economic loss. This is a great disincentive to risk-taking in the United States.

Professor Desai identified several countries, such as Japan, the U.K, Germany, Belgium, Egypt, Netherlands, and Spain that provide capital gains relief for certain classes of capital gains that are subsequently reinvested. I would encourage the Committee to consider reinvestment of the cash proceeds as a factor in its deliberations for addressing corporate capital gains relief in the context of overall tax reform.

As you can see, other major economies generally tend to subject corporations to materially lower effective long-term capital gains rates, permitting—if not encouraging—corporations in these countries to redeploy capital to a more productive use. The international competitiveness of U.S. businesses will be enhanced if the capital gains lock-in effect is reduced.

As I said earlier, we are not asking Congress to take an action that is without historical precedent. The 1986 Tax Code eliminated the reduced rate for corporate capital gains in order to raise sufficient funds to make the 1986 tax reforms revenue neutral. From 1942 to 1986, however, corporate capital gains had *always* been given a preferential rate.

The rationale Congress relied on for reducing individual capital gains rates in 1997 and again in 2003 is equally applicable to reducing the rate for corporations, namely, eliminating the lock-in effect promotes long-term economic growth and job creation, and better encourages work effort, savings and investment, which also happens to be President Bush's third criterion for tax reform.

Historically, support for reducing the individual capital gains tax rate rests in part on the theory that lower rates make individuals more willing to invest in capital assets in general and in stocks in particular. This theory is widely accepted by economists and policymakers. This theory, however, is even more compelling in the corporate context because of the greater magnitude of corporate capital investment activity and the more direct relationship between corporate capital spending and economic productivity.

Corporations raise huge amounts of capital from both stock issuance and debt sources, and redeploy it into business and investment ventures. In terms of new investment, corporations raise far more capital from borrowing than from new equity investment. This is evidenced by the fact that debt, rather than equity from public stock offerings, is a far more significant source of investment capital for corporations.

For example, in 2004 the ratio of global debt to stock underwriting was 10 to 1.[3] This means that for every dollar invested by individuals and others in new stock issuances, another 10 dollars was created by the corporation's own borrowing. When this new capital is used for new investment in productive assets, the result is a more immediate economic up-tick and increase in federal tax revenues than from individual investments in stocks.

Therefore, the magnitude of the benefits from reducing the corporate capital gains rate could dwarf the economic investment stimulus created by reducing the individual capital gains tax. If there is ever a circumstance in which reducing capital

[3] Diya Gullapalli, Underwriting Volume Rises to a Record, Wall St. J., Jan. 3, 2005, at R17.

gains tax will yield an immediate up-tick in investment reallocation and federal tax revenues, it is in the corporate arena.[4]

Unique Aspects of Corporate Tax Policy Compel Capital Gains Relief

A feature of corporate income taxation that distinguishes it from individual taxation is that corporate assets are indirectly owned by the corporation's shareholders. This can result in the so-called "double taxation" of corporate income: once to the corporation and again to the shareholder, either when the shareholder receives a dividend or when the shareholder sells stock in the corporation. Such double taxation applies to the corporation's sale of capital assets followed by a distribution of the sale proceeds (net of tax) to shareholders.

Under current law, it is not uncommon for corporate capital gains to be subject to triple taxation. As I mentioned earlier, corporate earnings are taxed a third time when the corporate capital gains tax is imposed. One common corporate investment provides an extreme example of a need for a policy change. In the situation where one corporation owns stock in a second corporation, the income from a disposition of that stock can result in triple taxation of the of the second corporation's income: once to the second corporation; once on the capital gain of the "owner" corporation when it sells its second corporation stock; and once to the individual shareholder of the "owner" corporation.

Because of the pervasive levels of double and triple taxation within a corporation, a lower corporate capital gains rate serves to mitigate, but not eliminate, the damaging effects of multiple taxation of the same income. What is even more troubling, however, is that much of the double and triple taxed income may not represent economic income at all. Corporate capital gains often represent an inflationary increase in asset value, which does not represent an economic enhancement of the corporation's financial condition.

Long before the benefits to the economy of reduced taxes on capital income achieved a high profile, the Code's capital gains preference served as a rough tool to ameliorate the taxation of gains that reflect inflation. An ideal income tax base would not tax inflationary gains, but the theoretical remedy of indexing basis has generally been judged too difficult to attempt, and so reduced tax rates on capital gains is a rough attempt at justice.[5] Policymakers should never overlook the dubious nature of capital gain "income" and the extent to which capital gains are attributable to inflation. In this respect, they represent no increase in the corporation's spending power and, hence, should not be viewed as income. Historically, the dubious nature of capital gain income has justified a lower capital gains rate.

Corporate Capital Gains Relief Is Not Provided by Corporate-Shareholder Integration or the 15–Percent Individual Dividends & Capital Gains Rate

I would add one final point. Some commentary has suggested that integration of the corporate and individual tax systems would eliminate the investment reallocation problems created by the current 35-percent corporate capital gains rate. We respectfully disagree. Corporations base their investment decisions and rate-of-return calculations on the effect to the corporation itself, not on whether a shareholder pays the current 15-percent tax on dividends or whether, under an integrated system, the shareholder would pay no tax on a dividend. The variety of shareholder tax rates and their possible tax-indifferent status (such as mutual funds and pension plans) make it impossible for a corporation to consider shareholder tax effects in its own investment decisions. What they do consider, however, is that one of the highest capital gains tax rate in the history of the United States creates a tax wedge that forces them to keep investment capital locked in place and borrow to the hilt to finance the future of their company, thereby depriving the economy of the highest and best use of those leveraged assets. This cannot, under anyone's measure, be considered sound tax policy.

Proposals to integrate the corporate and individual income taxes will not address the major reasons for corporate capital gains relief. Integration generally means eliminating or reducing the possibility that corporate income will be taxed a second time when it is distributed to the shareholders of the corporation as a dividend. The 15-percent rate for dividend income enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003 is a mitigating step toward integration. However, so long as

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[4] Stimulating corporate investment through reducing the corporate capital gains tax can also buoy the economy as a whole. The recession during the 2001 to 2003 timeframe was caused largely by a lack of business-to-business investment, rather than a downturn in consumer spending and investment.

[5] See U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform, p. 42 (Tax Analysts, 2d ed.).

the corporate capital gains tax is imposed, some level of the lock-in effect will continue. The question is what level of rate reduction is necessary to remove taxes as a material investment consideration. As noted above, corporations base their investment decisions and rate-of-return calculations on the effect to the corporation itself, not on whether a shareholder pays the current 15-percent tax on dividends or whether, under an integrated system, the shareholder would pay no tax on a dividend. What they do consider, however, is that the highest corporate capital gains rate in the history of the United States will appropriate 35-percent of their asset values if they redeploy assets to potentially more productive investments, forcing them to lock that investment in place.

Chairman CAMP. Thank you very much, Mr. Tisch. Mr. McKenna, you have 5 minutes.

STATEMENT OF MATTHEW M. MCKENNA, SENIOR VICE PRESIDENT OF FINANCE, PEPSICO, INC.

Mr. MCKENNA. Thank you, Chairman Camp, and thank you, Ranking Member McNulty and Members of the Committee. My name is Matthew McKenna. I am senior vice president of finance at PepsiCo, and it is an honor to be before you today.

I think as you may know, PepsiCo is a leading global food and beverage company with annual revenues of over $32 billion. We currently have 17 brands, each of which are in excess of $1 billion in revenue, the brands, which include not just the Pepsi branded beverages but Quaker Foods, Tropicana, Frito Lay, and Gatorade.

The United States is PepsiCo's largest single market. PepsiCo and its affiliates do business in every State of the Union and employ more than 60,000 people in the United States. Over the past decade, PepsiCo has expanded its market presence in the United States and continues to invest in the United States, with investments in new facilities such as the rapid expansion of our Gatorade facilities in Virginia, Oklahoma, West Virginia, and Florida.

I would like to talk today about two changes to the U.S. tax system that would provide tremendous economic benefit. The first is fairly straightforward: a reduction in the corporate tax rate. The second is more complex but equally important, and that is reform of the U.S. international tax rules. These changes, both the domestic and the international, would enhance the competitiveness of U.S. business and contribute to the continued growth of the U.S. economy through increased capital investment and increased U.S. jobs.

As referenced in the earlier panel, in the eighties, the United States led the international trend to lower corporate tax rates. The United States is now well behind the curve of other countries. The United States has one of the highest corporate tax rates among the OECD countries, and this fact alone, I think, would be a cause for reexamining the direction that we are going.

I urge you not to ignore the evidence from our trading partners and our competitors, and believe me, we are in competition with these countries, and in terms of tax rates, we are losing that competition.

A brief word about the choice between reducing tax rates or increasing credits and other tax preferences to provide incentives for specific actions. Speaking for PepsiCo, I feel that too often, tax preferences reward behavior that is already taking place, that too often, the loudest voices for such preferences are the companies that are already heavily engaged in those activities.

PepsiCo is in favor of rate reduction. Allow us to decide how to reinvest our earnings to maximize returns to the business and to our shareholders and make those decisions based upon productivity, profitability, and growth, rather than pursuing preferences and obstacles in the Tax Code. I also want to touch today on an equally important topic, the modernization of the U.S. international tax rules.

In addition to our activities in the United States, we do business in over 200 countries around the world. Our international business is exploding right now. In 2005, our international operations grew by over 20 percent, to the point where they now exceed more than a third of our overall revenue and almost half of our growth. Our international success, our international businesses, are built upon local businesses serving local customers in their country. Given the cost of transportation for potato chips and beverages, we need to establish local brands, local manufacturing facilities, and typically, our businesses are sourced in each country for that country's market.

Today, as has been referenced already a number of times, the U.S. operates under a worldwide system of taxation. The current U.S. worldwide tax system incents U.S. companies to redeploy their foreign earnings overseas rather than bring those profits back home. These incentives to redeploy overseas and the reaction by U.S. companies were demonstrated, I think, very categorically last year in the reaction to companies in response to the American Jobs Creation Act of 2004 (P.L. 108–357).

The U.S. tax system differs significantly from many of our overseas trading partners. As referenced already, there are a number of cases where we are at a competitive disadvantage to our international trading partners. Many times, our expansion overseas is by way of acquisition. We are competing for those acquisitions against our international competitors. Because of the competing tax regimes, our international competitors can afford to pay more for those investments than we can.

I urge you to consider that from a competitive point of view that hurts PepsiCo and hurts the American corporations. Thank you for the opportunity to testify today, and I look forward to answering your questions as well.

[The prepared statement of Mr. McKenna follows:]

Statement of Matthew McKenna, Senior Vice President of Finance, PepsiCo, Inc., New York, New York

Profile of PepsiCo

PepsiCo is a leading global food and beverage company with annual revenues of over $32 billion. We manufacture, market and sell a variety of food products and carbonated and non-carbonated beverages. Some of PepsiCo's well known brands include Pepsi branded beverages, Quaker Foods, Tropicana, Frito-Lay and Gatorade.

The United States is PepsiCo's single largest market. PepsiCo and its affiliates do business in all 50 states and the District of Colombia and employ more than 60,000 people within the United States. Over the past decade, PepsiCo has seen increased profits and a major expansion of its market presence in the U.S. and worldwide through acquisitions and product development. I am proud that PepsiCo continues to build plants in the U.S., like the new Gatorade facilities PepsiCo is in the process of building, to serve our growing market. PepsiCo also operates in over 200 countries. During 2005, our operations outside the United States had growth of 21%

and that growth continued in the first quarter of 2006. International operations now represent 35% of total revenue and constitute 46% of PepsiCo's overall growth. Our international success has been built upon local businesses, serving local customers. The cost of transporting our snacks and beverages, combined with the need to establish local brands, typically requires local sourcing in each country. PepsiCo continues ambitious international expansion and is investing hundreds of millions of dollars in plants and equipment in both developed and developing markets around the world.

The United States Needs a Competitive Tax System

Today's economy is truly global and is becoming more so every day. In this environment, the United States cannot afford to have a tax system that forces U.S.-based businesses to face foreign competitors with one hand tied behind their backs. Unfortunately, given the state of the U.S. tax laws, that is exactly how PepsiCo is forced to compete.

There are two areas where PepsiCo believes changes to the U.S. tax system would provide tremendous economic benefit. The first is simple and straightforward: a reduction in the corporate tax rate. The second is more complex, but is critically important: reform of the U.S. international tax rules. These changes would help enhance the competitiveness of U.S. businesses and contribute to the continued growth of the U.S. economy through increased capital investment and increased U.S. jobs.

I. Reduction in Corporate Tax Rate

Lower corporate tax rate fosters competitiveness, investment and growth: In the 1980s, the U.S. led the worldwide trend toward lower corporate tax rates. Today, however, the U.S. has one of the highest overall corporate income tax rates (35% federal; 39.3% combined federal and state) among all countries in the Organisation for Economic Co-Operation and Development (OECD). In contrast, the OECD trend has been to reduce corporate rates. Ireland, for example, reduced its rate by approximately 48%, down to 12.5%, and now has the lowest corporate tax rate of all OECD nations. This favorable rate has fostered foreign direct investment in Ireland and bolstered that country's economy. The average OECD rate is approximately 29.2% (combined central and sub-central tax rates), which is ten percentage points lower than the U.S. rate.

While the U.S. is clearly a leader in the global economy today, it must change in order to stay a leader. For U.S. companies to continue to be competitive with companies that reside in other large industrialized nations, and to foster foreign direct investment in the U.S., the corporate federal income tax rate should be reduced. A lower corporate tax rate would allow businesses to operate in a more efficient manner, enhance certainty for business planning purposes and ensure that strategic decisions are driven by productivity, profitability and growth concerns as opposed to the preferences and obstacles of the tax code.

Expensing versus lower corporate tax rate: The President's Advisory Panel on Federal Tax Reform proposed an option that would provide immediate expensing for capital assets as a means of encouraging economic investment. Capital investment clearly is important to the growth and expansion of U.S. businesses. Over the past three years, PepsiCo has expended $5.7 billion on acquisitions and other investments in the U.S. and around the world. At the same time, PepsiCo has returned $12 billion to its shareholders through dividends and share repurchases. However, if I were given a choice between increased expensing and a reduction in the corporate tax rate, my preference would be a lower tax rate.

Increased expensing provides only a timing benefit. In contrast, a lower corporate tax rate provides a permanent benefit. Increased expensing does not affect a company's book tax rate or net income for financial statement purposes. Most importantly, a lower corporate tax rate allows businesses to choose how best to deploy their earnings—whether to invest in tangible assets or intangible assets and whether to return funds to shareholders so that they may invest those funds. These decisions should be driven by the market and business plans—not based on accounting timing and methods.

Credits and other tax preferences versus lower corporate tax rate: The current U.S. tax code provides a variety of incentives to businesses through credits and other preferences, and PepsiCo benefits from many of these credits and preferences. Nevertheless, if I were asked to choose between increased credits and other preferences or a lower corporate tax rate, again I would choose the lower tax rate. As noted above, a reduction in the corporate tax rate would allow businesses to determine for themselves how best to deploy their earnings in order to maximize returns to the business and to the shareholders.

II. Modernize U.S. International Tax Rules

International competitiveness benefits the U.S. economy: With over 95% of the world's population living outside the United States, reform of the U.S. international tax rules is needed in order to protect and enhance the global competitiveness of U.S.-based businesses. It is important to understand that foreign activity of U.S. businesses—and continued success of PepsiCo's international investments—complements our U.S. activity; it is not a substitute for it. Our foreign investment contributes to the U.S. economy and to U.S. employment. The global success of U.S. businesses provides real benefits in terms of economic growth and jobs in the United States. The United States must ensure that policies are in place to allow U.S. businesses to make the most of the tremendous opportunities that globalization and technological advances provide.

U.S. worldwide tax system creates the wrong incentives:Today, the U.S. operates under a "worldwide" tax system in which U.S. resident companies are taxed on their worldwide income—regardless of where it is earned. The current system attempts to mitigate the potential for double taxation arising from overlapping source-country taxing jurisdictions. It does so by providing for a foreign tax credit for taxes paid on income that is also subject to tax in the U.S. In practice, U.S. companies are generally not taxed on business income earned by foreign subsidiaries until that income is repatriated to the U.S. as dividends.

The current U.S. worldwide tax system incents U.S. companies not only to redeploy foreign earnings abroad rather than in the U.S., but also to keep any excess or idle foreign cash that may not even be needed for foreign investment overseas rather than returning it to the U.S. These incentives and the resulting (and expected) reaction by U.S. companies are demonstrated by U.S. companies' response to the temporary reduced rate of taxation on repatriated dividends under the provisions of the American Jobs Creation Act (AJCA). To date, about $290 billion in AJCA repatriations have been announced by companies and as a result the U.S. Treasury has reportedly collected an additional $17 billion in taxes in a very short period of time. This capital, which had been held offshore, is now available and has freed up cash in the U.S. for the support of jobs, acquisition of capital assets, payment of dividends to U.S. shareholders, pay-down of debt, strengthening of U.S. pension plans and other important uses that will help to strengthen and stimulate U.S. companies and the U.S. economy as a whole.

In addition, the complexity associated with the current tax system causes U.S. companies to engage in a greater degree of tax—distorted business planning, versus companies that are not subject to a complex worldwide system. For example, companies can put great efforts into repatriating foreign earnings periodically in ways that do not trigger additional U.S. tax. These incentives and behaviors distort the business and investment decisions of U.S. companies and ultimately are detrimental to the U.S. economy as a whole.

Finally, in addition to being overly complex and disincenting U.S. companies to act in a manner that supports the U.S. economy, the current tax system also puts U.S. companies at a competitive disadvantage, versus their foreign competition. Under the current system, when foreign earnings are repatriated and U.S. tax is paid, U.S. companies are generally taxed at the higher of the source country or U.S. tax rate. In contrast, under a territorial system many U.S. companies' competitors are taxed only at the source country rate, even if it is lower than their tax rate at home. Combined with the high rate of tax in the U.S., as discussed above, this puts U.S. companies at a significant competitive disadvantage.

U.S. should consider a territorial tax system: The U.S. tax system differs significantly from the tax systems of many of our trading partners. Two-thirds of the OECD countries operate territorial tax systems. To create an efficient method of taxation that will enhance the competitiveness of U.S. multinationals and strengthen the U.S. economy in today's global marketplace, we should examine the various territorial systems used by so many of the world's developed economies. Under a purely territorial system, a country taxes only income derived within its borders, regardless of the residence of the taxpayer. Many countries tax resident corporations on a predominantly territorial basis by exempting dividends received from foreign subsidiaries from residence country tax—commonly referred to as a "participation exemption" system.

We believe that a territorial system would allow U.S. multinationals to invest overseas in order to grow their businesses. At the same time, it would remove the barrier or disincentive to repatriate earnings to the U.S. for investment here at home.

Of course, the extent to which a territorial tax system would enhance competitiveness depends upon the specific details of the system. The key design issues with respect to a territorial tax system include (1) what income is exempt from tax, (2) how expenses are treated, and (3) what rules apply to tax passive-type income. More work is needed to develop a territorial tax approach for the United States that would accomplish the objectives of reducing the complexity of the current U.S. international tax system, enhancing the competitiveness of U.S.-based companies operating in the global marketplace, and eliminating the disincentive to bringing profits home to the United States.

Some may argue that a territorial system that exempts active foreign income from U.S. tax is an invitation for U.S. businesses to invest overseas. In fact, foreign investment is necessary in order for U.S. companies to maintain their competitiveness in today's global economy. It is a plain and simple fact that in order for U.S. companies to remain healthy, and even viable, they must compete with their foreign competitors and invest in the growing and emerging markets around the world. Without tapping into that opportunity for growth, one can only imagine what would happen to the value of U.S. multinationals or what the stock market impact might be of the failure of U.S. multinationals to grow in these markets. Adverse impacts to employment in the U.S. and to the U.S. economy in general would no doubt follow if U.S. companies could not compete effectively in the global economy.

Lastly, some would argue that exempting active foreign income from U.S. taxation is an invitation for U.S. companies to off-shore their U.S. business operations. However, the global economy is a reality in connection with operating in and supplying not only foreign, but U.S. markets as well. Foreign competitors are locating operations in advantageous jurisdictions around the world in order to supply and compete in both foreign and domestic markets. The tax laws cannot be used to make U.S. companies more competitive and at the same time to stop U.S. companies from investing in operations overseas to supply foreign or U.S. markets. However, what the U.S. tax system can do and should do is to allow U.S. companies to be competitive with their overseas competition and at the same time incent U.S. companies to employ as many people as possible in the U.S. to support those growing business operations around the world.

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In conclusion, a tax system that allows U.S. companies to be competitive on a worldwide basis, provides an incentive to maintain and increase jobs in the U.S. to support those businesses and allows for the repatriation of significant foreign profits to the U.S. is a win-win situation for the competitiveness of U.S. business and ultimately for the U.S. economy as a whole. Similarly, a lower domestic corporate tax rate would allow businesses to operate in a more efficient manner, enhance certainty for business planning purposes and ensure that strategic decisions are driven by productivity, profitability and growth concerns as opposed to the preferences and obstacles of the tax code. Congress has an opportunity to develop a system to sustain our competitiveness and growth for the generations to come. We look forward to working with you on this critical initiative.

Chairman CAMP. Thank you, Mr. McKenna. Mr. Castellani, you have 5 minutes.

Mr. CASTELLANI. Thank you.

Chairman CAMP. If you could turn on your microphone. Thank you.

STATEMENT OF JOHN CASTELLANI, PRESIDENT, BUSINESS ROUNDTABLE

Mr. CASTELLANI. Thank you, Mr. Chairman, Ranking Member McNulty, Members of the Panel. The Business Roundtable is an association of CEOs of leading U.S. corporations with over $4.5 trillion in annual revenues and a work force of more than 10 million employees. Roundtable member companies comprise nearly one-third of the total value of the U.S. stock market and account for nearly one-third of all corporate income taxes paid to the Federal Government.

The Roundtable is committed to advocating public policies that ensure rigorous economic growth. Through economic growth, American workers can attain even higher living standards generation after generation, and it is this key objective, maximizing the sustainable long-term growth of the U.S. economy, that we bring to the consideration of tax policy and tax reform.

Now, whether we like it or not, tax policy ultimately affects business decisions and the ability to earn a profitable rate of return. In today's global business environment, U.S. tax policy can create an obstacle to the pursuit of global business strategies to the detriment of our domestic economy.

While taxes are not the only factor affecting our ability to compete globally, they do have a significant impact. We know we will never live in a world where no taxes are necessary, but the key to an appropriate tax policy is to collect the necessary revenue to fund government while minimizing the adverse impact that taxation can have on economic activity and the economic wellbeing of our society.

In this context, we believe that there is an urgent need to reform U.S. tax rules as they apply to both domestic and international commerce in order to improve the competitiveness of the United States. As U.S. companies seek to expand internationally, they often find that the U.S. tax system poses a serious impediment to their plans. Despite important reforms to the tax system over the years, the U.S. tax system today still reflects an economy of a different era, a time when international activity was far less important, and the United States faced far less international competition.

In 1970, U.S. multinational firms were dominant globally and accounted for over 50 percent of the world's cross-border investment flow. In contrast, in the three most recent years for which data is available, 2002 to 2004, the share of the world's cross-border investment made by U.S. firms averaged less than 25 percent.

Now, in my written testimony, I give several examples of problems faced by U.S.-based companies as they attempt to compete globally, but let me draw on one those to illustrate the impediments faced by U.S. companies. This major U.S. company has successfully pursued a global business strategy which has resulted in significant job expansion at home, with high-wage, high-quality jobs and U.S. employment of more than 200,000 workers. While it competes for business around the world, it finds that its major foreign rival has an effective tax rate that is some 15 percentage points below its own rate of approximately 38 percent. This tax advantage has permitted this rival to reinvest $2 billion globally over the past 6 years and thereby gain footholds around the world. One naturally wonders, what would this U.S. company have been able to achieve if it were able to compete on a level playingfield?

This example and more like it point to the need for substantive reform of the tax rules. U.S. businesses face strong competition around the world, and there can be no presumption that we can overcome the tax disadvantage in this competition. The two most significant areas in which our Tax Code must be reformed are, first, the statutory corporate tax rate, and second, our international tax rules.

In 1986, after the United States reduced its top income tax rate from 46 to 34 percent, as you have heard today, most of the other industrial countries followed suit. Thirty-five percent, our corporate rate, is no longer low. The U.S. Federal and the combined Federal and State corporate tax rates are approximately 10 percentage points above the corresponding OECD average rates.

Overwhelmingly, our members find that the international trend is for lower taxes on corporations, and if U.S. corporations are to remain competitive with foreign headquartered firms, they cannot be subject to high corporate tax rates that are 10 percent or more higher than what their competitors face.

Second, our U.S. tax rules are at variance with international norms. U.S. tax rules deviate significantly from those of our trading partners, and they are a detriment to our U.S. firms. The American Jobs Creation Act of 2004 has provided some important and positive steps to address the competitiveness of U.S.-based multinationals; however, complexities and barriers remain that continue to handicap U.S. competitiveness.

Even relative to other countries that have not adopted a territorial tax system, that is, countries that still follow a worldwide tax system, U.S. international tax rules often serve to impose a higher tax burden. In particular, no other country limits deferral as rigorously as the United States.

With growing world economic integration, the shortcomings of U.S. international tax policy will be increasingly magnified. The playingfield is already unlevel, and every year, we risk falling further behind. Eighty percent of the world's purchasing power and 95 percent of the world's population lie outside the United States. Success or failure for U.S. companies in their quest to compete in foreign markets as well as at home will affect domestic jobs and the growth of our economy. For U.S. companies to compete successfully and bolster U.S. growth, we need a tax system that does not handicap us. Thank you.

[The prepared statement of Mr. Castellani follows:]

Statement of John Castellani, President, Business Roundtable

Introduction

Business Roundtable ("the Roundtable") is an association of chief executive officers of leading U.S. corporations with over $4.5 trillion in annual revenues and a workforce of more than 10 million employees. Roundtable member companies comprise nearly one-third of the total value of the U.S. stock market and account for nearly one-third of all corporate income taxes paid to the federal government. Roundtable companies undertake nearly one-half of the total private R&D spending in the United States.

The Roundtable is committed to advocating public policies that ensure vigorous economic growth. Through economic growth, American workers can attain ever higher living standards, generation after generation. It is this key objective—maximizing the sustainable, long-term growth of the U.S. economy—that we bring to consideration of tax policy and tax reform.

Global Competitiveness and Tax Reform

Whether we like it or not, tax policy ultimately affects business decisions and the ability to earn a profitable rate of return. In today's global business environment, U.S. tax policy can create an obstacle to the pursuit of global business strategies, to the detriment of our domestic economy. While taxes are not the only factor affecting the ability of U.S. companies to compete globally, they have a significant impact.

We will never live in a world where no taxes are necessary. The basic purpose of the tax system is to fund the many essential services and activities of our government and business taxes will always be an important source of revenue to fund this need. Corporations share a responsibility to pay tax to support these essential government services. The key to an appropriate tax policy is to collect the necessary revenue to fund government while minimizing the adverse impact that taxation can have on economic activity and the economic well-being of our society.

In this context, as recognized by the President's Advisory Panel on Federal Tax Reform, there is an urgent need to reform U.S. tax rules as they apply both to domestic and international commerce—in order to improve the competitiveness of U.S. businesses and to improve the outlook for our economic growth. Achieving and sustaining economic growth requires that U.S. companies be competitive both at home and in the expanding markets of the world. In the globally competitive environment we face, this requires—at a minimum—a tax system that does not impede the ability of U.S. companies to compete on equal terms with their foreign-based competitors.

The world is rapidly becoming more integrated. Reductions in the cost of communication and transportation and falling trade and investment barriers have opened the door to competition on a truly global scale. Nearly 80 percent of the world's purchasing power rests in markets outside of the United States. China alone represents a market two-thirds the size of the U.S. market and it is expanding at an annual rate of 10 percent. American corporations and American workers stand to benefit from the economic growth and higher living standards made possible by these new and expanding markets.

U.S. firms are increasingly adopting global investment and marketing strategies. Over the past 40 years, exports by U.S. corporations have doubled as a share of the size of the total economy and the share of worldwide profits of U.S. corporations attributable to foreign earnings has nearly tripled.

As U.S. companies seek to expand internationally, they often find that the U.S. tax system poses a serious impediment to their plans. Despite important reforms to the tax system over the years, particularly the 2004 American Jobs Creation Act, the U.S. tax system today still reflects an economy of a different era—a time when international activity was far less important and the United States faced far less competition.

In 1970, U.S. multinational firms were dominant globally, accounting for over 50 percent of the world's cross-border investment flows. In contrast, in the three most recent years for which data are available (2002–2004), the share of the world's cross-border investment made by U.S. firms averaged less than 25 percent.

Let me give you some real-life examples of the problems faced by U.S.-based companies as they attempt to compete globally against foreign-based companies:

- One U.S. company has successfully pursued a global business strategy, resulting in significant job expansion at home, with high-wage, high-quality jobs. At the same time, it finds that its major foreign rival has an effective tax rate some 15 percentage points below its own rate of approximately 38 percent. This tax advantage has permitted its foreign rival to reinvest some $2 billion globally over the past six years and gain footholds around the world. One naturally wonders what the U.S. company would be able to achieve if it were permitted to operate on a level playing field.
- Another U.S. company had accrued foreign earnings abroad but faced a significant tax disincentive to repatriating these funds to the United States until a special one-year temporary provision was enacted in 2004. This company took advantage of that provision by bringing back the maximum it was permitted—more than $500 million—to expand domestic operations. The additional funds resulted in an improvement in the firm's credit rating, which brought about the opportunity to finance additional U.S. investments, and additional tax dollars to the U.S. Treasury. As the one-year provision has expired, this U.S. company and others like it will again be subject to a tax penalty for bringing home foreign earnings.
- Another U.S. company pays taxes to a foreign jurisdiction from its operations at a 15 percent tax rate, but due to U.S. subpart F rules, it pays an additional 20 percent on this income to the U.S. with no deferral. Its foreign-based competitors, however, pay tax at only the local country rate of 15 percent. This puts the U.S. company at a severe competitive disadvantage relative to its direct competitors.

These examples, and many more like them, point to the need for substantive reform of U.S. tax rules. U.S. businesses face strong competition around the world, and there can be no presumption that the U.S. business can overcome its tax disadvantage in this competition. Dominance of U.S. corporations in foreign markets is no longer assured. Of the world's largest global corporations (valued by foreign assets), just four of the twenty largest *non-financial* corporations and only three of the twenty largest *financial* corporations are headquartered in the United States.

Many countries have responded to the increasing importance of cross-border investment by removing tax obstacles to international commerce. The U.S. tax system has not kept pace with this need to adjust to new international realities.

Corporate Tax Rates

In 1986, after the United States reduced its top corporate income tax rate from 46 percent to 34 percent, most other major industrial countries followed suit. Today, at 35 percent the U.S. federal corporate income tax rate is no longer low; indeed it is now tied for highest among the thirty countries of the Organization for Economic Cooperation and Development (OECD), and is 8.6 percentage points above the OECD average tax rate of 26.4 percent. Including state and local corporate income tax rates, the U.S. rate is second highest in the OECD after Japan and is 10.4 percentage points above the OECD average of 28.9 percent. The U.S. rate is also 11 to 14 percentage points higher than the average national and combined national and local corporate tax rates of the twenty-five countries of the European Union (**see Table 1**). Researchers using other measures, such as effective tax rates, have found generally similar patterns: high U.S. rates, with our major competitors having lower rates that have declined over the past decade.

Overwhelmingly, the international trend is for lower taxes on corporations. If U.S. corporations are to remain competitive with foreign-headquartered firms, they cannot be subject to corporate tax rates that are ten percentage points or more higher than those of their competitors.

Table 1

Central Government and Central and Local Government Tax Rates, OECD, 2005

Country	***Central Top Rate***	***Central and Local Top Rate***
Japan	30.0	39.5
United States	**35.0**	**39.3**
Germany	26.4	38.9
Canada	22.1	36.1
Spain	35.0	35.0
Belgium	34.0	34.0
France	33.8	33.8
Italy	33.0	33.0
New Zealand	33.0	33.0
Greece	32.0	32.0
Netherlands	31.5	31.5
Luxembourg	22.9	30.4
Australia	30.0	30.0
Denmark	30.0	30.0
Mexico	30.0	30.0
Turkey	30.0	30.0
United Kingdom	30.0	30.0
Sweden	28.0	28.0
Norway	23.8	28.0
Korea, Republic of	25.0	27.5
Poland	19.0	27.5
Czech Republic	26.0	26.0
Finland	26.0	26.0
Austria	25.0	25.0
Portugal	25.0	25.0
Switzerland	8.5	21.3
Slovak Republic	19.0	19.0
Iceland	18.0	18.0
Hungary	16.0	16.0
Ireland	12.5	12.5
OECD average	26.4	28.9
European Union average	24.2	25.3

Source: OECD and PricewaterhouseCoopers

And as we watch our foreign competitors continue to reduce their taxes, there is one other key data point that stands out: in these other countries, the share of government revenue represented by corporate taxes remains largely unchanged. That is, the government's ability to fund other priorities has not been diminished as the corporate tax rate has fallen. This point has dramatic implications for evaluating how economic competitiveness and economic growth can be improved without reducing overall government tax collections.

U.S. International Tax Rules at Variance with International Norms

U.S. tax rules also deviate significantly in other ways from those of many of our trading partners to the detriment of U.S. firms. The American Jobs Creation Act of 2004 has provided some important positive steps to address the competitiveness of U.S.-based multinationals and the U.S. economy, including numerous changes to address the complexity of the foreign tax credit rules. However, complexities and barriers remain that continue to handicap U.S. companies in the global marketplace.

U.S. multinationals in many cases must pay U.S. tax in addition to foreign tax on income earned abroad. By contrast, competitors headquartered in countries with territorial tax systems generally do not pay home-country tax on business income earned abroad. The President's Advisory Panel on Federal Tax Reform, in recommending an option moving in the direction of the territorial tax systems employed by some of our major trading partners, noted that territorial systems are used by twenty-one of the thirty OECD countries. An appropriately structured territorial tax system that allows U.S. companies to compete globally on level terms is worthy of consideration. The variations of territorial systems employed by our major trading partners, as well as other possible variations, should be examined to determine the particular features of a territorial tax system that would serve to enhance the competitiveness of U.S. multinational companies in the global marketplace.

Even relative to other countries that have not adopted a territorial tax system, that is, countries following a "worldwide" system of taxation, U.S. international tax rules often serve to impose a higher tax burden. In general, U.S. multinational companies are not subject to U.S. tax on the operating earnings of their foreign subsidiaries until those earnings are actually paid to the U.S. parent as a dividend. This ability to defer tax until a dividend has been paid to the U.S. parent permits earnings to be reinvested by the foreign subsidiary without reduction for U.S. taxes. An important exception to this general rule of deferral is subpart F of the Internal Revenue Code, which taxes U.S. multinational companies on certain active business income earned by their foreign subsidiaries, even though no dividend has been paid to the U.S. parent. No other country limits deferral as rigorously as the United States. In the absence of deferral, a U.S. company has only 65 percent of its foreign source earnings to reinvest (with up to 35 percent going to U.S. tax) while a foreign competitor can reinvest up to 100 percent, depending on the foreign rate of tax. There is urgent need to modernize these rules, including making permanent the treatment of financial services income as active income not subject to the subpart F restriction.

With growing world economic integration, the shortcomings of U.S. international tax policy will increasingly be magnified. The playing field is already un-level and every year we risk falling further behind.

Double Taxation of Domestic Income

All of the major trading partners of the United States relieve or eliminate the double taxation of corporate income, which occurs when corporate profits (but not the profits of any other type of business) are taxed at both the corporate and shareholder levels.

Double taxation increases the cost of capital for U.S. companies compared to foreign competitors whose countries have eliminated or reduced this handicap. Partial relief from double taxation was enacted in 2003 in the form of a reduced individual tax rate on corporate dividends received by shareholders. This partial relief is set to expire after 2008 unless extended, as House-passed legislation provides, or made permanent, as requested by the President.

Permanent relief from double taxation would provide significant economic benefits to the U.S. economy. Since enacting the temporary dividends investment incentives in 2003, economic growth is up, more than 5 million new jobs have been added, business investment has been very strong, and companies have rapidly expanded their dividend payments. As noted in a recent study by the Federal Reserve Bank of Boston, the dividends investment incentives expand investment by corporations and lead to higher paying jobs for American workers.

A Tax Code for the 21st Century

The broad brush of reform must reach into other areas, as well. To enhance economic growth, U.S. policy must encourage increased savings by individuals, including long-term savings which can in turn be used as a source for long-term investment capital for businesses. Capital investments in plant and equipment can be fostered through depreciation allowances that properly reflect the more rapid obsolescence of capital goods in today's modern economy. We must also recognize the need for promoting investment in research and development. When we name research and development, the Roundtable speaks not only of the critically important tax credits for finding and perfecting new products and technologies—credits which should be extended and strengthened as swiftly as possible along the lines of legislation passed by both the House and the Senate—but also of the need to develop our human capital by improving math and science education so that our citizens, too, improve their global competitiveness.

The Roundtable is ever mindful of the U.S. federal budget and deficit concerns. We consistently and enthusiastically advocate responsible budgetary policy. At the present time, with economic activity appearing to have fully recovered from a previous slowdown in the economy, it is imperative to focus on deficit reduction.

In light of the need to maintain fiscal discipline to promote long-term economic growth, we support an approach to tax reform in a revenue neutral manner—that is, formulation of tax proposals that neither increase overall tax collections nor reduce overall taxes and cause deficits to expand. However, revenue neutrality must not be reached by increasing business taxes to pay for individual tax reductions. In today's competitive international business environment, tax increases on business have a doubly negative impact. By increasing our cost to finance new investment, business taxes reduce the ability of U.S. businesses to grow and expand at home *and* they cause U.S. businesses to lose sales to our foreign competitors who are unhindered by U.S. tax rules.

Conclusion

Current U.S. tax policy is handicapping our economic prowess at a time when it needs to be unleashed. Expanding demand for consumer products and capital equipment around the world creates extraordinary potential growth opportunities for U.S. companies. With 95 percent of the world's population and 80 percent of the world's purchasing power residing outside of the United States, success or failure of U.S. companies in their quest to compete in foreign markets, as well as at home, will have a significant impact on domestic jobs and the growth of our economy. For U.S. companies to compete successfully and bolster U.S. growth, we need a tax system that doesn't handicap us from the starting line.

The number one priority of Business Roundtable to enhance the competitiveness of U.S. companies is a significant reduction in the corporate tax rate. If U.S. companies are to remain competitive in world markets, they cannot be subjected to tax rates more than ten percentage points above those of their foreign-based competitors.

Second, our international tax rules must be modernized to permit U.S. multinational companies to operate on a global scale through global operations. We encourage Congress to examine features of other territorial tax systems, as well as other reforms, that can serve to promote the competitiveness of U.S. companies with international operations rather than penalize them as our present tax system often does.

As the importance of international commerce will only become more pronounced each decade, the longer we wait in undertaking these reforms, the greater is the loss to our economy.

Long-term economic growth will also require that we take a disciplined approach toward deficit reduction. As projections from all governmental authorities show, any realistic attempt to hold down long-run deficits requires that spending on entitlement programs be kept in check. Spending on the three major entitlement programs of Social Security, Medicare, and Medicaid will, if left unchanged, absorb an unsustainable share of economic resources and overwhelm the federal budget. We welcome the opportunity to explore ideas and proposals that will slow the rate of growth of these programs while continuing to provide increasingly higher living standards for all Americans.

The Roundtable greatly appreciates the work this Committee and its Members are undertaking by addressing this weighty and complex subject. But as complicated as the subject may be, the underlying truth is a simple one: American companies are at a competitive disadvantage in the global marketplace and tax reform that allows our companies to be more competitive is a critical step towards reinvigorating America's business edge abroad and economic growth at home.

I appreciate this opportunity to share with you our concerns. On behalf of Business Roundtable, we look forward to continuing to work with the Congress as it explores ways to modernize our tax system to reflect the realities of today's globally competitive environment and undertake reforms to augment future economic growth. I thank you for your time and attention and I welcome your questions.

Chairman CAMP. Thank you very much. Thank you all for your testimony. Mr. Castellani, first of all, I would like to mention that many witnesses today have raised the international competitiveness concerns about our tax system, and we will be holding a hearing in June on the international tax issues, but I did want to ask a question about, as a rule of thumb, do you find that a country's rates, the rate a country imposes on a tax base, is that more important than specific incentives in terms of business investment? I realize this is in your role working with the senior management of many prominent companies throughout the country and world.

Mr. CASTELLANI. Yes; in general, our experience and our members' experience is that it is the rates that have the greatest long-term impact on investment decisions. A lot of specific incentives can be transitory. They can disappear. Ultimately, they create artificial behavior, but when we look across all of our member companies and the countries in which we compete and the companies with which we compete around the world, it is the rates that affect those business decisions the most significantly.

Chairman CAMP. All right; thank you. Mr. Tisch, thank you for your comments regarding long-term capital gains. I do have a question: do you see much value in pursuing the book versus tax conformity reporting requirements?

Mr. TISCH. The first I have really heard of that was during the prior panel, and the conclusion that I quickly drew, that is my preliminary conclusion, is that it sounds good when you say it fast but that when you dig deeper and deeper into it, I dare say I do not think Congress wants the Financial Accounting Standards Board (FASB) determining what tax policy is for the United States, and I do not think that would be particularly good for the United States either.

Chairman CAMP. Do you, in your role as a CEO, see compliance—not really concerns but cost issues with complying with both systems, or is that not a concern for your—in your experience?

Mr. TISCH. It is very, very expensive to comply both with FASB and the U.S. Securities and Exchange Commission (SEC) rules with respect to GAAP accounting, and it is also very expensive to comply with IRS rules. But this year, our company will earn between $1.5 billion and $2 billion. So, the costs, while large, in the tens of millions of dollars, will nonetheless be manageable within the context of our company.

Chairman CAMP. Thank you. Mr. McKenna, you said that the rates are generally favored over expensing. Does that lead to the same result?

Mr. MCKENNA. Perhaps in the short-term, it leads to the same result in terms of producing a tax savings. But if the long-term plan is to influence behavior, and that is the point I was trying to make, that the tax preferences and tax credits in the case of PepsiCo really don't influence our behavior. They reward activities that we would otherwise already be doing.

That may sound counterproductive, and I do not mean to be glib about that, but comparing a long-term tax rate benefit with a more targeted tax preference, PepsiCo and our shareholders would benefit much more, assuming the dollars are equal, would enjoy much more the benefits of a long-term rate reduction.

Chairman CAMP. Thank you. Again, thank you all for your testimony. Mr. McNulty may inquire.

Mr. MCNULTY. I also thank all of you for taking the time to be here today, and based upon my earlier comments about our huge budget deficits and the staggering national debt and the impact that that will have on future generations, my question is, do you believe that the proposals which you are making here today will have the impact of reducing budget deficits in the future, hopefully moving us toward balanced budgets and then eventually the ability to start paying down the national debt rather than increasing it every year, and if so, how? I would just like to get a brief comment from each of you on that.

Mr. TISCH. Congressman, I think that the reduction in the rate for long-term corporate capital gains will actually raise revenues for the Treasury. The reason for that is that there is an enormous backlog of gains that have not been taken by companies because the tax rate is so high. A reduction in the rate will do several things: number one, it will get companies to sell capital assets that they otherwise have been holding, and so, it would generate revenue for the Treasury.

Number two, it will lead to increased economic activity, because the assets that companies are holding that they want to sell but for the tax rate are probably not being maximized by those companies, and the sale of those assets to other companies that want to own that asset and want to maximize the value of that asset will result in increased job creation and will result in increased national income and revenue for the Treasury.

Mr. MCNULTY. Has that been the history in the past, when we have made cuts in the capital gains rate?

Mr. TISCH. We do not know, because the tax rate for corporate capital gains has been so high for so long. It is 35 percent now. Let me take you through a very simple example. We are in the hotel business. Suppose a long time ago, we bought a hotel for $20 million, and suppose, today, it is worth about $100 million, because it has income of about $5 million a year.

As a corporate CEO, here is what would go through my mind in determining whether to continue owning the hotel or whether to sell it. I would look at how much I would get; $100 million; sounds like a lot of money, and it sounds, on a pretax basis, like I am selling it at a pretty good yield, at 5 percent. However, I would have $80 million of gain on that transaction. At the 35-percent rate, that means I would pay $28 million in taxes.

So, when the dust has settled on the transaction, I am going to have $72 million, meaning that my yield is really 7 percent. My reinvestment yield is 7 percent. I have to be able to get 7 percent just to break even with the 5 percent that I was earning before the transaction. So, what we are seeing is that the reinvestment rate has gone up 40 percent.

Now, suppose instead we had a 15 percent capital gains rate for corporations similar to what we have for individuals. There, I would sell the asset, because there would not be such an enormous tax wedge, and the Treasury would get $12 million, which is 15 percent of the $80 million gain, as opposed to getting zero dollars, which is what it is currently getting, because I am unwilling to sell the asset. Not only that; once I have sold the asset, it is going to go to hands that are going to exploit that asset more, exploit in the good sense. I am going to get cash that I can then use to reinvest in yet other assets that I want to own more than that hotel that I sold. So, everybody wins. There is economic activity; there is job creation; and there is dramatically more revenue to the Treasury.

Mr. MCNULTY. Thank you. Mr. McKenna?

Mr. MCKENNA. Mr. McNulty, my comments domestically were focused more on the competitiveness of U.S. corporations and the efficiency of how the tax laws are administered and goes more toward targeting lower tax rates as opposed to targeted tax benefits. Internationally, the additional point I made goes to the competitiveness of U.S. companies competing abroad, which is that our competition is taxed at lower rates, and that has all the obvious business pressures for U.S. companies trying to compete against those companies in those locales.

Mr. MCNULTY. How concerned are you about the budget deficits and the national debt that we have right now?

Mr. MCKENNA. It is a significant concern; obviously, a significant concern.

Mr. MCNULTY. Mr. Castellani?

Mr. CASTELLANI. If I might address that, there are two aspects of the economy that your question gets to, and both are very important.

One is to have the economy growing at its maximum efficiency. In fact, most of our members believe that this economy, particularly with our productivity improvements and the tremendous productivity of American workers could probably grow at a noninflationary rate, at a much higher rate than we are seeing now, which is a pretty robust rate. Every percentage of GDP growth increase produces more than $620 billion over a five-year period in additional tax revenues, so that is one part of the equation.

But the other part has been and remains a concern for the members of the Business Roundtable, and that is over the long-term, we need to reduce our deficit. That part of our equation is reducing our spending. The very substantial portion of the Federal outlays that are in entitlement programs will grow to be nearly half of the budget, and Social Security and Medicare and Medicaid present a very significant problem for the economy as a whole and our worldwide competitiveness if we do not address them.

So, our view has been keep the economy going as well as it can grow efficiently without causing inflation and producing income but at the same time begin to modernize our systems and our entitlement systems to reflect not only the demographic reality but also our ability and our need to compete internationally.

Mr. MCNULTY. Thank you all very much, and I thank Mr. Chairman for letting me go over my time a little bit.

Chairman CAMP. Thank you. It was helpful to hear from the whole panel. Mr. Foley may inquire.

Mr. FOLEY. Thank you, and Mr. Tisch, I was intrigued by your analogy of the buildup of value and what a corporation does with that asset, but would it not be fair to say that a corporation would maybe find a way to maybe swap out that asset or trade stock with another corporation or like-kind exchange? Does the Tax Code not provide mechanisms by which you can defer viability?

Mr. TISCH. There is some of that, but the rules are very difficult, and you have to jump through hoops to comply. It is easier in real estate than it is anywhere else, but even in real estate, you only have 6 months to make the reinvestment. So, you have to tee up not one transaction but two transactions simultaneously, and that is oftentimes very difficult to do.

With respect to other capital assets, it is very, very difficult to do, and generally, it does not give you, at the end of the day, cash that you can use to spend to buy something else. So, we have found, not wanting to tie ourselves up in to all kinds of knots, that instead, we just do not do transactions.

Mr. FOLEY. I guess that was my point, because there are ways to do it. You could leverage the building and add debt, pull out cash tax-free in the real estate sense, maybe not from the operating side, but the fact remains that if we had a preferable rate of 15 percent, most would prefer to transact, pay the tax, and move on; is that correct?

Mr. TISCH. That is right, and I think Professor Desai estimated that there are $800 billion of gains locked up in companies. My guess is that his number is very, very low.

Mr. FOLEY. See, and that is something I wish we would all focus on. When we talk about rates, we get caught up in what is it going to cost the Treasury. My example of how companies operate, individuals, if I have a liability on a sale of assets, I am going to find a way to exchange it out and move forward to the—at some point, there is a day of reckoning, but I am going to make complicated transactions in order to minimize taxation.

I will keep a lot of people busy, accountants and lawyers, to make sure that I have complied with the law, but in essence, I have delayed the day of reckoning, starved the government moneys that it could have earned on the day of a closing. So, the simplicity by which you are advocating under the John F. Kennedy model of lower taxes, greater revenue, truly is an example that we witness after we reduce capital gains from 27 to 15 percent.

Mr. TISCH. If it is good for individuals, the question is why is it not good for corporations? My strong belief is that it would increase revenues to the Treasury.

Mr. FOLEY. Mr. McKenna, could you describe something PepsiCo may do that would avoid a domestic operation in favor of an international one, based on the tax climate?

Mr. MCKENNA. It is difficult, Mr. Foley. Most of our businesses must be fairly established in each local country. We could perhaps choose to source the United State from Mexico or Canada, where transportation costs are not that significant. We could choose to perhaps locate a factory in one country or another based upon the tax laws, but in most cases, because our businesses are so local, our operations have to be located in that country. PepsiCo's tax planning with respect to growing our international markets, is much more a question of looking at local laws as opposed to the impact today of U.S. laws, with one exception, and that is the U.S.

law that taxes those profits when they come home. That taxation is a major hurdle that we have to put into our investment models.

Mr. FOLEY. Did you bring back moneys when we reduced the level for repatriation?

Mr. MCKENNA. Yes, we did. We brought back the maximum amount we were permitted under the law.

Mr. FOLEY. Do you recall the number?

Mr. MCKENNA. Over $7 billion.

Mr. FOLEY. So, $7 billion of PepsiCo's money that was worldwide, held offshore, was brought back based on a more efficient tax model.

Mr. MCKENNA. That is right.

Mr. FOLEY. Final thought, and I do not expect an answer, but in the effort to reduce taxes for corporations, one of the things that we are hit with politically is the fact, and we open the paper and see huge compensation packages, $200 million; $400 million as a walkaway; something to keep in the back of our minds as we are working together to make a better business climate. The fallout of some of those makes it very difficult for us to say let us reduce rates, even though we can enthusiastically make the case that when do reduce rates, as in the case of Pepsi, Apple, IBM, I can go through a litany, brought home hundreds of billions of dollars that are now domestically deployed that not have been, so I think those are things that we all have to work on together. Thank you.

Chairman CAMP. Thank you. The gentleman's time has expired. Mr. Doggett may inquire.

Mr. DOGGETT. Thank you, Mr. Chairman. If I understand correctly, all three of you agree that you would like to see a lower corporate tax rate, and you would be willing to yield some tax preferences and some tax credits in order to get one.

Mr. MCKENNA. Speaking for myself, the answer is yes, yes, sir.

Mr. CASTELLANI. When the very diverse membership of the Business Roundtable, and as you know, they represent every sector in the economy, look at how the Tax Code can be made most effective and enhance competitiveness, the two answers that are almost universal are lower the rate and reform our international tax system.

Mr. DOGGETT. Same for you, Mr. Tisch?

Mr. TISCH. No.

Mr. DOGGETT. Well, that argument has some appeal to me, even though we come from a different perspective. I would like to know what we are getting in order to lower the tax rate. Just beginning with you, Mr. McKenna, which tax credits or preferences that PepsiCo regularly uses would you recommend that we repeal in order to lower corporate tax rates?

Mr. MCKENNA. I can perhaps answer the question in a little bit different fashion.

Mr. DOGGETT. Could you answer that question first? Are there any that you can identify that PepsiCo regularly uses in the way of tax credits or tax subsidies or preferences of any kind that you would recommend we repeal in order to get to a lower corporate tax rate?

Mr. MCKENNA. Yes; we would be willing, on our books alone, to trade some of the depreciation benefits that are available today in exchange for a lower tax rate.

Mr. DOGGETT. All right; and you, Mr. Tisch?

Mr. TISCH. I did not say that I was in favor of lower corporate rates. I think that the goal of the CEO is to maximize the income of the company.

Mr. DOGGETT. Certainly.

Mr. TISCH. We have to generate pre-tax earnings, as much pre-tax earnings as possible. Then, we pay our taxes; and then, we have net income, which is what the shareholder looks at. My job is not going to be different if the rate is 35 percent or 30 percent.

Mr. DOGGETT. Okay.

Mr. TISCH. However, my behavior will change if you lower the corporate capital gains tax rate. I will make dramatically different investment decisions as a result of that.

Mr. DOGGETT. With regard to your position on the territorial tax system that you would recommend, do I understand that each of you also favor a territorial system in which taxes would be limited to profits generated here in the United States, and if PepsiCo has operations in India or Nigeria or Italy that you would pay your taxes there, but you would not pay taxes here in the United States on those profits?

Mr. MCKENNA. That is right. When they came home, they would not be taxed a second time. That is right.

Mr. DOGGETT. That is something that you support also, Mr. Tisch?

Mr. TISCH. I have not given it a dramatic amount of thought, but on first thought, yes.

Mr. DOGGETT. That is what I believe what your paper advocates.

Mr. CASTELLANI. Yes.

Mr. DOGGETT. You call it a territorial system, but what it really is is no tax in America on any profits earned outside of America, is it not?

Mr. MCKENNA. Yes, or an exemption system, that is right.

Mr. DOGGETT. It is an exemption for all earnings. So, like, Exxon-Mobil, on everything that it earns outside the Continental United States, it would pay no tax whatsoever ever on those earnings.

Mr. MCKENNA. The exact ramifications of a territorial system are not quickly decided upon, and I think from a policy perspective, a great deal of study is necessary before deciding exactly what is taxed and what is not taxed——

Mr. DOGGETT. We can agree on that. Since my time is running out, let me just ask you once more about your company. During the time you have been there, has PepsiCo ever paid an effective tax rate of 35 percent on its total corporate earnings?

Mr. MCKENNA. Our current effective tax rate is not 35 percent.

Mr. DOGGETT. You would fire your whole tax department if they paid 35 percent effective tax rate, would you not? No corporation around here of the size of your corporation pays a 35 percent effective tax rate, does it?

Mr. MCKENNA. Probably not very many, but I cannot speak to——

Mr. DOGGETT. No, sir. The ones that are losing, they are losing shareholders, perhaps, but there are so many ways to avoid the 35 percent effective tax rate that no one pays it. Thank you very much, Mr. Chairman.

Chairman CAMP. Mr. Tisch, did you want to make a comment? You had your hand up.

Mr. TISCH. Yes; the question as to whether you are paying an effective 35 percent tax rate, I understand what the numerator is. The numerator is cash that you pay to the government. The thing I do not completely understand is what the denominator is. If, in fact, the denominator is what you call GAAP net income, then, in fact, no, companies do not pay a 35 percent effective rate. If the denominator instead is the bottom line that comes out on the tax form, our taxable net income, then, obviously, yes, all companies pay that 35 percent net rate.

Chairman CAMP. All right; thank you. Just briefly, Mr. McKenna, we did have a repatriation provision in the JOBS Act of 2004. Did that affect Pepsi in any way?

Mr. MCKENNA. Yes, it did.

Chairman CAMP. I realize we are going to have a hearing on the international provisions later, but I just wanted——

Mr. MCKENNA. Yes, it did. PepsiCo did take advantage of the ability to bring back accumulated profits overseas, profits that we hesitated to bring back because of the tax consequences until that law was passed.

Chairman CAMP. All right; thank you. Mr. Linder may inquire.

Mr. LINDER. Mr. McKenna, how much do you still have offshore?

Mr. MCKENNA. In terms of earnings, sir, or cash?

Mr. LINDER. Cash.

Mr. MCKENNA. I think at this point, on a net basis, probably a deficit of cash offshore. I cannot say exactly.

Mr. LINDER. Do you have any idea how much is offshore in offshore financial centers in dollar-denominated deposits?

Mr. MCKENNA. No, I could not tell you that off the top of my head.

Mr. LINDER. Would $10 trillion surprise you?

Mr. MCKENNA. Pardon me?

Mr. LINDER. Would $10 trillion surprise you?

Mr. MCKENNA. From a cumulated point of view, it would not surprise me, sir, but I do not know.

Mr. LINDER. How much do you spend every year on your tax department?

Mr. MCKENNA. Several million dollars a year.

Mr. LINDER. How much do you spend in total compliance costs in addition to that?

Mr. MCKENNA. Again, an additional several millions of dollars a year.

Mr. LINDER. How much money do you think you put into calculating the tax implications of a business decision?

Mr. MCKENNA. That is an important consideration of every decision we make.

Mr. LINDER. Mr. Tisch, same thing for you?

Mr. TISCH. We spend about $20 million a year on accountants. We spend——

Mr. LINDER. Inside accountants or outside accountants?

Mr. TISCH. Outside accountants. We probably spend another $20 million of internal people just putting together financial statements, and then, we probably spend another, oh, I would say $10 million or $15 million across all of our companies complying with Tax Codes.

Mr. LINDER. On top of that, what do you spend, do you think, calculating the tax implications of a business decision?

Mr. TISCH. It is difficult to say, because that just goes part and parcel with——

Mr. LINDER. Every decision.

Mr. TISCH. Every decision.

Mr. LINDER. Yes; if we had no tax on capital or labor and taxed only personal consumption, how much of the offshore business would be onshore? Mr. McKenna? You mentioned transportation costs, and people doing business in Detroit would probably like to be in Detroit if it were not for the tax implications.

Mr. MCKENNA. By transportation costs, I meant moving from the factory to the customer to the warehouse. Our operating businesses probably would not be impacted at all in the sense that our operating businesses are, more often than not, local businesses in each country, in France or Germany or India, wherever it might be. Those markets need to be sourced from local production.

Mr. LINDER. Is it not true that Daimler-Chrysler really wanted to be Chrysler-Daimler, and they really wanted to be in New York except for the crushing tax on capital in this country?

Mr. MCKENNA. I cannot speak for them; I am sorry.

Mr. LINDER. Mr. Castellani, have you, through your organization, ever taken the time through your companies to try to calculate how much we spend complying with a code that brings in roughly $1.5 trillion a year?

Mr. CASTELLANI. We have not, but as you know, others have. The figure is rather astounding. I do not recall it, but I am sure you do; we have not calculated it. We have relied on others to do that, because we only have one portion of the economy that we look at.

Mr. LINDER. Mr. McKenna, who pays your business taxes? Do you think it comes out of your shareholders pockets, your employees' pockets, or your consumers?

Mr. MCKENNA. I think as a corporate expense, it ultimately comes out of the returns that shareholders receive.

Mr. LINDER. You do not think your consumers are paying anything to that?

Mr. MCKENNA. It certainly impacts the pricing of our products, absolutely.

Mr. LINDER. Have you ever done an estimate of how much the tax component is in your price system?

Mr. MCKENNA. We have not approached it from that angle, no. We have not approached it from a revenue perspective, no.

Mr. LINDER. We have a study from Dale Jorgenson and Harvard, 1997, I think it was, that suggests that on average, 20 percent of the producer price system represents the embedded cost to the IRS, from leather goods at 15 percent to government services at 26 percent. Would that surprise you?

Mr. MCKENNA. No, I am sure it is significant.

Mr. LINDER. Does that make us less than competitive in a global economy?

Mr. MCKENNA. Certainly, the way the U.S. tax laws impact international tax laws impact our competitors.

Mr. LINDER. Thank you all. Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Ms. Tubbs Jones may inquire.

Ms. TUBBS JONES. Thank you, Mr. Chairman. I am sitting here laughing, because I am confident that many of the provisions of the Tax Code were put in place as a result of the lobbying the business community, even though we are all complaining we would like to get rid of all of these tax benefits and have a code that did not give you such blues in terms of preparation. You all will agree with that, that if we went back and looked at the tax history or the hearings with regard to this Committee that you were lobbying awful hard for an R&D tax credit or whatever other credit. Will you not agree with me, Mr. Castellani, just to be nice, so I can keep going with my line of questioning?

[Laughter.]

Mr. CASTELLANI. Well, ma'am, it has been very difficult——

Ms. TUBBS JONES. Short answer?

Mr. CASTELLANI. The answer is yes, because it has not been as simple as you have described, because no one is offering the very difficult task of a broad-based reform of the Tax Code.

Ms. TUBBS JONES. I did not ask about a broad-based reform, Mr. Castellani. I am saying if you went back and looked at the Congressional hearings, there were lobbyists on behalf of business saying give me this tax credit. I need this to do this, that or the other. Mr. McKenna——

Mr. MCKENNA. Absolutely.

Ms. TUBBS JONES. —you would agree that that is there somewhere, right?

Mr. MCKENNA. Yes, it is. It is certainly there somewhere.

Ms. TUBBS JONES. Mr. Tisch, you would agree with me, would you not?

Mr. TISCH. I would agree in terms of business in general. I can tell you this is my first time here, and my company rarely if ever lobbies for tax relief.

Ms. TUBBS JONES. Individually, you do not, but the Business Roundtable through Mr. Castellani, and you agree with a lot of the things that Mr. Castellani proposes.

Let me leave that alone and go on to something else. Can you tell me, Mr. McKenna, what did PepsiCo do with the money that they got back under the change and repatriation of dollars, the money you were able to bring back into the country? Did you give it to your shareholders? What happened with it?

Mr. MCKENNA. Well, it contributed to our continuing investment in the United States. I can tell you that in 2006, we are reinvesting approximately $1 billion into capital projects in the United States.

Ms. TUBBS JONES. So, how many more jobs did we get as a result of repatriation?

Mr. MCKENNA. I cannot identify the specific number, but the Gatorade factories and the Tropicana facilities around the country all will demand new, additional jobs.

Ms. TUBBS JONES. So, you are suggesting to me that by allowing you to bring money back to the United States that you paid no tax on previously that we then increase the revenue to the United States of America by having more jobs, and so forth. I am not asking you that question. I have one for you.

Mr. McKenna.

Mr. MCKENNA. Yes, I think it took away the disincentive to investing that money back into the United States.

Ms. TUBBS JONES. So, what exact benefit did you receive through repatriation? No tax on——

Mr. MCKENNA. There was a small tax paid. It was not quite tax free. There was a small tax but a significant reduction in tax.

Ms. TUBBS JONES. Mr. Castellani, if I said to you okay, I will give you your capital gains and dividend tax relief that you are asking for, what would you be willing to give up?

Mr. CASTELLANI. Well, ma'am, the capital gains and dividend relief that we had been asking for is in fact in the Code now. What we have seen as a result——

Ms. TUBBS JONES. I know it is in the Code now, sir, but there is a whole debate about whether it should be extended. So, my question to you is what would you be willing to give up if I said it was extended ad infinitum?

Mr. CASTELLANI. What I would not be willing to give up and what our members——

Ms. TUBBS JONES. No, my question is what would you give up?

Mr. CASTELLANI. —is our ability to be competitive, ma'am.

Ms. TUBBS JONES. What are you willing to give up? See, you are playing words with me. Mr. Castellani.

Mr. CASTELLANI. We do not view this as a zero sum game.

Ms. TUBBS JONES. You know what? That is the dilemma that we are in, because I am trying to have a real conversation with you. You have already said to me that the problem that we have in the United States of America are entitlement programs and the fact that Medicare and Medicaid and Social Security are going bankrupt. The reality is, Mr. Castellani, you do not believe that American workers should not have Medicare, Medicaid, or Social Security, or do you?

Mr. CASTELLANI. Oh, absolutely; we agree that it is very important that they have them and that those systems both reflect the needs of people who use them as well as reflect the new demography that we have in our country, quite frankly. One of the issues that we have been arguing for for a long time has been Social Security reform, and one of the problems we have had with the debate——

Ms. TUBBS JONES. Private accounts?

Mr. CASTELLANI. No, ma'am, we said the option for personal savings should be there.

Ms. TUBBS JONES. Do you know what, Mr. Castellani? I am trying to give you assistance in getting what you want. What I am suggesting to you is that there is enough money made in America that workers should not have to give up Social Security, Medicare, or Medicaid, and until we are able to talk honestly, Democrats and Republicans, see, I want business to do well in my country, because it provides jobs. But I do not want them to do well at the behest of the workers who are starving, making $5.15 an hour right now.

I am out of time. It is nice to talk with you. I look forward to further conversations, but the reality is there has got to be a give and take on both sides.

Chairman CAMP. All right; thank you. Mr. Chocola may inquire.

Mr. CHOCOLA. Thank you, Mr. Chairman. Thank you all for being here today. Before being elected, I was CEO of a publicly-traded company, much smaller than the companies you all represent. I just spoke with our CFO that is still there, and he said, you know, all we want to do is be competitive. I bring that out just because I think when we talk about these issues a lot of times, people think we are only talking about PepsiCo or Loews or members of the Business Roundtable.

We are talking about thousands and thousands of small companies for every one of the big companies that are dealing with these issues. So, no one is immune no matter what size your company is, if you are trying to compete in a global marketplace to try to be more competitive.

Let me just ask you from the territorial tax system questions, those who criticize it say it will create a flight of capital to some foreign land, is there anything preventing U.S. shareholders from making the decision not to invest in your companies but to invest in a foreign company that is more competitive because they have a territorial tax system?

Mr. TISCH. I would say, in fact, that the current system is chasing money out of this country. One of the industries we are in is the offshore drilling industry, and a few years ago, a number of offshore drilling contractors, our competitors, moved their operations offshore, incorporated in the Cayman Islands and in other places, and in essence, decamped from the United States and now no longer have the issue of worrying about bringing back foreign earnings to the United States.

So, I think that doing something to level the playingfield so that our domestic company could compete with those foreign companies would be greatly appreciated.

Mr. CHOCOLA. So, you think by making U.S. companies more competitive, more people would invest in U.S. companies; is it simple as that?

Mr. TISCH. Absolutely.

Mr. CHOCOLA. On the flip side, if we had, in effect, a territorial system in place, what would that do, Mr. McKenna, to PepsiCo's market share worldwide?

Mr. MCKENNA. It would—in each individual market outside the United States, it would allow us to increase our returns and invest more money in those markets and give us greater market share and greater return to our shareholders.

Mr. CHOCOLA. How about access to capital?

Mr. MCKENNA. PepsiCo does not have the particular need for access to capital at this point. We are able to fund most of our capital from internally generated cash at this point.

Mr. CHOCOLA. Nice position to be in. Just finally, in the previous panel, we heard that people who received dividend income are undertaxed. Do you agree with that, and what do you think would happen if we would raise the dividend tax rate or lower it to even zero? Mr. Castellani?

Mr. CASTELLANI. I am not sure of the Professor's definition of undertaxed or overtaxed. What I can say, because we are very strong advocates of eliminating the double taxation of dividends, the income, as you know well, that companies received that is paid out in dividends is already taxed at the company level. What we have seen as a result of the lowering of the dividend tax has been a substantial increase in dividends paid out by companies. In fact, I stopped counting when it got in the 500s and 600s of companies that announced it.

A very large proportion of that dividend income goes first to individuals; secondly, a disproportionate share goes to elderly individuals older than 60. The next thing that we saw is that it had both a very positive impact not only on wealth in the country but also on share price. To the extent that people who were nearing retirement or were retired or saving for a home or education saw the value of their savings that were in equities and shares go up, they felt better about the economy. They were better able to handle those needs. They participated more in the economy. So, of all of those things that were done in 2003, I think this probably had the most significant impact in terms of economic activity, increasing corporate payouts, and improving the valuation of savings.

Mr. TISCH. Let me chime in. I do not know what is the right rate, but what I do strongly believe is that if the individual gains rate is increased, or the current 15-percent rate is allowed to lapse, and we go to a higher rate, what you will see is enormous selling by individuals as the date, the expiration of that 15-percent rate comes along, and you will see markets take a very significant header as a result. It will probably take a long time to recover from that type of tax-induced selling.

Mr. CHOCOLA. Just real quick, Mr. Chairman: I do not think, Mr. Tisch, you have advocated this, but talk about fewer tax preferences, lower corporate rate. Has anybody built a model on what the appropriate rate would be?

Mr. MCKENNA. I have not. I cannot speak to that. I do not know.

Mr. CHOCOLA. All right; thank you.

Chairman CAMP. Thank you. I want to thank our distinguished panel of witnesses, and I want to thank the Members for their attendance at this hearing, and the Select Revenue Measures hearing on corporate tax reform is hereby adjourned.

[Whereupon, at 4:25 p.m., the Subcommittee adjourned.]

[Submissions for the record follow:]

Statement of Affordable Housing Tax Credit Coalition

The Low Income Housing Tax Credit and Corporate Tax Redorm

Comments of the Affordable Housing Tax Credit Coalition

The Low Income Housing Tax Credit (the "Housing Credit") provides an excellent example of how the corporate tax code affects a company's decision to utilize capital. The Housing Credit program is the most significant Federal resource for the production of affordable rental housing for America's low-income families. It is tested, efficient, transparent, and governed not only by the IRS and state agencies, but also the investing institutions themselves. The program, which has created more than 1.7 million units of affordable rental housing since its inception in 1986, stimulates economic development in general through housing production and creates safe, affordable, attractive housing. The program brings private capital investments to communities, and primes the market for other activities, including home ownership and retail facilities. Tax incentives have proven to be the most efficient way to create affordable housing, and the Housing Credit program is one of the areas in which use of the Internal Revenue Code to meet social goals is vital and has no viable alternatives.

Affordable Housing Tax Credit Coalition

The Affordable Housing Tax Credit Coalition is a group of developers, investors, lenders, nonprofit groups, public agencies, and others concerned with the low-income housing tax credit. The Coalition is a nonprofit corporation chartered under the laws of the District of Columbia and governed by an elected Board of Directors.

On an ongoing basis, the Coalition represents tax credit participants before Congress in seeking needed legislative changes to the program, and represents the interests of the tax credit community before groups that effectively have regulatory control over the program, including the Treasury, IRS, FASB, and the National Council of State Housing Agencies. AHTCC undertakes a public information campaign to make widely known the success of the tax credit program to house low-income Americans.

Background of the Housing Credit Program

Originally signed into law as part of the Tax Reform Act of 1986, the Housing Credit is responsible for the production of up to 50 percent of all multifamily housing starts in any given year, and virtually all affordable rental housing in the United States since that time—more than 1.7 million units since enactment. It is estimated that 200,000 affordable units are converted to some other use (such as market rate rental housing, condominium conversion, or demolition) each year. The Housing Credit accounts for construction of 130,000 new units each year. Thus, the nation continues to lose ground with its supply, even with the success of the Housing Credit.

Congress understood from the beginning that private capital could only be attracted to affordable housing if there were tax benefits to replace the cash flow typically paid to real estate investors. The program is a model of effective use of public resources, leveraging taxpayer dollars with private capital, creating well-aligned public-private partnerships, and relying on states for administration and local priority setting. Together these factors assure that any new housing developed meets local community needs and is developed and maintained in accordance with strict compliance rules.

In 1993 Congress decided to make the Housing Credit a permanent program. Its longevity is testimony to the fact that the program has operated as intended. The program enjoys widespread bipartisan congressional support. In 2000, legislation to increase the amount of Housing Credits was co-sponsored by 85 percent of the Congress, with almost equal numbers of Republicans and Democrats. In addition, in 2005, in response to the affordable housing crisis created by Hurricanes Katrina and Rita, Congress authorized a significant increase in Housing Credits available in the Gulf Opportunity Zone.

How the Housing Credit Works

The program provides tax incentives, in the form of credits against federal income tax, in exchange for investment in newly constructed or substantially rehabilitated affordable rental housing. For periods of 30 years or more, this housing must serve low to moderate income tenants, who pay restricted rents and who earn a maximum of 60 percent of area median income (although average incomes in these properties are often far lower). Credits are allocated to the States based upon their respective population. The States determine their own housing priorities, within broad federal guidelines, and then choose which proposed developments will receive Housing Credits.

Developers, many of which are non-profit organizations, must compete for Housing Credit allocations under a highly transparent selection process. The Housing Credit is capped, which helps ensure that only a rational and reasonable amount of housing is built. But in most States, demand for Housing Credits far exceeds the supply, even with the increase authorized in 2000.

Housing Credit developments are located in urban, suburban and rural areas. A majority of the properties serve families, but a substantial number serve also elderly, disabled and special needs populations.

Once the Housing Credits are awarded to a housing developer, investors provide equity capital to finance a substantial portion of the costs of constructing or rehabilitating the housing. This equity capital reduces the need for mortgage financing and decreases debt service payments, thereby lowering operating costs and allowing owners to rent to low-income persons who pay rents they can afford.

Approximately 98 percent of this equity capital is raised from corporations, including banks, financial institutions, insurance companies, and Government Sponsored Enterprises. Many banks invest in Housing Credits as a mechanism to fulfill their Community Reinvestment Act requirements. Investors have invested nearly *fifty billion dollars* since 1986.

Due to the passive loss limitations and alternative minimum tax limits, individual investors supply very little capital toward this program. Furthermore, raising capital from individual investors is far less efficient because individuals cannot be expected to make commitments at the levels which corporations invest, which are typically in the tens of millions of dollars. Thus, the existence of the tax credit does not create undue complications for the individual taxpayers; the Housing Credit is instead primarily utilized by institutional investors.

It is important to note that the prices which corporations are willing to pay for Housing Credits have risen dramatically over the past ten years, which translates into more equity available to build affordable housing. Prices began to rise after the Congress made the Housing Credit program a permanent part of the Code in 1993 because investors became confident that the program would exist for the long term. Indeed, prices have risen by approximately 50 percent in the past ten years, meaning that each tax credit dollar brings in more private capital, increasing the program's efficiency.

Housing Credits are earned over a 10-year period, although they are subject to recapture for 15 years if various program rules are violated. Accordingly, corporations are highly motivated to make sure that the Housing Credits are received and not lost to recapture. Many corporations engage firms with special expertise in this area, often referred to as Housing Credit syndicators, to help them in structuring and monitoring the properties. This very intense oversight and the effective administration conducted by States are the principal reasons that the program has operated in accordance with government requirements—and even exceeded expectations—throughout its history. The threat of the severe penalty of tax credit recapture—a penalty only available through the tax code—serves to keep the program operating as Congress intended.

Why Use Tax Incentives?

Affordable housing development simply cannot be financed without the private capital attracted by the credit. HUD subsidies and other programs do not provide sufficient resources to encourage the development of affordable housing. For example, housing vouchers would not provide upfront assistance to build housing developments, nor would they address issues of rehabilitating old housing. Prior to the enactment of the Housing Credit there was insufficient production of affordable rental housing. Furthermore, the States do not have the resources to provide something on the scale of the Housing Credit.

Other Positive Results from the Housing Credit

The Housing Credit is also a driver in the revitalization of lower income communities. Through the Housing Credit, private capital is used to reverse the cycle of decline. The Housing Credit has turned around neighborhoods and stabilized the urban core while these regions are growing at the periphery. The Housing Credit also contributes to recapitalization of existing housing and can be used to address special needs housing, such as housing for the elderly, formerly homeless, and special needs populations.

The Housing Credit also brings jobs to an area. The program is responsible for an estimated 167,000 jobs each year associated with the creation of housing financed through the Housing Credit.

The Tax Code is the Best Way to Meet the Nation's Affordable Housing Needs

A housing production program like this cannot be set up anywhere other than the tax code because the potential tax benefit (or loss thereof) and threat of tax credit recapture is not available in any spending program. There is no effective real estate collateral that can act as a penalty. The Housing Credit program provides for loss of tax benefits and tax credit recapture in cases where there is evidence of non-compliance with program rules. The threat of loss of tax benefits and recapture has acted as a powerful compliance mechanism that spending programs simply cannot replicate.

Conclusion

The effect of the Low Income Housing Tax Credit on corporate investment decision-making demonstrates the necessity of the such a targeted corporate tax preference. Without the credit to spur investment and construction, our nation's supply of qualify affordable housing would be drastically reduced.

Statement of American Forest and Paper Association

Introduction

The American Forest & Paper Association (AF&PA) is the national trade association for the forest products industry. We represent more than 200 companies and related associations that engage in the ownership and management of timberlands for the production of timber and the manufacturing of pulp, paper, paperboard and wood products. America's forest and paper industry ranges from large landowners, to state-of-the-art paper mills, to small, family-owned sawmills, and to some 10 million individual woodlot owners. The U.S. forest products industry is vital to the nation's economy. We employ approximately 1.3 million people, we own millions of acres of forestland, and we rank among the top ten manufacturing employers in 42 states with an estimated payroll of $50 billion. Sales of the forest products industry top $230 billion annually in the U.S. and export markets. We are the world's largest producer of forest products.

The forest products industry manages timberland and produces timber and wood fiber for use in its two main product segments: pulp & paper and finished wood. Many firms in the industry are integrated growers and manufacturers. Others specialize in growing and selling timber, while others specialize in manufacturing. The forest products industry has faced heightened foreign competition during recent years as an increasing number of other countries with low-cost labor, abundant wood fiber reserves, and more favorable corporate tax systems become increasingly active in world markets. In fact, the United States' overall trade balance in forest products has deteriorated from a small surplus during the early 1990s to a $21 billion trade deficit last year. The increase in the industry's trade deficit accelerated in the late 1990s in part because of the dollar's strength between 1997 and 2002 but principally due to the emergence of competition from overseas.

The increasing effectiveness of this foreign competition has serious negative consequences on our industry's major product segments. The paper segment of the industry, which produces communications papers (used for newspapers, office correspondence, magazines, books, and catalogs), packaging products (bags and boxes and cartons), and tissue paper, saw U.S. production of paper and paperboard peak at 97 million tons in 1999, but since then U.S. production has declined some 6 percent to 91 million tons. During that same period, imports of foreign-produced paper and paperboard increased 10.5 percent to 20.4 million tons.

In some paper grades, such as the coated papers used in magazines, corporate annual reports, and advertising materials, the import surge has been particularly dramatic. For these paper grades, the import market share increased from about 15 percent in 1995 to 27 percent in 2005. Most of the increase in imports came from South Korea, China, and Western Europe, particularly Finland.

The packaging segment of the paper industry suffers from the general decline in domestic manufacturing, which brings with it a corresponding decline in demand for domestic packaging, because packaging occurs where the products are made.

The pressures of foreign competition have contributed to severe consequences for the U.S. paper industry. Paper mill employment has declined by 37 percent since early 1997. Industry capacity to produce paper has been contracting since 2001 and the paper industry has earned a return on capital of only 3.2 percent in the 2000–

2005 period, which is not nearly sufficient to encourage re-investment to maintain capacity and to maintain employment.

In contrast to the paper segment, demand for wood products (lumber, plywood, other panels) has been strong during recent years owing to robust home construction. However, foreign suppliers have captured much of the increase in demand. U.S. imports of wood products (measured in dollars) overall increased 49 percent since 1999, and the share of U.S. softwood lumber consumption met by foreign suppliers rose from 35 percent in 1999 to 39 percent in 2005. These gains for imports were mainly attributable to South America and Europe, regions that have not been traditional suppliers of the U.S. market. Canada's share of the U.S. softwood lumber market has remained stable during recent years at approximately 34 percent. While imports from foreign sources increase, U.S. exports have stagnated, further straining our once-dominant domestic industry.

Like paper packaging, the wood segment of the industry suffers from declining U.S. manufacturing of finished goods, with this production being won by foreign manufacturers. This is especially the case with hardwood products as more and more wood furniture is being made in China and other developing countries. While it is true that the United States exports some wood products to China for use in making furniture, the exodus of the domestic wood furniture business is a net drain from the United States.

The real-world impact of these trends is that some 350 paper and wood mills have closed since 1997 and more than 150,000 industry jobs have been lost. The indirect effects of these losses are even more severe as many mill towns lose their core businesses and entire communities face uncertain futures.

The truth is that these losses could have been prevented. The U.S. forest products industry is losing market share to those countries and regions that have moved aggressively to capitalize not only on supplies of material and labor, but also to enact corporate tax laws that enable their companies to better compete on a global scale. The U.S. forest products industry faces significant hurdles from our outdated tax system. Absent reform in U.S. tax policy to improve the ability of U.S. companies to compete effectively, the trends of job loss and reduced production will continue to the detriment of our industry, job growth in the United States, and the American economy in general.

The Urgent Need for Corporate Tax Reform

It is critical that the U.S. tax system provide the forest products industry an opportunity to compete on a level playing field. Currently, U.S. tax policy does not provide this opportunity; on the contrary, relative to many other countries, the domestic forest products industry is disadvantaged by U.S. tax policy.

Even with the improvements made by the American Jobs Creation Act of 2004, U.S. tax rules consistently raise disadvantages for U.S. corporate forest product investments relative to the tax rules of most of the industry's major competing nations. An April 2005 report by PricewaterhouseCoopers on behalf of the American Forest & Paper Association found that U.S. income taxes are the second highest of the major competing nations for the industry—with U.S. effective tax rates exceeding the median of the competing nations by a whopping 17 percentage points for paper and 16 percentage points for wood or, stated another way, U.S. effective tax rates are 50 percent or more higher than the median effective rates for the competing nations.[1] The overall result of these high taxes is that U.S. companies cannot profitably undertake certain investments that foreign competitors can undertake because U.S. investors would be left with an insufficient return after paying tax whereas foreign investors would enjoy an ample net return. U.S. companies compete against foreign companies in capital and product markets both at home and abroad and the overwhelming U.S. tax disadvantage ultimately limits the degree to which U.S. companies may successfully challenge foreign competitors.

Significant reform of the U.S. tax system is necessary in order for the U.S. forest products industry to compete in the global marketplace. A key feature of any tax reform must be to significantly reduce U.S. corporate income tax rates so that the U.S. forest products industry does not continue to face effective tax rates as much as 50 percent higher than the median of the major competing nations. Important additional reforms include an exclusion for timber gains, improved cost recovery for business investment, repeal of the corporate alternative minimum tax (AMT), and

[1] The report, *Taxes in Competing Nations: Their Effects on Investments in Paper Manufacturing and Timber Production* (April 2005), and a companion policy paper providing reform options, *Reducing Tax Disincentives for Corporate Investments in Paper Manufacturing and Timber Production* (April 2005), are included in this submission. The effective tax rate considers taxes paid on corporate earnings at both the corporate and individual levels.

modernization and simplification of U.S. international tax rules. We will briefly examine each in turn.

Lower Rates

While the United States was once a leader in moving to a competitive tax rate structure, this is no longer the case. At 35 percent, the U.S. statutory corporate tax rate is among the highest in the world. Even taking into consideration the fully-phased in value of the domestic manufacturing deduction enacted in the American Jobs Creation Act of 2004, U.S. taxes on the forest products industry remain considerably higher than in competing nations. The PricewaterhouseCoopers study examined reform options that would be necessary to bring the effective tax rate on the forest products industry into a competitive range, which we define to be the median of the industry's competitors. The effective tax rate accounts for taxes paid on corporate earnings at both the corporate and individual levels. The study found that for the corporate paper manufacturing segment of the industry, all statutory tax rates—both corporate and individual—would need to be cut by 40 percent. That is, the top corporate and individual tax rate would drop from 35 percent to 21 percent and the individual tax rate on capital gains and dividends would drop from 15 percent to 9 percent. For corporate timber production, a more than 40 percent reduction in these rates would be needed to move into the competitive range.

The United States stands out among our trading partners in not providing permanent relief from double taxation of domestic income at both the corporate and personal levels. The temporarily reduced individual tax rates on dividend and capital gains income enacted in 2003 should be made permanent.

Timber Exclusion

Timber growing is a unique activity when compared to other economic activities. It takes between 20 and 70 years to grow timber to be ready for harvest. This extraordinarily long investment period requires a strong commitment from investors. Timber is subject to risks of nature throughout the growing cycle, including fire, storms, insects, and disease. Acts of nature are not insurable, thus greatly adding to the risk and unpredictable nature of timber investments.

As a result of these special characteristics of timber and timber growing, timber gain has been eligible for long-term gain tax treatment for over 60 years. Under current law, timber gain of individuals is taxable at the maximum 15 percent long-term gain rate rather than the maximum 35 percent tax rate applying to ordinary income. However, due to various phase-outs, some individual timber gain can be taxed at significantly higher rates. In addition, the individual AMT can cause effective tax rates on long-term gains to rise as high as 22 percent. Since 1987, timber gain of corporations has been taxable at the regular corporate income tax rate, which currently is 35 percent.

The Timber Tax Act, H.R. 3883, and companion legislation in the Senate (S. 1791) would exclude 60 percent of qualified timber gain from the sale or exchange of timber held for more than one year, resulting in a maximum timber gain tax rate of 14 percent for both individuals and corporations.[2]

The PricewaterhouseCoopers study found that, compared to the major competing countries of the forest products industry, the United States has the second highest tax rate applying to corporate income from the sale and cutting of timber. Passage of the Timber Tax Act would implement a needed update to the tax rules for timber, improve the ability of the U.S. forest products industry to compete against international competition, and represent a significant step towards larger tax reform.

Investment Recovery

More advantageous rules could be implemented for recovering the costs of business investment, including expensing for business assets. The U.S. tax system could be reformed to allow expensing for all equipment and structures, or a combination of partial expensing and accelerated depreciation. The PricewaterhouseCoopers study found that a system of expensing could lower the effective tax rate in the paper manufacturing industry to the median of the industry's foreign competitors. A system of partial expensing, while beneficial, would be insufficient to bring the paper manufacturing effective tax rate into the competitive range without further reforms, such as rate reduction. For corporate timber production, full expensing of reforestation expenditures, while also beneficial, would be insufficient to bring the effective tax rate into the competitive range without additional reforms.

[2] These bills are currently sponsored and co-sponsored by 139 members in the House and 30 members in the Senate.

Corporate AMT

The corporate alternative minimum tax, an additional tax burden placed on corporations that mandates even slower depreciation allowances, should be repealed. A 2001 study by the staff of the Joint Committee on Taxation recommended repeal of the corporate AMT. As noted in the PricewaterhouseCoopers study, even in the absence of the AMT, the rules of the U.S. tax system serve to disadvantage the industry relative to its competitors. The AMT provides yet a further hurdle on top of an already heavily burdened industry.

Companies with AMT credits should be permitted to utilize these credits in a timely manner. Freeing up these credits, which represent prepayment of tax liability, will provide funds to finance new investment, expand employment, fund pension plan contributions and employee and retiree health benefits, and undertake other worthwhile business investments to improve competitiveness.

International Reforms

Despite recent reforms to U.S. international tax rules, they remain in urgent need of reform. U.S. companies operate under tax rules that are far more complex and disadvantageous in the taxation of foreign income than those of our trading partners. The United States should consider reforming its international tax rules so U.S. multinational corporations can compete effectively. Items to consider include a review of the use of worldwide income as a starting point in determining taxable income, revision of tax laws to encourage repatriation of earnings to the United States, and overall simplification of international tax laws.

Transition

Any significant reform should consider the need for phase-ins, delayed effective dates, or transition relief to provide companies an opportunity to deduct unrecovered costs and receive the benefit of other tax attributes, such as loss carryforwards and tax credits, currently being carried forward. In the absence of a coordinated transition to a new tax system, certain business activities may be double taxed due to timing differences between the old and new tax systems.

Conclusion

We appreciate the opportunity to provide the Subcommittee with our concerns and thoughts on the need to reform the corporate tax system. The U.S. forest products industry is at the heart of a vibrant economy that has produced the highest living standards in the world. However, the industry faces global competition and challenges on a level previously unseen. One of the most serious challenges to its future viability is that the current U.S. corporate income tax system functions as a major obstacle in global competition. Tax reform is urgently needed to level the playing field. At home, that means a more abundant supply of the materials that build the American dream and a more stable and fruitful way of life for the communities that thrive in the forest products industry. We would welcome the opportunity to discuss these issues with you in more detail.

Statement of Employee-Owned S Corporations of America

As the Ways and Means Committee continues its work to examine the many issues inherent in reforming the Internal Revenue Code, the Employee-Owned S Corporations of America ("ESCA"), on behalf of member companies and their employee-owners, appreciates the opportunity to share our unique concerns and views on this issue.

ESCA is the leading voice of the employee-owned S corporation community, serving to protect and promote employee ownership of private Subchapter S businesses for workers across the nation. ESCA was formed in 1999, and in its short history represents more than 45,000 employee-owners. Member companies operate in virtually every state in the nation, engaging in a broad spectrum of business activities that range from heavy manufacturing to hospitality. All sizes of companies are represented (from large firms with 7,000 employee-owners to small operations with as few as 50 employee-owners). ESCA companies are a hallmark of American entrepreneurship, providing jobs and a key retirement savings opportunity for tens of thousands of American workers.

As the Committee is well aware, employee-owned S corporations have been in existence since 1998. They are pass-through entities owned in part or fully by an employee stock ownership plan ("ESOP"). As such, these entities offer their employees a "piece of the rock" as a retirement savings opportunity. In this sense, S corporation ESOPs are much more than standard retirement savings plans; hundreds of thousands of employees who own a stake in their employers through ESOPs are amassing impressive nest eggs—often hundreds of thousands of dollars or more—that enable them to retire from line jobs with dignity and free from the need for federal support.

I. President's Advisory Panel on Federal Tax Reform

While S corporations are a tremendous benefit to employee-owners of these companies, they are also uniquely structured entities that are vulnerable to changes in the tax code and in pension laws. Indeed, the unique structure of employee-owned S corporations raises questions about how they might be treated under the new retirement security paradigm recommended by the President's Advisory Panel on Federal Tax Reform (the "Panel"). Given this, ESCA and its members are concerned, first, with the Panel's proposal to apply a blanket, entity-level tax on S corporations and all other non-C corporations (except sole proprietorships). Without an exemption for employee-owned S corporations similar to the exemption the Panel envisions for regulated investment companies ("RICs") and real estate investment trusts ("REITs"), an entity-level tax on an ESOP's share of S corporation income would eliminate the ability of the company's employee-owners to build up meaningful retirement savings.

Another concern of ESCA's members is that the Panel's employer-based "Save at Work" proposal does not address ESOPs. The omission of ESOPs in the Panel's proposal to streamline several current defined contribution plans into one "Save at Work" retirement plan suggests that ESOPs might be affected by this sweeping change. While we do not believe that the Panel intended to eliminate ESOPs, we do believe that any tax reform proposal put forward by the Congress should confirm the important function that S corporation ESOPs in particular have in helping the employee-owners of these companies amass substantial retirement income through their ownership stake in these companies.

A. Entity-Level Tax

Under the Panel's Simplified Income Tax Plan ("SITP"), all large businesses—those with more than $10.5 million in receipts—would be taxed at the entity level, paying a 31.5 percent rate. The Panel's report recognizes the importance of making certain exceptions to this rule, and exempts RICs and REITs from the entity-level tax. Under the Panel's Growth and Investment Tax Plan ("GITP"), businesses other than sole proprietorships would pay a corporate rate of 30 percent at the entity level, although it is unclear whether a tax-exempt shareholder's share of business income would be taxed.

If Congress does ultimately support an entity-level tax system similar to the SITP or GITP, it is critical that employee-owned S corporations be allowed to retain their current pass-through attributes and not be subjected to the entity-level tax with respect to the ESOP's share of S corporation income. Congress quite specifically designed the S corporation ESOP structure to ensure only one level of taxation, and adding another tax at the entity level would clearly go against Congress' intent, while undermining the retirement savings attributes of the S corporation ESOP to employee-owners of these companies.

The pass-through structure is especially important for employee-owned S corporations because it allows these companies to rapidly grow retirement wealth in the ESOP for their employees. An entity-level tax would, for many employee-owned companies, reduce the amount of funds available for retirement savings in the ESOP.

Moreover, a tax paid at the entity-level by these companies is equivalent in substance to the qualified retirement plan (the ESOP as the owner) paying income taxes. This result runs counter to long-standing tax policy, whereby participants (employee shareholders in the case of employee-owned S corporations) in qualified plans are not taxed until income is received upon retirement.

B. Clarity Needed for ESOPs

A second concern raised by the Panel is that it did not address the role of ESOPs in the context of its proposed new tax treatment of defined contribution plans. The Panel's SITP and GITP call for the consolidation of the following employer-sponsored defined contribution plans into the "Save at Work" plan: 401(k), ?SIMPLE 401(k),' Thrift, 403(b), governmental 457(b), ?SARSEP,' and SIMPLE IRA. ESOPs are left out of the analysis. Although ESOPs are not explicitly singled out for consolidation in the Panel's report, some in the business community have expressed fears that the Panel envisions that all defined contribution plans, including ESOPs, should be consolidated into its "Save at Work" plan.

ESOPs are, as this Committee is aware, a key economic asset to thousands of companies and their employees. Employee-owned S corporations are an increasingly utilized business structure found across the nation and in every state, and with their proliferation has come an important increase in the retirement savings of the ESOP participants in these companies. Fuelled by the work and commitment of their employee-owners, these companies provide jobs for workers across the economic and industrial spectrum, including manufacturing, construction, health care, trucking and tourism. Indeed, a recent study by the National Center for Employee Ownership that surveyed nearly 2,000 employee-owners from S corporation ESOP companies around that nation found that:

- Have account balances three to five times higher than the U.S. average for 401(k) plans—with large numbers of these ESOP participants amassing $75,000 to $100,000 in their accounts;
- Have even higher account balances—five to seven times the average for 401(k) plans—when measured among employee-owners nearing retirement age; and
- Quit at a rate of half the national average, and are fired or laid off two-thirds less frequently than workers in other kinds of companies.

ESCA believes that Members of Congress recognized the tremendous promise of S corporation ESOPs when legislators first created these structures, and we note that employee-owned S corporations have long enjoyed broad bipartisan support on Capitol Hill. Indeed just five years ago, Congress reaffirmed its support for employee-owned S corporations during consideration of the Economic Growth and Tax Relief Reconciliation Act (P.L. 107–16). In 2001, the Ways and Means Committee said that it "continues to believe that S corporations should be able to encourage employee ownership through an ESOP." [1]

With this in mind, and given the pervasiveness of ESOPs and the major role they play in providing a secure source of retirement income for retirees, we respectfully urge that any tax reform proposal supported or put forward by the Congress recognize and affirm the continued existence of ESOPs, and S corporation ESOPs more specifically.

ESCA appreciates the Committee's consideration of the concerns and interests of our members. We would welcome the opportunity to discuss these issues further with Committee members and staff in the weeks and months ahead.

ESCA EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

ESCA MEMBER COMPANIES 2006

Member Company	***Headquarters Location***
Acadian Ambulance	Louisiana
Agron, Inc.	California
Albert C. Kobayashi	Hawaii
Alion Science and Technology	Virginia
Amerequip, Inc.	Wisconsin
Amsted Industries	Illinois
Antioch Company	Ohio
Appleton	Wisconsin
Appleton Marine	Wisconsin
Austin Industries, Inc.	Texas
BCC Capital Partners	California
Bimba Manufacturing	Illinois
Columbia Financial Advisors	Oregon
Community Bancshares, Inc.	Missouri
Crowe Chizek & Co.	Ohio
Deloitte	Illinois
The Dexter Company	Iowa
DuCharme, McMillen & Associates	Illinois
Duff & Phelps, LLC	Illinois
ESOP Services	Virginia
First Bankers Trust Services	Illinois
Ferrell Companies, Inc.	Kansas
Floturn, Inc.	Ohio
Freeman Companies	Texas
Garney Companies, Inc.	Missouri

[1] H.R. Rep. No. 107–51, part 1, at 100 (2001).

ESCA EMPLOYEE-OWNED S CORPORATIONS OF AMERICA—Continued

ESCA MEMBER COMPANIES 2006

Member Company	*Headquarters Location*
The George P. Johnson Company	Michigan
GreatBanc Trust	Illinois
Greenheck Fan Corporation	Virginia
Herff-Jones, Inc.	Indiana
Hisco	Texas
Holborn Corporation	New York
Houlihan, Lokey, Howard and Zukin	Illinois
Inland Truck Parts Company	Kansas
Katten Muchin Rosenman LLP	Illinois
Keller Structures	Wisconsin
Krieg DeVault Alexander	Indiana
Lake Welding Supply Company, Inc.	Michigan
LaSalle Bank, N.A.	Illinois
Lifetouch, Inc.	Minnesota
McDermott, Will and Emery	Illinois
Messer Construction Company	Ohio
Molin Concrete Products	Minnesota
Moretrench American Corporation	New Jersey
Morgan Lewis and Bockius	Illinois
Muehlstein & Co., Inc.	Connecticut
Nathan Alterman Electric Co., Inc.	Texas
The Parksite Group	Illinois
Pavement Recycling Systems, Inc.	California
PERCS USA Inc.	Florida
Performance Contracting Group, Inc	Kansas
Phelps County Bank	Missouri
Pridgeon & Clay, Inc.	Michigan
The Principal Financial Group	Wisconsin
Richard Goettle, Inc.	Ohio
Round Table Pizza, Inc.	California
RSM McGladrey	Iowa
Schreiber Foods, Inc.	Wisconsin
Scitor Corporation	California
Scot Forge Company	Illinois
Segerdahl Corporation	Illinois
Social & Scientific Systems	Maryland
Sonalysts, Inc.	Connecticut
Spee Dee Delivery Service, Inc.	Minnesota
State Street Bank	Massachusetts
Stout Risius Ross, Inc.	Illinois
The Scooter Store	Texas
Sundt	Arizona
Thirdpage Services	Virginia
Thoits Insurance	California
Thybar Construction	Illinois
Vector Health Sytems, Inc.	Rhode Island
Vermeer Equipment of Texas Inc	Texas
Volkert & Associates	Alabama
Walman Optical Company	Minnesota
Williams Brothers Construction	Texas
Woodfold Inc.	Oregon

Statement of Financial Executives International Committee on Taxation and Committee on Private Companies

IMPACT OF INTERNATIONAL TAX REFORM ON U.S. COMPETITIVENESS

I. INTRODUCTION

Financial Executives International ("FEI") is a professional association representing the interests of 15,000 CFO's, treasurers, controllers, and other senior financial executives from over 8,000 major companies throughout the United States and Canada. FEI represents both the providers and users of financial information. Furthermore, FEI acts on behalf of the business community to advocate policies which will rationalize corporate operations, improve global competitiveness, and promote long-term business stability.

This testimony addresses the relationship between U.S. tax policy and international competitiveness. In many instances, current rules regarding the taxation of both domestic and foreign income create barriers that harm the competitiveness of U.S. companies. These rules also are excessively burdensome for both taxpayers and the Internal Revenue Service. This testimony represents the views of FEI's Committee on Taxation and the Policy Subcommittee of the Committee on Private Companies.

II. U.S. MULTINATIONALS AND THE U.S. ECONOMY

In a global market, the competitiveness of a country depends on the ability of its enterprises to produce goods and services that are successful both at home and in foreign markets. Today, almost 80 percent of world income and purchasing power lies outside of U.S. borders. Opportunities for U.S. companies to grow their businesses increasingly lie overseas. For the largest American companies included in the S&P 500, sales by foreign subsidiaries have increased from 25 percent of total corporate sales in 1985 to a remarkable 39 percent in 2005.[1]

A. U.S. Investment abroad and Exports

It is a common perception that investment abroad by U.S. multinationals comes at the expense of the domestic economy. This is an incorrect view. The primary motivation for U.S. multinationals to operate abroad is to compete better in *foreign* markets, not *domestic* markets. According to the Commerce Department, less than 11 percent of sales by U.S.-controlled foreign corporations were made to U.S. customers.[2]

Investment abroad is required to provide services that cannot be exported, to obtain access to natural resources, and to provide goods that are costly to export due to transportation costs, tariffs, and local content requirements. Foreign investment allows U.S. multinationals to compete more effectively around the world, ultimately increasing employment and wages of U.S. workers.

While 44 percent of U.S. multinational parent companies are in the services sector, 61 percent of all foreign affiliates are in this sector, which includes distribution, marketing, and product support services.[3] Without these sales and services subsidiaries, it would be impossible to sustain current export volumes.

According to the U.S. Commerce Department, in 2003, U.S. multinationals were directly responsible, through their domestic and foreign affiliates, for $412 billion of U.S. exports, or 57 percent of all U.S. exports.[4]

A study by the Organization for Economic Cooperation and Development (OECD) found that each dollar of outward foreign direct investment is associated with $2.00 of *additional* exports.[5]

B. U.S. Employment

Foreign investment by U.S. multinationals generates sales in foreign markets that generally could not be achieved by producing goods entirely at home and exporting them.

A number of studies find that U.S. investment abroad generates additional employment at home through an increase in the domestic operations of U.S. multinationals. As noted by Professors David Riker and Lael Brainard:

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[1] 1985 figure from: The Business Roundtable, "Taxing U.S. Corporations in the Global Marketplace" April 1993. 2005 figure from calculations based on data from S&P's Compustat database.

[2] U.S. Department of Commerce, "U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2003 Estimates," (2003).

[3] *Ibid*.

[4] U.S. Department of Commerce, "U.S. Multinational Companies: Operations in 2003," *Survey of Current Business*, July 2005.

[5] OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, p. 50 (1998).

"Specialization in complementary stages of production implies that affiliate employees in industrialized countries need not fear the multinationals' search for ever-cheaper assembly sites; rather, they benefit from an increase in employment in developing country affiliates." [6]

Moreover, workers at domestic plants owned by U.S. multinational companies earn *higher* wages than workers at domestic plants owned by companies without foreign operations, controlling for industry, size of company, and state where the plant is located.[7]

C. U.S. Research and Development

Foreign direct investment allows U.S. companies to take advantage of their scientific expertise, increasing their return on firm-specific assets, including patents, skills, and technologies. Professor Robert Lipsey notes that the ability to make use of these firm-specific assets through foreign direct investment provides an incentive to increase investment in activities that generate this know-how, such as research and development.[8]

Among U.S. multinationals, total research and development in 2003 amounted to $161 billion, of which $140 billion (86 percent) was performed in the United States.[9] Such research and development allows the United States to maintain its competitive advantage in business and be unrivaled as the world leader in scientific and technological know-how.

D. Summary

Recent analysis of data on U.S. multinational firms collected by the U.S. Bureau of Economic analysis finds that the domestic and foreign operations of U.S. multinationals are complements rather than substitutes. Professors Desai, Foley and Hines find that:

". . . 10% greater foreign capital investment is associated with 2.2% greater domestic investment, and that 10% greater foreign employee compensation is associated with 4.0% greater domestic employee compensation. Changes in foreign and domestic sales, assets, and numbers of employees are likewise positively associated; the evidence also indicates that greater foreign investment is associated with additional domestic exports and R&D spending. The data do not support the popular notion that greater foreign activity crowds out domestic activity by the same firms, instead suggesting the reverse." [10]

In summary, U.S. multinationals provide significant contributions to the U.S. economy through:

- Sales of U.S. goods and services abroad;
- Domestic employment at above average wages; and
- Critical domestic investments in equipment, technology, and research and development.

Thus, the United States has an important interest in ensuring that its tax rules do not hinder the competitiveness of U.S. multinationals.

III. DOMESTIC TAX COMPETITIVENESS

A. Corporate Income Tax Rate

With the reduction in the U.S. corporate income tax rate from 46 to 34 percent, as a result of the Tax Reform Act of 1986, it is commonly thought that the United States is a low-tax jurisdiction for corporations. While true immediately after the 1986 Act, it is no longer true today. The United States increased the corporate income tax rate to 35 percent in 1991. Meanwhile, the average central government corporate tax rate in OECD member states has fallen since 1986 to 26.2 percent in 2005—8.8 percentage points less than the U.S. rate (see Exhibit 1a). This disparity in corporate tax rates would be even larger if corporate income taxes imposed by subnational levels of government were taken into account.

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[6] David Riker and Lael Brainard, *U.S. Multinationals and Competition from Low Wage Countries*, National Bureau of Economic Research Working Paper no. 5959 (1997) p. 19.

[7] Mark Doms and Bradford Jensen, *Comparing Wages, Skills, and Productivity between Domestic and Foreign-Owned Manufacturing Establishments in the United States*, mimeo. (October 1996).

[8] Robert Lipsey, "Outward Direct Investment and the U.S. Economy," in *The Effects of Taxation on Multinational Corporations*, p. 30 (1995).

[9] U.S. Department of Commerce, "U.S. Multinational Companies: Operations in 2003," *Survey of Current Business* (July 2005).

[10] Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Foreign Direct Investment and Domestic Economic Activity," National Bureau of Economic Research Working Paper No. 11717, October 2005.

Moreover, the high rate can produce an impediment to future investments in the U.S. For example, under an analysis of the costs of a high tech semiconductor manufacturing facility located in the U.S. compared with potential non-U.S. locations (especially in Asia), the U.S. corporate income tax rate is the largest contributing factor to the ten-year costs of constructing, equipping and operating such a factory in the U.S. being a billion dollars more than if located outside the U.S. A reduced U.S. corporate income tax rate would help alleviate what is effectively an anti-competitive cost penalty on future U.S. investments. Such a multi-billion dollar facility would employ over a thousand high-wage employees, utilize state-of-the art t technology and equipment, attract many other businesses to supply and maintain the facility, and significantly contribute to local, state, and national economic prosperity.

Privately-owned companies also support an overall reduction in the tax rate, as well as the repeal of the estate tax. These companies labor under high tax rates which drain critical business funds that could be used to expand their businesses and/or to create new jobs. The "death tax" is particularly onerous, since it forces many business owners to liquidate their concerns upon the death of a key member of the enterprise. The owners of private companies typically have the vast majority of their wealth tied up in the business but that wealth is not liquid. The value of that wealth is also not known, either by the preparer of the estate return or the IRS. Too often the result is a forced sale and the loss of jobs and good "corporate citizens" in the community.

B. Double Taxation of Corporate Dividends

Prior to 2003, the United States was one of only three OECD member countries that did not provide some form of relief from the double taxation of corporate dividends (see Exhibit 3).[11] Most OECD countries relieve double taxation of corporate dividends at the shareholder level through some form of credit, exemption, or special tax rate for dividend income. Starting in 2003, dividends accruing to shareholders in the top individual income tax bracket (35.0 percent) are taxed at a lower rate (15.0 percent). The combination of corporate and individual income tax is over 44 percent of distributed corporate income (see Exhibit 3). The combined income tax rate on distributed corporate income is even higher if state and local taxes on corporate and individual income are taken into account. Furthermore, the special (lower) rate on dividends is set to expire at the end of 2008 unless extended or made permanent. If the 15 percent rate is not extended, the combined corporate and individual income tax rate on dividends will increase to 57.75 percent starting in 2009.

C. Reliance on Income and Profit Taxation

While the total tax burden as a percent of Gross Domestic Product (GDP) is relatively light in the United States compared to other OECD countries, reliance on income taxes to fund spending at all levels of government is unusually high. In 2003, the United States relied on income and profits taxes for almost half of all revenues (43.3 percent) while the average OECD country raised slightly over one-third of revenues (34.4 percent) from this source (see Exhibit 4). The U.S. data include sales taxes imposed by state and local governments; the federal government is even more heavily reliant on income and profits taxes as there is no broad-based consumption tax at the federal level. Indeed, the United States is the only one of the 30 OECD member countries that does not have a national value-added tax.

D. Conclusion

When compared to other OECD and EU member countries, the United States relies relatively heavily on income taxes to fund government operations, has a comparatively high corporate income tax rate, and is unusual in not providing a permanent mechanism for relieving the double taxation of corporate income.

From a trade standpoint, heavy reliance on income taxes relative to consumption taxes may be viewed as disadvantageous because the WTO Agreement on Subsidies and Countervailing Measures permits border tax adjustments for indirect taxes such as consumption taxes, but prohibits such adjustments for income and profits taxes. However, from the standpoint of U.S. economic growth, the main reason to avoid over-reliance on income and profit taxes is that they discourage savings and investment, which are closely linked to growth in national income.

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[11] Prior to 2001 there were three countries which did not provide some form of relief for the double taxation of corporate dividends. However, starting in 2001, the Netherlands exempted investment income from taxes with minor exceptions.

IV. INTERNATIONAL TAX COMPETITIVENESS

A. Rising Level of International Competition

In 1962, when the controlled foreign corporation rules in Subpart F were adopted, U.S. multinationals overwhelmingly dominated global markets. In this environment, the consequences of adopting tax rules that were out-of-step with other countries were of less concern to many policymakers.

Today, the increasing integration of the world economies has magnified the impact of U.S. tax rules on the international competitiveness of U.S. multinationals. Foreign markets represent an increasing fraction of the growth opportunities for U.S. businesses. At the same time, competition from multinationals headquartered outside of the United States is becoming greater.[12]

- Of the world's largest multinationals (measured by foreign assets), just four of the 20 largest non-financial multinational firms and only three of the 20 largest financial multinational firms are headquartered in the United States.[13]
- U.S. multinational companies' share of global cross-border investment declined from 53 percent in 1970 to 31 percent in 2004.[14]
- The 25,000 foreign affiliates of U.S. multinationals compete with about 690,000 foreign affiliates of foreign multinationals.[15]

If U.S. rules for taxing foreign source income are more burdensome than those of other countries, U.S. multinationals will be less successful in global markets, with adverse consequences for exports and employment at home.

B. International Comparison of Rules for Taxing Multinational Companies

A study published by the European Commission in 2001 found that, on average, U.S. multinational companies bear a higher effective tax rate when investing into the European Union than do EU multinationals. The additional tax burden borne by U.S. multinationals ranges from 3 to 5 percentage points depending on the type of finance used (see Exhibit 5).

In addition to the relatively high U.S. corporate income tax rate, there are a number of other reasons why the United States has become a relatively unattractive jurisdiction in which to locate the headquarters of a multinational corporation.

First, 70 percent of the OECD countries have a dividend exemption ("territorial") tax system under which a parent company generally is not subject to tax on the active income earned by a foreign subsidiary (see Exhibit 6). By contrast, the United States taxes income earned through a foreign corporation when repatriated (or when earned, if subject to U.S. anti-deferral rules).

A second difference from the multinational tax rules of other countries is the unusually broad scope of the U.S. anti-deferral rules under subpart F. While most countries tax passive income earned by controlled foreign subsidiaries, the United States is unusual in taxing a wide range of unrepatriated *active* income as a deemed dividend to the U.S. parent, including:[16]

- Foreign base company sales income;
- Foreign base company services income; and
- Active financial services income (an exclusion of this income from Subpart F is scheduled to expire at the end of 2006).

The net effect of these tax differences is that a U.S. multinational frequently pays a greater share of its income in foreign and U.S. tax than does a competing multinational company headquartered outside of the United States.

C. Complexity

The U.S. rules for taxing foreign-source income are among the most complex in the Internal Revenue Code. A survey of Fortune 500 companies found that 43.7 percent of U.S. income tax compliance costs were attributable to foreign-source income even though foreign operations represented only 26–30 percent of worldwide employ-

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[12] See, National Foreign Trade Council*, International Tax Policy for the 21st Century, vol. 1, 2001, pp 95–96.*

[13] UNCTAD, "Largest Transnational Corporations" available on-line at: http://www.unctad.org/Templates/Page.asp?intItemID=2443&lang=1.

[14] UNCTAD, World Investment Directory On-Line.

[15] U.S. Bureau of Economic Analysis "U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2003 Estimates" and UNCTAD, "World Investment Report, 2004."

[16] *Ibid*., vol. 1, Part I.

ment, assets and sales.[17] These data show that U.S. tax compliance costs related to foreign-source income are grossly disproportionate. These high compliance costs are a hidden form of taxation that discourages small U.S. companies from operating abroad and makes it more difficult for larger companies to compete successfully with foreign multinationals. The Treasury Department's tax simplification project, described in the Administration's FY 2003 Budget, also identifies the international tax rules as an area singled out by taxpayers as one of the biggest sources of compliance burden.[18]

D. Risks of a Non-Competitive tax regime for MNCs

If the United States is an unattractive location—from a tax standpoint—to headquarter a multinational corporation, then U.S. multinationals will lose global market share. This can happen in a variety of ways. First, U.S. individual and institutional investors can choose to invest in foreign rather than U.S. headquartered companies. This allows U.S. shareholders to invest in multinational companies whose foreign operations generally are outside the scope of U.S. tax rules. Second, in a cross-border merger, the transaction may be structured as a foreign acquisition of a U.S. company rather than the reverse. By choosing to be headquartered abroad, the merged entity can invest outside the United States without being subject to the complex and onerous U.S. rules that apply to the foreign-source income of U.S.-headquartered companies.[19] Third, an increasing number of new business ventures are being incorporated at inception as foreign rather than U.S. corporations.

While some have suggested that reducing the U.S. tax burden on foreign-source income could lead to a movement of manufacturing operations out of the United States ("runaway plants"), a noncompetitive U.S. tax system will lead to a migration of corporate headquarters outside the United States.[20] A decline in the global market share of U.S. multinationals may adversely affect the U.S. economy because, as noted above, U.S. multinationals play a vital role in promoting U.S. exports and creating high-wage jobs.

E. Conclusion

While, the American Jobs Creation Act of 2004 made considerable progress in streamlining the foreign tax credit system, significant opportunities to increase the competitiveness and reduce the complexity of the current worldwide tax system remain.

V. DIRECTIONS FOR TAX REFORM

Based on the preceding analysis, FEI offers the following recommendations for Congressional consideration of domestic and international income tax reform.

A. Domestic Tax Reform

From the perspective of economic growth and competitiveness, one of the most important priorities for reform of business taxation is a reduction in the corporate income tax rate. The combined federal, state and local corporate income tax rate in the United States is now over 10 percentage points higher than the average for the 30 OECD countries and 14 percentage points higher than the average of the 25 EU countries.

A lower corporate income tax rate would encourage investment in the United States by both U.S. and foreign companies, reduce the use of sophisticated tax planning strategies intended to reduce taxable income in the United States, and would lower the current barrier to repatriating income from foreign subsidiaries (because U.S. tax on repatriated earnings is limited to the *excess* of the U.S. tax rate over the foreign rate). Moreover, economic analysis of data from 72 countries indicates that higher corporate taxes lead to lower wages: "A 1 percent increase in corporate

[17] Marsha Blumenthal and Joel Slemrod, "The Compliance Costs of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications, *International Tax and Public Finance*, vol. 2, no. 1, 37–54 (1995).

[18] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2002*, *Analytical Perspectives*, p. 79

[19] Where business reasons dictate the form of a transaction, there generally is no cause for concern. The concern we are raising is that non-competitive U.S. tax rules may be influencing the form of transactions.

[20] To block corporate "inversions," Congress adopted measures in 2004 that impose heavy tax penalties on companies that re-incorporate outside of the United States (by merging the U.S. parent into a foreign affiliate).

tax rates is associated with nearly a 1 percent drop in wage rates."[21] Thus, a reduction in the U.S. corporate tax rate would be expected to lift wages of U.S. workers.

A second priority for business tax reform is to impose equal taxation on investment regardless of the legal form of the organization. Under present law, businesses organized as sole proprietorships, partnerships, and S corporations, are subject to a single level of federal income tax at the individual owner level regardless of size, while regular C corporations are subject to federal income tax both at the corporate and individual shareholder levels. Eliminating the double taxation of corporate income would remove the incentive under present law for companies to select non-corporate forms of organization (which generally restrict liquidity and public trading) for tax reasons. The current single level of taxation for S-corporations has proven itself as an effective tax structure for encouraging investment and driving US employment growth.

A third priority for business tax reform is to impose equal taxation on investment regardless of industry. If all business income is subject to equal taxation, tax considerations will not distort the allocation of investment away from its most productive uses.

B. International Tax Reform

A key choice in international tax reform is whether to continue to use the worldwide system of taxation or to move to a dividend exemption (territorial) tax system. This paper first identifies opportunities for reform of the current system and then discusses adoption of a territorial tax system.

1. Incremental Reform of Worldwide Income Tax System

The American Jobs Creation Act did relatively little to reform the U.S. anti-deferral rules. Thus, one of the priorities for international tax reform is to enhance the competitiveness of U.S. multinationals by limiting the amount of active business income subject to subpart F, including:

- Enactment of the look-through rules that were included in the House—and Senate-passed versions of the American Jobs Creation Act of 2004, and in the House-passed version of the pending tax reconciliation bill.[22] This provision would classify inter-CFC payments of interest, dividends, and royalties as foreign personal holding company income based on the underlying character of the income out of which the payment is made. The provision allows U.S. MNCs to redeploy funds among their foreign affiliates without triggering U.S. tax.
- Repeal of the foreign base company sales and services income rules which, among other things, increase the tax burden on foreign affiliates established for the purpose of promoting exports of U.S. goods and services. Few other OECD countries have comparable rules—indeed the United States originally enacted the predecessor of the Foreign Sales Corporation ("FSC") rules in order to allow U.S. exports to compete on a more equal footing with exports of European countries that exempt income earned by foreign sales corporations. The original policy rationale for these rules was thrown into doubt by the Treasury Department's December 2000 policy study on Subpart F, which concluded that the economic efficiency effects of the base company rules were "ambiguous."[23]
- Permanently extend the active financial services income exception to subpart F that is scheduled to expire at the end of 2006.

While, the American Jobs Creation Act of 2004 made considerable progress in streamlining the foreign tax credit system, some additional simplification should be considered, including:

- Use of financial statement or foreign taxable income rather than U.S. earnings and profits ("E&P") for purposes of calculating the indirect foreign tax credit limitation. Under present law, each of the foreign affiliates of a U.S. multinational is required to re-compute its taxable income under U.S. rules, with certain adjustments required to translate taxable income into E&P. U.S. multinationals currently must train accounting staff in each of their foreign affiliates on U.S. E&P measurement and collect this information on an annual basis. Other countries generally do not impose a similarly burdensome tax requirement on multinational companies.

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[21] Kevin Hassett and Aparna Mathur, "Tax and Wages," *American Enterprise Institute*, March 6, 2006.

[22] H.R. 4520 as passed by the House (sec. 311) and the Senate (sec. 222) in 2004. H.R. 4297 as passed by the House (sec. 202) on December 8, 2005.

[23] U.S. Department of the Treasury, Office of Tax Policy, *The Deferral of Income Earned through U.S. Controlled Corporations: A Policy Study* (December 2000) p. 47.

- Reduction of double taxation by curtailing the amount of domestic expense that is required to be allocated and apportioned to foreign source income for purposes of the U.S. foreign tax credit limitation. As a result of these expense allocations, U.S. multinationals in some cases are unable to credit foreign income taxes even though the foreign tax rate is not higher than the U.S. rate (because other countries do not allow a deduction for allocated expenses.) The U.S. rules regarding allocation and apportionment of domestic R&D expense are of particular concern as they can have the unintended effect of encouraging U.S. companies to undertake research activities in laboratories outside of the United States.[24]

2. Adoption of a Territorial Tax System

In a November 2005 report, the President's Advisory Panel on Federal Tax Reform (the "Panel") recommended two tax reform options for the Treasury Department's consideration.[25] One option, the Simplified Income Tax ("SIT") plan, would adopt a so-called territorial income tax system with an exemption for active foreign source business income. This plan is similar, but not identical to a proposal described in a January 2005 report of the Joint Committee on Taxation ("JCT") staff, which was estimated to increase federal government revenues by $54.8 billion over the FY 2005–2014 period.[26]

The effects of a territorial tax system in the United States would depend critically on the details of the system. The JCT and Advisory Panel proposals each diverge in some significant respects from international norms to the detriment of U.S. multinationals, specifically:

- The proposals retain the overly broad U.S. anti-deferral regime, subjecting to immediate U.S. tax certain types of active foreign business income (whether or not repatriated).
- The proposals disallow deduction of certain domestic expenses to the extent allocable or apportionable to exempt foreign income (although the Panel's proposal disallows fewer deductions than the JCT's proposal).
- The Panel's proposal would impose higher U.S. shareholder taxation on dividends paid by U.S. companies with foreign-source income than purely domestic companies.

If Congress were to adopt a territorial tax system, FEI recommends that:

- The present law deduction for domestic expenses should not be disallowed. Disallowance of domestic expenses would put U.S. multinationals at a competitive disadvantage relative to foreign multinationals and, for some companies, would result in a huge tax increase. Disallowance of domestic R&D expenses would have the additional and undesirable effect of discouraging the location of research activities in U.S. laboratories.
- All foreign-source income should be exempt other than income subject to anti-deferral rules. If, instead, some foreign income is exempt and other foreign income is taxable as under present law (i.e., dividends are taxable with a credit for foreign income taxes), the result will be a tax system with greater compliance burdens.
- Appropriate transition rules should be provided. Fundamental changes in tax policy generally are accompanied by transition rules. One important transition issue would be the treatment of carryforwards of foreign tax credits. Elimination of these credits would prevent relief from double taxation of certain foreign income previously subject to U.S. tax and would likely be recorded as a reduction in deferred tax assets, reducing the taxpayer's reported equity and net income.

Finally, FEI notes that this type of fundamental change in U.S. tax law would require the re-negotiation of U.S. tax treaties that currently contemplate alleviation of double taxation through a foreign tax credit mechanism rather than an exemption mechanism. That re-negotiation process likely will take a significant period of time.

[24] See, James R. Hines, Jr., "On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s, in: Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod, eds. *Studies in International Taxation* (Chicago: University of Chicago Press, 1993), 149–187.

[25] President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, Report of the President's Advisory Panel on Federal Tax Reform*, November 2005.

[26] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS 02–05, January 27, 2005 (hereinafter "JCT Options Pamphlet").

Table 1. Top Statutory Corporate Tax Rates in OECD Countries, 2005
[Ranked by combined central and local government tax rate]

Country	Central Government	Central and Local Governments
Japan	30.0	39.5
United States	**35.0**	**39.3**
Germany	26.4	38.9
Canada	22.1	36.1
Spain	35.0	35.0
Belgium	34.0	34.0
France	33.8	33.8
Italy	33.0	33.0
New Zealand	33.0	33.0
Greece	32.0	32.0
Netherlands	31.5	31.5
Luxembourg	22.9	30.4
Australia	30.0	30.0
Denmark	30.0	30.0
Mexico	30.0	30.0
Turkey	30.0	30.0
United Kingdom	30.0	30.0
Norway	23.8	28.0
Sweden	28.0	28.0
Korea,	25.0	27.5
Poland	19.0	27.5
Czech Republic	26.0	26.0
Finland	26.0	26.0
Austria	25.0	25.0
Portugal	25.0	25.0
Switzerland	8.5	21.3
Slovak Republic	19.0	19.0
Iceland	18.0	18.0
Hungary	16.0	16.0
Ireland	12.5	12.5
Unweighted averages:		
OECD (30 countries)	26.4	28.9
EU (25 countries)	24.2	25.3

Source: OECD and PricewaterhouseCoopers

Exhibit 2—Taxation of Corporate Dividends in OECD Countries, 2005

	Method of relieving double taxation of corporate dividends			
No relief from double taxation of corporate dividends	Shareholder level Imputation system (partial or complete)	Tax credit method	Special personal tax rate	Corporate level
Sweden[5]	Australia*	Canada	Austria	
Switzerland	Mexico*	Ireland	Belgium	
	New Zealand*	Rep. of Korea*	Czech Republic	
	Norway		Denmark	
	Spain		Finland[1]	
	United Kingdom		France[2]	
			Germany[2]	
			Greece[3]	
			Hungary	
			Iceland	
			Italy	
			Japan*	
			Luxembourg[2]	
			Netherlands	
			Poland	
			Portugal[4]	
			Slovak Republic[3]	
			Turkey[2]	
			United States	

[1] Beginning January 1, 2005 the old imputation system has been replaced with a classical double taxation system but with a 43% dividend exemption.
[2] Dividends taxed at normal rates but with a 50% dividend exemption.
[3] Dividends are not subject to tax in the hands of the shareholder.
[4] Individuals must include 50% of gross domestic dividends in taxable income. In general, domestic dividends are also subject to a 15% withholding tax, but that tax is credited against the individual's final tax liability.
[5] Dividends are paid out of after-tax profits and are generally taxable at the individual level. However, a limited exemption applies for dividends from small or medium-sized companies.
Source: International Bureau of Fiscal Documentation, "European Tax Handbook 2005, except where noted.
* Information for 2004 from PricewaterhouseCoopers, Individual Taxes 2004–2005: Worldwide Summaries.

Exhibit 3A. Combined U.S. Individual and Corporate Statutory Tax Rate in 2005: Corporate Income Distributed as a Dividend to Individual Shareholder in Top Bracket

Corporate income	$100.00
Less corporate income tax at 35% (federal)	$ 35.00
Net income	$ 65.00
Dividend assuming 100% distribution	$ 65.00
Less individual income tax at 15.0% (federal)	$ 9.75
Net income after federal and individual income tax	$ 55.25
Combined corporate and individual income tax rate	44.75%

Table 3B. Combined U.S. Individual and Corporate Statutory Tax Rate in 2009: Corporate Income Distributed as a Dividend to Individual Shareholder in Top Bracket

Corporate income	$100.00
Less corporate income tax at 35% (federal)	$ 35.00
Net income	$ 65.00
Dividend assuming 100% distribution	$ 65.00
Less individual income tax at 35.0% (federal)	$ 22.75
Net income after federal and individual income tax	$ 42.25
Combined corporate and individual income tax rate	57.75%

Exhibit 4. Income and Profits Taxation, 2003

Percent of Total Taxation in OECD Countries

Rank	Country	Percent
1	Denmark	59.9%
2	New Zealand	59.6%
3	Australia	55.2%
4	Canada	46.0%
5	Iceland	44.3%
6	Norway	43.3%
6	**United States**	**43.3%**
8	Switzerland	42.9%
9	Ireland	39.3%
10	Belgium	39.0%
11	Finland	38.7%
12	United Kingdom	36.5%
13	Luxembourg	36.3%
13	Sweden	36.3%
15	Italy	30.9%
16	Japan	30.6%
17	Austria	29.7%
18	Spain	28.2%
19	Korea	28.0%
20	Germany	27.4%
21	Mexico	26.5%
22	Netherlands	25.5%
23	Czech Republic	25.3%
24	Hungary	24.8%
25	Portugal	24.5%
26	Turkey	23.7%
27	Greece	23.3%
28	France	23.2%
29	Slovak Republic	22.3%
30	Poland	18.2%
Unweighted averages		
	OECD	34.4%
	EU	31.7%

Source: OECD, Revenue Statistics, 1965–2004 (2005)

Exhibit 5—Effective Average Tax Rate for Investment into EU

Investment from MNC based in:	Financing of foreign subsidiary			
	Retained earnings	New equity	Debt	Average
EU	30.1%	30.4%	30.2%	30.2%
US	33.2%	35.7%	34.7%	34.5%

Source: Commission of the European Communities, “Towards an Internal Market without Obstacles,” Com(2001)582, Brussels, October 23, 2001.

Exhibit 6—Taxation of Foreign Subsidiary Dividends in OECD Countries, 2005

Dividend exemption ("territorial") system	Worldwide tax system
(by statute or treaty or for listed countries)	(with credit or deduction for foreign taxes)
1. Australia*	1. Czech Republic[2]
2. Austria	2. Ireland
3. Belgium[1]	3. Japan
4. Canada*	4. Rep. of Korea
5. Denmark	5. Mexico
6. Finland[3]	6. New Zealand
7. France	7. Poland
8. Germany	8. United Kingdom
9. Greece	9. United States
10. Hungary	
11. Iceland	
12. Italy[5]	
13. Luxembourg	
14. Netherlands	
15. Norway[6]	
16. Portugal[7]	
17. Slovak Republic[8]	
18. Spain	
19. Sweden	
20. Switzerland	
21. Turkey	

Source: President's Advisory Panel on Federal Tax Reform, Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System,2005, p. 243.

Statement of S Corporation Association

As the Ways and Means Committee examines the many issues inherent in reforming the Internal Revenue Code, the S Corporation Association ("S–CORP") appreciates this opportunity to share our views on behalf of our member companies and the 3.2 million S corporation owners nationwide.

S–CORP is the only organization in the Nation's Capitol exclusively devoted to protecting America's S corporation community. Our mission is to defend America's small and family-owned S corporation businesses from excessive taxes and government mandates, while also working to ensure that America's most popular corporate structure remains competitive with other business structures in the Twenty-First Century.

Before Congress created S corporations, entrepreneurs had two basic choices when starting a business. They could form a regular "C corporation," enjoy liability protection, but shoulder federal taxes both at the corporate and individual level. Or they could form a partnership, enjoy a single layer of taxation at the individual level, but sacrifice the umbrella of liability protection.

In 1958, Congress enacted Subchapter S of the Internal Revenue Code to combine a single layer of tax (at the individual level) with corporate liability protection. Creation of the "S corporation" was a huge step forward in encouraging small and family business creation in the United States. Nearly a half century later, S corporations are the most popular corporate structure in America. Small businesses are the cornerstone of the American economy, and S corporations are the cornerstone of America's small business community.

S–CORP encourages the Committee to keep in mind the unique history and structure of S corporations, and the dramatic improvement the development of subchapter S represented in the history of taxing small and closely held enterprises, as it reviews plans to reform the tax code.

Advisory Panel Recommendations

The President's Tax Reform Panel has put forward two alternative plans for consideration by the Administration and Congress—the Simplified Income Tax Plan and the Growth and Investment Tax Plan.

For S corporations, SITP divides the business community into two groups, those with more than $10 million in annual revenues, and those with less. Those with less than $10 million in annual revenues would be allowed to retain their current structure (S corporation, LLC, etc) with certain changes, many of them beneficial.

S corporations with more than $10 million in revenues, on the other hand, would need to convert to the new corporate structure with the following main features: a lower 31.5-percent top tax rate imposed at the business level, a 100 percent dividend exclusion for domestic corporations on their domestic earnings, and a 75 percent exclusion for capital gains realized from the sale of the corporate stock.

The GITP similarly divides businesses into two groups, those with a single shareholder (sole proprietorships) and those with two or more shareholders. S corporations and others with multiple shareholders would, under the GITP, be subject to a new corporate structure and tax. Under the new structure, companies that are currently S corporations would be taxed at the corporate level at a top rate of 30 percent, and dividends from the new corporation would be taxed an additional 15 percent. Capital investments could be expensed and interest received would be tax free.

While there are too many moving pieces to definitively state that either plan would result in a better or worse approach to taxing S corporations, America's Subchapter S businesses are extremely troubled by any proposal to impose a new tax at the entity level or elsewhere on their businesses. The point of creating the S corporation fifty years ago was elimination of double taxation. In many ways, the Panel's report reflects a retreat from that premise.

And while one could read between the lines of the report and discern an unwritten objective of trading a single layer of tax at the shareholder level with a single layer of tax at the corporation level, several details within the Panel's report fail to live up to that theme.

For example, the GITP plan explicitly recreates two layers of taxation for all businesses with two or more shareholders. In some cases, this double layer results in a higher level of federal tax than the current tax code—an S corporation shareholder in the top tax bracket pays a 35 percent tax, while that same taxpayer under the new structure would pay a tax of 41 percent. In a similar fashion, the SITP would increase capital gains taxation on smaller businesses that choose to remain S corporations while imposing on them a higher top marginal tax rate than would be paid by businesses which elect the new corporate structure.

Finally, we note that S–CORP and its member S corporations are cognizant of the inherent risks involved in the legislative process. A plan that begins its legislative life by trading a single layer of tax for two layers of taxation, even at reasonably low levels, could easily become a conference report that imposes two layers of tax at much higher levels. S–CORP encourages Congress to remain committed to a single layer of tax as the starting point for tax reform.

The Comprehensive Business Income Tax

The President's tax reform effort now moves to its second stage, with the Department of Treasury considering the Tax Reform Panel's report before making its own recommendations to the President. With that in mind, S–CORP would like to comment on the concept of a Comprehensive Business Income Tax.

As evidenced by the testimony heard by the Advisory Panel and its subsequent report, Panel members were heavily influenced by a 1992 Treasury report outlining the economic benefits of a comprehensive business tax. That report sought to create a single, unified business tax structure that taxed business income once while eliminating many of the biases in the current code.

Treasury found CBIT would produce significant welfare gains to the economy by improving the allocation of investment between the corporate and non-corporate world, eliminating the bias towards debt and against equity financing, and improving the tax treatment of dividend payments to corporate shareholders.

As noted above, S–CORP strongly supports reform efforts that pursue the goal of taxing business income once. We also note that most of the economy efficiency gains of CBIT come not from the uniform business structure it would establish, but rather from the elimination of the bias in the tax code. In other words, most of the economic benefits of CBIT can be realized without eliminating those business structures that already enjoy a single layer of federal tax.

Build on Subchapter S

For the S corporation community, tax reform represents both an opportunity and a risk. Tax reform is an opportunity for Congress to continue what it started back in 1958 when it first created the S corporation—a continued improvement in the tax treatment of America's businesses, one that fosters growth, innovation, jobs and investment.

On the other hand, tax reform represents the risk that Congress may turn away from this basic premise, and—in the name of simplification—impose new taxes where none now exist. Moreover, it represents a risk that Congress will choose to eliminate S corporations, LLCs, and other pass-through businesses without noting the cost to those businesses and the economy of transitioning from one business structure to another.

S–CORP appreciates the opportunity to bring these issues and concerns before the Committee. We look forward to working with you in the weeks and months ahead as you continue your consideration of federal tax reform.

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