

# FUNDAMENTAL TAX REFORM

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HEARING  
BEFORE THE  
COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED TWELFTH CONGRESS  
FIRST SESSION

JANUARY 20, 2011

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## FUNDAMENTAL TAX REFORM

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THURSDAY, JANUARY 20, 2011

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

The committee met, pursuant to call, at 9:03 a.m., in Room 1100,  
Longworth House Office Building, the Honorable Dave Camp  
[chairman of the committee] presiding.

[The advisory of the hearing follows:]

# HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

## Chairman Camp Announces First in a Series of Hearings on Fundamental Tax Reform

*First Ways and Means Hearing of the 112th Congress to Examine the Burdens Imposed by the Current Federal Income Tax System and the Need for Reform*

January 19, 2011

House Ways and Means Committee Chairman Dave Camp (R-MI) today announced that—pursuant to House Rule XI, clause 2(g)(3), and with the concurrence of the Ranking Minority Member—the Committee on Ways and Means will hold a hearing on the costs imposed on families, employers, and the economy at large by the current structure of the Federal income tax. **The hearing will take place on Thursday, January 20, 2011, in 1100 Longworth House Office Building, beginning at 9:00 A.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 Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

### **BACKGROUND:**

This year marks the 25th anniversary of the enactment of the bipartisan Tax Reform Act of 1986 (Pub. L. No. 99-514)—landmark legislation that broadened the tax base by closing loopholes and curtailng tax expenditures, while dramatically reducing marginal tax rates on both individuals and businesses. Since then, marginal rates have gradually risen again, while the tax base has been narrowed significantly by the enactment of myriad new tax preferences. These tax preferences, which frequently favor certain groups and activities over others, add substantial complexity to the Tax Code and increase the compliance and administrative burdens on taxpayers and the Internal Revenue Service alike.

The costs, both in terms of money and time, of complying with Federal tax laws—in addition to the vast resources poured into sophisticated tax planning and tax-motivated transactions—deprive both households and businesses of capital needed for more productive uses. Ensuring long-term prosperity in the face of increasing global competition and acute fiscal pressures requires the Congress to re-examine the Tax Code to determine the specific ways in which the current structure of the Federal income tax discourages job creation and economic growth.

In announcing this hearing, Chairman Camp said, **“This hearing marks the beginning of a dialogue that the President and the Congress—both Republicans and Democrats—must have with the American people about broad-based tax reform that will allow families to thrive and employers to create jobs. With nine out of ten families either hiring tax preparers or purchasing tax software in order to file their taxes, it is clear that the Tax Code is too complex, too time-consuming and too costly for our families and businesses. We have one of the highest corporate tax rates in the world, and our small businesses are struggling with continued uncertainty about individual tax rates and new regulations. It is this Committee’s responsibility to examine ways to reform the code so that it won’t be a continued barrier to economic growth and job creation.”**

**FOCUS OF THE HEARING:**

The hearing will examine the economic and administrative burdens imposed by the current structure of the Federal income tax. It will explore the cost of complexity borne by American families, the cost of a corporate tax system that is increasingly out-of-step with the rest of the world, and the broader cost to the U.S. economy of a tax system that fails to maximize job creation and impedes economic growth.

**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 "Hearings." 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, submit all requested information. ATTACH your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, February 3, 2011**. 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 or (202) 225-3625.

**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.

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.

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

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Chairman CAMP. The committee will come to order.

We meet today in our first hearing of the 112th Congress to begin what I expect will be a long discussion, and one I hope will be bipartisan, on the need to reform our Federal income tax system. As I did on Tuesday, I again want to extend my appreciation

to Ranking Member Levin for agreeing to allow this hearing to move forward today even though the committee did not officially organize it until two days ago.

Twenty-five years ago, a Democrat House and a Republican Senate sent to the White House, and the President signed, landmark legislation known today as the 1986 Act. This is where we started in 1913. This is the entire Tax Code of the United States of America and all the regulations, this pamphlet. This is where we are today. This is the Tax Code and all of the regulations that Americans have to deal with today.

The law in 1986, which marked the successful culmination of years of work, broadened the tax base and lowered tax rates; and it remains the basis of our system of taxation. But, in some sense, it is a shell of its former self. In the intervening years, Members of Congress from both sides of the aisle have loaded the Tax Code with a dizzying array of credits, deductions, exclusions, and exemptions.

The late economist, David Bradford, once provided a tongue-in-cheek example to illustrate the concept of tax expenditures and why they are little more than disguised spending.

Bradford proposed to cut the defense budget for weapons procurement to zero, while creating a new weapons supply tax credit that could be claimed by defense contractors for appropriate weapons "donated" to the Pentagon. And under this regime it would appear to the untrained eye that both spending and taxes would be reduced, thus allowing elected officials to claim the government was smaller. But, in reality, nothing would have changed. A spending program would still exist. It would just be cleverly disguised as a tax credit.

Bradford's cautionary tale seems all too real to those who have parsed the Tax Code and its mysterious tax expenditures for congressionally blessed industries and activities, both big and small. And, regardless of the merits of any individual tax expenditure, the broader picture is not a pretty one. The President's deficit commission which I served on, along with the gentleman from Wisconsin, Mr. Ryan, and the gentleman from California, Mr. Becerra, measured the impact of these expenditures in terms of higher tax rates.

The Bowles-Simpson report makes clear that taxpayers foot the bill for those expenditures in the form of higher tax rates. The Bowles-Simpson report called for eliminating all tax expenditures and would have moved individual rates to 8, 14, and 23 and dropped the corporate rate to just 26 percent. And if their plan used all of the higher revenue from eliminating tax expenditures to push down rates, those numbers would have been even lower.

As we will hear from Nina Olson, the Taxpayer Advocate, the impact of the changes to the Tax Code to create, expand, and extend these expenditures can be measured by the thousands of additional pages added to the Code or the thousands of changes enacted in the last decade alone. Clearly, the Tax Code is too complex, it is too costly, and it takes too much time to comply with. All of this adds more burdens on our families, and on our employers, making it more difficult to create jobs in this country.

I am under no illusion that the task before us will be easy. To really reform the Tax Code in a way that lowers the tax rate,

broadens the base, and promotes the competitiveness of American employers, we will need to make some tough choices. I don't think this can be or should be a partisan exercise, and it can't just happen because one Chamber passes a bill. It will require the active participation of all members of this committee, and it will require us to work with the administration, and, yes, we will even have to talk to the Senate now and again. But, more importantly, we will talk to the American people—individuals, families, employers large and small—who are actually impacted by the laws we pass here in Washington.

So this is just the first hearing of many. I have asked our witnesses to confine their remarks at this first hearing to defining the problems of the current tax system. I look forward to hearing from many other witnesses and working with all of you as we undertake this enormous challenge. As we do so, we will have many further opportunities to consider various solutions, but today our focus should be on making sure we begin to understand the scope of the challenge.

And with that, I yield to my friend and Ranking Member, Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. We welcome this opportunity.

Clearly, there is a need for tax reform. Clearly, any tax reform, which was true in 1986, will have to be bipartisan, it will have to be bicameral, and also it will require leadership from the executive, which I am sure will be forthcoming.

In a way, this hearing is a pickup of an effort some years ago. Next to me, Mr. Rangel was chairing the committee, introduced legislation to try to move ahead this issue of tax reform.

I am not going to be here for a bit because I think Kevin Brady and I will be going to meet with President Hu of China. I hope this hearing will indeed move the ball forward, though let's not expect any touchdowns. It is a long way from the goal line.

I do think we need to keep in mind some basic principles, including the need for our tax system to help create jobs, to help promote economic growth.

I also think—and this may be somewhat controversial and difficult—that also we need to make sure that reform is fiscally responsible.

Another principle that we need to keep in mind is that any tax reform has to benefit the working families of America.

Also, let's keep in mind that the Code is complex. Answering it through tax reform will not be easy.

Mr. Chairman, you have referred to the testimony of the National Taxpayer Advocate, who is here with us; and I join in welcoming all of you. As we looked at the materials last night of all of your testimony, which I am glad we received in time to review, on Page 10, Ms. Olson, you list the tax expenditures under the caption, on page 9, "The Dirty Little Secret: Tax Breaks Generally Benefit the Masses. That is your language".

I just urge that everybody go through the list of tax expenditures on page 10 to understand why some have advocated their being there, the breadth of their coverage, and the need for us on a responsible, bipartisan basis to have, as you have said, Mr. Chair-

man, an intelligent, forthright discussion as to each and every one of them.

So this is the kickoff. The field will not be easy. There may be snow, rain. We are used to that in Michigan on fields. But I think we need to pursue this, and we Democrats look forward to our working together to tackle this issue.

Thank you, Mr. Chair.

Chairman CAMP. Thank you very much.

Today, we are joined by five witnesses. Our first witness will be the Honorable Nina Olson, the National Taxpayer Advocate; and we welcome you back to the committee.

After her, we will hear from Bob McDonald. Mr. McDonald is the Chief Executive Officer of Procter & Gamble and is testifying today in his capacity as the Chairman of the Business Roundtable's Fiscal Policy Initiative. I should note that Mr. McDonald will need to leave promptly at 11 a.m. But given the schedule of votes that we are going to have today, I don't think that will be an issue.

Our third witness will be Warren Hudak, who is the President of Hudak and Company, a small business that provides tax services to other small businesses.

And, fourth, we will hear from Dr. Kevin Hassett, a Senior Fellow and Director of Economic Policy Studies at the American Enterprise Institute.

And, last, we will hear from Dr. Martin Sullivan, a contributing editor for Tax Analysts.

We welcome all of you, and we look forward to hearing your testimony.

Before recognizing our first witness, let me just note that our time this morning is limited, so I will not be asking questions today. And with the concurrence of the Committee, questions by Members will be limited to 3 minutes in the hopes of giving more Members the opportunity to be recognized. But each of the witnesses will have five minutes.

So, Ms. Olson, your written statement, like those of all of the witnesses, will be made part of the record; and you are recognized for five minutes. Welcome and good morning.

**STATEMENT OF THE HONORABLE NINA E. OLSON,  
NATIONAL TAXPAYER ADVOCATE, WASHINGTON, D.C.**

Ms. OLSON. Thank you, Chairman Camp, Ranking Member Levin, and distinguished Members of the Committee. Thank you for inviting me to testify today about the subject of tax reform.

Let me begin by saying bluntly that, in my view, the Tax Code today is a mess. Since the last major reform 25 years ago, the Code has become an ever-expanding patchwork of provisions with little logical connection and it has become unreasonably difficult for taxpayers to understand and comply with.

In my 2010 annual report to Congress, I identified the complexity of the Tax Code and the confusion and distrust it engenders as the number one most serious problem facing taxpayers and the IRS. I titled that section The Time for Tax Reform is Now, because, while there has been a lot of talk of tax reform in recent years, experience has shown that it will require a sustained bipartisan ef-

fort with the support of an engaged public to make tax reform a reality.

I start by noting that the Tax Code as it stands today imposes excessive compliance burdens on individual taxpayers and businesses.

It is rife with complexity and special tax breaks, helping taxpayers who can forward expensive tax advice and discriminating against those who cannot.

The complexity obscures understanding and creates a sense of distance between taxpayers and the government, undermining taxpayer morale and leading to lower levels of voluntary compliance.

The complexity of the Tax Code is also burdensome for the IRS, making it more difficult for the agency to meet taxpayer needs and probably resulting in more audits and enforcement actions than a simpler code would require.

Now, despite the existence of many narrow special interest attacks break, it is important to recognize that the overwhelming majority of tax breaks by dollar value accrue to large segments of the taxpaying public. In short, we are the special interests. If tax rates are to be lowered substantially and overall tax liabilities on average are to remain unchanged, virtually every taxpayer will have to give up cherished tax breaks. There is simply no free lunch. Yet I am convinced that what I call the "busy majority" of taxpayers wants fundamental tax simplification and will support it. Lower tax rates will offset the loss of tax breaks; and, at the same time, taxpayers will understand how their taxes are computed and will save time and money on return preparation.

To assist Congress in deciding which tax breaks and IRS-administered social programs to retain and which to eliminate, I suggest utilizing a zero-based budgeting approach. Under that methodology, the starting point for discussion would be a Tax Code without exclusions or reductions in income or tax. A tax break or IRS-administered social program would be added only if lawmakers, you, decide on balance that the public policy benefits of running the provision or program through the Tax Code outweigh the tax complexity challenges that doing so creates for taxpayers and the IRS.

In my view, tax reform will have a better chance to succeed if it proceeds on a revenue-neutral basis. Although there is widespread recognition that we ultimately must take steps to reduce our current deficit level, I am concerned that if we attempt to solve those issues through tax reform we may never achieve structural tax reform. Rather, we are likely to get stuck in partisan debate precisely when we need a calm and civil analysis of the structure of the Tax Code.

For all of these reasons, I believe that fundamental reform must be made a priority. A simpler, more transparent Tax Code will substantially reduce the estimated 6.1 billion hours and \$163 billion that taxpayers spend on return preparation. It will increase the likelihood that taxpayers will claim all benefits to which they are entitled. It will reduce the likelihood that sophisticated taxpayers can exploit arcane provisions to avoid paying their fair share of tax. It will enable taxpayers to understand how their tax liabilities are computed and prepare their own tax returns, improve taxpayer morale and tax compliance and perhaps even the level of connection

that taxpayers feel with the government. And it will enable the IRS to administer the tax system more effectively and better meet taxpayer needs. I am confident that, in the end, public support for a simpler code will be strong and deep.

Thank you.

[The prepared statement of Nina E. Olson follows:]

**WRITTEN STATEMENT OF**

**NINA E. OLSON**

**NATIONAL TAXPAYER ADVOCATE**

**HEARING ON**

**TAX REFORM**

**BEFORE THE**

**COMMITTEE ON WAYS AND MEANS**

**U.S. HOUSE OF REPRESENTATIVES**

**JANUARY 20, 2011**

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Chairman Camp, Ranking Member Levin, and distinguished Members of the Committee:

Thank you for inviting me to testify today about the subject of tax reform. Let me begin by saying bluntly that, in my view, the tax code today is a mess. Since the last major reform 25 years ago, the tax code has become an ever-expanding patchwork of discrete provisions, often with little logical connection, and it has become unreasonably difficult for taxpayers to understand. In the National Taxpayer Advocate's 2010 Annual Report to Congress, I identified the complexity of the tax code and the confusion and distrust it engenders as the #1 most serious problem facing taxpayers – and the IRS. I titled that section "The Time for Tax Reform Is Now," because while there has been a lot of talk of tax reform in recent years, experience has shown that it will require a sustained, bipartisan effort – with the support of an engaged public – to make tax reform a reality.

In my testimony today, I will make the following points:

1. The tax code as it stands today imposes excessive compliance burdens on individual taxpayers and businesses.
2. The tax code is rife with complexity and special tax breaks, helping taxpayers who can afford expensive tax advice and discriminating against those who cannot.
3. Complexity obscures understanding and creates a sense of "distance" between taxpayers and the government, undermining taxpayer morale and leading to lower levels of voluntary compliance.
4. The complexity of the tax code is also burdensome for the IRS, making it more difficult for the agency to meet taxpayer needs and probably resulting in more audits and enforcement actions than a simpler code would require.
5. Despite the existence of many narrow special interest tax breaks, the overwhelming majority of tax breaks by dollar value accrue to large segments of the taxpaying public. If tax rates are to be lowered substantially and overall tax liabilities on average are to remain unchanged, virtually every taxpayer will have to give up cherished tax breaks. There is simply no free lunch. Yet I am convinced the "busy majority" of taxpayers wants fundamental tax simplification and will support it. Lower tax rates will offset the loss of tax breaks, and at the same time, taxpayers will understand how their taxes are computed and will save time and money on return preparation.
6. To assist Congress in deciding which tax breaks and IRS-administered social programs to retain and which to eliminate, I suggest utilizing a "zero-based budgeting" approach. Under that methodology, the starting point for discussion would be a tax code without exclusions or reductions in income or tax. A tax break or IRS-administered social program would be added only if lawmakers

decide, on balance, that the public policy benefits of running the provision or program through the tax code outweigh the tax complexity challenges that doing so creates for taxpayers and the IRS.

7. In my view, tax reform will have a better chance to succeed if it proceeds on a revenue-neutral basis and if decisions about whether and how much to adjust revenue levels are kept separate. I make that statement recognizing that with major tax provisions set to expire after 2012, even deciding the meaning of "revenue neutral" presents significant challenges. Although there is widespread recognition that we ultimately must take steps to reduce our current deficit levels, I believe that if we attempt to solve those issues through tax reform, we will never achieve structural tax reform. Rather, we will get stuck in partisan debates precisely when we need a calm and civil analysis of the structure of the tax code.

Before I delve into these issues, I wish to make two points clear. First, my statutory mandate is to address tax administration issues – not tax policy issues. While the line that separates tax administration and tax policy is sometimes fuzzy, I will try to describe the burdens that tax complexity imposes, identify challenges to enacting tax reform, and suggest some ways to approach it. However, my office does not take a position on tax rates, revenue levels, or the specifics of which tax breaks should be retained and which should be eliminated. Second, my statutory mandate is to present an independent taxpayer perspective. Therefore, although I am an IRS employee, my comments do not necessarily reflect the position of the IRS or the Administration.<sup>1</sup>

#### **I. The Current Tax Code Imposes Excessive Compliance Burdens on Individuals and Businesses.**

Consider the following:

- According to a TAS analysis of IRS data, individuals and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Internal Revenue Code.<sup>2</sup> And that figure does not include the millions of

<sup>1</sup> The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

<sup>2</sup> The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for tax year 2008 by the average amount of time the IRS estimated it took to complete the form. While the IRS estimates are the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. This TAS estimate may be low because it does not take into account all forms and, as noted in the text, it does not include the amount of time taxpayers spend responding to post-filing notices, examinations, or collection actions. Conversely, the

additional hours that taxpayers must spend when they are required to respond to IRS notices or audits.

- If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the "tax industry" requires the equivalent of more than three million full-time workers.<sup>3</sup>
- Compliance costs are huge both in absolute terms and relative to the amount of tax revenue collected. Based on Bureau of Labor Statistics data on the hourly cost of an employee, TAS estimates that the costs of complying with the individual and corporate income tax requirements for 2008 amounted to \$163 billion – or a staggering 11 percent of aggregate income tax receipts.<sup>4</sup>

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TAS estimate may be high because IRS time estimates have not necessarily kept pace fully with technology improvements that allow a wider range of processing activities to be completed via automation. We note that the aggregate burden of 6.1 billion hours is lower than the 7.6 billion hour estimate included in our 2008 report. Analysts in the IRS Office of Research, Analysis and Statistics (RAS) have advised us that the lower burden estimates likely reflect efficiency gains attributable to wider use of tax software, particularly by higher income business taxpayers. However, these efficiency gains have not necessarily reduced the burden on middle income and lower income taxpayers. Indeed, measured by dollars, RAS estimates that the mean burden has declined but the median burden has increased. TAS cannot independently determine the margin of error of existing estimates, and RAS acknowledges that the reduction in the time burden estimates may be at least partially attributable to measurement error.

<sup>3</sup> This calculation assumes each employee works 2,000 hours per year (*i.e.*, 50 weeks, with two weeks off for vacation, at 40 hours per week).

<sup>4</sup> The IRS and several outside analysts have attempted to quantify the costs of compliance. For an overview of previous studies, see Government Accountability Office, GAO-05-878, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System* (Aug. 2005). There is no clearly correct methodology, and the results of these studies vary. All monetize the amount of time that taxpayers and their preparers spend complying with the tax code. The TAS estimate of the cost of complying with personal and business income tax requirements (and thus excluding the time spent complying with employment, estate and gift, excise, and exempt organization tax requirements) was made by multiplying the total number of such hours (5.6 billion) by the average hourly cost of a civilian employee (\$29.18), as reported by the Bureau of Labor Statistics. See Bureau of Labor Statistics, U.S. Department of Labor, *Employer Costs for Employee Compensation – December 2008*, USDL: 09-0247 (Mar. 12, 2009) (including wages and benefits), at [http://www.bls.gov/news.release/archives/ecec\\_03122009.pdf](http://www.bls.gov/news.release/archives/ecec_03122009.pdf). The TAS estimate of compliance costs as a percentage of total income tax receipts for 2008 was made by dividing the income tax compliance cost as computed above (\$163 billion) by total 2008 income tax receipts (\$1.45 trillion). See Office of Management and Budget, Budget of the United States Government - Fiscal Year 2011, Historical Tables, Table 2-1, at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf>.

TAS's estimate that compliance costs amount to about 11 percent of aggregate income tax receipts falls on the lower side of some previous estimates. For example, Professor Joel Slemrod computed that compliance costs constitute about 13 percent of receipts, while the Tax Foundation computed that compliance costs constitute about 22 percent of income tax receipts. See Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Joel Slemrod, Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, University of Michigan Stephen M. Ross School of Business); Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), at <http://www.taxfoundation.org/research/show/1281.html>.

- According to a tally compiled by a leading publisher of tax information, there have been approximately 4,428 changes to the tax code over the past 10 years, an average of more than one a day, including an estimated 579 changes in 2010 alone.<sup>5</sup>
- The tax code has grown so long that it has become challenging even to figure out how long it is. A search of the Code conducted using the “word count” feature in Microsoft Word turned up 3.8 million words.<sup>6</sup> A 2001 study published by the Joint Committee on Taxation put the number of words in the Code at that time at 1,395,000.<sup>7</sup> A 2005 report by a tax research organization put the number of words at 2.1 million, and notably, found that the number had *almost tripled* since 1975.<sup>8</sup> (The methodologies underlying these word counts probably differed and the results therefore may not be comparable.)
- Individual taxpayers find return preparation so overwhelming that about 60 percent now pay preparers to do it for them.<sup>9</sup> Among unincorporated business taxpayers, the figure rises to about 71 percent.<sup>10</sup> An additional 29 percent of

<sup>5</sup> Unpublished CCH data provided to TAS (Dec. 22, 2010).

<sup>6</sup> To determine the number of words in the Internal Revenue Code, TAS downloaded a zipped file of Title 26 of the U.S. Code (*i.e.*, the Internal Revenue Code) from the website of the U.S. House of Representatives at [http://uscode.house.gov/download/title\\_26.shtml](http://uscode.house.gov/download/title_26.shtml). We unzipped the file, copied it into Microsoft Word, and used the “word count” feature to compute the number of words. The version of Title 26 we used was dated Feb. 1, 2010, so the count does not reflect legislation enacted during the second session of the 111<sup>th</sup> Congress. In Word, the document ran 11,045 single-spaced pages. The printed code contains certain information that does not have the effect of law, such as a description of amendments that have been adopted, effective dates, cross references, and captions. The word count feature also counts page numbers, the table of contents, and the like. Therefore, our count somewhat overstates the number of words that are officially considered a part of the tax code, although as a practical matter, a person seeking to determine the law will likely have to read and consider many of these additional words, including effective dates, cross references, and captions. Other attempts to determine the length of the Code may have excluded some or all of these components, but there is no clearly correct methodology to use, and there is no easy way to selectively delete information from a document of this length.

<sup>7</sup> See Staff of the Joint Committee on Taxation, 107<sup>th</sup> Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (vol. I), at 4 (Comm. Print 2001).

<sup>8</sup> J. Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), at <http://www.taxfoundation.org/research/show/1281.html>.

<sup>9</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008); George Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity 7* (presented at IRS Research Conference, June 2010).

<sup>10</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008).

individual taxpayers use tax software to help them prepare their returns,<sup>11</sup> with leading software packages costing \$50 or more. IRS researchers estimate the monetary compliance burden of the median individual taxpayer (as measured by income) rose from \$220 in 2000 to \$258 in 2007, an increase of 17 percent.<sup>12</sup>

**II. The Tax Code Is Rife with Complexity and Special Tax Breaks, Helping Taxpayers Who Can Afford Expensive Tax Advice and Discriminating Against Those Who Cannot.**

The tax code contains a multitude of tax breaks that benefit narrow groups of taxpayers or industries. These tax breaks are enacted for understandable reasons, including to encourage certain types of behavior or to provide benefits in certain circumstances. While any list is necessarily selective, here is a small sampling of narrow benefits, either intended or incidental, for which the average taxpayer does not qualify:

- *Easement for Harmonious Shapes and Textures.* This provision allows donors of certain easements for conservation purposes to claim a charitable deduction, but it is almost impossible for the IRS to administer.<sup>13</sup> For example, it requires valuation of real property rights that preserve historic facades of houses or preclude development of open space, which under the tax regulations take into account such variables as the “harmonious variety of shapes and textures” on a landscape.<sup>14</sup>
- *Electric Vehicle/Golf Cart Credit.* This provision provides a credit for the purchase of qualified plug-in electric vehicles, which at one point included golf carts. While that loophole has been closed, the credit still covers the \$100,000-plus Tesla sports car.<sup>15</sup>
- *Film and TV Deduction.* This provision allows taxpayers to expense costs associated with the production of films and television programs in lieu of the less generous depreciation deduction generally available to businesses.<sup>16</sup>
- *Forestry Conservation Bonds.* This provision authorizes a credit for investors in bonds issued by a government or non-profit entity for the purpose of acquiring at

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<sup>11</sup> George Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity* 7 (presented at IRS Research Conference, June 2010).

<sup>12</sup> *Id.* at 26.

<sup>13</sup> See IRC § 170(h).

<sup>14</sup> Treas. Reg. § 1.170A-14(d)(4)(ii)(A)(5).

<sup>15</sup> See IRC § 30D.

<sup>16</sup> See IRC § 181.

least 40,000 acres adjacent to a national park, subject to a native fish habitat conservation plan of the U.S. Fish and Wildlife Service.<sup>17</sup>

- *Railroad Track Maintenance Credit*: This provision provides a special credit for taxpayers who happen to own a railroad.<sup>18</sup>

Beyond these narrow provisions, the tax code contains many general provisions that well-advised taxpayers may exploit. Indeed, many large accounting firms, law firms, and investment banking firms have regularly mined the code for ambiguities in order to develop tax-reduction "products" they can sell to paying clients.

At the same time that taxpayers who can afford pricey legal advice are benefiting disproportionately from tax breaks, unsophisticated taxpayers who could benefit from tax breaks sometimes fail to claim them because they do not know they exist. In 2006, for example, individual taxpayers were permitted to claim a one-time tax credit for telephone excise taxes that the government had improperly collected.<sup>19</sup> The standard amount of the credit ranged from \$30 to \$60, depending on the number of exemptions the taxpayer was entitled to claim on the return.<sup>20</sup> No substantiation was required unless a taxpayer claimed a larger amount, so this credit was essentially free money. Yet IRS data show that 28 percent of eligible taxpayers (37 million out of 133 million) did not claim the credit.<sup>21</sup> Why would 37 million taxpayers fail to claim an authorized credit? The most likely explanation is that they never learned about it because they were already so overwhelmed by the complexity of their tax returns.<sup>22</sup>

Overall, the complexity of the tax code leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them to either overpay their tax or become subject to IRS enforcement action for mistaken underpayments. On the other hand, sophisticated taxpayers often find arcane provisions that enable them to reduce or eliminate their tax liabilities.

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<sup>17</sup> See IRC §§ 54A & 54B.

<sup>18</sup> See IRC § 45G.

<sup>19</sup> See IRS Notice 2006-50, 2006-1 C.B. 1141. Unlike the other examples cited in this section, the telephone excise tax refunds were authorized by the Department of the Treasury after several circuits of the U.S. Court of Appeals ruled that the long-distance telephone services at issue were not subject to taxation.

<sup>20</sup> IRS News Release, *IRS Announces Standard Amounts for Telephone Tax Refunds*, IR-2006-137 (Aug. 31, 2006).

<sup>21</sup> IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008).

<sup>22</sup> One might assume that tax preparers would know about the credit. Yet IRS data show that 16 percent of practitioner-prepared returns failed to claim the credit. IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008). An alternative explanation we have heard from preparers is that some taxpayers were concerned that claiming the credit might increase their audit risk. To the extent that some taxpayers had this concern, it provides further evidence of the disconnect between taxpayers and the government and the need to make the tax system more transparent.

**III. Complexity Obscures Understanding and Creates a Sense of Distance Between Taxpayers and the Government, Resulting in Lower Rates of Voluntary Tax Compliance.**

IRS data show that when taxpayers have a choice about reporting their income, tax compliance rates are remarkably low. Workers who are classified as employees have little opportunity to underreport their earned income because it is subject to tax withholding. Employees thus report about 99 percent of their earned income. But among workers whose income is not subject to tax withholding, compliance rates plummet. IRS studies show that nonfarm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent.<sup>23</sup>

Noncompliance cheats honest taxpayers, who must pay more to make up the difference. According to the IRS's most recent comprehensive estimate, the net tax gap stood at \$290 billion in 2001,<sup>24</sup> when 132 million tax returns were filed.<sup>25</sup> This means that each taxpayer was effectively paying a "surtax" of some \$2,200 to subsidize noncompliance by others.

To me, this raises an important question: Why is it that few Americans would steal from a local charity, yet a high percentage of taxpayers who have a choice about paying taxes appear to have no compunctions about cheating their fellow citizens?

The Taxpayer Advocate Service has conducted some research into the causes of noncompliance and plans to conduct additional studies. While we do not have definitive answers, we can suggest at least two hypotheses.

First, no one wants to feel like a "tax chump" – paying more while suspecting that others are taking advantage of loopholes to pay less. Taxpayers who believe they are unfairly paying more than others inevitably will feel more justified in "fudging" to right the perceived wrong. Transparency is a critical feature of a successful tax system and is essential if the system is to build taxpayer confidence and maintain high rates of tax compliance. Simplifying the tax code so tax computations are more transparent would go a long way toward reassuring taxpayers that the system is not rigged against them.

Second, most people feel a sense of affinity and unity with local organizations, while in relative terms, they feel disconnected from the federal government. This may be because members of a community generally understand the services that local organizations provide and the benefits they personally derive, while many Americans do

<sup>23</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>). As low as these rates are, they would be even lower if not for the fact that some of this income is reported to the IRS by third parties.

<sup>24</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).

<sup>25</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2001).

not understand how their tax dollars are spent or how they benefit. Or it may be because they know the leaders of local community groups personally, while the government is faceless. Either way, I suspect that stealing from a local charity feels to many like stealing from family and friends, while cheating on one's taxes feels to some like a victimless offense.<sup>26</sup>

For these reasons, I think it is important to increase taxpayer awareness of the connection between taxes paid and benefits received. I have recommended that Congress direct the IRS to provide all taxpayers with a "taxpayer receipt" showing how their tax dollars are being spent. This "taxpayer receipt" could be a more detailed version of the pie chart currently published by the IRS but should be provided directly to each taxpayer annually.<sup>27</sup> I believe better public awareness of the connection between taxes and government spending may improve civic morale, increase tax compliance, and make more productive the national dialogue over looming fiscal policy choices as well.

#### **IV. The Tax Code Is So Complex That the IRS Has Difficulty Administering It.**

The IRS employs about 100,000 workers<sup>28</sup> and performs many of its tasks very well, but it faces daunting challenges in administering the tax code. Despite the fact that about 90 percent of individual taxpayers rely on preparers or tax software packages, the IRS received 110 million calls in each of the last two fiscal years.<sup>29</sup> That is a staggering volume of calls, and not surprisingly, the IRS was unable to answer over 25 percent of them.<sup>30</sup> In FY 2008, the IRS received approximately 167 million calls,<sup>31</sup> largely inquiries generated by the Economic Stimulus Act,<sup>32</sup> and it was only able to answer 53 percent.<sup>33</sup>

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<sup>26</sup> See generally National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 147-150 (Research Study: *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*) (discussing the effect of social norms on tax compliance).

<sup>27</sup> See IRS Form 1040 Instructions (2009), at 100.

<sup>28</sup> IRS Data Book, 2009, Table 31 at <http://www.irs.gov/pub/irs-soi/09db31ps.xls>.

<sup>29</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (weeks ending Sept. 30, 2009 and Sept. 30, 2010).

<sup>30</sup> The Customer Account Services Level of Service was 70 percent in FY 2009 and 74 percent in FY 2010. See IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (weeks ending Sept. 30, 2009 and Sept. 30, 2010). These percentages reflect the number of calls that reached telephone assisters among all callers seeking to do so.

<sup>31</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2008).

<sup>32</sup> Pub. L. No. 110-185 (2008).

<sup>33</sup> IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (week ending Sept. 30, 2008).

In our 2010 Annual Report to Congress, we describe other key challenges facing the IRS. To cite one example, the IRS cannot process on a timely basis a considerable portion of the more than 11 million pieces of taxpayer correspondence it receives each year. This situation leads to erroneous tax assessments, improper collection actions, additional penalties and interest for taxpayers, and additional refund interest costs to the government.<sup>34</sup> To cite another example, the IRS relies heavily on automated processes to achieve efficiencies, but in doing so, it sometimes fails to address the unique circumstances of individual taxpayers. The dramatic increase in automated lien filings over the past decade and the IRS's unwillingness to require its employees to make individualized lien determinations are also described in our most recent report.<sup>35</sup>

Simply put, tax code complexity strains the IRS's ability to serve taxpayers, while a simpler code would make the job of the tax administrator much easier – something that would benefit taxpayers and the government alike.

#### **V. The Dirty Little Secret: Tax Breaks Generally Benefit the Masses.**

There is a widespread belief that the influence of "special interests" is the biggest roadblock to comprehensive tax reform. There is no doubt that many provisions in the tax code benefit narrow groups of taxpayers, including several described above. But the dirty little secret is that the largest special interests are us – the vast majority of U.S. taxpayers. Virtually all of us benefit from tax breaks that are technically called "tax expenditures." A tax expenditure is generally defined as any reduction in tax revenue attributable to an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate, or deferral of tax.<sup>36</sup>

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<sup>34</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 235-249 (Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*).

<sup>35</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 302-310 (Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien Filing Policies on Taxpayers and Future Tax Compliance*).

<sup>36</sup> Congressional Budget and Impoundment Control Act, Pub. L. No. 93-344, § 3(3) (1974). When Congress wishes to spend money, it may do so in either of two ways. It can make expenditures directly via cash outlays, or it can make expenditures by providing tax breaks through the tax code. As a practical matter, a tax expenditure has the same impact as a government spending program. Assume that an individual facing a 25 percent tax rate pays \$10,000 in mortgage interest and that the government wants to provide a subsidy for home ownership. It could accomplish this objective in two ways: (1) it could allow the taxpayer to deduct the \$10,000 of mortgage interest from his gross income, which would produce a tax reduction of \$2,500, or (2) it could make a direct payment of \$2,500 to the taxpayer in lieu of the tax deduction. The taxpayer ends up in the same economic position either way. For a detailed discussion of tax expenditures, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

In December 2010, the Joint Committee on Taxation (JCT) published its annual analysis of tax expenditures for the five-year period FY 2010 through FY 2014, and the largest were the following:<sup>37</sup>

- The exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance (\$659.4 billion).
- The exclusion for retirement plan contributions and earnings (\$596.5 billion).<sup>38</sup>
- The mortgage interest deduction for owner-occupied housing (\$484.1 billion).
- The reduced rates of tax on dividends and long-term capital gains (\$402.9 billion).
- The exclusion for various Medicare benefits (\$337.1 billion).<sup>39</sup>
- The earned income tax credit (\$268.8 billion).<sup>40</sup>
- The deduction for nonbusiness state and local taxes (\$237.3 billion).
- The exclusion of capital gains at death (\$194.0 billion).
- The deduction for charitable contributions (\$187.5 billion).

Other popular benefits include the child and dependent care credits and exclusions for distributions from Roth IRAs, for distributions from Section 529 education savings plans, for contributions to Flexible Spending Accounts (both medical and dependent care), and for public transportation subsidies.

Another perspective: On an annual basis, the JCT estimates that tax expenditures total about \$1.1 trillion a year.<sup>41</sup> As compared with about 138 million individual tax returns filed in 2010,<sup>42</sup> that amounts to an average reduction in tax per return of about \$8,000.

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<sup>37</sup> See Staff of the Joint Committee on Taxation, 111<sup>th</sup> Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, Table 1 (Joint Comm. Print 2010).

<sup>38</sup> This total represents the sum of defined benefit plans (\$303.2 billion), defined contribution plans (\$212.2 billion), and plans covering partners and sole proprietors (sometimes known as "Keogh" plans) (\$81.1 billion).

<sup>39</sup> This total represents the sum of hospital insurance - Part A (\$175.8 billion), supplementary medical insurance - Part B (\$124.5 billion), prescription drug insurance - Part D (\$35.1 billion), and exclusion of certain subsidies to employers who maintain prescription drug plans for Medicare enrollees (\$1.7 billion).

<sup>40</sup> This estimate reflects the full value of the EITC, including the refundable portion associated with significant outlay effects. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, Table 1, at 52 n.5.

Because tax is computed as a percentage of income, the total amount of exclusions or deductions that would generate an \$8,000 tax reduction is a multiple of the tax reduction. Assume for purposes of illustration that a taxpayer pays a flat tax rate of 25 percent and does not qualify for any tax credits. At a 25-percent tax rate, the average tax reduction of \$8,000 would translate to deductions or exclusions from income worth \$32,000.

#### Example

A single parent with two children under 17 receives income and benefits totaling \$100,000 in 2010. Included in this amount are "tax expenditures" of \$32,000 (consisting of exclusions of \$16,000 for employer-provided health insurance and retirement plan contributions and deductions of \$16,000 for mortgage interest, state and local taxes, and charitable contributions). In addition, the parent receives the benefit of personal and dependency exemptions – one for herself and one for each child – totaling \$10,950.<sup>43</sup> Therefore, the taxpayer reduces her \$100,000 starting total by \$42,950 (the sum of tax expenditures for which she qualifies and three exemptions) to arrive at a taxable income of \$57,050. Under the 2010 rate tables, the taxpayer computes a federal income tax of \$9,120, which is reduced by a child tax credit of \$1,550 and a Making Work Pay credit of \$400, for a net total tax of \$7,170. Thus, despite the fact that this taxpayer falls into the 25-percent marginal tax rate bracket, she ends up paying an average rate of tax of about 7 percent of her income and excluded benefits.<sup>44</sup>

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<sup>41</sup> See Staff of the Joint Committee on Taxation, 111<sup>th</sup> Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (Joint Comm. Print 2010). The JCT provides a separate estimate for each tax expenditure, but it does not add them up to provide an aggregate total. Tax expenditures have interactive effects for which the JCT has not attempted to account. If those effects were incorporated, the aggregate total of foregone revenue would be somewhat lower. Nevertheless, the aggregate total provides a reasonable approximation of the level of tax expenditures, and we use it in this report for that purpose. See Leonard Burman, Eric Toder & Christopher Geissler, *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?* Discussion Paper 31, Amer. Soc. Sci. Assoc'n (New Orleans, La., Jan. 5, 2008) 3, shorter version published in 98 *Amer. Econ. Rev.* 79 (2008) (stating that despite interaction effects, "commentators have added up tax expenditures to make general statements about their magnitude").

<sup>42</sup> See IRS 2010 Filing Season Statistics at <http://www.irs.gov/newsroom/article/0,,id=220953,00.html>.

<sup>43</sup> The JCT does not consider either personal exemptions or the standard deduction to be tax expenditures because they "defin[e] the zero-rate bracket that is a part of normal tax law." See Staff of the Joint Committee on Taxation, 111<sup>th</sup> Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, at 4-5 (Joint Comm. Print 2010). Therefore, they reduce income further.

<sup>44</sup> Because tax rates rise with income, this taxpayer pays tax at 10 percent on the first \$11,950 of taxable income, at 15 percent on taxable income between \$11,950 and \$45,550, and at 25 percent on additional income. We are assuming that this taxpayer uses head-of-household filing status.

In Appendix A, we present tax computations that illustrate the role of tax expenditures in four different situations – a married couple with two children, a small business owner, a low income single parent, and a retired couple. The scenarios are fictitious, but they illustrate the extent to which a variety of tax benefits may apply to different types of taxpayers. Moreover, although most of my testimony today is focused on individual taxpayers, I believe the rationale for trading lower rates for a simpler tax code applies to the taxation of businesses as well. The scenario involving a small business owner provides one illustration of this point.

These scenarios make clear that tax reform is not an easy issue. In theory, most of us agree that the tax code is too complex and that broadening the tax base by eliminating existing tax breaks in exchange for lower rates would improve the system.<sup>45</sup> In practice, the prospect of lower rates may seem speculative and distant, while the threatened loss of existing tax breaks raises immediate concerns. And the lower we want tax rates to be, the more of these tax breaks we have to be willing to give up.

Despite these concerns, I personally believe that fundamental tax reform is essential and urgent. More importantly, I believe that taxpayers will support tax reform by wide margins if they gain a better understanding of the trade-offs involved and are engaged in an informed dialogue. If tax reform is enacted on a revenue-neutral basis, the average taxpayer's bill will not go up, and taxpayers will be much happier to have a more transparent system. They will understand how much tax they are paying, they will understand how their tax is computed, and many will save time and money because they no longer will have to pay fees to a preparer to do the job for them.

Both to gauge and build public support, I encourage you to discuss with your constituents both the complexity of the existing tax code and the trade-offs between tax rates and tax breaks that tax reform will require. An uninformed taxpayer who hears he may lose a tax break will instinctively seek to retain it to prevent his tax bill from rising. An informed taxpayer who understands she will be losing a tax break but probably will not pay more tax because rates will be substantially lowered will have a very different reaction. The Tax Reform Act of 1986 was the last major revision of the tax code, and despite considerable initial concerns, taxpayers came around. On the final votes, the Act was supported by significant bipartisan majorities in the House and the Senate.<sup>46</sup> I am hopeful and optimistic that a similar dynamic will play out again in the near future.

To help promote a public dialogue, my office recently launched a web page at [www.taxpayeradvocate.irs.gov](http://www.taxpayeradvocate.irs.gov) to solicit taxpayer suggestions regarding tax reform. We promised to track and post comments periodically. We asked taxpayers to approach

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<sup>45</sup> The bipartisan fiscal commission appointed by the President recently made recommendations along these lines. See National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 15, 28-34 (Dec. 2010) at <http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform>.

<sup>46</sup> The vote to approve the conference report was 292-136 in the House and 74-23 in the Senate. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 4 (1987).

this with the frame of mind that everything – even the tax breaks from which they benefit personally – should be on the table. All of us should consider which tax breaks we would be willing to give up in exchange for simplification of the tax code, and which provisions we think are unduly burdensome or unfair. To date, we have received more than 1,000 comments. I have been amazed by how seriously taxpayers have taken this request and by the extraordinary thoughtfulness and good sense so many of them have exhibited in their suggestions. I believe that as taxpayers understand more about the sources of current tax law complexity, their desire for tax reform and support for their legislators' making hard choices will increase.

**VI. A Zero-Based Budgeting Approach Could Assist Congress in Deciding Which Tax Breaks and IRS-Administered Social Programs to Retain and Which to Eliminate.**

My suggestion is to approach tax reform in a manner similar to zero-based budgeting. Under that approach, the starting point would be a tax code without any exclusions or reductions in income or tax. As discussions proceed, tax breaks and IRS-administered social programs would be added only if lawmakers decide on balance that the public policy benefits of running the provision or program through the tax code outweigh the tax complexity challenges that doing so creates for taxpayers and the IRS. Some tax provisions and programs will meet this test, while others will not. Factors to consider in making this assessment include whether the government continues to place a priority on encouraging the activity for which the tax incentive is provided, whether the incentive is accomplishing its intended purpose, and whether a tax expenditure is more effective than a direct expenditure for achieving that purpose.<sup>47</sup>

The immediate elimination of certain tax benefits could cause hardships for individuals or businesses where established pricing or conduct is based on those provisions. For example, persons who own homes paid a purchase price that took into account the federal subsidy provided through the mortgage interest deduction. Sudden elimination of that deduction could cause the value of existing homes to drop substantially. If Congress decides to eliminate tax incentives in situations like this, transitional relief should be provided.

In our 2010 Annual Report to Congress, I recommended adoption of a process to evaluate whether a tax expenditure presents an administrative challenge to the IRS or taxpayers and the extent to which it achieves its intended purpose.<sup>48</sup> In addition, in our 2009 report I proposed an analytic framework for evaluating whether specific social

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<sup>47</sup> See National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

<sup>48</sup> See *id.*

benefit programs – whether for individuals or for businesses – should be run through the tax system.<sup>49</sup>

If, in the context of structural tax reform, we apply this rigorous analytical framework to all proposed tax expenditures, we will adopt solely those provisions that fulfill a compelling public policy purpose, that the IRS can effectively administer without undue burden to taxpayers, and that are designed to capture information to evaluate whether the benefit achieves its intended public policy outcome. Importantly, taxpayers and policymakers will thus understand why such a provision is included in the tax code and will be able to ascertain its effectiveness.

This approach, at a conceptual level, is similar to two other proposals presented during the past year. In December 2010, the National Commission on Fiscal Responsibility and Reform issued a report that, among other things, also recommended a zero-based budgeting approach to tax reform.<sup>50</sup> In February 2010, Senators Wyden and Gregg introduced legislation that would substantially revamp the tax code.<sup>51</sup> While we do not endorse specific proposals, we think both are thoughtful and worthy starting points.

We are not so naïve as to suggest that all tax expenditures will be eliminated, even in the most robust tax reform effort. In fact, there are excellent public policy or administrative reasons for including some programs in the tax code – whether they benefit individuals, small businesses, or entire industries.<sup>52</sup> And we believe that given adequate lead time, proper design, and sufficient resources, the IRS can successfully administer many of these programs without unduly burdening taxpayers or itself.<sup>53</sup> But

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<sup>49</sup> National Taxpayer Advocate 2009 Annual Report to Congress, Vol. 2, at 75-104 (*Running Social Programs Through the Tax System*). Among other factors, we suggested that Congress consider the IRS's existing relationship with and access to the targeted population as well as the additional burden imposed on that population, the IRS's ability to deliver the benefit in a timely manner and at the appropriate time, the IRS's access to information necessary to make an eligibility determination, and the IRS's suitability to be the administrator of the provision in light of its enforcement culture.

<sup>50</sup> See National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 28-34 (Dec. 2010) at <http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform>. The mandate of the commission was to address the nation's long-term fiscal challenges, and as a result, its tax reform recommendations are partly designed to increase revenue. It is beyond the mission of the National Taxpayer Advocate to take a position on these broader fiscal issues.

<sup>51</sup> Bipartisan Tax Fairness and Simplification Act, S. 3018, 111<sup>th</sup> Cong. (2010).

<sup>52</sup> For example, the IRS in some cases already has access to all the financial or other data necessary to determine eligibility for a benefit. If another agency were tasked with administering the benefit, the beneficiary would be required to submit the information twice (once to the IRS and once to another agency) or the IRS would be directed to share confidential tax return information, which would impose administrative burden on two agencies and could undermine future tax compliance.

<sup>53</sup> In our 2010 Annual Report to Congress, we recommended that the IRS revise its mission statement to explicitly acknowledge and describe its dual mission of collecting taxes and delivering social benefits. We believe that recognition of the IRS's dual role will help ensure that the IRS is adequately funded to deliver all of its programs and cause it to shift its emphasis from primarily enforcement to providing better service and assistance to its taxpayers and beneficiaries as well. See National Taxpayer Advocate 2010 Annual

the tax system will run much more smoothly if only tax benefits and social programs that withstand this analysis are included in the tax code.

Two additional notes: In a presentation to the President's Advisory Panel on Federal Tax Reform in 2005, I laid out certain principles for tax reform that I view as important from a taxpayer perspective.<sup>54</sup> These principles are included as Appendix B. In addition, the National Taxpayer Advocate's Annual Reports to Congress over the past decade have offered numerous proposals to simplify various sections or areas of the tax code. While these proposals were not written with the goal of comprehensive structural tax reform in mind, they provide an additional illustration of tax-law complexity and should serve as a checklist to ensure that key areas of complexity are addressed in tax reform legislation. A summary of these proposals is included as Appendix C.

**VII. The Odds of Achieving Tax Reform Are Higher if the Issue Is Addressed Separately from Decisions About Adjustments to Revenue Levels.**

Although my office does not take a position on fiscal policy issues or tax rates, I am mindful that leaders of both parties have expressed deep concerns about the long-term structural imbalance between government revenues and government spending, and that in addition to spending cuts, tax revenues at some point may have to be increased. I am also mindful that the question of whether and to what extent to raise revenue is extremely contentious.

If comprehensive structural tax reform and revenue levels are considered together as part of a package, I am concerned that the debate over revenue levels could overshadow and derail meaningful tax reform. Therefore, my suggestion is that Congress consider addressing these issues separately. First, Congress could enact comprehensive structural tax reform on a revenue-neutral basis. Second, Congress could decide on appropriate revenue levels and adjust the tax rates as it deems appropriate.

**VIII. Conclusion: The Time for Tax Reform Is Now.**

For all the reasons described above, I believe that fundamental reform must be made a priority. A simpler, more transparent tax code will substantially reduce the estimated 6.1 billion hours and \$163 billion that taxpayers spend on return preparation; increase the likelihood that taxpayers will claim all tax benefits to which they are entitled; reduce the

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Report to Congress 15-27 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

<sup>54</sup> See Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate). For additional detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-380 (Legislative Recommendation: *A Taxpayer-Centric Approach to Tax Reform*).

likelihood that sophisticated taxpayers can exploit arcane provisions to avoid paying their fair share of tax; enable taxpayers to understand how their tax liabilities are computed and prepare their own returns; improve taxpayer morale and tax compliance – and perhaps even the level of connection that taxpayers feel with the government; and enable the IRS to administer the tax system more effectively and better meet taxpayer needs.

Based on all the comments we receive every year in the Taxpayer Advocate Service and our experience in handling nearly 300,000 taxpayer cases a year, lowering rates in exchange for broadening the tax base seems like an excellent bargain. I am confident that in the end, public support for a simpler code will be strong and deep.

# APPENDIX A

## Appendix A - 2

**Example 1: MARRIED COUPLE WITH TWO CHILDREN**

Taxpayer A is married with two children under 17. A works for a large company that pays him \$75,000 annually. Of this, A directs \$5,000 of his earnings into a retirement plan (401(k)), and the company matches his contribution with \$5,000. A directs another \$5,000 of his earnings into a Flexible Spending Account (FSA) for out-of-pocket medical expenses, while the company provides health insurance coverage worth \$13,000 for A and his family. Further, the company provides A with a commuter transit subsidy worth \$2,000. Because these employee benefits (including the voluntary salary reductions for the 401(k) and FSA) are not included in gross income for tax purposes, A's "adjusted gross income" is only \$65,000.

A pays home mortgage interest of \$10,000, state, local, and property taxes of \$5,000, and charitable contributions of \$2,000. A's wife enrolls in community college courses for which an education tax credit of \$1,000 is allowed. In addition to a \$3,650 exemption for each member of the family, a \$1,000 child tax credit for each child and a Making Work Pay credit for A and his wife are allowed.

Although A's pay was \$75,000, rising to \$95,000 with pre-tax benefits, his taxable income was only \$33,400 after subtraction of exclusions and deductions. The marginal tax rate on this amount would be 15 percent, for a tax of about \$4,200. After tax credits, A pays approximately \$400, which is 0.4 percent of his \$95,000 of income and benefits.

Table 1. Tax Treatment

Category	Item	Amount (\$)	Net (\$)
Income including benefits	Salary	75,000	95,000
	Retirement (employer match)	5,000	
	Health insurance (employer-provided)	13,000	
	Transit subsidy	2,000	
Exclusions	FSA	5,000	(30,000)
	Retirement (employer & employee parts)	10,000	
	Health insurance	13,000	
	Transit subsidy	2,000	
Deductions	Mortgage interest	10,000	(31,600)
	State, local, and property tax	5,000	
	Charitable contributions	2,000	
	Exemptions	14,600	
Taxable income	(15% marginal bracket)		33,400
Tax (rounded)			4,200
Credits	Child	2,000	(3,800)
	Education	1,000	
	Making Work Pay	800	
Net tax	(0.4% result)		400

**Example 2: SMALL BUSINESS OWNER**

Taxpayer B operates as a sole proprietor his own contracting business that grosses almost half a million dollars yearly, but after the costs of equipment and supplies, yields income of \$200,000 out of which he pays expenses such as wages, licenses, insurance, fees, and advertising of \$25,000. Late in 2010, B bought a new SUV of over 6,000 pounds that he drove solely for business that year. Under a provision for "bonus" depreciation, the full \$60,000 price is deductible. Because B's contracting business is considered to be a domestic production activity, he also can deduct about \$5,000 of "qualified production activities income." Through the business, B obtains health insurance for \$10,000 and puts away another \$10,000 for retirement (in a simplified employee pension plan known as a SEP). As a self-employed proprietor, B must pay about \$14,850 in self-employment (SE) tax, but half of this is deductible.

Mrs. B earns \$25,000 as a kindergarten teacher, buying classroom supplies out-of-pocket of which she can deduct \$250. The Bs pay \$10,000 in state, local, and property tax, \$10,000 in home mortgage interest, and \$5,000 in charitable contributions.

Although the Bs have income of \$200,000, the deduction of numerous tax expenditures brings them down into the 25-percent bracket (and the Alternative Minimum Tax does not apply to this situation). For income tax purposes, after an \$800 Making Work Pay credit, B pays about \$10,300, or 5 percent of the \$200,000. In addition, B pays about \$14,850 of SE tax (the counterpart to certain payroll tax on employees).

Table 2. Tax Treatment

Category	Item	Amount (\$)	Net (\$)
Income	Business income after expenses	175,000	200,000
	Salary	25,000	
Deductions	Bonus depreciation	60,000	(124,950)
	Domestic production	5,000	
	Health insurance (SE)	10,000	
	Retirement (SEP)	10,000	
	½ SE tax (rounded)	7,400	
	Schoolteacher expenses	250	
	State, local, and property taxes	10,000	
	Mortgage interest	10,000	
	Charitable contributions	5,000	
	Exemptions	7,300	
	Taxable income (25% marginal bracket)		
Income tax	(rounded)		11,100
Credit	Making Work Pay		(800)
Net tax	(5% result)		10,300

## Appendix A - 4

**Example 3: LOW INCOME SINGLE PARENT**

Taxpayer C is single with a child under 17. C earns \$10,000 from minimum-wage work, but also has received unemployment compensation of \$1,000. C is eligible for the standard deduction and two exemptions, which more than offset C's income. Moreover, C qualifies for several refundable credits – the Making Work Pay credit, the earned income tax credit and the additional child tax credit. The result is a "negative" tax paid to C by the U.S. government of about 40 percent of \$11,000.

Table 3. Tax Treatment

Category	Item	Amount (\$)	Net (\$)
Income	Wages	10,000	
	Unemployment compensation	1,000	11,000
Deductions	Standard	8,350	
	Exemptions	7,300	(15,650)
Taxable income	(10% marginal bracket)		-0-
Tax			-0-
Credits	Making Work Pay	400	
	Earned Income	3,050	
	Additional child	1,000	(4,450)
Negative tax	(-40% result)		(4,450)

## Appendix A - 5

**Example 4: RETIRED COUPLE**

Taxpayer D, age 70, is retired after a career in the public and private sectors (during which she paid into public and private retirement funds). Her husband, age 60, is blind. They receive Social Security benefits of \$24,000, the taxable portion of which is \$20,000. From former jobs, D receives public and private pensions of \$27,000. The IRS could determine the taxable portion for a \$1,000 fee, but as a financially educated professional, D is able to calculate the taxable portion at \$23,000. D receives tax-free municipal bond interest of \$1,000. Additionally, D owns a real estate investment that generates rent of \$5,000, which covers \$4,000 of mortgage interest and other operating expenses, but after depreciation, results in an allowable passive activity loss of \$1,000.

D takes a standard deduction of \$11,400 for a married couple filing jointly. D and Mr. D qualify for an \$1,100 additional standard deduction for the elderly and an \$1,100 additional standard deduction for the blind. They also take two \$3,650 personal exemptions.

Thus, D has income of \$45,000, less an exclusion of certain investment income, and finally reduced by deductions. Ultimately, the tax bill of \$2,300 is five percent of the incoming \$45,000.

Table 4. Tax Treatment

Category	Item	Amount (\$)	Net (\$)
Income	Social Security	20,000	
	Pensions	23,000	
	Muni-bond interest	1,000	
	Rent after operating expenses	1,000	45,000
Exclusion	Muni-bond interest	1,000	(1,000)
Deductions	Rental depreciation	2,000	
	Standard deduction	11,400	
	Additional standard deduction	2,200	
	Exemptions	7,300	(22,900)
Taxable income	(15% marginal bracket)		21,100
Tax (rounded)	(5% result)		2,300

# **APPENDIX B**

**TAX REFORM PRINCIPLES RECOMMENDED  
BY THE NATIONAL TAXPAYER ADVOCATE**

The National Taxpayer Advocate has recommended six core taxpayer-centric principles to help guide the development of tax reform legislation:

1. The tax system should not "entrap" taxpayers.
2. The tax code should be simple enough so that most taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistants can fully and accurately answer taxpayers' questions.
3. The tax code should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.
4. The tax code should provide some choices, but not too many.
5. Where the tax code provides for refundable credits, the credits should be designed in a way that the IRS can effectively administer.
6. The tax code should incorporate a periodic review of itself – in short, a sanity check.<sup>1</sup>

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<sup>1</sup> The National Taxpayer Advocate previously articulated these principles in a presentation to the President's Advisory Panel on Federal Tax Reform. See Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate). For additional detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-380 (Legislative Recommendation: *A Taxpayer-Centric Approach to Tax Reform*).

# APPENDIX C

**SIMPLIFICATION PROPOSALS RECOMMENDED  
BY THE NATIONAL TAXPAYER ADVOCATE**

Over the past decade, the National Taxpayer Advocate's Annual Reports to Congress have made numerous proposals to simplify various sections or areas of the tax code. While these proposals were not written with the goal of comprehensive structural tax reform in mind, they should be considered as part of an overall tax reform process. A summary of our key proposals follows:

**Repeal the Alternative Minimum Tax (AMT) for Individuals.** Few people think of having children or living in a high-tax state as a tax-avoidance maneuver, but under the unique logic of the AMT, that is essentially how those actions are treated. The AMT effectively requires taxpayers to compute their taxes twice – once under the regular tax rules and again under the AMT rules – and then to pay the higher of the two amounts. The regular rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing “double taxation” at the federal and state levels), but the AMT rules disallow those deductions. An estimated 77 percent of all additional income subject to tax under the AMT is attributable to the disallowance of deductions for dependents and state and local tax payments. The AMT computations are also extremely burdensome. The National Taxpayer Advocate has recommended that the AMT be repealed. Moreover, we note that if tax expenditures are substantially reduced, the AMT would be rendered largely irrelevant.<sup>1</sup>

**Consolidate the Family Status Provisions.** Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004, the tax code's family status provisions continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction. These provisions include filing status, personal and dependency exemptions, the child tax credit, the EITC, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b). Many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting

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<sup>1</sup> The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony since 2001. See National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (Legislative Recommendation: *Repeal the Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-177 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); see also *Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (March 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

audits into taxpayers' personal and private lives. The National Taxpayer Advocate has recommended that, as part of a comprehensive reform of the tax code's tax treatment of families, Congress consolidate the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Worker Credit would provide an incentive and subsidy for low income individuals to work.<sup>2</sup>

**Improve Other Provisions Relating to Taxation of the Family Unit.** The tax code currently imposes "joint and several liability" on married persons who file a joint federal income tax return. This concept dates back to the early years of the income tax when a husband was typically the sole wage earner for the family unit. Today, husbands and wives often have separate assets and incomes that they do not equally control. Recognizing that it is inequitable to hold one spouse liable for tax on the other spouse's income, at least in cases where he or she does not know about the income of the other spouse and does not significantly benefit from it, Congress has enacted relief rules. However, these relief rules are complex, do not always produce the right result, and impose a large burden on the "innocent spouse" to prove his or her case. The National Taxpayer Advocate has recommended several steps to improve equity and simplify the rules, including eliminating joint and several liability for joint filers.<sup>3</sup>

The "kiddie tax" rules are another family-related area of taxation that create significant burden for some taxpayers. The tax code currently taxes a minor child's unearned income above a certain threshold at the parent's tax rate. The parent must decide whether to file a separate return for the child or include the child's income on the parent's own return. The calculations required to determine which option is preferable in a particular case are complex. Moreover, if the child's parents are separated, additional complications arise. If a custodial parent has been designated, the child's income must be included on that parent's return. If no custodial parent has been designated, the law requires the tax to be computed by reference to the return of the parent with the greater taxable income. During a divorce proceeding, however, spouses sometimes conceal their assets or income from the other spouse, making compliance with these rules impractical. The National Taxpayer Advocate has recommended that the unearned income of minor children above a specified threshold be taxed at a higher rate and that the link between the computation of the child's tax liability and the parent's tax return be severed.<sup>4</sup>

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<sup>2</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 363-369 (Legislative Recommendation: *Simplify the Family Status Provisions*); National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach*).

<sup>3</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 407-432 (Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*); see also National Taxpayer Advocate 2001 Annual Report to Congress 128-165 (Legislative Recommendation: *Joint and Several Liability*).

<sup>4</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 231-242 (Legislative Recommendation: *Children's Income*).

**Consolidate Education Savings Tax Incentives.** The tax code contains at least 11 separate incentives to encourage taxpayers to save for and spend on education. The eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. However, taxpayers will only respond to incentives if they know they exist and understand them. Few, if any, taxpayers are aware of each of the education tax incentives and familiar enough with the particulars to make wise choices. The National Taxpayer Advocate has recommended that Congress consolidate incentives and harmonize definitions and other terms to the extent possible.<sup>5</sup>

**Consolidate Retirement Savings Tax Incentives.** The tax code contains at least 16 separate incentives to encourage taxpayers to save for retirement. These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. Similar to education incentives, the large number of options and lack of common definitions and terms can preclude taxpayers from making wise choices or understanding how each incentive works. The National Taxpayer Advocate has recommended that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses and governmental entities (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.<sup>6</sup>

**Simplify Worker Classification Determinations to Minimize Employee-versus-Independent Contractor Disputes.** The complexity of, and ambiguities in, the existing worker classification rules create uncertainty and lead to noncompliance. In general, businesses are only required to pay and withhold employment tax, withhold income tax, and provide benefits with respect to employees. Consequently, businesses often classify workers as independent contractors to reduce their costs. Some employees seeking to avoid their tax obligations may also prefer to be classified as contractors if the employer does withhold taxes or report the payments for employees to the IRS. Depending on the terms of the relationship between a business and a worker, however, many workers should be classified as independent contractors. The National Taxpayer Advocate has recommended that Congress (1) replace § 530 of the Revenue Act

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<sup>5</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 370-372 (Legislative Recommendation: *Simplify and Streamline Education Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 403-422 (Legislative Recommendation: *Simplification of Provisions to Encourage Education*).

<sup>6</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 373-374 (Legislative Recommendation: *Simplify and Streamline Retirement Savings Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 423-432 (Legislative Recommendation: *Simplification of Provisions to Encourage Retirement Savings*).

of 1978 with a provision applicable to both employment and income taxes and require the Secretary to issue associated guidance, including guidance with specific industry focus; (2) direct the IRS to develop an electronic tool to determine worker classifications that employers would be entitled to use and rely upon, absent misrepresentation; (3) allow both employers and employees to request classification determinations and seek recourse in the United States Tax Court; and (4) direct the IRS to conduct outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.<sup>7</sup>

**Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets.**

The tax code contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Tax sunsets make it difficult for both the government and taxpayers to plan ahead, especially when it is uncertain whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets make it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicate tax administration for the IRS, reduce the effectiveness of tax incentives, and may even reduce tax compliance. The National Taxpayer Advocate has suggested several ways for Congress to reduce or eliminate the procedural incentives to enact temporary tax provisions.<sup>8</sup>

**Eliminate (or Simplify) Phase-Outs.** More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer's income increases. There are, in fact, legitimate policy reasons for using phase-outs in certain circumstances. Like tax sunsets, however, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. Moreover, phase-outs are burdensome for taxpayers, reduce the effectiveness of tax incentives, and make it more difficult for taxpayers to estimate their tax liabilities and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance. Phase-outs also create marginal "rate bubbles" – income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively high income taxpayer. Because Congress could achieve a similar distribution of the tax burden based on income level by adjusting marginal rates, phase-outs introduce unnecessary complexity to the Code. The National Taxpayer Advocate has recommended that Congress repeal phase-outs or at least reassess them individually to ensure that they are necessary to accomplish their intended objective.<sup>9</sup>

<sup>7</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 375-390 (Legislative Recommendation: *Worker Classification*).

<sup>8</sup> See *id.* at 397-409 (Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*).

<sup>9</sup> See *id.* at 410-413 (Legislative Recommendation: *Eliminate (or Simplify) Phase-outs*).

**Streamline the Penalty Regime.** The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today. The last comprehensive reform of the tax code's penalty provisions was enacted in 1989, after careful study by Congress, the IRS, and others. Since then, legislative and administrative changes to the penalty regime have proceeded piecemeal, but without the kind of careful analysis conducted in 1989. The National Taxpayer Advocate has recommended that Congress direct the IRS to (1) collect and analyze more detailed penalty data on a regular basis and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. Congress should appropriate additional funds for this research, as necessary. In the meantime, based on penalty reform principles identified in 1989, the National Taxpayer Advocate recommended 11 steps that could be taken immediately.<sup>10</sup>

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<sup>10</sup> See *id.* at 414-418 (Legislative Recommendation: *Reforming the Penalty Regime*), and vol. 2, at 1-44 (Research Study: *A Framework for Reforming the Penalty Regime*).

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Chairman CAMP. Thank you very much.  
Mr. McDonald, your written statement is also part of the record;  
and you have five minutes. Thank you very much.

**STATEMENT OF ROBERT A. MCDONALD, CHAIRMAN OF THE BOARD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE PROCTER & GAMBLE COMPANY, CINCINNATI, OHIO, TESTIFYING IN HIS CAPACITY AS CHAIRMAN, FISCAL POLICY INITIATIVE OF THE BUSINESS ROUNDTABLE, WASHINGTON, D.C.**

Mr. MCDONALD. Chairman Camp, Ranking Member Levin, and distinguished Members of the Committee, my name is Bob McDonald; and I am the Chairman, President and Chief Executive Officer of the Procter & Gamble Company. I am here today in my capacity as Chairman of the Business Roundtable's fiscal policy initiative.

I appreciate the opportunity to discuss the importance of corporate tax reform to competitiveness, U.S. investment, and U.S. job growth. The world has changed dramatically since the basic operating rules of our international tax system were adopted. The spread of free markets around the world has opened up new opportunities for America's businesses and workers to sell their products to the 95 percent of the world's population that live outside the United States. At the same time, American companies and workers face heightened competition from foreign competitors as they seek out these new markets.

The time in which multinational corporation was synonymous with American corporation has long passed. As just one example, in 1960, the largest worldwide companies were nearly all American companies. U.S.-headquartered companies comprised 17 of the world's largest 20 companies. By 1985, there were only 13; and, by 2010, just 6 U.S.-headquartered companies rank among the top 20.

In this hypercompetitive environment, many factors can disadvantage American companies and cause them to lose out in this competition to the detriment of the U.S. economy and American workers. Taxes are a very important factor. American companies seeking to expand in markets at home and abroad are working with one of the least competitive tax systems in the world. Let me explain why.

As this slide shows, the United States has the second-highest corporate tax rate among advanced economies. After Japan adopts its proposed 5 percentage point corporate rate reduction this spring, the U.S. will have the highest corporate tax rate in the OECD, 14 percentage points above the average.

This next slide shows that it was not always the case that the U.S. tax system was so uncompetitive. In 1986, when the last major tax reform was undertaken, the U.S. went from among the highest corporate tax rates to among the lowest. But, since that time, the tax systems of the rest of the world have caught up and surpassed us.

As this next slide shows, the United States is also one of the few remaining advanced economies that taxes its companies on foreign earnings from active business operations when remitted home. Most other OECD countries have adopted territorial tax systems that largely exempt these active earnings from home country taxation.

Recently, both Japan and the United Kingdom have switched to territorial tax systems. They have chosen these territorial systems

to improve the competitiveness of their businesses and their economies.

This tilted playing field created by the U.S. tax system hurts the competitiveness of American companies and American workers. First, diminished sales around the world directly reduce U.S. exports of goods and services along with investments and jobs in the United States. Second, high taxes imposed on American companies that bring foreign earnings back to the United States discourage use of these funds to expand U.S. operations. Third, a high U.S. corporate tax rate on domestic profits discourages investment here in America by both U.S.-based and foreign-based companies. And, fourth, the highest price paid is paid by the American worker in the form of lower wages and a more slowly growing economy.

On behalf of the Business Roundtable, I look forward to working closely with this committee, the Congress, and the administration on this incredibly important issue.

Thank you, Chairman Camp.

[The prepared statement of Robert A. McDonald follows:]

**Testimony of  
Mr. Robert A. McDonald  
Chairman, Fiscal Policy Initiative  
Business Roundtable**

**Before the  
House Committee on Ways and Means**

**Hearing on Tax Reform**

**January 20, 2011**

**Overview**

Chairman Camp, Ranking Member Levin, and distinguished members of the Committee, I appreciate the opportunity to share the views of the Business Roundtable on this very important topic.

Business Roundtable is an association of chief executive officers of leading U.S. companies with nearly \$6 trillion in annual revenues and more than 12 million employees. Member companies comprise nearly a third of the total value of the U.S. stock markets and more than 60 percent of all corporate income taxes paid to the federal government. Annually, they pay \$167 billion in dividends to shareholders and the economy.

On behalf of the member companies of Business Roundtable, I appreciate your holding this hearing on tax reform and the invitation to appear before you to discuss the importance of corporate tax reform to competitiveness, U.S. investment, and U.S. job growth.

Today, the U.S. corporate tax system stands out as an outlier relative to the tax systems of our trading partners, imposing a high rate of tax on corporate income and maintaining other structural features that result in American companies being less globally competitive, reducing investment in the United States, and resulting in fewer jobs for American workers and a more slowly growing economy.

Done properly, tax reform can significantly enhance the growth of the U.S. economy and the well-being of Americans through increased investment, higher wages, and more jobs in the United States.

The world has changed dramatically since the basic operating rules of our international tax system were put in place some 50 years ago and since the last major overhaul of our tax system in 1986, 25 years ago. The spread of free markets around the world has opened up new opportunities for America's businesses to sell their products to the 95 percent of the world's population that live outside the United States. At the same time, American companies face heightened competition from foreign competitors as they seek out these new markets, and foreign competition is significantly stronger in our domestic market as well.

The enhanced competition American companies face both at home and abroad is evident in the data showing the growth of foreign direct investment around the world. Across all countries, cross-border foreign direct investment among all countries has expanded from less than 6 percent of the world's GDP in 1980 to 33 percent by 2009. But American companies comprise a much smaller share of this cross-border investment than they did 30 years ago. Whereas American companies accounted for 40 percent of world cross-border investment in 1980, they now account for less than 23 percent.

Not only is competition in foreign markets much greater than it was in the past, competition in the domestic U.S. market from abroad is also much stronger. In 1980, foreign direct investment into the United States was just 3 percent of GDP; by 2009 the stock of foreign direct investment in the United States had grown to 23 percent of GDP.

This intense global competition for consumers and new markets has resulted in a very different world for America's corporations and workers. In 1960, the largest worldwide companies were nearly all American companies -- U.S.-headquartered companies comprised 17 of the world's largest 20 companies. By 1985, there were only 13, and by 2010 just six U.S.-headquartered companies ranked among the top 20. The world is much more competitive for American companies and American workers than ever before.

In the hyper-competitive environment we face today, many factors can disadvantage American companies and cause them to lose out in this competition -- to the detriment of the U.S. economy and American workers. Taxes are a very important factor. American companies seeking to expand in markets at home and abroad are working with one of the least competitive tax systems among developed countries in the world. Why?

- Tax Rates: After Japan adopts its proposed five-percentage point corporate rate reduction this spring, the U.S. will have the highest corporate tax rate in the 34-member Organization for Economic Cooperation and Development, 14 percentage points above the average of the others.
- Tax Base: The United States is also one of the few remaining advanced economies that taxes its companies on foreign earnings from active business operations when remitted home. All other G-7 countries and most other OECD countries have adopted "territorial" tax systems that largely exempt these active earnings from home country taxation.
- Innovation Tax Policy: Once a leader in promoting innovation, the United States now ranks 24th out of 38 OECD and advanced emerging economies in terms of the competitiveness of its R&D tax incentives.

The tilted playing field created by the U.S. tax system hurts the competitiveness of American companies in the world's markets both at home and abroad. Diminished sales around the world directly reduce U.S. exports of goods and services, along with investment and jobs in the United States. High taxes imposed on American companies that bring foreign earnings back to the United States discourage use of these funds to expand U.S. operations. And a

high U.S. corporate tax rate on domestic profits discourages investment here in America by both U.S.-based companies and foreign-based companies. The highest price paid for the uncompetitive U.S. corporate tax system is paid by the American worker.

A growing body of research shows that the corporate income tax burden is borne in large part by labor in the form of lower wages, a result of reduced worker productivity due to the smaller amount of capital investment.<sup>1</sup> OECD research concludes that the corporate income tax has the most adverse effect on economic growth of any tax, lowering per capita GDP by more than any other tax.<sup>2</sup>

American companies with operations both at home and abroad are responsible for 63 million U.S. jobs. These companies directly employ 22 million American workers and they create an additional 41 million American jobs through their supply chain and the spending by their employees and their suppliers. It is estimated that worldwide American companies purchased \$1.52 trillion in supplies from U.S. small businesses alone in 2008. The ability of American companies to be competitive in both domestic and foreign markets is essential to the creation of well-paying American jobs and rising living standards.

Business Roundtable strongly supports tax policies that increase the opportunity of American companies and their workers to be competitive in markets at home and abroad. Business Roundtable believes that tax reform must increase the competitiveness of American companies in order to boost U.S. employment in the short term and to set the country on a strong path for long-term economic growth.

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<sup>1</sup> See, for example, William C. Randolph, "International Burdens of the Corporate Income Tax," Congressional Budget Office, August 2006; Kevin A. Hassett and Aparna Mathur, "Taxes and Wages," American Enterprise Institute, June 2006; and Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffini, "The Direct Incidence of Corporate Income Tax on Wages," Discussion Paper No. 5293, Institute for Study of Labor, Bonn Germany, October 2010. Reviews of the theoretical and empirical literature on the degree to which the incidence of the corporate income tax is borne by labor are provided in Rosanne Altshuler, Benjamin Harris, and Eric Toder, "Capital Income Taxation and Progressivity in a Global Economy," Tax Policy Center, May 12, 2010, and William M. Gentry, "A Review of the Evidence on the Incidence of the Corporate Income Tax," OTA Paper 101, U.S. Department of the Treasury, December 2007.

<sup>2</sup> See, Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, "Tax and Economic Growth," OECD Economics Department Working Paper No. 620, July 11, 2008, and Jens Arnold, "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries," OECD Economics Department Working Paper No. 643, October 14, 2008. Other OECD studies showing reduced investment and reduced productivity from high corporate taxes include Cyrille Schweltnus and Jens Arnold, "Do Corporate Taxes Reduce Productivity and Investment at the Firm Level? Cross-country Evidence from the Amadeus Dataset," OECD Economics Department Working Paper No. 641, September 30, 2008; and Laura Vartia, "How Do Taxes Affect Investment and Productivity? An Industry-Level Analysis of OECD Countries," OECD Economics Department Working Papers No. 656, December 19, 2008.

### **The U.S. Corporate Tax System Hinders U.S. Competitiveness**

The U.S. tax system is no longer competitive for American companies and American workers competing in a global economy. Specifically, the United States has a high corporate tax rate and an antiquated international tax system that together discourage investment in the United States, reduce U.S. production and U.S. exports, disadvantage American companies competing in foreign markets, and reduce U.S. wages.

A more internationally competitive corporate tax system would provide greater opportunities for American companies to succeed in world markets; boost domestic investment, production and exports of American-made goods and services; and result in more and higher wage jobs for American workers.

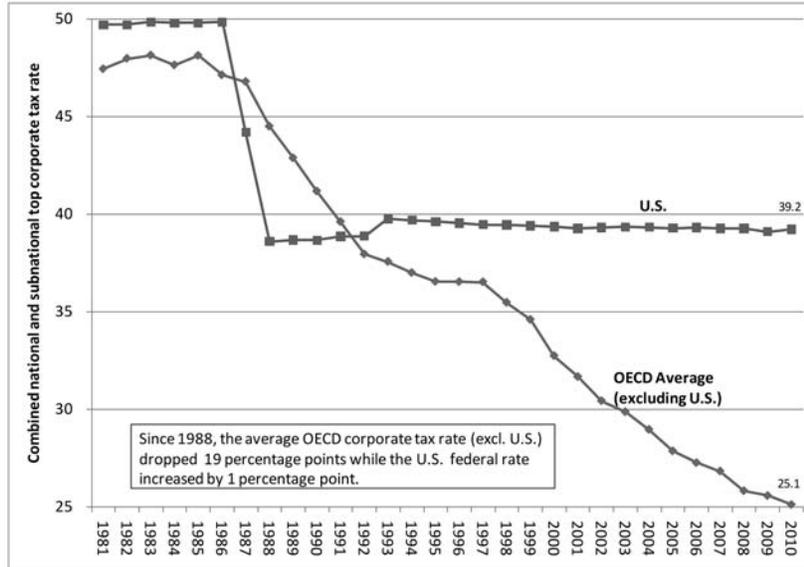
Let me highlight two of the ways in which our current corporate tax system inhibits growth of the U.S. economy: (1) the high U.S. corporate tax rate and (2) the method by which the United States taxes foreign earnings of American companies with global operations.

#### **1. Corporate tax rates**

In 1986, when the last major tax reform was undertaken, the U.S. went from among the world's highest corporate tax rates to among the lowest, reducing the federal rate from 46 percent to 34 percent. A principal objective of the 1986 reform was to lower marginal tax rates to promote economic growth by encouraging all income-producing forms of capital investment. Since 1986, there has been widespread recognition throughout the world of the importance of lower corporate tax rates to increase capital investment and promote economic growth. With increasing international mobility of capital, through both direct foreign investment and portfolio investment, the importance of corporate tax rates in competitiveness is multiple times greater than in 1986.

As shown in the accompanying figure (**Figure 1**, next page), corporate income tax rates in the rest of the OECD have fallen steadily since the 1986 U.S. reform. Since 1988, corporate rates in the rest of the OECD have fallen by an average of slightly less than one percentage point a year: falling from 44.5 percent in 1988 to 25.1 percent in 2010. By contrast, the U.S. corporate rate has actually risen in the United States since 1988, principally from a one percentage point increase in the federal corporate tax rate in 1993. In 2010, the U.S. federal and state combined corporate tax rate stood at 39.2 percent -- 14 percentage points higher than the 25.1 percent average rate of the other OECD member countries.

Figure 1.--Average OECD Member Country Corporate Tax Rate, 1981-2010



Source: OECD tax database; 2010 average includes reported tax rates for three members that acceded to the OECD in 2010 that are not yet included in the tax database. The U.S. rate is based on the 35-percent federal tax rate and average state taxes of 6.47 percent, which are deductible from federal taxes.

In 2010, the U.S. combined corporate tax rate was the second highest in the 34-member OECD, just fractionally lower than Japan's 39.5 percent rate (Table 1, next page). Japan has announced its intention to lower its corporate tax rate by five percentage points beginning in April 2011, at which time the U.S. will have the ignominious distinction of having the highest corporate tax rate among advanced economies in the world.

Table 1.--OECD Combined National and Sub-National Corporate Tax Rates, 2010

1	<b>Japan*</b>	39.5
2	United States	39.2
3	<b>France</b>	34.4
4	<b>Belgium</b>	34.0
5	<b>Germany</b>	30.2
6	<b>Australia</b>	30.0
7	<b>Mexico</b>	30.0
8	<b>New Zealand</b>	30.0
9	<b>Spain</b>	30.0
10	<b>Canada</b>	29.5
11	<b>Luxembourg</b>	28.6
12	<b>Norway</b>	28.0
13	<b>United Kingdom</b>	28.0
14	<b>Italy</b>	27.5
15	<b>Portugal</b>	26.5
16	<b>Sweden</b>	26.3
17	<b>Finland</b>	26.0
18	<b>Netherlands</b>	25.5
19	<b>Austria</b>	25.0
20	<b>Denmark</b>	25.0
21	<b>Israel</b>	25.0
22	<b>Korea</b>	24.2
23	<b>Greece</b>	24.0
24	<b>Switzerland</b>	21.2
25	<b>Estonia</b>	21.0
26	<b>Turkey</b>	20.0
27	<b>Slovenia</b>	20.0
28	<b>Czech Republic</b>	19.0
29	<b>Hungary</b>	19.0
30	<b>Poland</b>	19.0
31	<b>Slovak Republic</b>	19.0
32	<b>Chile</b>	17.0
33	<b>Iceland</b>	15.0
34	<b>Ireland</b>	12.5
	<b>OECD average, excluding U.S.</b>	<b>25.1</b>

Source: OECD tax database; 2010 average includes reported tax rates for three members that acceded to the OECD in 2010 that are not yet included in the OECD tax database. The U.S. rate is based on the 35-percent federal tax rate and average state taxes of 6.47 percent, which are deductible from federal taxes.

\* Note: Japan has proposed a 5-percentage point reduction in its tax rate to be effective in 2011 that would result in the United States having the highest combined national and sub-national corporate tax rate in the OECD.

Other countries in addition to Japan are also continuing to reduce their corporate tax rates. For example:

- The United Kingdom lowered its corporate tax rate from 28 percent to 27 percent in 2011, and over the next three years will further reduce it at a rate of one percent each year until it reaches 24 percent in 2014.
- Canada has lowered its federal rate in several stages from over 22 percent in 2007 to 18 percent last year, and will further reduce its rate to 16.5 percent in 2011 and 15 percent beginning in 2012.<sup>3</sup>

Lower U.S. corporate tax rates would attract investment to the United States and make American companies more globally competitive, boosting jobs and wages for American workers.

## **2. U.S. taxes on international operations**

In addition to a very high corporate tax rate, the United States also stands out from other OECD countries in its tax treatment of foreign earnings. Most OECD countries (27 of the 34) employ a "territorial" tax system under which their multinational companies pay foreign taxes to the countries in which they operate but pay little or no additional home country tax on their foreign earnings when remitted home as a dividend to the parent corporation. Under territorial tax systems, a multinational corporation operating in a particular country generally pays the same tax in that country as its local competitors.

In contrast, under the U.S. system of worldwide taxation, foreign subsidiary earnings are additionally subject to U.S. tax when remitted home to the U.S. parent. As a result, the earnings of a foreign subsidiary of a U.S. company bears additional tax when these earnings are remitted home to the U.S. that is not faced by a competitor headquartered in most other OECD countries. This additional tax burden faced by a U.S.-owned subsidiary makes American-owned companies less competitive in the local foreign market and, once an American company has made a foreign investment, the additional U.S. tax levied on dividend remittances discourages such payments and reduces the reinvestment of foreign earnings in the United States.

These additional taxes make American companies less competitive in competing for customers in foreign markets and ultimately harm U.S. workers and the U.S. economy.

In contrast to the perception of some that the foreign operations of American companies displace American workers, strong foreign operations of American companies have been

<sup>3</sup> Additional provincial level taxes also generally apply in Canada and are set by each province. For example, the Ontario provincial corporate income tax rates were 12 percent in 2010. These rates are scheduled to decline in 2011, 2012, and 2013, reaching 10 percent in 2013.

shown to increase exports from the U.S., increase investment in the U.S., and increase U.S. wages and U.S. employment.<sup>4</sup>

As our member companies can attest, the foreign subsidiaries of American companies serve as export platforms for U.S.-produced goods and services into foreign markets. The foreign operations of American companies expand employment of American workers by increasing the demand for U.S.-produced goods and services for export, including supplies of intermediate goods and services, ranging from raw materials to a broad range of services, research and development, design, marketing, finance, and logistics.

But the current U.S. tax system diminishes the ability of American-owned businesses to serve these foreign markets relative to companies headquartered elsewhere. As foreign-headquartered companies expand abroad, it is *their* domestic economies that receive the benefits of increased demand for their products and services. And as these foreign-headquartered companies expand and become stronger abroad, they also become stronger competitors in *our* U.S. domestic market. As a strong believer in market economics, I welcome every strong competitor whether domestic or foreign-headquartered -- but we should not seek to tip the balance in a fair competition by disadvantaging American companies through our own tax rules that limit their ability to grow and expand.

As shown below (**Table 2**, next page), the combination of a high U.S. corporate tax rate and an unfavorable international tax system results in American companies facing the highest tax rate in the OECD on foreign earnings remitted home. Twenty of the 27 OECD countries with territorial tax systems have a 100 percent exemption on foreign dividends remitted home resulting in no additional home country tax. The other seven territorial countries exempt from 95 percent to 97 percent of foreign dividends from taxation. For example, a Japanese company repatriating foreign earnings from one of its foreign subsidiaries would face approximately a 2 percent tax on such remittances (i.e., 5 percent of the dividend taxed at approximately 39.5 percent), the highest tax rate of any territorial country.

Of the seven OECD countries that tax worldwide income, the United States has the highest tax rate at 39.2 percent. The other six OECD countries without territorial tax systems -- Chile, Ireland, Israel, Mexico, Poland, and South Korea -- have much lower tax rates and, excluding Ireland (which has a 12.5 percent tax rate), undertake little foreign investment (together accounting for less than 2 percent of the world's outward foreign direct investment in 2009).

Our major trading partners have adopted tax systems that give their multinational companies the most competitive access to consumers in every market in the world and the ability to return foreign earnings for reinvestment in their home country without facing additional tax. In just the past two years, both Japan and the United Kingdom have switched to territorial tax systems. They have explicitly chosen these territorial systems to improve the competitiveness of their economies and provide more and better paying jobs for their workers.

<sup>4</sup> See, for example, Mihir Desai, C. Fritz Foley, and James R. Hines, Jr., "Domestic Effects of the Foreign Activities of US Multinationals," *American Economic Journal: Economic Policy*, February 2009.

Table 2.--OECD Home Country Method of Tax on Foreign-Source Dividends

Method of Taxation	Countries	Dividend Exemption Percentage	
<b><u>Territorial Tax Systems</u></b>	<b>OECD Countries with Territorial Tax Systems</b>		
<b>Exempt foreign-source dividends from domestic taxation through territorial tax system<sup>1</sup></b>	Australia, Austria, Canada, Czech Republic, Denmark, Estonia, Finland, Greece, Hungary, Iceland, Luxembourg, Netherlands, New Zealand, Portugal, Slovak Republic, Spain, Sweden, Switzerland, <sup>2</sup> Turkey, United Kingdom	100% exemption	
	Norway	97% exemption	
	Belgium, France, <sup>3</sup> Germany, Italy, Japan, Slovenia	95% exemption	
<b><u>Worldwide Tax Systems</u></b>	<b>OECD Countries with Worldwide Tax Systems</b>		
	<b>Country</b>	<b>2010 Tax Rate<sup>4</sup></b>	
<b>Worldwide system of taxation with foreign tax credit</b>	Chile	17.00%	0% exemption
	Ireland	12.50%	0% exemption
	Israel	25.00%	0% exemption
	Korea	24.20%	0% exemption
	Mexico	30.00%	0% exemption
	Poland	19.00%	0% exemption
	<b>United States</b>	<b>39.21%</b>	<b>0% exemption</b>

<sup>1</sup> In general, territorial tax treatment providing exemption of foreign-source dividends depends on qualifying criteria (e.g., minimum ownership level, minimum holding period the source country, and/or the source country tax rate).

<sup>2</sup> The effective exemption may be reduced by up to 5% as a proxy for general and administrative expenses.

<sup>3</sup> The exemption percentage is at least 95%, but can be higher.

<sup>4</sup> Refers to generally applicable tax rate, including surcharges, of combined central and sub-central government taxes.

Source: Business Roundtable, "Roadmap for Growth"

**Conclusion**

Since the last comprehensive reform of corporate taxes took place over 25 years ago in 1986, the world has changed. American companies and American workers face a far more competitive global economy. But these changes have also brought opportunities for American companies who are now able to reach consumers in every part of the world, greatly expanding the market for American-made goods and services.

We now need to make sure the United States has a tax system that is in keeping with the more globally competitive environment we face today. American companies produce the most innovative products in the world and -- given a level-playing field -- will go head-to-head against any competitor. But if we are handicapped by an uncompetitive corporate tax system, we will slow the growth of the U.S. economy to the benefit of our competitors.

On behalf of Business Roundtable, I look forward to working closely with this Committee, the Congress, and the Administration to develop bipartisan proposals for a competitive corporate tax system consistent with the realities of today's global markets. A competitive corporate tax system will result in more and better paying jobs, attract and increase U.S. investment, and set the nation on a path for strong and sustained economic growth.

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Chairman CAMP. Thank you very much, Mr. McDonald.  
Mr. Hudak, you also have five minutes; and your written statement will be part of the record.

**STATEMENT OF WARREN S. HUDAK, PRESIDENT, HUDAK AND COMPANY, LLC, NEW CUMBERLAND, PENNSYLVANIA**

Mr. HUDAK. Good morning, Chairman Camp, Ranking Member Levin, and Members of the Committee. I am pleased to be here as a small business owner and as a tax professional assisting small businesses.

My business, Hudak and Company, provides a full range of tax services for small businesses, so I know firsthand the challenges that my clients and our company face in complying with the Tax Code. The complexities of the Tax Code are especially onerous on small businesses. They can't afford staffs, HR staffs, tax professionals on hand. They have to outsource all of that at a tremendous price. They spend about 1.9 billion hours \$19 million in costs in complying with the Tax Code. It is a staggering amount of money.

I am also a member of NFIB, which has 350,000 members; and we recently surveyed our members. Two of the top, top priorities for small businesses is the Federal Tax Code and its complexity.

One thing to be very sure of from a small business perspective, the business can't be separated from the owner. Most small businesses are structured as a pass-through company. The earnings are taxed at the individual company rate. They select this for simplification. It is a simplified way of being able to understand their taxes.

The best example I can give in understanding the small business is two examples from this year. We had two companies that were getting ready to retire, they wanted to use—they counted on their business to be their retirement plan. They were regular corporations and in order to avoid the double taxation of C Corp they switched to an S Corporation. Because of the onerous 10-year built-in capital gain provision, they actually lost 50 percent of all of their earnings that they worked their whole life for, 18 hours a day. Some of these businesses are second generations and losing that kind of money is staggering, preventing them from investing in other business, starting a new venture, pursuing a new idea; and for one owner it meant he had to continue working into retirement. So we are all struggling with the Tax Code.

To speak to the complexity of the Tax Code, the IRS recently sent out a postcard to all small business owners saying they were no longer going to accept payroll taxes to be remitted using a paper voucher. They were no longer allowing them to submit that. And some of my most sophisticated clients, who have been clients for a long period of time, e-mailed me and said, what have we been doing wrong? Why did I get this notice? They didn't even understand the very nature of the notice.

What was even more mind-blowing for me was the fact that we have always submitted their taxes electronically. For 8, 9 years we have been submitting their taxes electronically. To get a simple postcard in the mail saying we will no longer accept paper vouchers and they are panicked, what are we doing wrong, what is going on. They didn't understand the very fact that we were already doing it electronically.

That is a very simple example of the misunderstanding about what is actually going on. My clients, as hard as we try, try to get

them to understand the Tax Code, this leads to terrible compliance problems. The Tax Code definitely has to be simplified.

Thank you.

[The prepared statement of Warren S. Hudak follows:]

Testimony of Warren Hudak  
President, Hudak and Co.

House Ways and Means Committee  
Examining the Burdens Imposed by the Current Federal Tax System and  
the Need for Reform

January 20, 2011

Good morning, Chairman Camp, Ranking Member Levin, and members of the Committee. I am pleased to be here both as a small business owner and as a tax professional assisting small businesses.

My business, Hudak and Co, provides a full-range of tax services for small businesses, so I know first-hand the challenges that my clients and our company face in complying with the tax code. The complexities of the current tax code are especially onerous on small businesses. I appreciate that the Committee is interested in hearing from an active tax professional who has worked with numerous small business owners to get the help they needed to keep up with the changing federal tax laws.

In addition, I am a member of the National Federation of Independent Business (NFIB), the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. The results of the most recent NFIB Research Foundation's Small Business Problems and Priorities survey shows the challenges the tax code presents for small businesses. Four of the top ten issues identified in the survey are tax-related. Specifically, federal taxes ranked third and tax complexity ranked fifth.<sup>1</sup>

The results of surveys like this, as well as the tax issues raised by small business clients like mine, demonstrate the need for tax reform. In addition, a less complicated tax code would reduce the cost of doing business and create a stronger business environment supporting the overall economy. Beginning the conversation early in this new Congress is a good first step.

Small businesses face particular challenges when complying with the tax code and they are unique to the structure and function of a smaller business. Small businesses are not miniature versions of larger corporations. While tax laws impact each small business differently, there are two general principles to keep in mind when considering taxes and small businesses. First, the business and the business owner cannot be separated and second, the tax code is too complicated.

#### **The Business and the Business Owner Cannot be Separated**

No matter what business entity the small business owner chooses, you cannot separate the business owner from the business. The majority of small businesses are organized as pass through entities, with nearly 75-percent choosing a pass through business structure.<sup>2</sup>

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<sup>1</sup> William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC series.

<sup>2</sup> Firms of all size responded that 20.9-percent organized as sole proprietors, 5.8-percent as partnerships, 25.6-percent as C-Corps, 30.9-percent as S-Corps, 12.4-percent as LLCs, and 4.2-percent as other/DNK. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 4, Issue 7, 2004.

Pass through businesses play an important role in the economy and have been a growing source of entrepreneurship. From 1985 to 2005, the number of S Corps increased from 725,000 to 3.7 million and from 1993 to 2005 the number of LLCs taxed as partnerships grew from 17,000 to almost 1.5 million.<sup>3</sup> Many of these are small businesses, which account for about 50 percent of GDP and 50 percent of employment in the overall economy.<sup>4</sup>

Business entities are chosen for different reasons. Entities such as sole proprietorships and S-Corps can ensure that a small business is not overburdened with extra layers of taxation. In other cases, entities like C-Corps, S-Corps, and LLCs can protect the business owner from personal liability. While the variety of business entities may lead to additional rules in the code, various models provide the business owner with more flexibility to organize their business in a way that best suits the needs of the business. The structures allow the business owner to make decisions based on the fundamentals of their business. If the business grows or changes, the different entities allow the business owner to adapt so that the business continues to operate effectively.<sup>5</sup>

The tax implications of choosing a pass through entity should play a major role in the tax reform debate. Discussions about tax reform are often coupled with a discussion about lowering the corporate tax rate. There is certainly an argument to be made that the corporate tax rate is too high, especially relative to the rest of the world, and the corporate provisions of the tax code are filled with complexity. But it is necessary to recognize the important role played by small businesses and the impact they have on the economy. The pass through rules helped to spur entrepreneurship, partially because of the tax treatment afforded to these business entities. That is why keeping in mind the importance of the individual tax rates that most small businesses pay should be part of any debate about tax reform.

Congress should also closely examine the rules governing pass through entities to determine if they need to be updated or simplified. The tax rules governing these business entities should not drive economic decisions. For example, some S Corp owners who either switched business entities or purchased another business are forced to hold onto certain assets known as built-in gain assets for up to 10 years.<sup>6</sup> The idea of the holding period is to avoid certain abuses, but the current rules mean that a business may be sitting on a productive asset for a decade.

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<sup>3</sup> *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper*, U.S. Department of the Treasury, July 23, 2007.

<sup>4</sup> *How Important is Small Business to the U.S. Economy*, Frequently Asked Questions, SBA Office of Advocacy. (<http://www.sba.gov/advocacy/7495/8420>).

<sup>5</sup> Small businesses rarely change their business structure, with only about seven-percent of businesses making a change. The main two reasons why businesses changed entities were liability protection and taxes respectively. The change is usually made in response to a major change in the business itself. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 4, Issue 7; 2004.

<sup>6</sup> 26 U.S.C. 1374.

While the pass through rules help many small business owners and entrepreneurs, one area of the pass through rules problematic to these owners is the tax treatment of health insurance. The value of health insurance is not excludable from income for the self employed as it is for employees or owners of C Corps. This creates an inequity for many small business owners and increases the complexity of the code. In the Small Business Jobs Act, Congress provided a one-year of equal tax treatment for the self employed, but only for 2010.<sup>7</sup>

### **The Tax Code is Too Complicated - Keep It Simple**

Small businesses spend annually between 1.7 billion to 1.8 billion hours on tax compliance and \$18 billion to \$19 billion on compliance costs.<sup>8</sup> The result is that 88 percent of small business owners now hire a paid tax preparer to complete their returns.<sup>9</sup> Small business owners also spend on average \$74.24 per hour on the paperwork associated with tax compliance – the highest paperwork cost imposed on small business by the federal government.<sup>10</sup>

This is exactly what I see in my own business. My average client employs about 10 workers and their average tax return is more than 50 pages long.

The complicated and, in many ways unpredictable tax code, places a heavy burden on small business owners. Unlike a larger business, small businesses generally do not have a finance department or a staff of accountants and lawyers to focus on the nuances and changes in the tax laws. Ultimately, this leads to additional costs and takes money away from the day-to-day business operations or investing in and expanding the business.

The confusing tax code leads to more errors. The vast majority of small business owners try to comply with their tax obligations, but a direct correlation exists between the ability to comply and small business owners actually meeting their tax obligations.

### Key Challenges Facing Small Business

First, too many provisions in the tax code are temporary, adding to the confusion and complexity of the code. In fact, in the NFIB Problems and Priorities survey “frequent changes in the federal tax laws” was noted as one of the top tax problems. The Alternative Minimum Tax (AMT) is an example of this problem. For the past few years, Congress has provided taxpayers, many of whom are small businesses, with relief from the AMT. Unfortunately, this relief was not finalized until the end of the year. Delaying

<sup>7</sup> Section 2402 of the Small Business Jobs Act of 2010; P.L. 111-240

<sup>8</sup> Donald DeLuca, Scott Silmar, John Guyton, Wu-Lang Lee, and John O'Hare, “Aggregate Estimates of Small Business Taxpayer Compliance Burden,” Proceedings of the 2007 IRS Research Conference.

<sup>9</sup> *Tax Complexity and the IRS – NFIB Small Business Poll*; NFIB Research Foundation; Washington, DC, Volume 6, Issue 6, 2006.

<sup>10</sup> *Paperwork and Record Keeping – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 3, Issue 5; 2003.

such relief prevents taxpayers from knowing what their liability will be and, when passed late in the year, adds to the tax filing burden.

Section 179 expensing is another example of uncertainty in the tax code. Congress has continued to change the allowable amount of section 179 expensing and the current rules are set to expire in 2012. Expensing simplifies the tax code for small business. Instead of following complicated depreciation schedules and keeping the paperwork associated with the investment, the business owner can simply claim the deduction in the year the investment is made. Expensing simplifies the deduction for allowable business investments and puts money back into the business faster. If Congress fails to act, expensing will be reduced to \$25,000. Setting the expensing limit permanently at \$125,000 (adjusted for inflation) would provide businesses with the ability to plan when making investments.

Second, Congress should not make tax filing more complicated and add to the already high paperwork burden. The expanded 1099 reporting requirements included in the Patient Protection and Affordable Care Act (PPACA) demonstrates what not to do.<sup>11</sup> In an attempt to find additional revenue, PPACA created a major new reporting requirement on small businesses. This new requirement means that small businesses will have to report annually on all transactions that cumulatively exceed \$600. This is a massive new paperwork and reporting requirement making complying with the tax code more complicated and expensive. The new reporting requirement should be repealed.

Third, provisions of the code should not be so onerous that taxpayers avoid them. This is the case with the home office deduction. Home-based businesses are one of the fastest growing areas of small businesses, but the current deduction is especially complicated requiring the business owner to determine how much of the home is used for business and to keep detailed records to substantiate the deduction. The one-page form used to claim the deduction refers the taxpayer to the instructions 13 times.<sup>12</sup> Many small business owners avoid the deduction because of the complications and the fear of a potential audit.<sup>13</sup>

Finally, the complexity of the tax code too often drives business decisions. My clients do not think strategically about their business, but tactically because the tax code forces them in that direction. The tax code rewards consumption and debt financing, as opposed to capital formation and saving. Savings and investments are often double taxed and many tax incentives are too complicated or arbitrary. Any examination of the tax code must consider the kinds of incentives currently in the code and what kind of tax laws would best promote sound economic and business decisions.

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<sup>11</sup> Section 9006 of the Patient Protection and Affordable Care Act.

<sup>12</sup> IRS Form 8829, Expenses for Business Use of Your Home.

<sup>13</sup> Only 27% of businesses located in the home and 36% of businesses with a primary office in the home claimed the deduction. The top reasons for not claiming the deduction were that the it was too complicated or they were advised against it for fear of an audit. *Business Activity in the Home – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 8, Issue 4; 2008.

### Conclusion

Small businesses are a major source of economic activity and job creation in the economy. But small businesses have struggled to recover from the recession. The most recent NFIB Small Business Economic Trend Survey (SBET) shows that many small businesses are still struggling, although they are more confident that conditions will improve. Fundamental tax reform is one way that Congress can create an economic environment which helps small businesses to thrive. By improving our tax system, Congress can address a constant concern of small businesses, reduce the cost of doing business, and create a tax system that will support economic growth.

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Chairman CAMP. Well, thank you very much.  
Dr. Hassett, you also have 5 minutes; and your written statement will be part of the record. Welcome.

**STATEMENT OF KEVIN A. HASSETT, PH.D., SENIOR FELLOW  
AND DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN  
ENTERPRISE INSTITUTE, WASHINGTON, D.C.**

Mr. HASSETT. Thank you very much, Chairman Camp. Ranking Member Levin is not here, so perhaps Mr. Rangel is the highest ranking. But thank you so much for having me here. It is a real pleasure and honor to be here and to talk to you about this important topic.

The first part of my testimony discusses recent research by Carmen and Vincent Reinhart that looks at the long-run economic impact of a financial crisis. They find that one can expect to have slower growth for a good long period after a financial crisis, perhaps as long as a decade. And if we have the typical experience of an economy after a severe financial crisis, then we will grow about a percent a year slower over the next 8 years, and the unemployment rate 8 years from now will be about 8 percent. This is an unacceptable outcome to everyone.

But I note at the outset of my testimony that this is a medium-term problem, and a short-term stimulus is of little use. More fundamental changes must be considered, which is why I celebrate this hearing.

The first part of my testimony talks about the complexity of the Tax Code. It provides a chart of the marginal tax rates under the current system that account for all of the phase outs, for all of the different targeted tax policies that we have. It shows that the marginal tax rate as we go up with income goes up and down sort of like a city skyline.

Now, progressives generally favor tax rates that increase with incomes and others favor rates that are flat across incomes. And I don't think anybody thinks that the marginal tax rate schedule should look like a city skyline, but that is what we have. This is really logically indefensible and the reason why fundamental tax reform could have a very large impact.

Now, sound reform should not only fix the rates but also should reform the definition of the tax base as well. If we do this, we can accomplish a lot.

A well-designed reform could easily produce significant growth effects. Just to sketch the terrain, a survey of 69 public finance economists conducted by Victor Fuchs, Alan Krueger, and James Poterba in 1998 found that the median of respondents believed that the 1986 tax reform produced about 1 percentage point of higher growth over a long period. My review of the literature with Alan Auerbach suggested that this is a consensus that is a fair reading of the broader tax reform literature.

Now, there are many possible reforms that would broaden or modify the base, but the key point is that they can conceivably have effects that are just about big enough to offset the growth shortfall that we have inherited because of the financial crisis.

In the first part of my system, I make these points, but then I move on to look specifically at the case of the corporate tax. While there is a broad consensus that the high statutory corporate tax in the U.S. makes investments in the U.S. uncompetitive relative to other OECD economies, some question the extent to which effective taxes paid by corporations are equally high.

As there will be much discussion of these factors in coming months, the remainder of my testimony looks specifically at the question of effective rates. I begin with the statutory rate analysis that is very similar to what you have just seen. The statutory rate, though, is an imperfect measure of tax competitiveness, because it does not take into account the breadth of the tax base. This causes countries with high rates and a narrow base, such as the United States, perhaps to appear more uncompetitive than they really are. Effective tax rates resolve this issue by taking into account offsets, the present value, depreciations, and other deductions that narrow the base.

There are two measures of effective rates that are really the industry standard, the effective average tax rate, which you can think of as being the rate that affects something like a plant location decision, and the effective marginal rate, which affects decisions like should I buy a new machine for the plant that is already there.

Now, in the forthcoming study that I have done with my colleague, Aparna Mathur, we looked at national rankings of statutory rates and of these effective rates. Our analysis finds that the United States' performance in the global economy does not look much better when scored with effective rates than when scored with top statutory rates.

In 2010, for example, the U.S. effective average rate, which is again the rate that is marginal when you are trying to locate a plant somewhere, was 29 percent, while the average for all OECD economies was 20.5 percent. This is the second-highest effective average rate in the OECD. The United States compares slightly more favorably to other OECD countries when we look at the effective marginal rate, which is the rate which influences the decision to buy a machine.

Even with the effective marginal rate, however, we are not doing so well. In 2010, the U.S. effective marginal tax rate was 23.6 percent relative to the non-U.S. OECD average of 17.2 percent. This was the fifth-highest in the OECD.

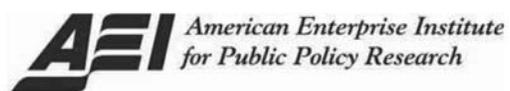
Any discussion of tax rates is incomplete without analysis of trends in corporate tax revenues. With one of the highest corporate tax rates in the world, one might expect the share of revenues from corporate capital to be higher in the U.S. than other OECD economies, but this is not the case. In fact, in the U.S., our revenue is lower than the OECD average.

This pattern is consistent with the literature that explores the responses of tax revenue to changes in the corporate rate. Alex Brill and I found significant evidence that a reduction of the corporate tax rate in the U.S. would increase the corporate tax revenue by looking at the changes in revenue in response to other nations' reductions in corporate rates. There is a large literature that generally finds a Laffer curve in the corporate tax base.

Given the significant headwinds that the economy faces, the indefensible state of the current Code, and the horrifyingly high U.S. corporate tax rate, I am glad we are considering reform at this moment.

Thank you.

[The prepared statement of Kevin A. Hassett follows:]



Testimony before the House Ways and Means Committee  
Regarding the Importance of Comprehensive Tax Reform

Kevin A. Hassett  
Director of Economic Policy Studies  
American Enterprise Institute  
January 20, 2011

*The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.*

Chairman Camp, Ranking Member Levin, and members of the committee, it is an honor to appear before you to discuss the need for comprehensive tax reform.

In the wake of the recent financial crisis, Americans are hopeful that the economy will return to normal, and policy makers are rightly seeking ways to hasten this restoration. Everyone is disappointed with the recovery so far, and the sad fact is that this disappointment was predictable. It is normal for recessions that are accompanied by a financial crisis to linger uncomfortably long.

According to a study last summer by Carmen and Vincent Reinhart (2010), absent significant policy changes, we shouldn't expect the economy to fully rebound for quite some time.<sup>1</sup>

Reinhart and Reinhart examined economic indicators in the ten years preceding and following the fifteen most severe financial crises in modern history. Their findings (summarized in Table 1), suggest that economic growth for the rest of this decade will be about one percentage point slower than we have grown accustomed to. This slow growth has a real human cost. Fully a decade after the typical financial crisis, the unemployment rate remained about double what it was before the crisis. That means that we should expect the policy status quo to give us an unemployment rate eight years from now that is still above 8 percent.

As we look in this new Congress for areas of agreement between the parties, let us begin by stipulating that the status quo is unacceptable to everyone. I would add that we should also stipulate that this low-growth baseline is a medium-term problem. It will take years for Americans to do the hard work of digging out from the mess we are in. Thus, a short-term stimulus is of little use, and more fundamental changes must be considered.

To skip to the conclusion of my testimony, amidst all this bad news, there is some good news as well. We can do much to speed up the economic recovery process, indeed the literature on fundamental tax reform suggests that a well-designed reform could deliver about a percent a year of extra growth over the next decade, offsetting the handicap that is the residual of the financial crisis.<sup>2</sup>

#### **The Tax Reform Opportunity**

As April 15<sup>th</sup> approaches each year, taxpayers are frustrated by the complexity of our current income tax system. With its various rates, credits, and phase-outs it's difficult for the average person to understand what their marginal tax rate really is. Illustrating this point, Figures 1 and 2 (from Hassett, Lindsey, and Mathur 2009) show the marginal tax rates for those filing married or single with two children.<sup>3</sup>

Now progressives generally favor tax rates that increase along with incomes. Others favor rates that are flat across incomes. Nobody I know thinks the marginal tax rate schedule should look like a city skyline, but that is what we have. This is logically indefensible and a national embarrassment. Through comprehensive tax reform, the system could be streamlined to improve taxpayers understanding (helping them make rational choices) and remove distortions that hamstring economic growth.

A sound reform should not only fix our rates, but also should reform the definition of the tax base as well.

Let's begin with an idea that everyone accepts: the government should try to minimize distortions to relative prices and try not to have a heavy tax on apples, with no tax on oranges.

Consider the following illustration from a volume on fundamental tax reform that I edited in 2005 along with my colleague Alan Auerbach of UC Berkeley:<sup>4</sup>

<sup>1</sup> Vincent Reinhart and Carmen Reinhart, "After the Fall," (paper presented at the annual Federal Reserve Bank of Kansas City conference, Jackson Hole, Wyoming, August 17, 2010).

<sup>2</sup> Victor R. Fuchs, Alan B. Krueger, and James M. Poterba, "Economists' Views about Parameters, Values, and Policy: Survey Results in Labor and Public Finance," *Journal of Economic Literature* 36 (3): 1387-1425.

<sup>3</sup> Kevin A. Hassett, Lawrence B. Lindsey, and Aparna Mathur, "Moving Toward a Unified Credit for Low-Income Workers," *Tax Notes*, August 10, 2009: 589-602.

<sup>4</sup> Alan J. Auerbach and Kevin A. Hassett, *Toward Fundamental Tax Reform*, (Washington, DC: AEI Press, 2005), 6.

Think of consumption today as being represented by apples, and consumption ten years from now as oranges. If you give up an apple today, you get a number of oranges ten years from now that depends on the interest you get on the money you saved by not eating the apple. At 10 percent interest, a dollar saved today becomes \$2.60 ten years from now. If we tax that interest at 50 percent, a dollar saved today only yields \$1.63 ten years from now.

This distortion grows bigger and bigger with the time horizon. Under the same assumptions, one dollar saved today produces \$17.45 thirty years from now, but only \$4.32 if the interest is taxed. Since it is not efficient for the tax system to create big changes in relative prices, and compounding is, as Einstein said, "the most powerful force in the universe," reform efforts should promote efficiency by minimizing taxes to capital income.

While a consensus has emerged in the literature that consumption-based taxes are more efficient than income-based taxes, there is less agreement on how much this inefficiency costs the American economy and how much of this cost could be eliminated by changing the tax structure.

Finally, I should add that these distortions could well be a big deal, and a well-designed reform could easily produce significant growth effects. Just to sketch the terrain, a survey of 69 public finance economists conducted by Victor Fuchs, Alan Krueger, and James Poterba (1998) found that, at the median, respondents believed that the 1986 tax reform produced about one percentage point higher growth over a long period.<sup>5</sup> My review of the literature with Alan Auerbach suggested that this consensus is a fair reading of the broader tax reform literature.<sup>6</sup>

There are many possible reforms that would broaden and/or modify the base and then lower marginal rates. The key point is that they can conceivably have effects big enough to offset the growth shortfall that results from the financial crisis.

#### **The Case of the Corporate Tax**

In the previous section, I argued that the case for reform could easily be made by highlighting the inefficiency of our current system. In this section, I provide another motivation for major surgery to the tax code: our corporate tax is now a worldwide outlier, and has become the economic equivalent of the ball and chain.

A study published in 2010 by the Organization for Economic Cooperation and Development (OECD) reviewed tax policy reform across OECD nations and listed recommendations based on that experience. The study concluded that, "The analysis suggests a tax and economic growth ranking order according to which corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable property being the least harmful."<sup>7</sup>

Given this, and the general observation that fundamental reform would be most beneficial if we moved toward consumption taxation, I will digress and discuss in a little more detail the case for corporate tax reform specifically.

While there is broad consensus that the high statutory corporate tax rate in the U.S. makes investments in the U.S. uncompetitive relative to other OECD economies, some question the extent to which *effective* taxes paid by corporations are equally high. As there will be much discussion of these factors in coming months, I turn to providing some hard data. To skip to the conclusion, even if one looks at effective rates, the U.S. is in a bad spot.

#### **Statutory Tax Rates**

The top national statutory corporate tax rates in 2010 among the 31 members of the OECD ranged from 8.5 percent in Switzerland and 12.5 percent in Ireland to 35 percent for the U.S (see Table 2).<sup>8</sup> Hence within the OECD countries, the U.S. has the highest statutory rate of taxation at the national level.

<sup>5</sup> Victor R. Fuchs, Alan B. Krueger, and James M. Poterba, "Economists' Views about Parameters, Values, and Policy: Survey Results in Labor and Public Finance," *Journal of Economic Literature* 36 (3): 1387-1425.

<sup>6</sup> Alan J. Auerbach and Kevin A. Hassett, *Toward Fundamental Tax Reform*, (Washington, DC: AEI Press, 2005), 150.

<sup>7</sup> *OECD Tax Policy Studies: Tax Policy Reform and Economic Growth* (OECD Publishing, 2010), 10.

<sup>8</sup> "OECD Tax Database," <http://www.oecd.org/ctp/taxdatabase>.

The picture changes only marginally when we add the sub-national corporate tax rates to the top national rate. In the case of the United States, the average top statutory rate imposed by states in 2010 added just over 4 percent (after accounting for the fact that state taxes are deducted from federal taxable income)—for a combined top statutory rate of 39.2 percent. Among all OECD countries in 2010, the United States' top statutory combined corporate tax rate was the second highest, after Japan's at 39.5 percent. In 2011, the United States will be left with the highest national and combined corporate tax rates in the world when Japan introduces a planned 5 percentage point reduction to its top rate.

Top combined statutory rates amongst OECD countries have fallen from an average of about 48 percent in the early 1980s to 25.5 percent in 2010 (see Figure 3). The main wave of reforms occurred in the mid to late 1980s but has continued in the 1990s and through the 2000s. In fact, the OECD average fell almost 9 percent in the first decade of the 21<sup>st</sup> century. The U.S., on the other hand, has not reduced its top statutory rate since 1993.

If we look at the frequency distribution of countries (using a kernel estimator) at different tax rates in 1981, 1996 and 2010, we can see a striking change in the U.S. position relative to other OECD countries (see Figure 4).<sup>9</sup>

In 1981, the bulk of OECD countries had an average combined tax rate of slightly above 47 percent.<sup>10</sup> The U.S. rate was about 3 percentage points higher than that, at 50 percent. In 1996, the U.S. tax rate was close to the average for the bulk of OECD countries, at approximately 39 percent. However, in 2010, with no change in the top rate since the 1990s, the U.S. is now amongst only 4 other OECD countries that have tax rates above 30 percent. Thus, the competitive gap between U.S. and OECD corporate tax rates has opened up since the 1990s primarily because of widespread and substantial rate reductions abroad, rather than any significant corporate tax increase in the United States.

#### Effective Tax Rates

The statutory tax rate is an imperfect measure of tax competitiveness, because it does not take into account the breadth of the tax base. This causes countries with high rates and a narrow base, such as the United States, to appear more uncompetitive. "Effective" tax rates resolve this issue by taking into account tax offsets, the present value of depreciations, and other deductions that narrow the base.

Effective tax rates can be measured using an approach outlined in a 1999 paper by economists Michael Devereux and Rachel Griffith.<sup>11</sup> Extending a literature that dates back to the early 1960s, they propose that effective rates be explored using two main measures. The first is the "effective marginal tax rate" (EMTR), which applies to marginal investment projects where the last unit invested provides just enough pre-tax return to cause the project to break even after-taxes. In other words, the marginal investment equates the net present value of the income stream to the net present value of the investment costs.

The EMTR would always be applicable under the assumption that "all potential investment projects that earn at least the cost of capital will be undertaken."<sup>12</sup> However, in the real-world there are many cases when an investor must make a choice between two projects that each earns more than the minimal return required to make the project worthwhile. The effective average tax rate (EATR) summarizes the distribution of tax rates for an investment project over the range of possible profitability levels. When deciding between mutually exclusive projects where the net present value of the income streams are *greater* than the pre-tax net present value of the investment costs, the EATR will inform the decision. That is, the EATR is likely the right rate to consider when exploring whether taxes are inducing firms to locate plants abroad. Conditional on that decision, the EMTR will inform the scaling of the project. If the concern is the observation that many profitable plants have been moved abroad, then the right effective rate to inspect is the EATR.

<sup>9</sup> Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).

<sup>10</sup> "OECD Tax Database," <http://www.oecd.org/ctp/taxdatabase>.

<sup>11</sup> Michael Devereux and Rachel Griffith, "The Taxation of Discrete Investment Choices," Institute for Fiscal Studies, Working Paper Series No. W98/16 (1999).

<sup>12</sup> *Doing Business 2011: Making a Difference for Entrepreneurs*, (International Bank for Reconstruction and Development/The World Bank, 2010).

In a forthcoming AEI paper, my colleague Aparna Mathur and I computed the EATR and the EMTR for all countries in the sample and for each time period using the methodology outlined by Devereux and Griffith (1999) assuming fixed parameter values for the economic depreciation rates, the inflation rate, and the annual discount rate.<sup>13</sup>

#### Effective Average Tax Rates

Our analysis finds that the United States' performance in the global economy does not look much better when scored with effective average tax rates than when scored with the top statutory tax rates. The kernel densities (Figure 5) show that the U.S. has moved far to the right of the mode of the OECD distribution. Or, more accurately, the OECD moved to the left. In 1996, the United States' EATR was slightly below the OECD average, 29.2 versus 29.7. In later years, the OECD average improved by over 9 percentage points, while the United States' EATR remained relatively unchanged. In 2010, the U.S. effective average rate was 29 percent, while the average for all the other OECD economies was 20.5 percent.

#### Effective Marginal Tax Rates

The United States compares marginally more favorably to other OECD countries when it comes to the effective marginal tax rate. However, even the EMTR is significantly higher than the OECD average. According to the distribution charts (Figure 6), in 1981 the United States was left of the mode, however in the intervening years the rates in other countries have declined leaving the United States with one of the highest effective marginal tax rates. In 2010, the U.S. effective marginal tax rate was 23.6 percent, relative to the non-U.S. OECD average of 17.2 percent (see Table 3).

#### Tax Revenues

Any discussion of tax rates is incomplete without an analysis of trends in corporate tax revenues. With one of the highest corporate tax rates in the world, one might expect the share of revenues from corporate capital to be higher in the U.S. than in other OECD economies. This is not the case, however. As Figure 7 clearly shows, except for a brief period in the 1990s, U.S. corporate tax revenues have been consistently lower than those of the OECD economies.<sup>14</sup>

In 1981, the U.S. raised about 2.3 percent of GDP from revenues, but between 2000 and 2004, it raised between 1.7 to 1.9 percent of GDP from revenues. The 2005 number was slightly higher than 1981, leading to the upward spike in the chart. The chart also shows that for the U.S., revenues dipped substantially below the OECD average in 1983, 1987, and peaked in 1995.

For the average OECD country, corporate income tax revenues relative to GDP increased between 1981 and 2008 from about 2.4 percent to 3.9 percent, before declining precipitously in the aftermath of the Great Recession. For the U.S., revenues have shown a slight uptick in the most recent year, narrowing some of the revenue gap with the OECD economies. The glaring result from comparing the U.S. relative tax position to the relative revenue position is that despite (or perhaps because of) the relatively higher corporate tax rates in the U.S., the U.S. earns less federal revenue from corporate income as a percentage of GDP than the average OECD economy.

This pattern is consistent with the literature that explores the responses of tax revenue to changes in the corporate tax rate. Alex Brill and I found significant evidence that a reduction of the corporate tax rate in the U.S. would increase corporate tax revenue.<sup>15</sup>

#### Conclusion

Given the significant headwinds that the economy faces, the indefensible state of the current tax code, the horrifyingly high U.S. corporate tax rate both statutory and effective, and the consensus that the economic impact of a fundamental tax reform would be positive, opposition to tax reform this year would be difficult to comprehend.

<sup>13</sup> Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).

<sup>14</sup> "OECD Tax Database," <http://www.oecd.org/ctp/taxdatabase>

<sup>15</sup> Kevin A. Hassett and Alex Brill, "Revenue-Maximizing Corporate Income Taxes: The Laffer Curve in OECD Countries," AEI Working Paper #137 (2007).

## Tables

**Table 1: Median Behavior Surrounding the 15 Most Severe Financial Crises**

	Growth of Real GDP per capita (%)	Unemployment rate (%)	Change in equity prices (%)	Real house prices
6-10 years before	3.3	4.1	8.1	73.3
2-5 years before	4.4	3.5	14.5	92.1
1 year before	3.2	3.4	-15.1	100.0
Crisis Year	1.6	5.1	-27.6	95.1
1 year after	-5.8	6.8	-4.5	83.7
2-5 years after	3.0	9.0	10.9	76.4
6-10 years after	3.8	6.2	12.1	82.8

Notes:

- House prices are indexed to t-1=100
- Countries in the sample: Spain 1977, Norway 1987, Finland 1991, Sweden 1991, Japan 1992, Indonesia 1997, Korea 1997, Malaysia 1997, Philippines 1997, Thailand 1997, Chile 1981, Colombia 1998, Mexico 1994, Argentina 2001, and Turkey 2001
- Unemployment average excludes the following countries: Thailand 1997, Chile 1981, Mexico 1994, Argentina 2001, and Turkey 2001

Source: Vincent Reinhart and Carmen Reinhart, "After the Fall," (paper presented at the annual Federal Reserve Bank of Kansas City conference, Jackson Hole, Wyoming, August 17, 2010).

**Table 2:**

Country	2010 Top Statutory Corporate Income Tax Rates	
	Central Govt.	Combined
Australia	30.0	30.00
Austria	25.0	25.00
Belgium	33.0	33.99
Canada	18.0	29.52
Chile	17.0	17.00
Czech Republic	19.0	19.00
Denmark	25.0	25.00
Finland	26.0	26.00
France	34.43	34.43
Germany	15.83	30.18
Greece	24.0	24.00
Hungary	19.0	19.00
Iceland	15.0	15.00
Ireland	12.5	12.50
Italy	27.5	27.50
Japan	30.0	39.54
Korea	22.0	24.20
Luxembourg	21.64	28.59
Mexico	30.0	30.00
Netherlands	25.5	25.50
New Zealand	30.0	30.00
Norway	28.0	28.00
Poland	19.0	19.00
Portugal	25.0	26.50
Slovak Republic	19.0	19.00
Spain	30.0	30.00
Sweden	26.3	26.30
Switzerland	8.5	21.17
Turkey	20.0	20.00
United Kingdom	28.0	28.00
United States	35.0	39.21

Sources:

- Authors' table. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
- "OECD Tax Database," <http://www.oecd.org/ctp/taxdatabase>.

**Table 3: 2010 Tax Rates**

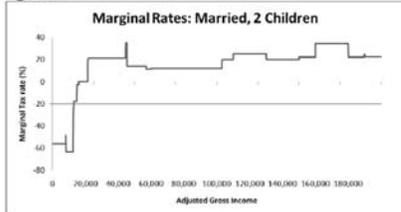
Country	EATR	EMTR	Statutory Combined	World Bank Estimate
Australia	22.2%	17.0%	30.0%	25.9%
Austria	20.8%	18.2%	25.0%	15.7%
Belgium	22.3%	13.9%	34.0%	4.8%
Canada	25.5%	23.4%	29.5%	9.8%
Chile	13.9%	11.5%	17.0%	
Czech Republic	18.4%	18.1%	19.0%	7.4%
Denmark	19.9%	16.5%	25.0%	21.9%
Finland	20.7%	17.3%	26.0%	15.9%
France	27.5%	23.8%	34.4%	8.2%
Germany			30.2%	22.9%
Greece	17.9%	13.4%	24.0%	13.9%
Hungary	15.7%	13.4%	19.0%	16.7%
Ireland	10.9%	9.7%	12.5%	11.9%
Iceland			15.0%	6.9%
Italy	24.3%	22.6%	27.5%	22.8%
Japan	33.0%	30.5%	39.5%	27.9%
Korea	18.1%	13.6%	24.2%	15.3%
Luxembourg	20.1%	13.9%	28.6%	4.1%
Mexico	28.4%	27.7%	30.0%	
Netherlands	19.4%	15.1%	25.5%	20.9%
New Zealand			30.0%	30.4%
Norway	24.2%	22.1%	28.0%	24.4%
Poland	16.2%	14.1%	19.0%	17.7%
Portugal	18.3%	12.2%	26.5%	14.9%
Slovak Republic	19.2%	19.3%	19.0%	7.0%
Spain	27.5%	26.3%	30.0%	20.9%
Sweden	18.5%	12.6%	26.3%	16.4%
Switzerland	15.4%	10.9%	21.2%	8.9%
Turkey	13.1%	7.3%	20.0%	8.9%
United Kingdom	22.3%	18.8%	28.0%	23.2%
United States	29.0%	23.6%	39.2%	27.6%
Average excluding U.S.	20.5%	17.2%	25.5%	15.9%

Sources:

- Authors' calculations. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
- *Doing Business 2011: Making a Difference for Entrepreneurs*, (International Bank for Reconstruction and Development/The World Bank, 2010)

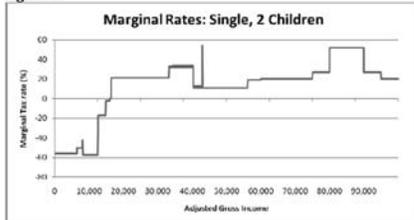
Figures

Figure 1:



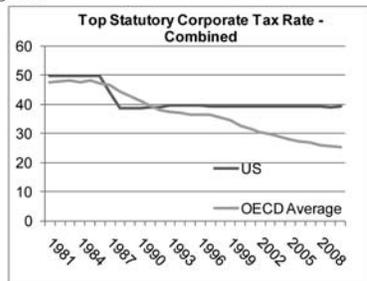
Source: Kevin A. Hassett, Lawrence B. Lindsey, and Aparna Mathur. "Moving Toward a Unified Credit for Low-Income Workers," *Tax Notes*, August 10, 2009: 589-602.

Figure 2:



Source: Kevin A. Hassett, Lawrence B. Lindsey, and Aparna Mathur. "Moving Toward a Unified Credit for Low-Income Workers," *Tax Notes*, August 10, 2009: 589-602.

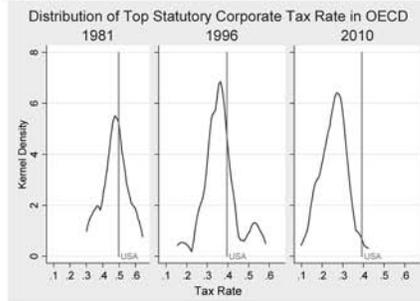
Figure 3:



Sources:

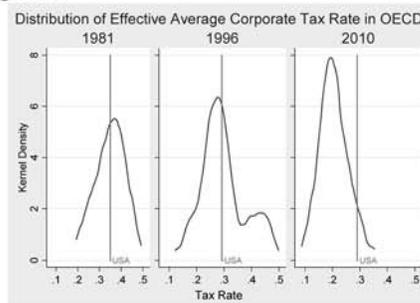
- Authors' chart. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
- "OECD Tax Database," <http://www.oecd.org/ctp/taxdatabase>

**Figure 4:**



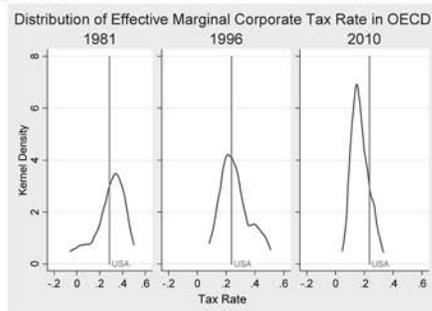
Source: Authors' calculations. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).

**Figure 5:**



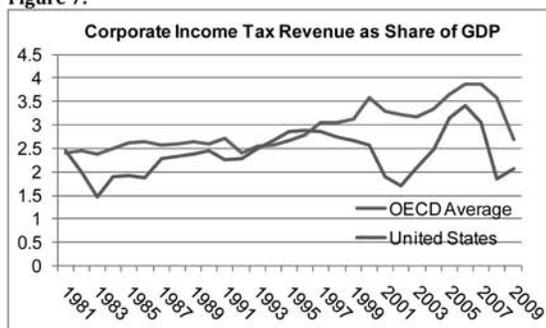
Source: Authors' calculations. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).

**Figure 6:**



Source: Authors' calculations. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).

Figure 7:



Sources:

- Authors' chart. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
- "OECD Tax Database," <http://www.oecd.org/ctp/taxdatabase>

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Chairman CAMP. Thank you very much. Thank you, Dr. Hassett.

Dr. Sullivan, you also have 5 minutes; and your testimony will also be part of the record, your written testimony. Thank you. Welcome.

**STATEMENT OF MARTIN A. SULLIVAN, PH.D., CONTRIBUTING EDITOR, TAX ANALYSTS, ALEXANDRIA, VIRGINIA**

Mr. SULLIVAN. Mr. Chairman, Members of the Committee, thank you for this opportunity to testify.

A quarter of a century ago, President Reagan defied all the sceptics and provided the leadership for a bipartisan overhaul of the tax system. He lowered the tax rates. He cut the tax breaks. It was a victory for the public over the special interests.

Twenty-five years later, the need for tax reform is greater than ever. Tax complexity costs businesses billions. Families endure endless hours of anxiety and paperwork. The perception of unfairness, whether it is due to outright cheating by investors hiding funds in Caribbean havens or to special interests who lobby their way to lower taxes, is an insult to Americans paying their fair share.

On top of all this, our Tax Code is deadweight on the shoulders of the American economy. The Tax Code's long list of subsidies defies any notion of a free market.

My focus today will be on the corporation tax, which is in particular need of reform. As we have just heard, Japan has announced its intention to cut its corporate rate by 5 percentage points. This leaves the United States with the dubious distinction of having the highest corporate tax rate in the world. Cutting the corporate tax rate is no longer just a good idea. It is an absolutely necessity.

At the same time, we must recognize our dire budget problems. We are on the road to fiscal catastrophe; and, so far, Congress has done nothing to remedy the problem. To put the Nation's finances on a sustainable path, that is, just to get our debt to GDP level to stabilize, far, far away from balancing the budget, that will require annual deficit reduction of \$500 billion a year.

In this environment, with these unprecedented budget pressures, it seems reasonable to assume necessary corporate tax cuts must be accompanied by corporate base broadening. Mr. Chairman, a fundamental feature of U.S. international tax law is that it favors foreign job creation over domestic job creation. If an American corporation opens a factory in Indiana, it pays a 35 percent tax rate. If the same corporation opens a factory in Ireland, it pays a 12.5 percent tax rate. Let us say the factory generates \$100 of profit. The choice is between after-tax profit of \$65 in the United States or \$87.50 in Ireland. Obviously, the U.S. tax law provides a strong incentive for building factories in low tax countries.

Now, it is essential at this point to discuss transfer pricing. It should be front and center of any discussion of a corporate tax reform. Transfer pricing is not a detail. Data from a variety of sources indicate any inappropriate profit shifting occurring on a large scale.

What I would particularly like to bring to the committee's attention is that, over the last decade, the transfer pricing problem has gone from bad to worse. When you work out the math, what you

discover is that transfer pricing is not just a revenue problem, which could be 30, 40, \$50 billion a year, but it is also a job creation problem. The effective tax rate for a typical investment in Ireland is not just 12.5 percent. It is actually negative. This means that the U.S. Treasury Department is subsidizing investment in Ireland. It is no different than, say, the Commerce Department directly sending checks to companies. This is corporate welfare only available to businesses investing abroad.

So, irrespective of one's views about whether the United States should move to a territorial system, we should all be able to agree that the inefficiency of subsidies provided through aggressive transfer pricing is a drag on the economic growth and job creation and that any tax reform should include strong measures through use of inappropriate profit shifting.

Multinationals record on domestic job creation is not good, as indicated on the screen. Between 1999 and 2008, they reduced domestic employment by 1.9 million jobs and at the same time increased foreign employment by 2.4 million.

In conclusion, let me just say this. The essence of an efficient and competitive tax system is a level playing field. Government should not attempt to outguess the market and pick winners and losers. As you can see from this slide, our corporate Tax Code has created winners and losers. The winners are those companies that are able to locate profits and offshore tax havens. The losers are companies that did not have that opportunity.

Of course, multinational corporations are important to the U.S. economy. They are research intensive, they are export intensive, and America wants strong multinationals. But multinationals competitiveness and overall competitiveness are not the same things. Yes, U.S. multinationals create jobs but so do purely domestic companies, so do small businesses, and so do foreign headquartered companies in the United States.

Thank you, Mr. Chairman.

[The prepared statement of Martin A. Sullivan follows:]

**Testimony of Martin A. Sullivan, Ph.D.  
Economist and Contributing Editor,  
Tax Analysts<sup>1</sup>  
www.taxanalysts.com and www.tax.com**

**Before the Committee on Ways and Means,  
U.S. House of Representatives  
January 20, 2011**

**Hearing on the Current Federal Income Tax  
and the Need for Reform**

Good morning, Chairman Camp, Ranking Member Levin, and other members of the Committee. Thank you for this opportunity to share my views on tax reform, a critically important issue for the future competitiveness of the American economy. My testimony will focus on a component of the U.S. tax system that is particularly in need of reform: the corporation income tax.

A quarter of a century ago, President Reagan defied all the skeptics and provided the leaderships for a bipartisan overhaul of the tax system that dramatically lowered tax rates and scaled back tax breaks that favored certain groups and activities over others. It was a victory for the public over the special interests.

Twenty-five years later the need for tax reform is greater than ever.

The complexity of the law costs businesses billions of dollars. Families endure endless hours of anxiety and paperwork.

The perception of unfairness—whether due to outright cheating by investors hiding funds on Caribbean islands or to special interests who can lobby their way to lower taxes—is an insult to the majority of taxpayers bearing their fair share.

And on top of all this our tax code is dead weight on the shoulders of the American economy. Its long list of subsidies and handouts defies any notion of a free market. The tax code's interference with the free-market impedes the efficient allocation of capital, hampers productivity growth, and reduces international competitiveness. To promote job creation the

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<sup>1</sup> The views here are my own and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

tax code should minimize its role in the economy by rechanneling the revenues devoted to tax breaks into lower rates.

### **1. Reduction in the Corporate Tax Rate is a Necessity**

In recent years the need for a significant reduction in the corporate statutory tax rate has moved from being just another good idea to being an absolute necessity for maintaining international competitiveness. Between 1995 and 2005, foreign statutory corporate tax rates have dropped on average about one percent per year, and since then rates have continued their decline.<sup>2</sup> And just last month, the Japanese government announced its intention to reduce its corporate tax rate by 5 percentage points, effective April 1 of this year.<sup>3</sup> This will leave the United States with the dubious distinction of having the highest statutory corporate tax rate in the world.

A high corporate tax rate is an invitation for a host of troubles. It encourages corporations to issue debt. It encourages corporations to engage in complicated and expensive tax planning. Most of all, it reduces investment and job creation in the United States.<sup>4</sup>

### **2. Severe Budget Pressures Suggest Revenue-Neutral Corporate Reform**

As already noted, base broadening corporate tax reforms are good in and of themselves because they remove market-distorting subsidies from the tax code. In this fiscal environment, base-broadening assumes additional importance.

We are on the road to fiscal catastrophe, and so far practically no action has been taken to remedy the problem. In order to put the nation's finances on a sustainable path—that is, just to get our debt-to-GDP level to stabilize (far short of balancing the budget)—will require annual deficit reductions of approximately \$500 billion.<sup>5</sup>

With these enormous and unprecedented budget pressures, it seems reasonable to assume necessary corporate tax cuts must be accompanied by corporate base broadening. This is the view of the White House, as articulated by Treasury Secretary Geithner on January 12: “We are going to take a look at whether we can find political support for a reform of the corporate tax code that would lower rates by broadening the base but not lose revenue on net.”<sup>6</sup> Rate

<sup>2</sup> Martin A. Sullivan, “On Corporate Tax Reform, Europe Surpasses the U.S.,” *Tax Notes*, May 29, 2006; more recent data is available from the Organization for Economic Cooperation and Development, [http://www.oecd.org/document/60/0,3746,en\\_2649\\_37427\\_1942460\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/document/60/0,3746,en_2649_37427_1942460_1_1_1_37427,00.html).

<sup>3</sup> Martin A. Sullivan, “Japan Cuts Corporate Rate, Puts Austerity on Hold,” *Tax Notes*, Jan. 3, 2010.

<sup>4</sup> Martin A. Sullivan, “Beyond the Conventional Wisdom: Rate Cuts Beat Expensing,” *Tax Notes*, Jan. 28, 2008.

<sup>5</sup> Martin A. Sullivan, “Deficit Commission: How Big Will the Tax Hikes Be?” *Tax Notes*, Mar. 1, 2010. New estimates from the Congressional Budget Office imply an even larger amount of deficit reduction will be required to put the federal debt on a sustainable path. See, CBO, “The Long-Term Budget Outlook,” June 2010, p. 14. Revised deficit projections will be released by the CBO on January 26, 2011.

<sup>6</sup> Eric Kroh, Drew Pierson, and Meg Shreve, “White House Begins Outreach Effort on Corporate Tax Reform,” *Tax Notes*, Jan. 17, 2011.

reductions in the United Kingdom, Germany, and Japan have been accompanied by significant expansions of the corporate tax base.<sup>7</sup>

### 3. The Current Corporate Tax Favors Some Business Sectors over Others

The essence of an efficient and competitive tax system is a level playing field. Government should not attempt to outguess the market and pick winners and losers. Unfortunately, there is a wide disparity in the tax treatment of businesses under current law.

The table below provides some examples of this disparity. While many corporations have effective tax rates approximately equal to the 35 percent statutory rate, other corporations have effective rates in the low twenties, the teens, and even the single digits. The major reason for these low effective tax rates is the ability of some corporations to shift a significant portion of their profits into low-tax jurisdictions.<sup>8</sup>

Winners and Losers Under Current Code			
	Effective Tax Rate		Effective Tax Rate
Cisco Systems	19.8%	Aetna	34.6%
General Electric	3.6%	CVS Caremark	38.8%
Hewlett Packard	20.0%	Disney	36.5%
Johnson & Johnson	22.0%	Home Depot	35.4%
Medtronic	19.7%	Target	37.2%
Merck	12.5%	United Health Group	35.4%
Pfizer	17.1%	Wal-Mart	33.6%

**Source:** Most recent company annual reports. Tax rates shown here are average of three years presented in most recent report.

As the table shows, low effective tax rates are common in industries like pharmaceuticals and computer equipment where it is easy to shift technology and manufacturing to low-tax jurisdictions. In industries where customer markets and the provision of services are largely domestic, the opportunities for reducing taxes through cross-border profit shifting are limited.

### 4. International Tax Rules Favor Foreign Over Domestic Job Creation

Under current law, if an American corporation opens a factory in Indiana, the profits of that factory are subject to the 35 percent U.S. corporate tax rate. If the same corporation instead opens a similar factory in Ireland, the profits from that factory are subject to a 12.5 percent tax rate. If that factory generates a profit of \$100, the choice is between an after-tax profit of \$65 in the United States and \$87.50 in Ireland. Obviously, U.S. tax law provides a large tax advantage for building and moving factories to low-tax countries.

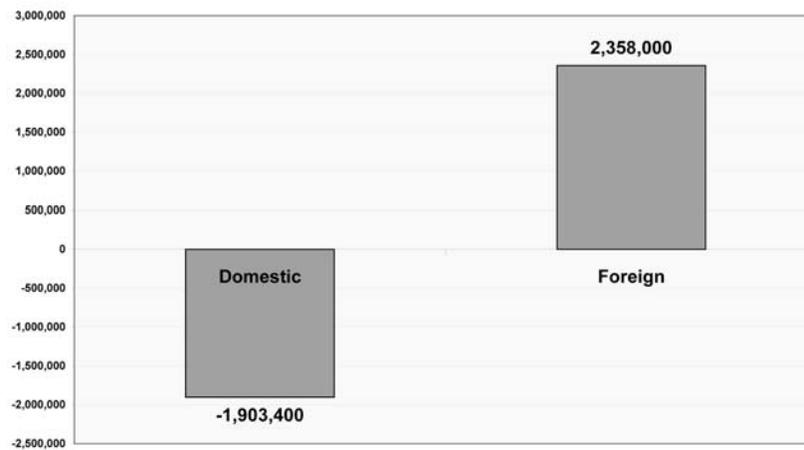
<sup>7</sup> For European examples, see Martin A., Sullivan, "A New Era in Corporate Taxation," Testimony before the Committee on Finance, United States Senate, June 13, 2006. For a description of corporate tax reform in Japan, see PricewaterhouseCoopers, "Japan Tax Update," special edition, issue 56, December 2010.

<sup>8</sup> Martin A. Sullivan, "Why Reported Effective Corporate Tax Rates Are Falling," *Tax Notes*, Mar. 3, 2008.

In their advocacy for relaxation of U.S. tax rules, U.S. multinational corporations like to ignore the possibility that foreign investment (provided incentive by U.S. tax laws) can *substitute* for U.S. investment. They focus instead on the idea that foreign investment can *complement* U.S. investment. In other words, it is in the best interest of the United States to increase *foreign* investment and job creation because this will increase *U.S.* investment and job creation.

No doubt foreign investment by U.S. multinational corporations has both substitution and complementary effects on U.S. investment. Intuitively, you can think about substitution occurring when a U.S. multinational decides to open a factory abroad rather than in America. Complementary effects are likely to occur when a multinational opens a distribution and marketing affiliate that increases worldwide sales, which in turn increases demand for U.S. research and development and U.S. headquarters services.

**U.S. Multinationals Job Creation, 1999-2008**



Source: Bureau of Economic Analysis, U.S. Department of Commerce.

The two effects are not mutually exclusive. They offset each other. One reduces U.S. job creation. The other increases it. Data from the U.S. Department of Commerce (in the figure above) shows that since 1999 U.S. multinational corporations have reduced domestic employment by 1.9 million while increasing foreign employment by 2.4 million. Whatever

the positive effects of foreign operations may be on domestic employment, they have not offset the job losses. U.S. multinational corporations are not net domestic job creators.<sup>9</sup>

### 5. Profit Shifting to Tax Havens Results in Large Revenue Loss

Data from a variety of sources indicate inappropriate profit shifting occurring on a large scale. By “inappropriate” I mean the perfectly legal but economically indefensible assignment of profits to subsidiaries in low-tax jurisdictions.

The table below presents the latest data on the profitability of affiliates of U.S. multinational corporations in five low-tax countries. In all these jurisdictions, the average effective tax rate of U.S. affiliates was below 10 percent. Although these are all small jurisdictions (with their economies equal to only about 2 percent of the world’s non-U.S. gross domestic product), they together account for 21 percent of foreign profits of U.S. multinationals. There is no perfect way to measure profitability, but by almost every measure these five tax havens have extraordinarily high rates of profit. These data strongly suggest U.S. multinationals are readily able to shift profits into tax havens and thereby significantly reduce taxes properly owed to the United States and other industrialized nations.<sup>10</sup>

Profits and Profitability of Foreign Affiliates of U.S. Multinationals in 2008						
	Before-tax Profits (millions)	Effective Tax Rate	Profit as % of Sales	Profit as % of Property	Profit as a % Employee Compensation	Profit per Employee
Ireland	\$ 46,337	7.3%	18.6%	117%	708%	\$ 520,640
Switzerland	\$ 16,352	11.5%	5.9%	141%	189%	\$ 200,638
Bermuda	\$ 8,354	4.8%	14.3%	132%	2,234%	\$ 2,610,625
Barbados	\$ 4,263	6.9%	38.0%	251%	11,218%	\$ 4,263,000
Singapore	\$ 12,255	8.1%	4.3%	84%	227%	\$ 103,157
<b>Five Tax Haven Total</b>	\$ 87,561	7.9%	10.0%	119%	417%	\$ 298,334
<b>Worldwide Total</b>	\$ 408,720	35.2%	7.9%	42%	93%	\$ 40,372

**Source:** Author’s calculations using latest data from the Bureau of Economic Analysis of the U.S. Department of Commerce. The BEA data do not include banks.

Over the last decade, the transfer pricing problem has gone from bad to worse. From 1999 through 2007, foreign profits of U.S. multinationals have increased by 163 percent, while over the same period, traditional indicators of economic activity have increased on average by only

<sup>9</sup> Advocates for multinational corporations often cite a study by Mihir Desai, Fritz Foley, and James Hines (“Domestic Effects of the Foreign Activities of US Multinationals,” *American Economic Journal: Economic Policy*) and work by Matthew Slaughter (“How to Destroy American Jobs,” *Wall Street Journal*, Feb. 3, 2010) as evidence that U.S. multinationals promote domestic job creation. But both lines of this research suffer from shortcomings. See Martin A. Sullivan, “Will Obama’s International Proposals Kill U.S. Jobs?” *Tax Notes*, June 1, 2009 and Martin A. Sullivan, “Jobs and International Tax Rules,” *Tax Notes*, Feb. 8, 2010.

<sup>10</sup> These findings are consistent with other studies that find an inverse relationship between the profitability of foreign subsidiaries and foreign tax rates. See, Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007, pp. 55-61.

97 percent. This excessive growth of foreign profits represents an annual revenue loss of \$28 billion over and above the revenue loss if transfer pricing rules were as effective as they were in 1999.<sup>11</sup> This is an estimate of the minimum annual revenue loss from inappropriate transfer pricing and income shifting.<sup>12</sup>

#### **6. Profit Shifting Turbo-charges the Incentive for Foreign Job Creation**

But the growing problem of profit shifting to low-tax countries is about more than lost revenue. It is about turbo-charging the incentive to move operations offshore. The ease with which U.S. corporations can move profits makes it vitally important for U.S. corporations to invest outside of the United States.

The simple example presented earlier—comparing the U.S. 35 percent rate with the Irish 12.5 percent rate—is unrealistic and grossly understates the tax advantages of foreign over domestic investment. That's because it does not take into account the enormous tax benefits derived from profit shifting through transfer pricing.

Not only can investment reduce tax on Irish profits, it reduces on taxes properly attributable to profits from high-tax countries, including the United States.

Building on the simple example described before, let's suppose that for a nominal fee the U.S. parent company allows the Irish subsidiary to use valuable marketing and manufacturing intangibles. Without access to these intangibles the Irish subsidiary would only have \$100 of profits. That \$100 is the true economic income attributable to the activities in Ireland. Access to the parent company's intangibles, however, allows the Irish subsidiary to book \$300 of profit. The Irish subsidiary should be paying the U.S. parent \$200 in royalties (or its equivalent), but because of lax transfer pricing rules it does not.

With a 12.5 percent tax rate, Irish tax liability on \$300 of reported profits is \$37.50. The shift of \$200 of profits out of the United States reduces U.S. taxes by \$70. The total tax effect of the investment in Ireland is an increase in Irish tax of \$37.50 and a reduction in U.S. tax of \$70. The net tax effect of investment in Ireland is a *reduction* in tax of \$32.50.

Given the \$100 of true economic profit in Ireland, the effective tax rate is *negative* 32.5 percent. Proponents of capital export neutrality and a worldwide system would argue the proper tax rate in this example is 35 percent (the U.S. rate). Proponents of capital import neutrality and a territorial system would argue the proper rate of tax in this example is 12.5 percent (the Irish rate). There is no principle of international taxation that can condone negative effective tax rates on foreign investment.

<sup>11</sup> Martin A. Sullivan, "Transfer Pricing Costs U.S. at Least \$28 Billion," *Tax Notes*, Mar.22, 2010.

<sup>12</sup> The total annual U.S. revenue loss is probably significantly larger than \$28 billion because (1) the data used in this estimate exclude financial corporations and (2) this estimate only accounts for increased revenue loss since 1999, and by all accounts there was already a significant transfer pricing problem in 1999. On this last point see, for example, James Hines and Eric Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," *Quarterly Journal of Economics*, February 1994.

Because of legal transfer pricing practices, the U.S. Treasury is providing billions of dollars of subsidies for U.S. companies to invest in Ireland and other tax havens.<sup>13</sup>

Irrespective of your views about whether the United State should move to a territorial system or not, we should all be able to agree that the inefficiency of subsidies, provided through aggressive transfer pricing, is a drag on economic growth and job creation.

### **7. Multinational Competitiveness is not U.S. Competitiveness**

Multinational corporations are important to the U.S. economy. They account for the bulk of our private-sector R&D. They are export-intensive—accounting for a proportionately larger share of exports than the rest of the economy. Of course, we want our multinationals to improve their competitiveness.

But support for U.S. multinational businesses should not come at the expense of other sectors. Yes, U.S. multinationals create jobs. But so do purely domestic corporations. So do small businesses. And so also do foreign-headquartered companies that invest in the United States. We must remember that multinationals' competitiveness and overall US competitiveness are not always the same thing. Promoting overall—or “standard of living competitiveness,” as the Joint Committee on Taxation labels it<sup>14</sup>—is the superior policy objective.

Favorable treatment of one sector over another generally hurts overall competitiveness because the free market allocation of capital is distorted.

To promote economic growth and maximum job creation all corporate business should be taxed evenly. Low rates of corporate tax are desirable for all these businesses. Any relaxation of current international rules would only increase disproportionate benefits for multinationals versus other businesses. To do this in the fairest and most efficient manner possible, we should minimize the enormous tax breaks for offshore job creation made possible by aggressive transfer pricing and use the revenue gains to lower corporate tax rates for all U.S. corporations.

### **8. Conclusion: Base-Broadening Should Begin with Reform of International Tax Rules**

When the Bush Treasury Department listed ways to pay for lower corporate tax rates, the three largest revenue raisers were: (1) changes to the depreciation rules, (2) repeal of the section 199 domestic production credit, and (3) repeal of the research credit.<sup>15</sup> These are direct incentives for domestic job creation. They are only available for business activity in the

<sup>13</sup> Martin A. Sullivan, “U.S. Serves as Silent Partner in Ireland Bailout,” *Tax Notes*, Dec. 6, 2010.

<sup>14</sup> Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, JCS-6-91, May 30, 1991.

<sup>15</sup> U.S. Department of the Treasury “Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century,” (December 20, 2007).

United States. In light of the current 9.4 percent unemployment rate, **when we start broadening the tax base to pay for corporate rate reduction, we should cut incentives for foreign investment before we cut incentives for domestic investment.** For obvious reasons, when Congress designs tax incentives it insists that they only be available for domestic activity. As so the tax benefits of accelerated depreciation and tax credits are only available for investment and job creation inside U.S. borders. Before we reduce depreciation allowances, or the domestic production credit, or the research credit, we should limit the ability of corporations to shift profits to low-tax countries and to take advantage of enormous incentives to create jobs offshore.

Whatever direction corporate reform takes—whether the United States moves to a territorial system or retains the current worldwide system—Congress must consider tougher measures to prevent transfer pricing abuse. Current statutes and regulations enshrine the arm’s-length standard. This standard gives primacy to the often futile search for comparable, unrelated-party transactions in the hope of using those transactions to determine the terms for related-party transactions.

The arm’s-length method is seriously flawed in both theory and practice. The theoretical problem is that because of synergies within large corporations—what economists call “economies of scope”—the economic relationship between entities within a corporate group are not the same as those between unrelated parties.<sup>16</sup> The practical problem is the lack of truly comparable unrelated transactions that can be used to apply the arm’s-length method to related-party transactions.<sup>17</sup> Modifying the arm’s-length standard will not get the job done.<sup>18</sup>

The major alternative to the arm’s-length method for allocating income to locations is formulary apportionment. The major problem with a pure formulary approach is international coordination (including a lot of renegotiation of existing tax treaties). The major benefit would be the elimination of profit accumulation in tax havens with little or no real economic activity. Although proponents of the arm’s-length method hate to admit it, there are some formulary elements employed in current law.<sup>19</sup> Profit-split methods widely used for allocating income from intangibles are a crude version of a formulary method.

<sup>16</sup> Synergies in production, distribution, and risk-bearing are an economic explanation of why multinationals exist instead of a myriad of smaller companies buying and selling specialized products and services from each other.

<sup>17</sup> The only good opportunity for using comparables for determining royalties for related-party intangibles is when the multinational has licensed the same intangible to an unrelated party in another geographic market. But even under these circumstances, the degree of comparability can be unsatisfactory because of market differences. For example, the per-unit profitability of a rice cooker employing a new technology may be different in Asia than in Europe.

<sup>18</sup> “To date, the JCT Staff is unaware of any comprehensive proposal to modify the arm’s-length pricing rules in a manner that would ensure their effectiveness.” (Joint Committee on Taxation, “Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment,” June 25, 2008, JCS-55-08.)

<sup>19</sup> Martin A. Sullivan, “A Middle Path between the Arm’s Length and Formulary Methods,” *Tax Notes*, Jan. 18, 2010; and Lee. A. Sheppard, “Stress Testing Transfer Pricing,” *Tax Notes International*, Mar. 16, 2009,

Another method of attacking the transfer pricing problem would be to reduce the availability of deferral in situations where transfer pricing abuse is likely. Around the world and traditionally in the United States, anti-deferral rules (usually referred to as “Subpart F rules” in the United States or “controlled foreign corporation rules” in the rest of the world) are widely-used as a backstop to the transfer pricing rules.

Other major industrialized countries, most of whom have exemption systems, have anti-abuse rules that revoke the exemption privilege not only for passive income but also for active income where there is potential for transfer pricing abuse that threatens the domestic tax base.<sup>20</sup> The rules vary widely and are highly complex. These rules struggle to maintain a balance between competitiveness (by providing a full exemption for properly measured foreign source income) and preventing tax avoidance (by preventing shifting of domestic income to tax havens).

In trying to identify situations where transfer pricing abuse is likely, these rules look at a number of factors. High on the list is the favorability of the tax system of the jurisdiction in which the foreign subsidiary operates. Some countries form “white lists” of jurisdictions that have sufficiently high levels of taxation or have treaties with the home country. Subsidiaries operating in white list countries automatically qualify for exemption or face less stringent anti-avoidance rules. Other countries have created “black lists” of tax havens where exemption is not permitted or is much more difficult to obtain. Still another method is to determine the effective tax rate of a subsidiary and only allow exemption if it exceeds some threshold. In addition to low tax rates, other factors that could trigger anti-avoidance treatment are lack of commercial activity or lack of local management and control in a subsidiary in a low-tax jurisdiction.

In its FY2011 budget, the Obama Administration proposed creating a new category of subpart F income. Under the proposal, the profits subject to Subpart F inclusion would be (1) from an intangible, (2) from a subsidiary paying low foreign taxes (suggested by the Treasury to be less than 10 percent), *and* (3) earning an excessive return (suggested by Treasury to be above 30 percent). All three of these characteristics are commonly found in inappropriate transfer pricing. **The Obama proposal is in line with the well-established practice of using CFC/Subpart F rules as a backstop to transfer pricing rules.** As such, if it is properly

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<sup>20</sup> There is no disagreement about the need for passive income to be subject to anti-deferral rules. (Otherwise, U.S. taxpayers could shift assets to tax haven corporations and pay no tax on income from those assets.) The issue is what, if any, foreign active business income should be subject to immediate U.S. tax. In 1962, Congress recognized that certain situations were highly susceptible to transfer pricing abuse. At that time, when most real business activities of U.S. multinationals took place in high-tax countries, the establishment of “base companies” in low-tax jurisdictions and the transfer of profits through related-party transactions to these base companies provided significant tax savings. To take the tax benefit out of these transactions, Congress subjected base company income to immediate taxation under Subpart F. (These rules are now largely obsolete because of “check-the-box” rules.)

designed, it would be an important additional tool for IRS efforts to combat transfer pricing abuse.<sup>21</sup>

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Mr. Chairman, thank you for the opportunity to share my views.

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<sup>21</sup> The administration's proposal is probably too cautious. It targets the low hanging fruit (i.e., profits that are from low-tax countries *and* are from intangibles *and* are "excessive.") One simpler alternative is a minimum tax on foreign earnings. (Martin A. Sullivan, "Should the U.S. Limit 'Excessive' Returns in Low-Tax Countries?" *Tax Notes*, Mar. 15, 2010) Unlike the Obama proposal, all suspect earnings would be subject to a new 10 percent minimum tax (instead of the 35 percent statutory rate). While the penalty rate is lower, the net is cast wider than under the Obama plan. Under the proposed minimum tax, there would be no difference between the treatment of intangibles and other types of income (an often impossible distinction to make). And there would be no need for an arbitrary determination of "excessive profits." Under this plan, all foreign income would be subject to at least a 10 percent tax. If the foreign rate is less than 10 percent, the new U.S. tax would make up the difference.

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Chairman CAMP. Thank you. Thank you very much, Dr. Sullivan. Thank you to our entire panel.

Now we will go to questions, and the chair recognizes Mr. Rangel for the opportunity to question.

Mr. RANGEL. Thank you, Mr. Chairman. Richard Neal and I will attempt to fill the absence of our Ranking Member.

But I think it is generally agreed with this panel as relates to corporate taxes that if we were to exclude the credits, the deductions, the exemptions, as Dr. Sullivan referred to, we could have a dramatic decrease in the corporate tax rate. But everybody wants to cut the loophole for the other guy but not the incentive that he or she or the corporation enjoys.

Dr. Sullivan, in your dealing with the corporate world, do you find any tremendous objection to starting with ground zero in terms of the loopholes that we have in the corporate system so that we can more easily, dramatically reduce the statutory rate for corporations?

Mr. SULLIVAN. Just as Chairman Camp was saying, we should think of tax expenditures just like direct expenditures. We need to go through our tax expenditures with a fine-tooth comb and look for abuse and inefficiency; and I think, as we say on the direct spending side, everything should be on the table. I think when you start picking through the details you will see that most of the tax breaks in our Code could be trimmed and made much more efficient.

Mr. RANGEL. So what you are saying is there is no big target out there. If we were talking about individual tax rates and start talking about mortgage deductions and charitable contributions and local and State deductions, that is the big mountain that we would have to climb. In the corporate area, however, what would be our biggest obstacle, in your opinion, if we started off with no exemptions at all? What would we have to overcome politically in order to do that?

Mr. SULLIVAN. We would have to eliminate the tax incentives for offshore job creation that is intrinsic in our international tax rules.

Mr. RANGEL. So you don't think that our corporate leaders would not think that it would be competitive if we reduced the rate and then they can decide where to make the investment and remove the subsidy for encouraging investment abroad?

Mr. SULLIVAN. I think it depends on which corporate leader you are speaking to. Because some corporations under current law do not have opportunity—frankly, they don't have a lot of tax breaks available to them, while others do. So the companies that do not have those tax breaks available to them are going to be in much more in favor of lowering the rates across the board.

Mr. RANGEL. Thank you. I yield back.

Chairman CAMP. Thank you very much, and now the chair recognizes Mr. Herger for three minutes.

Mr. HERGER. Thank you, and I would like to thank the chairman for this very important hearing.

There are a number of reasons for Congress to seriously consider tax reform, but I would like to focus on the impact on jobs. Mr. Hudak, you expressed concern about the expiring tax provisions and the uncertainty that creates. This is something that has long been a concern of mine as well. As someone from a small business background, I recognize that business owners have to plan for the future when they make investment decisions. Tax relief that lasts only one or two years isn't all that helpful when you are planning an investment that will pay off five or ten years down the road.

Could you elaborate further on how the uncertainty of temporary tax provisions affects some of the businesses to which you provide services?

Mr. HUDAK. Absolutely. The Tax Code causes businesses to think tactically instead of strategically. When provisions are temporary or when provisions are put in place to incentivize, oftentimes we miss the mark because of their complexities. The Section 179 deduction, the AMT fix that we wait until the very last moment at the end of the year might be the difference between a 5 or \$10,000 tax bill going into the next year. And that could mean the difference between a new truck, maybe an on-line marketing initiative, or maybe even a new employee. It has a direct impact, the temporary provisions and the last-minute uncertainty that we have been seeing increasingly over the last decade. It is very important that businesses think strategically and not tactically.

I had a situation where, for instance, we had a complicated provision that allowed people who bought a certain kind of truck, a certain size truck, were able to get a deduction. So he went out and talked to his accountant and bought a truck. It was the wrong truck. It was a massive truck. He was hoping to grow into it. He was in a paper products company, and that truck became his warehouse. He used it to pick up his paper products, put it in the truck, and why bother unloading it. He just drove around with his warehouse in his back. He was thinking tactically and not strategically, and the Tax Code does that continuously.

Mr. HERGER. Thank you.

Thank you, Mr. Chairman.

Chairman CAMP. Thank you very much.

Mr. Johnson is recognized.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. McDonald, I would like to have your comments. I think we have got IRS people in darn near every corporation now. And what they do is sit there and keep you out of trouble, theoretically, and then turn around and come back at you when you make a mistake which they are there to prevent, theoretically. I think that is a waste of effort, frankly.

I think you probably know that the IRS Commissioner, Douglas Shulman, does not file his own taxes in part because he believes the Tax Code is too complex. He says—and I will quote him—“I have used a tax preparer for years. I find it convenient. I find the Tax Code complex so I use a preparer,” he said. That means to me that the average American can’t fathom this Tax Code and we need to do something to fix it.

But, basically, I want to thank you for being here and ask you to what extent has our corporate tax system adversely affected investment and job creation in America?

Mr. MCDONALD. Well, Congressman Johnson, the issue we have talked is that the corporate tax rate of the United States, both the rate itself being the—soon to be the highest in the world as well as the worldwide system disadvantages American corporations.

In the case of the Procter & Gamble company, the company I am the CEO of, most of our competition is international competition; and, on average, we pay about 2 percentage points higher corporate

tax than those international competitors. Plus, we face the higher tax rate if we repatriate money that we earn overseas. That is a disincentive for any company to invest in the United States.

In our case, because we are a global company and because we can't export our product, we can't make a disposable diaper in Mehoopany, Pennsylvania, and ship it to China and make any money on it. We do have an organization around the world, and we do have 150 plants around the world. So for us there is never really a decision as a company that we invest either here or there. We have to invest everywhere in order to sell to the 4 billion people we reach every single day with our products.

Mr. JOHNSON. Does that make you think that some of the corporate structure might move overseas just to get out from under our Tax Code?

Mr. MCDONALD. Certainly it could be possible. What we are attempting to do is provide a competitive system for this country so that businesses stay here and flourish here the way they have for years.

Mr. JOHNSON. Thank you.

All right, Mr. Chairman.

Chairman CAMP. Thank you. Thank you very much.

Mr. Stark is recognized.

Mr. STARK. Mr. Chairman, I yield to Mr. Neal.

Chairman CAMP. All right. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. Thanks for holding this hearing. Thanks to Mr. Stark.

A couple of questions that I would like to direct to the panelists, because this is complicated work and oftentimes in this town it is reduced to jargon, as you know. I think there are reasonable arguments.

I have been to that Gillette plant, Mr. McDonald, in Boston. It is a remarkable story about domestic manufacturing. And perhaps you can let us in on how many blades are going to be added during the Super Bowl to that razor. I know that is a closely held secret.

But is it possible, Mr. McDonald, to focus on growth and keep the initiative revenue neutral?

Mr. MCDONALD. Congressman Neal, it is a great question. We believe it is best to take a look at getting a competitive system first.

Many of our CFOs had meetings with Secretary Geithner last week, and, revenue neutrality, we ask to take that off the table for now and let's just agree that what we want to do is to do something that is fiscally responsible the way the chairman and I think the Ranking Member talked about. I think if we work together we can develop a competitive tax system for this country and do it in a fiscally responsible way, and that is what we are setting out to do.

Mr. NEAL. When Mr. Rangel kicked out his proposal, if you recall, the critics jumped on it. It was a starting point in the conversation. That is all it was. It was an opportunity to shed some light on the needless complexity of the current Code.

Now, let me use an example of how I think we got burned here.

A few years back, the former chairman of the committee argued for repatriation; and, right now, American companies are estimated

to be sitting on more than \$300 billion in revenue offshore. But recall that when money was repatriated at 5.25 percent, and there were no jobs created. In fact, in one instance, one company laid off I believe 6,000 people in the next few weeks after the money had been repatriated. So I share the argument that getting that money back for job creation is a good idea, but what assurance do we have that as the money is returned that in fact domestic job creation would occur?

Mr. MCDONALD. I think if we start with the premise that we have a noncompetitive system, we set up that competitive system, that will lead to economic growth, that will lead to business growth, and that will lead to job creation. So, as a Business Roundtable, we have encouraged our members to not look for a one-time repatriation but rather to work on—with us—getting a competitive rate, going to a territorial system so that we can grow the economy and create jobs in this country. Obviously, if we are in a territorial system, the repatriation takes care of itself and we create jobs here.

Mr. NEAL. How many people wake up every morning and use a Gillette razor?

Mr. MCDONALD. Not enough.

Chairman CAMP. With that answer, the gentleman's time has expired.

Mr. NEAL. Mr. Camp, I believe Mr. Stark yielded the time to me. Would you allow me to pursue the next three minutes that I have along the same line?

Chairman CAMP. Well, it is now time to go to the other side of the dais, but then we will come back to you.

So Mr. Nunes is recognized for 3 minutes.

Mr. NUNES. Thank you, Mr. Chairman. I will be very brief. I want to thank the panelists for coming. But I want to just take this time, Mr. Chairman, to encourage you to move forward with fundamental tax reform. I think that last year President Obama's Commission, the Debt Commission that you served on and some of the Members of the committee served on, really undermined the power of this Committee and undermined our Constitutional duties that we have in this Committee. So I hope that you will work with Ranking Member Levin in a bipartisan manner and that we can move real tax reform legislation through this House this year. I think it would be great if we could do it in a bipartisan way, and I yield back.

Chairman CAMP. All right. Mr. Tiberi is recognized.

Mr. TIBERI. Thank you, Mr. Chairman. Thank you all for coming.

Mr. McDonald, following along what Mr. Neal was talking about, I am from Columbus, Ohio. And during the last campaign season in Columbus and I am sure in Cincinnati we saw a lot of ads regarding trade and regarding taxes and regarding incentives. In fact, in the Governor's race, which was all about jobs, we saw the current Governor attacked for a vote or votes in Congress, that he voted for tax breaks to "send American jobs overseas," and most of that was targeted to American worldwide companies that were expanding into different markets.

Obviously, Procter & Gamble has a huge presence overseas. Can you tell me what those tax breaks are that “send jobs overseas,” in your mind?

Mr. MCDONALD. Congressman Tiberi, as I said, we invest everywhere. Our investment decisions are not we invest here or there. In fact, our international business is about 60 percent of our total sales. Our U.S. business is about 40 percent of our total sales. Yet we pay 60 percent of our taxes in the United States. We are one of the largest taxpayers here in the United States.

What is important is, as we grow overseas, that creates jobs in the United States. Twenty percent of our jobs in the United States depend upon our international business. Forty percent of our jobs in Ohio depend upon our international business. So even though we may be the largest consumer goods company in China with 7,000 Chinese employees, we have got a lot of people in Columbus, Ohio, and in Cincinnati, Ohio, who depend upon the strength of that business for their jobs; and we take that very, very seriously.

Mr. TIBERI. Is it fair to say then—and others have said this to me, CFOs and tax accountants—that if we aren’t proactive here in the United States with respect to tax policy and competitiveness, even though Procter & Gamble, for instance, has been in Ohio for over 100 years, you don’t have to be headquartered in Ohio or the United States; and other countries would love to have you. Is that a fair statement?

Mr. MCDONALD. I think the chart that I showed earlier that showed how statutory tax rates have gone down over time is suggestive of the fact that countries around the world are competing for investment and they are competing for companies like ours to move outside of their home country. We have got to get into that game, and we have got to be competitive, and we have got to get people to invest here in the United States.

Mr. TIBERI. And, ultimately, the more diapers you sell in China or the more toothpaste you sell in Europe is going to mean more jobs in Ohio?

Mr. MCDONALD. Yes, sir. More jobs in Ohio.

Mr. TIBERI. Thank you.

Chairman CAMP. Thank you.

Mr. Neal is recognized.

Mr. NEAL. Thank you, Mr. Chairman.

I want to come back to the point that I was raising earlier.

Dr. Sullivan, I was caught by the statement that Dr. Hassett made that cutting corporate tax rates increased tax revenues. It sounds a lot to me like tax cuts pay for themselves. I think tax reform is a worthy pursuit and very sensitive to the international arguments that are being made here today, but in some measure didn’t America get into trouble based upon that notion, that tax cuts pay for themselves?

Mr. SULLIVAN. Certainly the idea that tax cuts pay for themselves is very attractive politically and appears to make the issue very easy—for example, in the 1980s, that notion was very popular, the Laffer curve. And there are some dynamic aspects to the revenue estimates. But to think that tax cuts pay for themselves, except in very extraordinary circumstances, is mostly wishful thinking.

If you look back at the 1986 Tax Reform Act, we lowered the rates and broadened the base; and immediately after the 1986 Act there was a whole set of hearings in the Senate finance about where did the corporate revenue go. There was actually less corporate revenue collected than expected.

And, also, if you follow the efforts of the joint committee and the Treasury Department, the official revenue estimator, I don't think they would ever score it that way.

Mr. NEAL. Part of the problem then in some measure is the fact that we are fighting two wars and we have cut taxes by \$2.3 trillion and that has been a drain on the Federal Treasury. In the course of this conversation, based upon what you have said, would you argue that tax cuts pay for themselves?

Mr. SULLIVAN. No, certainly not—no, I would not argue that corporate tax cuts pay for themselves.

Mr. NEAL. So that invites the next question. As we go forward, how do we devise a system, as Mr. McDonald said, that perhaps can be revenue neutral and at the same time keep our companies competitive in a global economy?

Mr. McDonald, do you want to weigh in on that as well?

Mr. MCDONALD. Congressmen, I think that is the challenge; and what we have said is let us prioritize getting to the competitive system and make sure we do it in a fiscally responsive way. I am not sure we will be exactly revenue neutral, but let us do it in a fiscally responsible way.

Mr. NEAL. And the last question—Ms. Olson, I appreciate your good work. My time is running out quickly, but I do want to thank for your parallel pursuit of my career, doing something about alternative minimum tax.

Ms. OLSON. Thank you, sir.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman CAMP. Thank you very much.

Mr. Davis is recognized.

Mr. DAVIS. Thank you, Mr. Chairman.

When we talk about international business and its reach and impact domestically, I harken back to being deployed in the Middle East in the 82nd Airborne Division and taking a walk through the desert one night. Under the moonlight, a wrapper blew up to my feet, and it was an Arabic-labeled Pampers package, and I began to understand the reach of our economy.

Mr. McDonald, P&G has about 1,300 employees, 1,200 of whom live across the river in our district. That created \$138 million in wages. And your company also purchased \$160 million in goods from over 260 suppliers that are in our region in Kentucky. Those are real numbers. Those are real jobs that impact a lot of lives and a much broader supply chain that is multiplied in the economy.

At a time when the economy is struggling to regain its footing, we have looked at job creators, small businesses but also, very much so, large businesses like P&G, as a means to put Americans back to work. Companies want to manufacture in the United States, but they are currently faced with a tax and regulatory structure that encourages them to do otherwise. As you try to grow P&G and invest in Kentucky, Ohio, Indiana versus foreign markets, do you factor tax liability into your decisions? And if you do,

do you look more at the corporate marginal tax rate, your overall effective tax rate, and why?

Mr. MCDONALD. We certainly do look at tax rate, Congressman Davis. Whenever we site an operation anywhere in the world, we look at tax rate.

As I said earlier, because we do sell to 4 billion people a day around the world, we really do have to invest everywhere. And normally what happens is when we invest in the United States it becomes a decision of where to put the operation in the United States. Right now, we are building a factory in Utah, in Box Elder, Utah. It is a \$300 million investment. It will employ about 300 people. We did that because it is a paper factory and we need to get our paper products more efficiently on the west coast.

One of the things you see today going on which is very different than it was in the 1980s, in the 1980s when I joined Procter & Gamble, the manufacturing expense of a product was more important than the logistics cost. But because of the cost of fuel today and for other reasons, the logistics costs are much higher than the manufacturing expense. So it becomes much more difficult to produce a product in the United States, for example, particularly something as low cost as a diaper, and ship it somewhere overseas.

But what we have in Cincinnati, what we have in Kentucky are high-paying technical jobs. Our research and development operations are there, our corporate headquarters is there, and those really have a lot of very highly skilled people who are running our businesses around the world.

Mr. DAVIS. Do you have a sense, just in closing, when you create or open a new market or expand in an overseas market, what is the multiplier effect back home on jobs generally?

Mr. MCDONALD. It can generally be anywhere from 6 to 10, depending upon the supply chain. We work very hard to develop suppliers who can be global suppliers for us. In fact, today we are recognized as one of the top companies in the United States for developing minority owned suppliers. We will take a minority owned supplier, and we will work to develop them into a global supplier, and today we do about \$2 billion a year of business with minority owned suppliers in the United States, many of them located in Kentucky or in Ohio.

Chairman CAMP. Thank you.

Chairman CAMP. Mr. Reichert is recognized.

Mr. REICHERT. Thank you, Mr. Chairman. I want to thank Mr. Camp for holding this hearing. And I think all of us in this room have recognized for many years that the Tax Code is complicated. That's an understatement. But I think that the testimony and the questions that we have heard today and the testimony from Ms. Olson saying, it is a patchwork, it has no logical connections, it is confusing, and it creates mistrust; And Mr. Hudak, saying it is onerous. I mean, these are words that all of you on the panel have used over and over again.

So I hope that we can come together in a bipartisan way to begin to address some of these issues. Yesterday we had the opportunity to meet—some of us did—with Mr. Ballmer from Microsoft and, Mr. McDonald, he was saying some of the same things that you were saying about corporate structure. But I think that one of the

things that really struck me as he spoke to us yesterday was, he urged us to think not just about a corporate tax rate, but the competitive tax system, as is the point that all of you have been making today.

And, of course, one of our big concerns is—at least one of mine—is the small businesses. So my question is for Mr. Hudak. What challenges does the amount of business income taxed at the individual level present for reforming the Tax Code in a way that helps American businesses grow and create jobs and compete?

Mr. HUDAK. Well, 70 percent of small businesses are pass-through companies. They are taxed at the individual rate. So taxing anything beyond what a business owner is due as wages for his work is really taxing capital formation. It is really hitting on his ability to invest, create jobs. Certainly everybody should be subject to the full force of employment taxes for the value of their work. But beyond that, because of the corporate structure of the small business, when you tax beyond that, you are really hitting on the small business owner's ability to form capital, dream dreams, invest, innovate. And that is a very important point.

Mr. REICHERT. I appreciate the answer. And I yield back. Thank you, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Doggett is recognized.

Mr. DOGGETT. Thank you, Mr. Chairman. Let it be remembered that Congress began this debate on whether or not to reduce corporate tax revenues to pay for our national security on the same day that our committee leadership, like our President, is meeting with the Chinese. Because the first question that needs to be answered in this debate is how much more America will borrow from the Chinese so that some corporations can pay less. To say, as the representative of the Business Roundtable has done here, that "revenue neutrality should be off the table" may be consistent with the misguided holiday tax deal that added another almost \$1 trillion to the national debt. But it is just another way of saying, Go borrow from the Chinese.

Of course, there may well be some merit to lowering the statutory corporate tax rate. All of our witnesses are suggesting that there is. One should realize, of course, that to the extent that we lower the statutory rate, if all corporations were paying that, that would represent a substantial tax increase for many of our multinationals. You have noted General Electric, for one, that would be paying many times the effective rate if it paid the lowered statutory rate that is being proposed.

To call for a pure territorial system is really just another way of saying, We want a permanent repatriation of profits holiday like the one that didn't produce more jobs for Americans last time, and it is a surefire way to encourage the continued export of more American jobs.

I would ask you, Dr. Sullivan, when we talk about competitiveness, which all of us are for, shouldn't we be concerned about promoting a level playing field so that our smaller American corporations, the ones that are the real engine for economic growth who don't have subsidiaries and tax havens, whose lobbyists haven't come up here to this committee to add hundreds, if not thousands, of pages to the Tax Code and regulations that Chairman Camp

showed at the beginning of this meeting and to make it so complex, have a level playing field and aren't at a disadvantage against their larger multinational competitors?

Mr. SULLIVAN. Thank you, Mr. Doggett. Yes, the most important thing that we can do to improve the competitiveness of our tax system is to make the tax system neutral across all types of companies. We need to look for pockets of over subsidization. And that is what we find in certain areas of the international tax law. So we want a level playing field so that job creation can be uniform across the economy, particularly when our deficit problem is at these incredible levels.

Chairman CAMP. Thank you. The gentleman's time has expired. Mr. Roskam is recognized.

Mr. ROSKAM. Thank you, Mr. Chairman. Mr. McDonald, an observation and a question. The observation—I am from suburban Chicago. And I am sometimes kind of amazed at conversations that I will have with folks in the Chicagoland area who are working for worldwide American companies who have not had a sense of clarity about the fact that their very employment is dependent upon the success of that company in overseas markets.

So my statement to you, as the leadership of the Business Roundtable, I think that there is a lot of advocacy that is left on the table because businesses are somehow reluctant to engage in substantive philosophical conversations because they feel like they are going to be perceived as donkeys and elephants and get into partisan issues when you are really talking about a world view that says capital markets are good, competition is good. And I am telling you, I am amazed at the level of conversation. So that is my observation.

Mr. MCDONALD. I agree with you, Congressman. All of our members would agree. We have to do a better job.

Mr. ROSKAM. Terrific. To amplify Mr. Tiberi's point, there has been, you know, the slogan, Shipping jobs overseas is a bright and shiny bumper sticker, which is very, very catchy. And it seems like the more subtle but more robust argument is a five-paragraph economics essay which makes lots of sense, but you have got to get through all five paragraphs. And if you do get through all five paragraphs, you say, "Oh, makes sense". I get it. But we and many on both sides of the aisle—have done a very bad job of communicating about overseas markets and their relationship to American prosperity.

And I would just encourage you, and we want to be part of this conversation with you—about how to communicate more effectively to American citizens that prosperity overseas for U.S. companies means prosperity at home.

Mr. MCDONALD. Absolutely, Congressman. In fact, I wanted to clear up a potential misrepresentation of a territorial tax system. A territorial tax system, which I discussed earlier, says that we pay the same tax, as a U.S. company in a foreign market, that our competitors pay, that our foreign-based competitors pay. It is not a tax break. We are not talking about a tax break. What we are talking about is paying the same as our foreign-based competition. Our foreign-based competition doesn't have to pay tax—incremental tax on

the repatriation of funds to their home market. That is the difference. It is very simple.

Mr. ROSKAM. I yield back.

Chairman CAMP. Mr. Gerlach is recognized.

Mr. GERLACH. Thank you. Following up on that point, Mr. McDonald, and also on what Mr. Neal raised a few moments ago, from your perspective, given your domestic business activities as well as your foreign business activities, from a perspective of what it would take from a Tax Code change to have you consider investing more in domestic job creation rather than foreign job creation, would that then be just a general reduction in the corporate tax rate itself? Or should there be more specific targeted language for the repatriated dollars that we would want to have you bring back to the United States and hopefully invest, and not as you raised, Mr. Neal, brought back but not have any jobs created?

So from your perspective, is a general tax rate reduction more favorable to you in that job creation here domestically or language that would say, if you brought those dollars back domestically, you would get a lower rate if you specifically invested that in R&D activities or manufacturing activities, something very specific and targeted that you would get that tax benefit by doing that? What, in your mind, would be the better way from a Tax Code standpoint to encourage you, Procter & Gamble, to invest more in the United States?

Mr. MCDONALD. Congressman, our principle would be, Let's come up with a competitive system, and that would be both the rate and moving from a worldwide to a territorial system. And what I would suggest is, let's benchmark the other countries that we are competing with. Because we are also not just talking about American companies investing here. We are talking about Chinese companies. I have met with Chinese CEOs who say, Help me figure out how to invest in the United States. And they are struggling with our Tax Code as well. And that is part of President Hu's visit and the reason I will need to leave too is because we are trying to get Chinese companies to invest here. And if we can get to a competitive system like those other OECD countries that have improved their systems, then I am sure we will succeed.

Mr. GERLACH. Thank you.

Mr. MCDONALD. Yes, sir.

Mr. GERLACH. Thank you, Chairman.

Chairman CAMP. Thank you. Mr. Thompson is recognized.

Mr. THOMPSON. Thank you, Mr. Chairman. Thank you for holding this hearing. I think it is an important discussion that we have to have. I think we need to simplify our Tax Codes, all the Tax Codes. And I would like to just ask the chairman for his help and cooperation this year on expanding that. I am going to reintroduce my bill on estate tax reform. I think it is a sad day when family farms have to be sold in order to pay estate tax on those family farms. And hopefully, we will be able to create a situation where if you inherit the family farm and you keep farming it, you will be able to get a postponement in any estate tax. So I hope we would expand it to that.

I don't think the idea of a tax policy that encourages jobs in this country, rather than overseas, is a bumper sticker. We received

this sheet that shows the number of foreign jobs that were created between 1999 and 2008 versus domestic jobs that were lost. I think we need to have a Tax Code that, in fact, does encourage job growth here in the United States of America. And I understand that businesses consider all of their investments, foreign and domestic, when they figure out their bottom line. But I think we have to pay particular attention to creating jobs here.

And then lastly—and kind of a statement but also a question—there has been a lot of talk about deficit neutrality when we work on reforming the Tax Code. I just don't think you can take that off the table or take care of it later on. I think this is a real, really important issue not only because of the growing debt, but the impact it is going to have on companies like Procter & Gamble.

There was discussion just this last year of lowering the U.S. credit rate because of our big deficit and our big debt. And I think that would impact U.S. competitiveness and U.S. corporate profits, if that were to happen.

So I don't think this is something that we can ignore. I would like to hear from both Dr. Sullivan and Mr. McDonald on that specific thing. How would that hurt U.S. companies both here and abroad if our credit rating was lowered because we don't pay attention to the deficit of our tax reform.

Chairman CAMP. We need short answers.

Mr. MCDONALD. Well, I think, Congressman Thompson, we have already seen somewhat the impact of that if we look at what is going on in Europe right now in places like Greece and places like Spain and places like Ireland. So we know what will happen. It will be a higher interest rate. It will be harder to get capital. The chart that you referenced, while a good chart, we have to get into the detail of that because the businesses and the economies are growing much faster in places like Asia and Africa than they are in places like Europe and the United States. So, of course, any time you have global business, you are going to be hiring more people in those geographies. So I just think we need to get into the details and understand why those jobs were being created abroad.

Chairman CAMP. The gentleman's time has expired. But, Dr. Sullivan, if you would just answer briefly. Thank you.

Mr. SULLIVAN. Thank you, Mr. Chairman. The deficit problems we face are unprecedented. They slowly weaken the foundations of our economy by sapping capital formation, and we risk financial collapse. So these are very serious problems for our competitiveness. Thank you.

Chairman CAMP. Mr. Heller is recognized.

Mr. HELLER. Thank you, Mr. Chairman. I appreciate you having this hearing. I apologize that I missed some of what was said here this morning because I was on the radio. And the timing of it and the discussion had specifically to do with our tax structure and what is going on here in Washington, D.C. and what we are trying to do. I told them that it is great that we are able to get the Republicans and Democrats together and actually start talking about some tax reform—long overdue, long overdue tax reform. And there isn't a small businessman or a manufacturer in my district that isn't talking about how complicated this tax system and the taxes are.

We have 14.4 percent unemployment in Nevada, and I have to believe that our current tax structure has something to do with that. And I am pleased to hear about the administration, talking about their desire and eagerness to look at some tax reform. There are Commissions out there. There are committees out there, Leadership on both sides of the aisle, as we are seeing here in this Committee meeting. But I think what we are missing and what is important to concentrate on is that it is the constituency out there, these small businesses and manufacturers, that are talking about the need for fundamental change in our Tax Code so that they can be competitive not only here in this country but abroad.

And we are hearing stories after stories—and I don't know if this was brought up—Microsoft talking about having to borrow in this country because they cannot bring money back from overseas. They have billions of dollars overseas. They can't bring it back to America to create jobs. Their only choice is to borrow because that is what is best for their shareholders. Those kinds of stories, those kinds of issues that we have right now are fundamentally flawed with the process that we have.

So, Mr. Chairman, I certainly do appreciate this hearing. I saw a couple of charts yesterday that were talking about deflation now here in this country. I know gasoline prices are going up. I know food prices are going up. But you get past those two obstacles, and then we start looking at the deflation of other goods and services. We are looking at falling wage growth here in this country, and I believe that that has a lot to do with the Tax Code we have here in this country. And I guess quickly—and I don't know how much time I have left—but you talked about a simpler code, Ms. Olson. Have we gotten to the point that our Code has run its course; our current Tax Codes has run its course? And are there alternatives out there to the current code as opposed to just making it simpler?

Ms. OLSON. Well, as I said in my testimony, I really think you need to, on the individual side, really just put everything on the table and then go through it—not first from a cost benefit but say, Is this a policy that we should run through the Internal Revenue Code? First, is it a policy that we want? Second, is it a policy that we should run through the Internal Revenue Code? If it is a policy you want, then when you answer that second question, you have to think, what is the burden that you are putting on individual taxpayers to have to document this thing, to tie their businesses up into knots in order to meet the requirements for it.

And then what are you making the IRS do? How are they going to treat taxpayers, whether they are businesses or individuals? Right now, you have just heard a morning of testimony about the difficulties that taxpayers are facing.

Mr. HELLER. Thank you, Chairman.

Chairman CAMP. Thank you. Dr. Price is recognized.

Mr. PRICE. Thank you, Mr. Chairman. And I want to congratulate you on obtaining the gavel for this Committee. I want to congratulate you and commend you for your passion for fundamental tax reform which is so necessary. I, frankly, am struck by the unanimity of the panel, especially as it relates to the corporate tax rate and the need to decrease the corporate tax rate.

I think it is imperative that we not punish the job creators. And I think, as the charts have shown, a high corporate tax rate does, in fact, punish job creators because we live in a global economy.

I was struck, however, Dr. Hassett, by comments about any decrease in corporate taxes, not increasing revenue necessarily to the Federal Government. I wonder if you would comment about what many of us believe: a decrease in corporate tax rates actually increases revenue to the Federal Government.

Mr. HASSETT. Thank you very much, Mr. Price, for the question. And Mr. Neal, I welcomed the opportunity also to respond to the earlier exchange.

The thing is that there is a well-developed literature, including, you know, a fairly recent Brookings paper a paper by a German economist who is definitely not Republican or Democrat. That shows that really a lot of the lessons in Mr. Sullivan's testimony are apparent in the data that if you are high tax place, and it is relatively easy for companies to move their profits to a low tax place. That is why you saw the lower average rates in Mr. Sullivan's testimony for some companies. It is that they have been very adept at locating activity in lower tax places.

If we reduce the tax here in the U.S., then they have less of an incentive to locate their profits and their activity abroad, and then it is just an empirical question. Is the change in incentive enough so that you could actually reduce the rate and get more revenue? It is almost never the case with taxes—at least in the near term—that when you reduce the rate, you get more revenue. But in the corporate tax space, there are actually academic papers that find that result. I would say a rough reading of the literature is that the revenue maximizing tax rate in the corporate tax space is maybe around 30 percent. So if we are above that, then it means we are actually losing revenue. And in part, it is because it is so easy to transfer to lower tax jurisdictions. And I put a reference in my testimony, inside that reference that—

Mr. PRICE. Thank you. A quick comment as well on something that has also been an area of disagreement and that is the repatriation of dollars. It seems that our friends on the other side think that would be a nasty thing to do, to allow that money to come back because they don't have any proof that there are jobs created. But the converse of that is that if you just leave the money over there, then it actually is better for the United States. Isn't it better for American workers and our American economy to, in some way, allow for that repatriation of resources?

Mr. HASSETT. Right. We need to allow firms to put their money where it can be best put to use, regardless of taxes; and repatriation shouldn't be relevant. I would counsel against a temporary measure. It should be a permanent measure.

Mr. PRICE. All right. Thank you. I yield back.

Chairman CAMP. Thank you. Mr. Larson is recognized.

Mr. LARSON. I want to thank the chairman and thank him for this opportunity. I have three quick questions for the panelists. One for Ms. Olson. In your testimony, it said, If tax compliance were an industry, it would be one of the largest in the United States. It consumes 6.1 billion hours. The tax industry requires the equivalent of more than 3 million full-time workers. These are a

pretty amazing statistics. I would like you to expand upon that, noting that it seems to me that our current tax system is broken. It was antiquated in the last century. We are already a decade into this century, and we still haven't made much gains in terms of straightening it out.

Second question, to any of the panelists, with regard to transaction taxes, noted on 60 Minutes that more than \$60 trillion takes place in transactions over the counter that are unregulated. And in terms of looking at revenue that takes place in the EpisPHERE or done algorithmically or whatever the case may be, it just seems to me like this is an opportunity that is worth looking at as opposed to taxing one's labor. So I would be interested in answers to those questions. Ms. Olson, I will start with you.

Ms. OLSON. I think what those numbers point out—and I must note that those numbers include business taxes as well as individual—but I urge this committee to not forget the individual taxpayers, the 132 million individual taxpayers who are your constituents, who are suffering under the current, you know, burden of this Code. And as we talk about businesses making decisions about where to place their profits or their activities, that very ability to make those decisions leads to a great distrust of your constituents of the Internal Revenue Code and of government. And it leads to the sense that they are being discriminated against by the Code and by their government because they cannot afford or do not have those kinds of breaks. So that was some of the things that we were trying to get across in our testimony.

Mr. LARSON. Over the counter transaction taxes, anyone? Dr. Sullivan, Dr. Hassett?

Mr. SULLIVAN. I do think it is important we re-evaluate our Tax Code in light of the financial crisis to remove the elements of the Code that contributed to it. For example, the deductibility of debt. However, a transactions tax has been tried in many countries around the world, and it is very hard to administer. So I think its initial appeal wears off the more you look at it.

Mr. HASSETT. I concur with Dr. Sullivan.

Mr. LARSON. So there is no way to regulate an over-the-counter trade in a way that it produces significant revenue?

Mr. SULLIVAN. Unless we went to a multilateral—where all countries agreed to do this, the trading activity, because it is so mobile, would shift to other countries. Sweden tried this several years ago, and other countries have tried it, and they had to repeal it because they just couldn't administer it effectively.

Chairman CAMP. Thank you. The gentleman's time has expired. Mr. Buchanan is recognized.

Mr. BUCHANAN. Thank you, Mr. Chairman. Someone mentioned earlier—it is interesting, we are having a tax debate, and the President of China is in town at the same time. As someone who has been in business for himself for 35 years, I can tell you that it is not Florida—I represent Sarasota, Florida against Alabama and Mississippi competing for business. The fact of the matter is that we are competing around the world. And one of our biggest competitors today by far, the 800-pound gorilla, in my mind, is China. I have done business overseas as well.

So when I think about this and the fact that we haven't touched the Tax Code in a material way since 1986, I think it is appropriate we have these discussions today because I always personally believe what makes America special and great is free enterprise.

So let me jump over, Mr. McDonald, quickly to you. When you talk in terms of Business Roundtable, the fact of the matter is—and I was a C corporation and moved to an S, and now I have a bunch of LLCs that my family runs—but the bottom line is, half the tax revenue, I understand, is through pass-through entities. So when you look at earners lowering the tax rate or the discussion of the tax rate for corporations, what are you going to do about all those employers that have 500, 100 employees, 50 employees that are LLCs?

I hope that will be taken into consideration. You can't do one without the other because otherwise you end up with a competitive advantage over someone else that happens to be a large family-run business. Could you comment on that quickly?

Mr. MCDONALD. I agree with you, Congressman Buchanan. And you are right. It is about half.

Mr. BUCHANAN. Yes. So what would you suggest? When you are having discussions around the Business Roundtable, hopefully—are you guys talking about C corps? Or are you looking at all the other entities, the LLCs and sub-S's and partnerships and everything else?

Mr. MCDONALD. Well, as I suggested earlier, my comments were about creating a competitive Code for everyone, not just our members, which tend to be the larger corporations. But we realize that 50 percent or so are the smaller companies, and we think that the Code has got to be competitive for all of them.

Mr. BUCHANAN. Thank you.

Mr. Hudak, let me just ask you quickly. When you look at it in terms of jobs, the fact of the matter is that 70 percent of the jobs created in America are created by small- and medium-sized businesses. In the State of Florida, Tallahassee, 99 percent of all companies registered in Tallahassee, whether they are LLCs or partnerships, are small- and medium-sized businesses. What is the biggest one or two things—because you primarily work with small businesses—we can do or should consider to help small businesses in terms of cost and complexity? What do you think are the two biggest things we could do in terms of having an impact?

Mr. HUDAK. Simplification on all levels of the Tax Code. For instance, a sole proprietor, just to take the home office deduction, it is a one-page form that refers to the instructions 13 times. Something you shouldn't do is like the 1099 provision. Right now, as a tax practitioner, I feel more like a paper pusher. I don't know who is going to collect all the W-9s to collect that information, but we don't have the staff to do it.

Mr. BUCHANAN. Thank you. I yield back.

Chairman CAMP. Thank you. Mr. Schock is recognized.

Mr. SCHOCK. Thank you, Mr. Chairman. And thank you, once again, for hosting this very important first hearing.

Mr. McDonald, has your group studied approximately how much money among your member companies and companies at large could be repatriated if Congress does act to allow for either perma-

ment or temporary repatriation at either zero or some small amount?

Mr. MCDONALD. I don't have that number right now, Congressman, but we can get back to you with that number. We have chosen, as a group, to prioritize the whole discussion of getting to a competitive system and a system which is territorial rather than worldwide, which would allow for the repatriation. But we can get you that number.

Mr. SCHOCK. Okay. And since that is your focus, what is the rate that you have decided would be necessary here in the United States that would not incentivize the sourcing of a multinational from a foreign source?

Mr. MCDONALD. Right. We haven't chosen a single rate. Again, I think the exercise we all need to do together to be fiscally responsible is to look at those OECD countries that we are competing with and see what effective rate we would need in order to compete effectively with them. But we haven't chosen the number yet. We look forward to working with you to do that.

Mr. SCHOCK. Yeah. I think this is a very important action that we can take sooner rather than later and doesn't have to be a part of the larger discussion of Tax Code simplification. I find it hard to believe that some of my colleagues think that if we repatriate this money, no jobs will be created. We met with a CEO of a large publicly traded company yesterday who estimated \$30 to \$40 billion just in that company alone that would be repatriated. I would have to think it would be in the trillions of dollars with all companies and that no jobs would be created here if that money came to our economy seems a bit crazy.

Dr. Sullivan, in your estimation, your opinion, which seems to vary a little bit from the rest of our panel, do you have a number in mind in terms of what you think the corporate rate in America needs to be to disincentive foreign sourcing when the customer is of equal distance?

Mr. SULLIVAN. Thank you for the question. Obviously, we want the rate as low as possible. Let's talk about what realistically can happen. Based on Treasury estimates, if we just do revenue-neutral corporate tax reform and get rid of most of the major incentives—we are talking about research credit, production credit, accelerated depreciation, we go full throttle, we would be lucky to get down to 30 percent, if we want to be revenue-neutral. If we want to go below that, but we need to—

Mr. SCHOCK. Let me ask you this: Are you making the assumption that the level of investment would remain static regardless of what the rate would be?

Mr. SULLIVAN. No. No, I am not. I think investment would increase as a result of the lower rate.

Mr. SCHOCK. And you stated earlier that obviously there is some risk reward based on that. So do you have a number in mind?

Mr. SULLIVAN. A number for—

Mr. SCHOCK. What the rate should be.

Mr. SULLIVAN. As low as possible.

Mr. SCHOCK. Like 0 percent?

Chairman CAMP. Thank you. The gentleman's time has expired. Mr. Blumenauer is recognized.

Mr. BLUMENAUER. Mr. Chairman, let me begin by expressing, as a number of our colleagues have, an appreciation for your starting our deliberations dealing with the Tax Code. I think you have taken the right direction and, I will say, the right tone. I have appreciated that and look forward to working with you on it, because this is, clearly, a unique opportunity. Part of the opportunity is just simply the value that is wasted, that you have documented, Ms. Olson. Part of our difficulty in having a productive conversation about the Tax Code is that it is so hopelessly complex that everybody is right. Every generalization, every complaint, right, left, center, they are right. They can find an example.

I am a tax junkie, as a revenue committee chair and a State legislator eons ago. I went to law school and took tax classes because I wanted to learn more about the job. I could not do my taxes today under torture with weeks worth of time, and I am not Warren Buffett. It is a scandal, and it is approaching a crisis point. The cost of compliance, the disconnection from tax provisions with what they were intended to do, the alternative minimum tax, the tax on millionaires who evaded taxes has morphed into a tax on the near rich who pay their taxes. And no billionaire hedge fund is ever touched by it.

I hope, Mr. Chairman, that we will be able to move forward with this with dispatch because I think it is a symbol of whether or not government itself can respond to something which is universally agreed that is in need of fixing, but whether we can follow that path. And in that connection, I guess I just have one question that I would offer to Ms. Olson and Mr. McDonald: Can we do this successfully if we disconnect the individual tax provisions from business? Or do they need to be done concurrently?

Ms. OLSON. Well, I think that although the business and the individual issue—they present different issues and different questions, but I do not think you can do them separately, in part because so many businesses are pass-through entities, and you still have to deal with the individual side.

Mr. BLUMENAUER. Mr. McDonald.

Mr. MCDONALD. Yes, sir. I would agree with that as well. Many of those pass-through entities are suppliers of ours, and they are very critical to our business all over the world, so it has to be done together.

Mr. BLUMENAUER. Thank you.

Chairman CAMP. In an effort to continue everyone's opportunities, Mr. Rangel and I have had a discussion, and we are now going to move to 2 minutes per member. So with that, Mr. Lee is recognized.

Mr. LEE. Thank you, Mr. Chairman. With shortness of time, I will just make a brief statement. But really, what I heard here today, and as a former businessman, what we hear with regard to the Tax Code—does not bring a lot of confidence for businesses to want to invest in this country with all things being equal. With regards to labor, the cost of building a facility, when you have this differential in the Tax Code, it is mind-boggling. And Ms. Olson talked about 6.1 billion hours with regards to compliance costs. The only area of this economy where I know we spend more time is de-

bating health care. So that is a frightening number because that is a cost that is an impediment to job growth in this country.

Some of the recent statistics, The Wall Street Journal reported just a few weeks ago that literally \$2 trillion in liquid assets are sitting on the sideline primarily because we do not have enough certainty. Our Tax Code over the last decade—literally, 10 years ago there were very few pieces of tax legislation that would be considered temporary, less than 12 to 18 months. Today that number has grown exponentially; thereby, again, making decisions on long-term investments in capital. We want to attract the other multinationals to the United States.

So we said, the Fortune 500—we look now on the position of U.S. corporations. There are many other countries around the world. We want those jobs here. Unless we do something about our Tax Code and make it a priority, we won't see the significant job growth that all Americans, frankly, deserve to have. I appreciate you being here today and look forward to moving forward on the subject.

Chairman CAMP. Thank you. Ms. Jenkins is recognized.

Ms. JENKINS. Thank you, Mr. Chairman, and thank you for holding the hearing.

I join my colleagues in having a passion for this particular topic. In particular, I have a keen interest in it. I spent, in my real life, many years practicing public accounting on the tax side of things. And I recall the last time Congress discussed tax simplification was a wonderful time in my career because there was job security.

So every time Congress begins a discussion about job security, I think every CPA firm in the tax department holds a party that day. And so with that in mind—I know we don't have enough time. I could spend hours with you folks. But does anybody want to just try to prioritize for us, if you could change three things, what they might be? Keeping in mind, I guess, the priority would be job creation and economic growth, if anybody wants to tee that up. And then I would just love to know your two second thoughts on the flat tax, and the Fair Tax.

Mr. MCDONALD. I would certainly prioritize, Congresswoman Jenkins, getting to a competitive tax system because, as you saw, we are uncompetitive with our foreign competition today.

Mr. HASSETT. I think that the main thing is the corporate rate just has to come down to make us more competitive. So that is all three of my things.

Mr. SULLIVAN. Ms. Jenkins, what I would just add to that is, this tax reform has to take into account our two credible deficit problems, which I don't think this Congress has fully come to grips with yet. Thank you.

Chairman CAMP. All right. Thank you. Thank you very much. Mr. Kind is recognized.

Mr. KIND. Thank you, Mr. Chairman. I want to thank you for holding this hearing, which I hope will be the beginning of many hearings that we have in this session. And one recommendation, Mr. Chairman, is perhaps getting the co-chairs of the Fiscal Commission, upon which you and others serve, to testify with some of their recommendations. Is it effective for the Tax Code and deficit reduction. But, Ms. Olson, let me first start with you and thank you for the work that the National Taxpayer Advocate office does

and your recommendations that you submit to us from time to time.

And I hope all of us do heed your admonition that we don't lose sight of the individual tax implications because—and I think you are right. I think there is a sense of fundamental unfairness for average working families, individuals, small business owners who feel that unless they have got their team of accountants, team of tax lawyers, that they are not able to take advantage of the great complexity and the loopholes that do exist. I think this does affect the compliance issue of tax filing and the underreporting and the cheating and the tax gap that has grown, just given the complexity of this Code.

So as we move forward, I hope that we can marry the issues of corporate reduction along with the individual rate, which I think is going to be imperative. My guess is that most of the folks in the audience today are more focused on the corporate rate and what is going to happen there and not the individual rate.

But back to Mr. Hudak raised with us today in his testimony and written testimony, most of the business in this country are pass-through entities. They are not C corps. They are S corps. They are sole proprietors. They are partnerships. And that is why getting to the individual rate is going to be so important for most of the job growth that does occur in all of our individual districts, which are small business-oriented, rather than the larger multinational businesses and the implication.

But I also agree with the rest of your testimony that, as we get into the corporate tax rate, this should be done through the prism of international competitiveness issues in light of the changes that have happened with the Tax Code in other countries, and to make us as competitive as we need to be. But it is one of the reasons—back to you, Mr. Hudak, why I have had legislation, the S corp modernization bill, to try to simplify and make easier the compliance and also to get at the built-in gains issue that we have to work on. So working with you and others, hopefully we will have a chance to get into that. Thank you again, Mr. Chairman.

Chairman CAMP. Thank you. Mr. Paulsen is recognized.

Mr. PAULSEN. Thank you, Mr. Chairman. And a lot of the conversation—I know whenever tax reform is brought up—it surrounds simplicity, fairness, the complex arguments that we heard about today. But I am pleased that a lot of the conversation today, obviously, is about economic growth and competitiveness, without a doubt. And I am wondering—maybe Mr. McDonald first—if you can just expand a little bit and talk a little bit about debt versus equity and the concept of how we encourage businesses and individuals to borrow and to finance their operations through debt rather than through asset creation or capital formation. And why that is important? Why we should be focused on that?

Mr. MCDONALD. Well, I understand that Steve Ballmer was here yesterday talking about the amount of money that Microsoft has overseas. And obviously with that money overseas and the inability to repatriate it without paying more tax—again, I want to, again, underscore the fact that we all pay tax in overseas markets. The difference with the United States and a very few countries that I showed on the chart was, you have to pay an additional tax

when you repatriate the money to your home country. There are very few countries in the world that do that. The United States is one. This causes them to have to borrow money here.

At the Procter & Gamble Company, we pay almost half of our profits in dividends, and most of our shareholders are our employees, our retirees, are people in this room. They are not institutions. Less than half of our shareholders are institutions. We have to have that cash in order to pay those dividends, and it becomes a burden to create that cash when you have to pay a higher tax rate on that money coming back. You are, in a sense, taxing the shareholder, taxing the common person.

Mr. PAULSEN. Thank you, Mr. Chairman.

Chairman CAMP. Mr. Berg is recognized.

Mr. BERG. Thank you, Mr. Chairman. This is my first hearing, and I can't think of a better topic. I am just tickled pink hearing all of the people that have presented. And you know, an issue like this is just so critical. I am a small businessman. It is good to hear that my colleagues, both Republicans and Democrats, have the same frustration with their taxes as I do. So again, I don't want to take any more time here. But just thank you for being here, and I thank the chairman for holding this meeting.

Chairman CAMP. Thank you. Mr. Pascrell is recognized.

Mr. PASCARELL. Thank you, Mr. Chairman. And thanking you for bringing us together on this critical issue. Ms. Olson, it is always an honor and a pleasure to listen to you because you make sense. You are a true advocate, and I am glad you brought up the subject of the average taxpayer because frequently, as has happened frequently, that person is forgotten. So while we are maybe trying to prioritize the cutting of corporate taxes, which I think is important and we need to address and it will be addressed, you cannot—and I want to know if you disagree with me—you cannot address, for instance, that issue in a vacuum without talking about what the trials and tribulations are of folks who are making \$25,000, \$30,000, \$35,000. Do you agree or disagree with me?

Ms. OLSON. I absolutely agree with that.

Mr. PASCARELL. Now do you think then that systemic change is doable?

Ms. OLSON. Yes. I think it is entirely possible. And it will take great courage and dedication. And I think you have to educate the public. We were talking about educating the public about businesses, but we need to educate the public about what they get as benefits through the Code and what will happen if we get rid of some of those benefits but lower rates.

Mr. PASCARELL. And educating the public is critical?

Ms. OLSON. Absolutely.

Mr. PASCARELL. And ourselves. Because take, for instance, and I don't make this a centerpiece. Take, for instance, do you think most Americans know that most of the folks, the great folks that are on the panel with you, that Federal, State, and local income taxes consumed 9.2 percent of all personal income in 2009 which is the lowest rate since 1951?

Ms. OLSON. Probably.

Mr. PASCARELL. Yes or no?

Ms. OLSON. No.

Mr. PASCARELL. Do you think that is important in looking at this thing in context?

Ms. OLSON. Yes, absolutely.

Mr. PASCARELL. Do we know what we are talking about on this side of the aisle, on this side of the barrier here about taxes?

Ms. OLSON. Do you know what you are talking about?

Mr. PASCARELL. Yes.

Ms. OLSON. Absolutely.

Mr. PASCARELL. Thank you.

Ms. OLSON. You are welcome.

Chairman CAMP. The gentleman's time is expired. Ms. Black is recognized.

Mrs. BLACK. Thank you, Mr. Chairman. And likewise, as has already been said, this is certainly a very important topic. I know in consideration of the time, it may be that we won't be able to answer these two questions that I have, and perhaps more in writing. And I am not sure that you will have an immediate answer to them.

But Ms. Olson, for you, I am looking at individuals. I am curious, if we were to simplify the system—because you have testified that people don't trust and they try to evade has there been any study done to show that if there were a more simplified system that we would, perhaps, collect more revenue because of so much evasion? And that would be one question that I would have.

Ms. OLSON. I think it depends on how you structure the system. We know when people have withholding and the income is reported to the IRS that 99 percent of the taxes, their incomes is reported. And so the taxes are paid on that income. When you don't have that kind of reporting and you have lots of opportunity to take deductions and claim special benefits, then that increases the opportunity to, you know, avoid an underreport.

So if you structure the system right, you can minimize non-compliance. The more complexity you have in the system, the more opportunity you have to have noncompliance.

Mrs. BLACK. Thank you. Mr. Chairman, my understanding is that we are able to submit questions that then can be answered separately. Am I correct on that?

Chairman CAMP. Yes. Members are able to submit questions for the record. And if they do, I hope our panel will respond promptly.

Mrs. BLACK. Thank you.

Chairman CAMP. Thank you. And now Ms. Berkley is recognized.

Ms. BERKLEY. Thank you. I want to thank you, Mr. Chairman. I think this was a wonderful hearing and I am glad it is just the beginning of a process. I would like to submit for the record my opening statement, which I wasn't able to make.

[The information received:]

**Shelley Berkley**

*Opening Statement*

Thank you, Mr. Chairman, and thank you to the witnesses joining us today. A serious discussion about reforming our nation's Tax Code is long overdue. The Tax Code is an area of law our constituents interact with everyday, yet we have created a system of taxation that is so dense and so complicated that few ordinary Americans—including, I'm sure, many Members of Congress—are able to calculate their

taxes competently and confidently. This complexity harms individuals, families, businesses big and small and the economy at large by cementing into law inefficiencies in the way people do business. Creating a Tax Code that removes these issues, and creates a system that is more accessible and comprehensible to the American public, has the potential to fix many of these problems.

Merely saying that we need tax reform for the sake of simplifying the code is not enough. As we look at the code, it is important to do so with an eye toward maintaining a fundamental level of fairness with regard to the burdens of taxation. I'd like to ensure that all taxpayers pay their fair share, and that those at the top of the income scale aren't able to manipulate the system at the expense of us all.

Warren Buffett has noted in the past how appalled he is that he pays a lower effective tax rate than most of his employees, despite being one of the wealthiest men in America. Efforts at reform must address this phenomenon so all Americans feel they are being given a fair shake by the system. We must thoroughly review the many deductions, credits and incentives we have created in the past and ensure they are still relevant to the economy today. We must not be caught up in maintaining an inefficient status quo merely because some of these breaks have "always been there." Reform, done right, could help spur our economy and bring greater fairness and predictability to the system.

I look forward to working with my colleagues on the Committee in the months ahead to craft a tax reform package that is fair, efficient, and far less complex than our current system. Doing so will help the American economy by removing inefficiencies that harm our citizens and businesses.

Ms. BERKLEY. I am very glad, Ms. Olson, that you talked about that we need to do the individual reforms with the corporate reforms. In my family, when I was growing up, my father was a waiter in one of the Las Vegas hotels. The way we did our taxes is we waited for my Uncle Nattie to come from New York once a year to do the taxes for us. And I don't think that is a good process for any American family, and I am sure, least of all, my own.

We just passed a massive tax package last month and in it, it had all the tax extenders, every one of them I supported. And I felt that I had friends in the race car track world. And the taxi companies that use propane gas, they kind of camped out in my office and explained how important all of these tax credits and tax breaks were to their business and how much they created jobs.

Now let me ask you something. If we actually lower the tax rates for corporations and companies throughout the United States, is that going to be enough? Are they going to be willing to give up all of these individual tax credits and breaks that are in our Tax Code? Or are they still going to be coming to me, explaining how they still can't make ends meet, they are going to go under, and they need have additional tax breaks? Because that is going to kill us when it comes to our deficit. There has to be revenue coming in somehow to support this country.

Ms. OLSON. Can I make a point about that? I think that that goes to the need for education so that people understand that at least on average, maybe their bill won't increase. But on the other hand, I think it is very important that we will never get rid of everything. And so when you decide to put something in the Internal Revenue Code, you have to make sure that you all have the information to be able to evaluate.

Chairman CAMP. And the witnesses can submit their answers in writing.

Ms. BERKLEY. And let me ask one other question that I was going to submit about repatriation.

Chairman CAMP. But Mr. McDermott and Mr. Levin would like to question. So Mr. McDermott is recognized.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I ask unanimous consent to enter into the record an article by David Cay Johnston called Johnston's Take, Reasons, Rules, and Riots: Our Societal Panic.

Chairman CAMP. Without objection.  
[The information follows:]

**Mr. McDermott**

*Statement for the Record*

Reasons, Rules, and Riots: Our Societal Panic

By David Cay Johnston

On the surface, what's going on with tax policy in Washington right now seems crazy. A Democratic president whose enemies call him a socialist makes a deal with Republicans that sells out both his party and the very tax promises that won him the election, while Republican leaders who say that debt is our overwhelming domestic problem insist on borrowing tens of billions of dollars to give tax savings to the richest among us. The polls, at the same time, show the public overwhelmingly favors ending tax cuts for high earners.

What we are witnessing, however, is much more profound than political, economic, or fiscal insanity. And it goes much deeper than disputes over whether extending temporary tax cuts for two years and long-term jobless benefits for 13 months is politically or economically smart. Those are mere manifestations of a much more pervasive problem. America is in the grip of a full-blown societal panic. Crazy, irrational, contradictory ideas about tax policy are just the most obvious symptom. Societal panics occur when the expectations and rules everyone has been accustomed to living under no longer work. They occur when some new force changes the rules of the game—a force that may be easy to identify or invisible, but whose effects are far-reaching and unstoppable.

Sometimes that force comes from nature, sometimes from a discovery, sometimes from inventions of the human mind. But in every case throughout history, that force, like the waters pouring over Niagara Falls, cannot be stopped, although sometimes it can be harnessed.

Because no one knows quite what to do when the old ways stop working, panic sets in, replacing reason. Crazy responses spread until an idea or a leader emerges, a new way to make sense of the change. The new leader is often the one who persuades people that it is better to live by new rules.

Humans have experienced societal panics time and time again. Sometimes they end in tragedy, sometimes in triumph. And those unexpected accidents of history often play a huge role in the outcome.

Consider what happened to the Greeks 2,700 years ago. The Lydians, Greek settlers in what is now the Mediterranean coast of Turkey, found a mine rich with electrum, a naturally occurring alloy of gold and silver. This find resulted in the invention of coinage, an invention so revolutionary that it launched the ancient Greeks into a societal panic that lasted two centuries, but at its end gave us two of the most powerful, intertwined, and enduring principles of Western Civilization—the moral basis for progressive taxation and democracy.

America was in the grip of a societal panic from the end of the Civil War until 1893, an era historians call the Gilded Age, but that could just as easily be called the Agrarian Death or the Industrial Triumph as America the land of yeoman farmers became America the land of industrial might. It was an era of turmoil and conflict—gilded mansion ceilings and a famous speech about oppressive debt and a gold cross; the invention of the electric light and violent night-time attacks on workers seeking more pay; and our first encounter with a politician who lost the popular vote but became president anyway.

Our current societal panic began almost four decades ago, when the economic glow created by emerging from World War II with half the world's industrial capacity wore off and President Nixon went to Beijing, opening the door to the transfer of that manufacturing capacity to China. The long-term effects of this, and the faux "free trade" policies adopted at the behest of our financier class, took time to affect society, just as the invention of coinage did not instantly disrupt ancient Greek social and commercial relations. Our panic turned into wildly unthinking behavior at the end of the last century, with taxes as the first sign that reason was giving way to belief, that dogma was trumping empirical evidence.

But while the symptoms we see are crazy tax policies, crazy borrowing, and neglect of the commonwealth property and policies that are the foundation for private wealth creation, our panic is about something much deeper.

David Cay Johnston is a former tax reporter for *The New York Times* and teaches at Syracuse University. He has also written two books about taxes, *Free Lunch* and *Perfectly Legal*.

Johnston shows how lessons from history can inform our chaotic tax debate.

Our societal panic is about what we as a nation fear almost as much as death itself—the end of American abundance, the death of the idea that each generation would do better than the last, the end of the notion that everyone who works hard and plays by the rules will at least prosper in the sense of having a roof over their heads and enough to eat. Our societal panic is about a new world of mind-numbing complexity where speculation with algorithms and borrowed money pays more in a day than thoughtful investment may return in a lifetime, where jobs pay less tomorrow than yesterday, and where loyalty is something we associate with frequent flier programs rather than careers.

Societal panics are like riots, something I found myself in the middle of a number of times in the turbulence of the '60s and '70s. When crowds turn violent, with steel pipes intended to support saplings pulled from the ground as weapons, when lines of police swing batons at anyone in their way, when rocks and bottles rain down from rooftops through a fog of tear gas, the natural instinct is to join the wildness, to become mindless because nothing makes sense but escaping the fear, the terror, that envelops you.

Keeping your head, becoming coldly rational, makes it possible to sidestep the cudgels and spot the street furniture that can provide a canopy from the hail of deadly missiles launched from the rooftops. But even if you keep your head, in riots there is no place for rational discussion. Fear is all consuming. As the novelist Frank Herbert taught us in *Dune*, his tale of an entire universe in panic and a new leader who ended the panic, fear is the mind killer.

The fear of what the new American economy means is killing reasoned debate about taxes, tax policy, and how to distribute the burdens of making our great nation function.

Fear keeps us from talking about how to create an economy in which prosperity is widespread and how using taxes can make us richer by insuring the efficient and bountiful supply of the common goods and services that modern economies require: education, research, infrastructure, and universal healthcare as a service, not a profit-making insurance product.

While societal panics are difficult to appreciate when you are in them, once they have passed they are easy to identify, along with their causes and how the problem that brought on the panic was resolved.

Often the disruptive force is unknown to a society, like the microbes that brought the Black Death to Europe, bequeathing us the murals of the *Danse Macabre*, featuring skeletons holding hands with kings and popes. Sometimes the force is obvious, as when locking up all the land in perpetual trusts (which many states now allow) brought worsening poverty to 18th century France until Dr. Guillotine's cutting edge severed the problem at the head.

Sometimes the disruptive force is obvious, as when the Lydians discovered electrum. The gold and silver alloy could be pressed into tokens that, in time, evolved into coins of different value.

The jingling of coins is so common today we think nothing of them. At their invention, however, the ease of engaging in transactions and building up a store of cash challenged ancient societies, which were built more on cooperative relationships than any medium of exchange.

It took the Greeks two centuries to work through the issues that began in Lydia, what we now call the Age of Tyrants. Their panic eventually produced the plays of Aristophanes and in time gave birth to two of the greatest ideas of Western Civilization, ideas intertwined to this day—the moral basis of progressive taxation and the various forms of selfrule we call democracy.

But before the classical age in Greece there was draconian law, named for the dictator Draco, who decreed death for all crimes because, he reportedly said, it was the appropriate sentence for petty theft and he could not think of a harsher punishment for worse offenses.

The Greeks endured these harsh laws for four decades, a reminder of how long people will endure harsh and unjust policies. Then came Solon, who repealed Draco's harsh laws, except for death as punishment for murder. Solon also forgave all debts, which enriched those who had borrowed heavily at the expense of the lenders and, for a time, made credit hard to get for poor farmers.

Eventually the crisis created by coinage helped the Greeks work through the idea of what freedom meant, how laws could define conduct, and how economic power was separate from political power.

This last insight resulted in the Greeks' reasoning that it was only because of Athens—its laws, its courts, its military—that one could legitimately acquire riches and have them protected, for in his natural state man was in a jungle, a war of one against all in which riches came by luck or plunder and could be taken away by brute force.

That insight resulted in the first progressive taxation. The moral basis for this was the principle that the greater the wealth Athens made possible, the greater the burden the wealthy must bear to sustain Athens, which in turn protected that wealth through laws and its military. Intertwined with that was the birth of the ancient world's first recorded example of self-rule through one-man, one-vote for Athenian citizens.

Societal panics, the ancient Athenians showed us, can have remarkably positive outcomes, although getting there can take a long time when much damage is done to society.

Our own nation was in a panic from the end of the Civil War until the economic collapse of 1893, the Gilded Age. After its collapse the underlying conditions changed little until one of those unexpected twists of history changed everything. In September 1901 a disgruntled office-seeker shot President William McKinley near Buffalo, N.Y. The new president was Theodore Roosevelt, who gave substance to the Progressive Era, an unexpected development because the Wall Street interests who detested Roosevelt as governor of New York had made him vice president to make sure he had no power to threaten their interests.

Imagine an America today without the many changes wrought by Roosevelt, or that he encouraged, in his assault on what he called "malefactors of wealth."

In our panic today we are bedeviled by tax policy and an economy built on rules that no longer work. The 20th century, what some historians will look back on as the American Century, prospered under a national, industrial-wage economy, flush with high-paying jobs and tax rules that discouraged withdrawals from operating businesses. Taxing wages was a smart way to finance government because wages were rising. But since 1973, with some brief exceptions, this has not been true for the vast majority, whose average income in 2008 was less than 1 percent greater than in 1980, while incomes at the top soared, spurred in part by rules that encourage withdrawals of capital from business for unproductive consumption because of extremely low tax rates.

The 21st century is an era of a global, digital, and asset economy with rules that favor the free flow of capital over labor, which is brutally suppressed in China and legally suppressed in America through anti-union laws, lack of enforcement of wage laws, and the dampening effects of a growing reserve army of the unemployed.

America's current societal panic is not going away soon. Tens of millions of people are out of work and tens of millions more fear their next paycheck could be their last. The temporary Bush-era tax cuts will not end next month, even though the huge deficits run up since 1980 hover over us like dark clouds of debt that could drop enough worthless government bonds to drown us all.

Yet we must deal with the circumstances we have created for ourselves. The price of self-governance and its freedoms is making wise choices and electing wise leaders or suffering the consequences.

The adoption of misguided economic policies, the election of politicians unwilling to be disciplined in opening the public purse, and the artificial deadlines imposed on us by the legislative gamesmanship used in enacting the 2001 and 2003 tax cut laws, together with our faux free trade policies, have put us in a deep hole.

In clawing our way back we must keep in mind that those Bush tax cuts were not tax cuts at all but simply loans against a future which has now arrived in giant waves of red ink.

There is talk, by very thoughtful people, that we can never recover from this hole, that our fate is sealed, and that we will descend into a future worse than the past within living memory. I believe we can go on to a richer future, but it will take a leader who synthesizes an understanding of how the old rules must be discarded and new ones adopted that flow from the changes in the world economy.

Before we get there things may get worse, much worse, as the Greek experience with Draco and his draconian laws should remind us. But we will never get on a path to sound tax policy, policy that flows from the new economic order instead of against it, until enough of us stand back from the riotous conditions and find a place where rational debate about taxes can grow into popular understanding.

Mr. MCDERMOTT. Talks about the history of taxation and that we establish progressive taxation along the Greek lines because we realize the people at the top got most of the benefits, so they ought to pay most of the taxes. And the Republicans, when they took over the Congress, last week, passed a rule which got no ripple in the press. Nobody even mentions it. They said that if we cut taxes, we don't have to replace the money. It is not a loss to the budget.

Now, I find it very hard, when we have been operating under PAYGO rules, to think that we are going to do any kind of reduction in corporate taxation and not replace the money, unless this is simply a hearing on, how do we cut spending? How do we cut investment in education? In higher education? In infrastructure? I would like to hear from you, Mr. Sullivan. Do I understand correctly what that rule means?

Mr. SULLIVAN. If I understand what it means, it is that tax cuts do not have to be paid for, which I think is—again, in this fiscal environment, is absolutely outrageous and it is dangerous to the long-term health of this economy.

Mr. MCDERMOTT. So it is saying we are really going to make these tax cuts and the only place we will get the money is by borrowing it internationally to continue the level of services that we have in this country. Otherwise, we are going to reduce the level of services?

Mr. SULLIVAN. Obviously, the choice between whether it should be tax increases or spending cuts is a political decision, but I think the rule should be neutral, and these rules are not neutral.

Mr. MCDERMOTT. Thank you. I yield back the balance of my time.

Chairman CAMP. Thank you. Mr. Levin is recognized.

Mr. LEVIN. We have to vote. But I just wanted to take the opportunity, Dr. Hassett. If it isn't directly related—it was in your materials. Or at least I saw them. You talked about the President, "his obsession with manufacturing and his policy of nationalizing GM and Chrysler." I don't think he has an obsession. I think manufacturing matters. And we have not nationalized GM and Chrysler.

Mr. HASSETT. Would you like me to respond?

Mr. LEVIN. Well, let's talk about it another time. But I want us to proceed in a rational bipartisan basis. And when I saw your article, I just wanted to say to you, I think that is not accurate. There is no obsession. There is a concern. And there is no nationalization, sir. We have met with the CEOs, and the last thing they would say is that they have been nationalized. So go out and buy one of their cars.

Chairman CAMP. Dr. Hassett, if you wanted to comment? You don't need to.

Mr. HASSETT. I look forward to having the exchange with Mr. Levin.

Chairman CAMP. This hearing was really about the burdens of the Federal tax system: the compliance burdens the administrative problems, the difficulties for families and small businesses, the problems of creating economic growth under the current system, as well as the high corporate tax rate and the international tax system being increasingly out of step with the rest of the world. But

I want to thank our witnesses for their testimony. This schedule has really been a difficult one this morning for us. Thank you for bearing with us through that. Again, members can submit questions to you, and I hope you will respond. And obviously you have made it very clear that our Code is a complex mess. It is frustrating to families and to businesses big and small. It encourages inefficient behavior. These points were actually made in an opinion piece published by Minority Whip Steny Hoyer. And while I don't necessarily subscribe to everything in that article, his comments about the need to act on a bipartisan basis to reform the Tax Code were right on point. I look forward to continuing this dialogue at future hearings. But for now, the committee is adjourned.

[Whereupon, at 10:55 a.m., the committee was adjourned.]

[Questions for the Record follow:]

**Nina E. Olson**

*Response*

The Honorable Dave Camp  
Chairman  
Committee on Ways and Means  
United States House of Representatives  
Washington, D.C. 20515

Dear Chairman Camp:

I am writing in response to your letter dated February 8, 2011, which requested that I answer two questions for the record submitted by Rep. Diane Black in connection with the Committee's January 20, 2011, hearing on Fundamental Tax Reform. The questions, and my responses, follow.

*Question 1*

Evasion at the individual taxpayer level: What are the statistics regarding tax evasion by individuals?

*Response 1*

The term "tax evasion" is generally used to describe solely willful and intentional noncompliance with the tax law. In practice, the reasons for noncompliance with the tax law form a continuum from confusion about the law's requirements, to errors attributable to the complexity of the law, to noncompliance that is facilitated by preparers, to willful and intentional noncompliance. I believe that the IRS needs to gain a better understanding of the reasons for various types of noncompliance, because the solutions vary based on the cause. For example, traditional enforcement measures may work best when dealing with taxpayers who are willfully and intentionally violating the law, while improved outreach (and, ultimately, tax simplification) may be most effective in addressing noncompliance that results from confusion about the law's requirements. In the National Taxpayer Advocate's 2010 Annual Report to Congress, we published an overview of studies that my office plans to conduct in the next few years to try to get a better handle on the causes of noncompliance.<sup>1</sup>

At present, the IRS does not know the extent to which tax noncompliance is intentional. However, the IRS has conducted periodic research studies to estimate the size of the so-called "tax gap." The tax gap is the amount of tax that is not voluntarily and timely reported and paid. According to the IRS's most recent estimates, which are based on audits of tax returns filed for 2001, the tax gap stands at about \$345 billion per year.<sup>2</sup>

As shown on the "tax gap map" (attached as Appendix A), the components of the tax gap include:

<sup>1</sup>See National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 89–99 (*Researching the Causes of Noncompliance: An Overview of Upcoming Studies*).

<sup>2</sup>IRS, *Tax Gap Map for Year 2001* (Feb. 2007), available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf). These figures do not include unpaid tax on income from illegal activities. Because the IRS projects it will ultimately recover about \$55 billion through late payments and enforcement action, it estimates the annual "net tax gap" to be about \$290 billion. *Id.*

- Nonfiling—\$27 billion (7.8 percent);
- Underreporting—\$285 billion (82.6 percent); and
- Underpayment—\$33 billion (9.6 percent).

A closer look at the data shows that withholding and third-party information reporting are the key drivers of tax compliance. Reporting compliance rates are about 99 percent on wages subject to withholding and third-party information reporting, about 96 percent on income subject to full third-party information reporting (*e.g.*, interest and dividends)—yet less than 50 percent on income *not* subject to third-party information reporting.<sup>3</sup> Unreported income earned by individuals in the “cash economy”—taxable income from legal activities that is not subject to information reporting or withholding—is the single largest component of the tax gap. As shown on the tax gap map, self-employed taxpayers who file returns but underreport their income (and related self-employment taxes) account for about \$148 billion in lost revenue per year, or 42.9 percent of the tax gap.<sup>4</sup>

I have proposed both administrative and legislative recommendations to improve tax compliance in the cash economy.<sup>5</sup> For example, I have proposed legislative recommendations to:

- Increase the use of the IRS’s electronic payment system for estimated tax payments;
- Authorize voluntary withholding agreements;<sup>6</sup>
- Eliminate the corporate exception from information reporting for small corporations;<sup>7</sup>
- Accelerate the taxpayer identification number validation process;
- Provide for withholding on payments to noncompliant contractors;<sup>8</sup> and
- Require financial institutions to report all accounts to the IRS by eliminating the \$10 minimum on interest reporting.

<sup>3</sup> IRS, *Tax Gap Map for Year 2001* (Feb. 2007), available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf).

<sup>4</sup> *Id.* The \$148 billion figure includes \$109 billion attributable to unreported business income on individual tax returns and \$39 billion attributable to unpaid self-employment taxes. *Id.*

<sup>5</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 490 (Key Legislative Recommendation: *Measures to Address Noncompliance in the Cash Economy*); National Taxpayer Advocate 2007 Annual Report to Congress 35 (Most Serious Problem: *The Cash Economy*); National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 1 (*A Comprehensive Strategy for Addressing the Cash Economy*). See also National Taxpayer Advocate 2003 Annual Report to Congress 257 (Key Legislative Recommendation: *Tax Withholding on Nonwage Workers*); National Taxpayer Advocate 2004 Annual Report to Congress 478 (Key Legislative Recommendation: *Tax Gap Provisions*); National Taxpayer Advocate 2005 Annual Report to Congress 381 (Key Legislative Recommendation: *Measures to Reduce Noncompliance in The Cash Economy*); Statement of Nina E. Olson, National Taxpayer Advocate, Before the Senate Committee on Finance, The Tax Gap and Tax Shelters (July 21, 2004), available at [http://www.irs.gov/pub/irs-utl/nta\\_sfc\\_testimony\\_tax\\_gap062104.pdf](http://www.irs.gov/pub/irs-utl/nta_sfc_testimony_tax_gap062104.pdf); Statement of Nina E. Olson, National Taxpayer Advocate, Before the Committee on the Budget, United States Senate, The Causes of and Solutions to the Federal Tax Gap (Feb. 15, 2006), available at [http://www.irs.gov/pub/irs-utl/nta\\_senbudget\\_taxgap\\_021506.pdf](http://www.irs.gov/pub/irs-utl/nta_senbudget_taxgap_021506.pdf); Statement of Nina E. Olson, National Taxpayer Advocate, Before the Subcommittee on Federal Financial Management, Government Information, and International Security of the Committee on Homeland Security and Governmental Affairs, United States Senate, The Tax Gap (Sept. 26, 2006), available at [http://www.irs.gov/pub/irs-utl/nta\\_testimony\\_senate\\_hsgac\\_092606.pdf](http://www.irs.gov/pub/irs-utl/nta_testimony_senate_hsgac_092606.pdf).

<sup>6</sup> For similar proposals, see the TAX GAP Act of 2010, S. 3795, 111th Cong. (2010) and Treasury Department, General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals 99 (Feb. 2011).

<sup>7</sup> Businesses making payments totaling \$600 or more in a calendar year to any non-employee service provider (*i.e.*, a contractor) that is not a corporation are generally required to send an information return to the IRS setting forth the amount as well as the name, address, and Taxpayer Identification Number (or TIN) of the contractor. IRC §§ 6041(a) & 6109(a)(3). Effective for payments made after December 31, 2011, the Patient Protection and Affordable Care Act, Pub. L. No. 111–148 (2010), expanded this information reporting requirement to include payments to a corporation (except a tax-exempt corporation) and payments for property. The National Taxpayer Advocate recommended that Congress repeal this requirement with respect to payments for property while retaining the requirement with respect to payments to corporations for services. National Taxpayer Advocate 2010 Annual Report to Congress 373–376. The Treasury Department recently made a similar proposal. See Treasury Department, General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals 97 (Feb. 2011).

<sup>8</sup> The Treasury Department recently made a recommendation to require businesses to withhold tax on payments to contractors who did not provide them with a valid TIN-name combination. Treasury Department, General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals 99 (Feb. 2011).

*Question 2*

Corporate tax: We know the high U.S. corporate tax rate is not the only factor that U.S. companies consider when deciding where to locate future investments and that companies also consider such things as the workforce, ease of access to raw materials, quality of the infrastructure, stability of the legal and political environment, the location of customers and the cost of shipping finished goods to them, etc. Can you help explain how companies weigh these factors and how large—or small—a factor the U.S. statutory tax rate is?

*Response 2*

I agree with the thrust of the question that corporations consider more than merely tax rates when deciding where to invest and locate their operations. Depending on the circumstances, costs such as those for labor or raw materials could outweigh tax effects. By statute, my office focuses on tax administration, and we do not have the expertise to identify or quantify factors that are considered in corporate decision-making.

For your convenience, I note that the Congress has at its disposal a staff of non-partisan economic experts who may address these issues in publications for Members. In particular, the Congressional Research Service (CRS) has observed that business relocation may be “the result of a variety of factors, ranging from technological progress, to exogenous shocks, to changes in institutional policies.”<sup>9</sup>

\* \* \* \* \*

I hope you find these responses useful. If you have further questions, please feel free to contact my office at (202) 622–6100.

Sincerely,

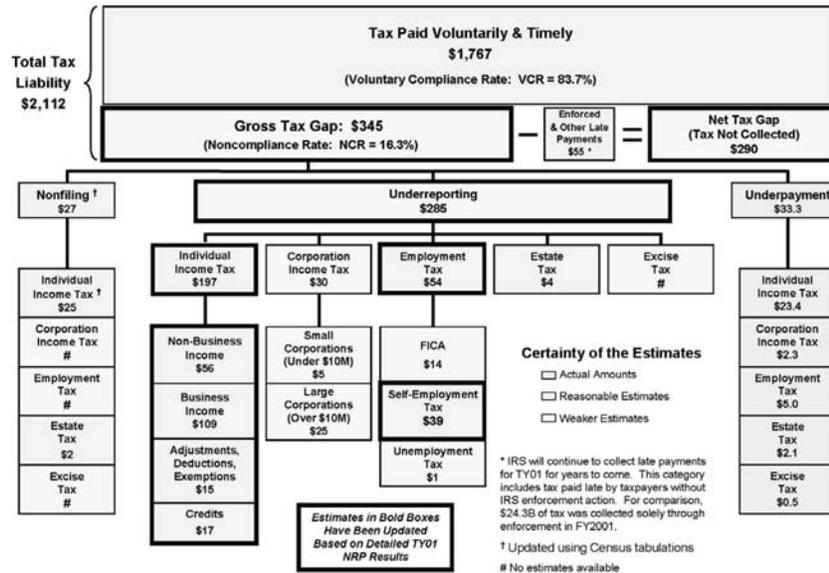
Nina E. Olson  
*National Taxpayer Advocate*

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<sup>9</sup>David L. Brumbaugh, *Taxes and International Competitiveness*, RS22445 (May 19, 2006) 6; see Staff of the Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses*, JCX–22–06 (June 21, 2006) 57 (stating there “is no consensus on what method of taxing international investment income minimizes distortions in the allocation of capital when nations tax income at different effective rates, but the alternatives of capital export neutrality and capital import neutrality are the most cited guiding principles”), available at <http://www.jct.gov/publications.html?func=startdown&id=1498>; *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*, Report of the President’s Advisory Panel on Federal Tax Reform (Nov. 2005) 104 (stating that the tax consequences of investment abroad depend “on the circumstances of the taxpayer”); *Simplification, Compliance, and Corporate Taxation*, Report on Tax Reform Options of the President’s Economic Recovery Advisory Board (Aug. 2010) 85–86 (discussing effects on the location of the economic activities of U.S. multinationals).

## Appendix A—Tax Gap Map Tax Year 2001 (\$ Billions)

Internal Revenue Service, Feb. 2007



**Responses to Questions for the Record submitted to Robert McDonald  
for the Committee on Ways and Means hearing on Fundamental Tax  
Reform, held January 20, 2011**

Questions from Rep. Diane Black

- 1. Evasion at the Individual Tax Payer Level:** What are the statistics regarding tax evasion at the individual level?

A: We do not have data independent of that compiled by the IRS on this matter. I believe the Taxpayer Advocate, Nina Olson, who testified on this panel is best able to provide you the appropriate information or refer you to the office within IRS who has studied the data.
- 2. Corporate Tax:** We know the high U.S. corporate tax rate is not the only factor that U.S. companies consider when deciding where to locate future investments and that companies also consider such things as the workforce, ease of access to raw materials, quality of the infrastructure, stability of the legal and political environment, the location of customers and the cost of shipping finished goods to them, etc. Can you help explain how companies weigh these factors and how large—or small—a factor the U.S. statutory tax rate is?

A: All of these factors are important and the relative importance of each factor will differ from product to product based on the attributes of the product. For many products, transportation costs can be a significant component of the total cost of manufacturing, so production needs to be located near the customer and consumer. More generally, each of these factors has to be included in an investment model in order to determine whether a company can deliver the final product to the consumer at a competitive price. For some investments, U.S. taxes—at about 39 percent of net income—can represent a sizable share of the return on investment and will weigh heavily in the investment decision.

One clear example of how taxes can affect the investment decision is when a foreign company is considering investing in North America. The company will soon be able to invest in Canada with a tax rate of about 25 percent or

it can invest in the United States with a 39 percent tax rate. In many cases, this tax difference will outweigh other factors and drive the investment decision to Canada.

The high U.S. rate affects other decisions that can also be counterproductive to the United States. The high U.S. rate in conjunction with our worldwide system of taxation also discourages repatriating foreign earnings to the United States because of the U.S. tax imposed on these remittances.

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**Warren Hudak**

**Responses to Questions for the Record  
Ways & Means Committee**

*February 22, 2011*

***Evasion at the Individual Tax Payer Level***

***What are the statistics regarding tax evasion by individuals?***

The starting point for any statistics relative to tax evasion begins by looking at the available data regarding the tax gap. The tax gap is defined as the amount of income owed to the Federal Government compared to the amount actually received. The estimated tax gap is about \$345 billion, but after enforcement efforts the total is closer to \$290 billion.

About 70 percent of the gross tax gap is attributable to the individual income tax. The individual income tax is the largest source of federal receipts.

Determining the reason for the tax gap is more difficult. Intentional evasion is difficult to measure, since it requires an intentional act and we can only measure those taxpayers who have been caught. In addition, a certain amount of the tax gap is the product of errors.

From the perspective of small business owners, simplifying the Tax Code would be a good way to help address these problems. A simplified Tax Code will reduce errors and also provide fewer opportunities for those looking to evade their tax obligations.

***Corporate Tax***

***We know the high U.S. corporate tax rate is not the only factor that U.S. companies consider when deciding where to locate future investments and that companies also consider such things as the workforce, ease of access to raw materials, quality of the infrastructure, stability of the legal and political environment, the location of customers and the cost of shipping finished goods to them, etc. Can you help explain how companies weigh these factors and how large or small a factor the U.S. statutory tax rate is?***

Your question outlines the main issues a business raises in determining where to locate future investments. The tax rate is certainly part of that consideration. For most small businesses, the statutory corporate rate is less of a factor than for a larger business. First, most small businesses are organized as pass through entities—about 75 percent—so they do not pay the corporate tax rate, but the individual tax rate. Second, fewer small business operate abroad so the corporate tax rate relative to the rest of the world is less of an issue.

That being said, tax rates are an important decision for any business owner. For smaller businesses, the federal tax rate is only part of the consideration. They must also consider the state and local tax rates, which when stacked with the federal rates in some states are creeping towards 50 percent. This is why keeping the individual tax rate low is so important for small businesses. The money that a business earns is often put back into the business or used to start another business. A successful small business will look for the next opportunity—either opening another branch or diversifying into another business. This is one factor that makes the small businesses a driver of job creation. Raising the individual tax rate deters capital formation and reduces the ability of small business owners to make the investment in new firms.

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**Kevin A. Hassett, Ph.D.**

*Response*

*March 21, 2011*

Committee on Ways and Means  
U.S. House of Representatives  
1102 Longworth House Office Building  
Washington, DC 20515-6348

Dear Representative Black:

Thank you for your questions. Please feel free to contact me if you would like additional information.

1. Evasion at the Individual Tax Payer Level

According to the latest IRS report on the tax gap, dated July 8, 2009, the estimated overall non-compliance rate for tax payments is approximately 16%. The gross tax gap is estimated at \$345 billion. After enforcement efforts, the net tax gap is approximately \$290 billion. Underreporting of income by individuals is responsible for approximately 50% of the tax gap. Due to its complexity, the tax gap is not well understood. Contrary to popular commentary, the tax gap is not a readily available revenue source. The gap is very difficult to close, because it would be practically impossible to monitor all the ways people potentially earn income.

Source: [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf).

2. Corporate Tax

There are, as you mention, many factors that determine location decisions, and taxes can, in principle, be a small part of the puzzle. As mentioned by my co-panelist, Proctor and Gamble, for example, often locates its activity close to its customers, which means that it must have operations all around the world. One way to check whether taxes at the margin are important is to watch the revenue impact of lower tax rates. When a nation cuts its rate, it makes itself more attractive, but the rest of its characteristics, presumably, remain the same. The evidence (as reviewed and extended in a recent paper I coauthored with Alex Brill) clearly indicates that there is a wide range over which revenues increase when corporate tax rates decline, suggesting that the tax variable is very important. I would add that for the U.S., at this time, with what is about to be the highest rate in the OECD, cutting the corporate rate would have a bigger impact on the U.S. than virtually any other policy that I can conceive of.

Link for Hassett-Brill reference: <http://www.aei.org/paper/26577>.

Warm Regards,

Kevin A. Hassett

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**Dr. Martin A. Sullivan**

*Response*

**1. What are the statistics regarding tax compliance by individuals?**

Details are important, and on the issue of tax compliance I must refer you to the detailed and excellent study by Eric Toder of the Tax Policy Center ("What is the Tax Gap?" available on the Urban Institute web site).

Let me summarize the situation as I see it. Individual compliance depends on what sort of income we are talking about. Different sources of income have hugely different compliance rates due to the differences in withholding and information reporting.

According to the IRS, underreporting by individuals can be divided into four categories:

1. When there is withholding and information reporting, the rate of underreporting of income is only 1.2 percent.
2. When there is substantial information reporting, the underreporting rate is 4.5 percent;
3. When there is some information reporting, the underreporting rate is 8.6 percent; or

4. When there is no information reporting, income is underreported by 53.9 percent.

Compliance is generally high in the individual sector because the bulk of income is wages (withholding and information reporting) and dividends and interest (extensive information reporting). Most individual noncompliance is due to small business. There is neither withholding nor information reporting on most small business income. Although they are now extremely unpopular on Capitol Hill, expansions of 1099 reporting are critical for reducing noncompliance and catching tax cheats.

## 2. Corporate tax: how important is the statutory rate?

At first glance, it would be reasonable to assume that the statutory corporate tax rate plays a minor role in location decisions. For a typical U.S. manufacturing firm, wage costs are about ten times larger than corporate tax payments. Obviously, the opportunity to cut wage costs in half is far more important than cutting taxes in half. And of course the other factors you mention—access to raw materials, infrastructure, political environment, etc.—are critical.

But, as you well know, business in the 21st century is more about patents and trademarks than bricks and mortar. It is easy to move intangible assets across international borders, and because our transfer pricing rules work so poorly it is easy to shift the profits attributable to these intangible assets to tax havens. So, by locating business operations in low-tax countries, U.S. corporations get a foothold on to which profits from high-tax countries—including the United States—can be directed. In short, the conventionally limited effect of the level of the statutory corporate tax rate on location decisions is turbo-charged by tax rules that allow significant profit shifting.

The significant presence of U.S. multinational corporations in Ireland illustrates these points. U.S. multinationals employ about 90,000 workers in Ireland. Ireland has a 12.5 percent statutory corporate tax rate. And it is this rate that was largely responsible for Ireland's economic boom from 1990 through 2008. U.S. corporations report profit rates about three times greater in than elsewhere. This is not "the luck of the Irish." This is tax law failing to do its job. If Ireland had a rate to 35 percent, it is fair to say the Irish economic miracle never would have happened. Alternatively, if the United States had lowered its corporate tax rate to 12.5 percent, the Irish economic miracle never would have happened.

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**John Pettengill**

*January 19, 2011*

Dear Committee,

Please consider my understanding of the FAIRTAX as expressed below. It seems clear to me that the FAIRTAX is a win..win for both the government and the taxpayers. Thanks so much for your time.

John Pettengill, Richmond, VA

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Under the **FAIRTAX** you will pay **over 4 percent less for everything** and still pay the Federal Government the same amount in taxes as you pay today . . . plus no April 15th tax preparation.

Today the one dollar shelf price of a loaf of bread includes 23% business taxes that are passed on to you. Consequently, under the FAIRTAX, the bread's shelf price will be reduced to just 77 cents. At the register, a 24% FAIRTAX will be added making the total cost to you 95.48 cents or 4.52% cheaper than a dollar. Of course, state and local taxes will still apply as they do today.

Under the **FAIRTAX**, we will have a whole group of **New Taxpayers**:

- Criminals (pimps, prostitutes, gang members, mobsters etc.)
- Tourists . . . since the prices will be the same/less, why not let them help.
- Tax Dodgers . . . those who purposefully avoid the current income tax.
- Those who now work for cash.
- Rich persons with high priced tax lawyers.
- Illegal immigrants (only those who do not pay income taxes now.)

Under the **FAIRTAX**, investment in business, savings and stocks would be free of government taxes and could provide more and better profits . . . and more jobs.

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**John W. McClelland**

*January 25, 2011*

Dear Mr. Chairman:

I am writing on behalf of the 4,000 members of the American Rental Association (ARA). ARA members rent construction and industrial equipment, tools, and party and event equipment to other businesses and the public from more than 7,500 locations throughout the United States. ARA wants to commend you for beginning a dialogue in the Ways and Means Committee that is aimed at developing serious proposals for fundamentally reforming our Nation's income Tax Code.

The equipment rental industry grew up in America in the days following World War II when young veterans came home looking for new opportunities. The scarcity of tools that could be used to provide housing for the growing families of the baby boom was one of the main drivers of the early equipment rental industry. ARA was formed by some of the early pioneers of the industry in 1955 and for the past 55 years ARA has represented and served the equipment rental industry.

In the early years of ARA, virtually all ARA members fit under the title of small business. However in the early 1990's some large investors, as well as equipment manufacturers, began to drive a significant consolidation in the equipment rental industry that has resulted in the existence of several large equipment rental companies with rental revenues in excess of \$1 billion annually and locations in virtually every state and several other super-regional players with annual revenues in excess of \$250 million.

These developments mean that the equipment rental industry and ARA are made up of a diverse group of companies. Most still are small businesses, about half of which organize as pass-through entities. Others are large corporations that have equity and/or debt financing. However, most of these large corporations are quite young and have very few exemptions of exclusions under the current Tax Code.

While the economic downturn has hit the equipment rental industry severely, we like the rest of the economy, are recovering slowly. In 2008 the combined revenues of the equipment rental industry were \$36.5 billion. Our research partner, IHS Global Insight, estimates our 2010 revenues will come in at \$27.9 billion. However, IHS Global insight has forecast rental revenues for 2015 to be \$45.1 billion. While this is a significant recovery, we believe reforming the current Tax Code to one that has a broader base with fewer exclusions and exemptions and creates a competitive tax system for business will help the equipment rental industry meet or even exceed those revenue projections.

The benefits to the equipment rental industry from a more competitive tax system with fewer tax expenditures are clearly stated by you in your opening statement at the Committee's January 20, 2011 Hearing on Fundamental Tax Reform. Taxpayers "foot the bill" for Tax Code expenditures by paying higher rates. ARA members are hopeful that the effort you have begun with this hearing will result in a competitive tax system that reduces compliance costs and strengthens the tax base.

ARA looks forward to working with you and other Members of the Ways and Means Committee as you develop proposals for reforming the Tax Code. We begin by offering our full support to this effort.

Sincerely,

John W. McClelland Ph.D.  
*Vice President Government Affairs*  
 American Rental Association

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**Geoffrey Burr**

Dear Chairman Camp and Ranking Member Levin:

On behalf of Associated Builders and Contractors (ABC), a national organization with 75 chapters representing 23,000 merit shop construction and construction-related firms with nearly 2 million employees, we appreciate the opportunity to pro-

vide our thoughts in response to the House Ways and Means Committee hearing regarding “Fundamental Tax Reform,” to examine the burdens imposed by the current federal income tax system and the need for reform.

Under the nation’s current tax system, rates are too high and laws are too complex, thus inhibiting the growth of small businesses. Currently, unemployment exceeds 20 percent in the construction industry, and adding increased taxes to an already burdened industry is not conducive to an expedient economic recovery. Therefore, tax relief is critical for businesses to spur reinvestment, create jobs, and grow.

During the 112th Congress, ABC urges Congress to provide immediate tax relief for small businesses, which includes the following:

- Increasing and indexing the threshold for small construction contractors for them to utilize the Completed Contract Method (CCM);
- Fully repealing the 3 percent withholding requirement, which is effective in 2012;
- Fully repealing the expanded Form 1099 reporting requirements under the Patient Protection and Affordable Care Act (PPACA, P.L. 111–148); and
- Fully repealing the new Medicare Hospital Insurance (HI) tax on investment income, which is effective in 2013.

Research from a 2008 study released by the Small Business Administration’s (SBA) Office of Advocacy illustrates that the small business community is disproportionately affected by burdensome federal regulations. The study found that small businesses spend more than approximately \$10,600 per employee annually to comply with federal regulations. In fact, the study concluded that small businesses spend three times as much per employee to comply with the federal Tax Code than larger firms. For the construction industry, excessive regulations translate into higher costs that are eventually passed on to the consumer.

#### ***Completed Contract Method (CCM)***

The 1986 Tax Act failed to increase and index the threshold for small construction contractors, and as a result, they are unable to utilize the Completed Contract Method (CCM). Under current law, the threshold is approximately \$10 million, and because of this, small construction contractors cannot use the CCM of accounting and are required to use the percentage of completion method (PCM), which does not accurately reflect results because of the required use of estimates.

However, to provide relief for small construction contractors and small businesses, in the 111th *American Job Builders Tax Reform Act of 2010* (H.R. 6097), a bipartisan tax bill that proposed to amend the 1986 Tax Act by increasing and indexing the threshold for small construction contractors and permitting them to utilize the CCM. The legislation also provided relief for small construction contractors from the Alternative Minimum Tax (AMT) and “look-back” accounting requirements. By increasing the threshold and eliminating the AMT adjustment, small construction contractors would no longer be subject to the burdensome “look-back” calculations for both regular and AMT purposes. ABC looks forward to working with Representatives Herger and Berkley in the 112th Congress for immediate reintroduction of this critical bill that will affect the construction industry and construction-related industries as a whole. Congress, Representatives Wally Herger (R–CA) and Shelley Berkley (D–NV) introduced the

#### ***Three Percent Withholding (Section 511)***

Additionally, ABC supports fully repealing the 3 percent withholding requirement (also known as Section 511) on all government payments for products and services made by federal, state and local governments with total expenditures of \$100 million or more, in accordance with Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005. Section 511 is effective in 2012, and to date, the Internal Revenue Service has yet to finalize regulations implementing this burdensome law and ultimately define how construction contractors will be repaid after the withholding. Construction contractors typically average a profit margin of 2.2 percent. Section 511 will undoubtedly deplete not only the construction contractor’s profit, but will also reduce sorely needed operating capital. Eventually, construction contractors will be forced to raise their proposal price to account for this shifting burden of financing and the taxpayer’s cost of construction will increase, or worse, drive small businesses out of the government contracting market.

#### ***Expanded Form 1099***

A new mandate under the Patient Protection and Affordable Care Act (PPACA, P.L. 111–148) expanded the Form 1099 reporting requirements to include two forms to be submitted for every business-to-business transaction of \$600 or more for both property and services. In this current economy, small businesses do not need an in-

creased paperwork burden. ABC strongly supports full repeal of this tax filing mandate to alleviate the increased reporting and paperwork requirements on small businesses.

Recently, an ABC member, who is the vice-president of a family-owned small business, indicated that the Form 1099 reporting requirements may force him to hire an additional full-time employee to work in his company's accounting department—such department already employs two full-time employees. Because the ABC member works with 1,200 vendors, of which only 4 or 5 presently issue a Form 1099, the accounting department will be required to spend countless hours on the increased paperwork and filing.

Two years ago, the same ABC member employed 136 employees; however due to the current construction market, he was forced to lay off employees, reducing his staff to 66. Instead of investing in equipment or hiring employees to actually perform work in the field, he may be faced with a huge overhead expense of hiring a full-time employee to solely work on this new burdensome mandate.

ABC members have also expressed the following concerns regarding the expanded Form 1099 reporting requirements:

- Businesses would easily have a multitude to request/collect/follow on receipt of W-9's (approximately double what they currently maintain);
- Businesses would have to incorporate a review process to ensure that a W-9 is on file prior to the release of payments (again at least double what is currently maintained);
- Businesses would have to "hold" payments from suppliers until they receive the W-9 which could delay payment, place holds on accounts, delay shipments, etc.;
- What is commonly known today as a "check request" would have to include a process of collecting a W-9 and vendor setup to track for 1099 purposes—which would cause a delay in the turnaround time;
- What are commonly known as "onetime vendors" would probably need to go away due to the inability to issue 1099's or even be able to review for year-end purposes—multiple payments to the same company/person made under this vendor;
- Field personnel would become part of the process. Before calling someone out to perform a service, or making an over the counter purchases, businesses would need them to be proactive and either notify the office prior to placing the order or collect the W-9 themselves; and
- Additional forms and postage would be an increased cost as well.

#### ***New Medicare Hospital Insurance (HI) Tax***

A new Medicare tax on non-wage income was also included in the PPACA. Starting in 2013, households with incomes above \$200,000 for individuals and \$250,000 for married couples will have a new 3.8 percent tax applied to their income from interest, dividends, capital gains, and some profits from investments in partnerships and S corporations. ABC opposes this new tax. Many of our members operate as S Corporations, partnerships, Limited Liability Companies, or LLC's treated as partnerships, who file their income tax return as an individual. According to the National Federation of Independent Business, 75 percent of small businesses are organized as pass-through entities (sole proprietors, partnerships, S Corps, etc.) and pay taxes on their business income based on the individual tax rates.

We appreciate you taking the time to address tax reform in a meaningful way. Lessening the tax burden on small businesses will encourage small business owners and construction companies to reinvest in their businesses, thus expanding the economy and creating jobs. ABC strongly supports minimizing the tax burden and providing relief for small businesses, including home-based businesses and the self-employed. We look forward to working with you in the future on tax reform initiatives.

Sincerely,

Geoffrey Burr  
*Vice President, Federal Affairs*

### Georgia Crowell, Statement

1. Eliminate all income tax and replace with a consumption tax similar to the Fairtax, but not including the elimination of social security taxes.
2. Instead of the Obamacare proposals, place a tax on all processed and artificial foods which are destroying our health, such as sugar, artificial sweetening, colors, preservatives and many other manufactured processes. Use this income to provide free clinics to whoever wants to use them. Also, use the proceeds from these types of taxes to provide free testing available 24/7 for everyone including the wealthy. As these taxes are levied, the junk food becomes more expensive than fresh fruit, vegetables, meat and dairy and people will be inclined to make the healthier choices (instead of being forced to do so).

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### Michael D. Warlick, Sr., Statement

The current income tax system (and we use the term “system” loosely) imposes economic and administrative burdens on American families that have become intolerable. Even the 1040EZ is too complex for many taxpayers, and the traditional Form 1040 that must be completed by those who itemize to take advantage of deductions is almost incomprehensible. Even with the help of software like TurboTax (which cost us \$80 this year), completing a tax return is still at least a two-day project.

Karen Walby, PhD, compared the total compliance costs and the budget of the Internal Revenue Service. In 2006, American families and businesses paid \$304 **Billion** to prepare and file their tax returns—including everything from the cost of corporate accountants and tax attorneys to the fees an individual taxpayer paid to H&R Block. The necessary record-keeping costs businesses must incur to document deductions, credits, offsets are staggering.

The United States now has the highest corporate tax rate of any developed country, and company and company relocates their headquarters from the U.S. to other countries to avoid the burdensome tax structure. Cisco is just one recent example. When Congress decides to increase corporate taxes, does no one understand that these taxes are ultimately passed on to individuals in the costs of goods and services? Cutting the income tax rates for middle-income taxpayers while increasing corporate rates is nothing more than a shell game, and more and more American taxpayers understand that this is not even real tax relief, much less true tax reform. A few more dollars in our paychecks are quickly absorbed by higher prices at the cash register.

We urge you to consider the real and measurable tax reform offered by HR-25, the Fair Tax bill introduced in the 112th Congress by Rob Woodall (GA-7) and now co-sponsored by 52 Congressmen. The national retail consumption tax on new goods and services, coupled with a monthly prebate passed on the number and household residents and keyed to the poverty level as determined by the Department of Health and Human Services, is the one true tax *REFORM* measure in Congress. Based on \$22 million in research by leading economists at seven universities, FairTax is the solution our country needs.

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### Katherine G. Lugar, Statement

On behalf of the Retail Industry Leaders Association (RILA), I write to offer retailers’ perspectives on tax reform as your committee begins efforts to review our current tax system and undertake fundamental tax reform. RILA supports tax policies that will improve the business climate for retailers, both domestically and internationally, by helping them continue creating jobs and bring price-competitive value to American consumers.

By way of background, RILA is the trade association of the world’s largest and most innovative retail companies. RILA promotes consumer choice and economic freedom through public policy and industry operational excellence. Its members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than \$1.5 trillion in annual sales, millions of American jobs and more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

### Principles for Tax Reform

As part of any major tax reform proposal, it is important to recognize that the current rules governing individual taxation and domestic and international taxation of businesses are inexorably intertwined. Accordingly, fundamental tax reform must address all aspects of the tax system. We recommend that Congress focus on the following principles as it considers proposals to reform the nation's tax system:

- **Keep tax rates low**—Enabling individuals to keep more of what they earn encourages savings and enables them to make purchases of needed consumer products, which also has the benefit of providing a major stimulus to the economy including sustained, improved retail sales. Similarly, low tax rates help American businesses by increasing capital for investment and job creation.
- **Enact simple, predictable and easy to understand tax rules**—A tax system that individual and business taxpayers can easily understand will improve compliance and reduce the cost of tax administration.
- **Establish tax rules that are consistent with economic reality**—For business taxpayers in particular, tax rules need to result in appropriate timing and accurate reflection of income without arbitrary rules that, for example, delay deductions beyond the period in which the income is earned or set depreciation periods inconsistently with the real economic life of the property.
- **Ensure the tax system fosters business competitiveness and promotes economic growth**—In an increasingly global economy, the tax system should not hinder the ability of U.S. businesses to compete internationally as well as domestically against foreign firms. A Tax Code that treats business fairly and equitably will minimize burdens on compliance and decision-making, thereby enhancing the productive capacity of U.S. businesses and the U.S. economy.
- **Implement reforms that ensure industry-specific neutrality**—Business decisions should be based on economic benefits of the particular transaction, not driven by special tax benefits targeted to one industry versus another. The economy does not benefit when the Tax Code chooses winners and losers. Accordingly, tax reform should allow the marketplace, not the tax system, to allocate capital and resources appropriately.
- **Avoid a whole-scale change in the tax base**—Dramatic shifts in tax policy, such as implementing a national retail sales or value-added tax, would be immensely disruptive to the economy and particularly detrimental to lower-income workers and families.
- **Make changes permanent and ensure certainty**—A new tax system must be permanent and stable, not littered with expiring provisions that cause uncertainty for families saving for college and retirement and business striving to expand, create jobs, and remain competitive in the United States and abroad.
- **Provide realistic transitions rules**—Significant changes to the current tax system will create substantial burdens on taxpayers, especially in the business sector, to ensure compliance. Establishing transition rules that provide adequate time for implementation and that take into account existing agreements, practices, and other requirements is essential for the success of any new tax system.
- **Recognize that tax revenues are one part of fiscal discipline**—As with any business, long-term fiscal viability requires careful management of *both* revenues and expenses. The tax-revenue lever can only be pulled so much and so often before it harms the business sector (with resulting effects on tax revenues from businesses, employees, and investments). Equal attention must be given to government spending to strike a reasonable balance with a Tax Code that fosters economic growth, job creation, and investment.

These principles represent a foundation on which a tax system can be built that will achieve the government's revenue needs but without the burdens and complexities of our current tax system, which stifle innovation, hinder job creation, and deter overall economic growth.

### Growth-Orient Tax Reform: Lower Business Tax Rate

The retail industry is vital to our nation's economy, representing one of the largest industry sectors in the United States with nearly 15 million jobs and \$3.9 trillion in annual sales in 2010. The industry pays billions of dollars in federal, state, and local income taxes, and collects and remits billions more in state and local sales taxes. As you consider tax-reform options, one of the most far-reaching options that

the Committee could endorse would be a reduction in the federal tax rates on corporations and other forms of business.

The last major overhaul of the system occurred with the enactment of the Internal Revenue Code of 1986, which substantially reduced the corporate tax rate along with major restructurings to the corporate tax system. Over the ensuing 24 years, Congress has made thousands of changes to the Tax Code increasing its complexity and the tax rate, resulting in greater burdens for American businesses. Today, the United States has nearly the highest statutory tax rate on corporate income, which has a number of significant ramifications for U.S. retailers.

Overall, high corporate taxes reduce the availability of critically needed capital for business to investment in labor. A number of studies confirm that a significant share of corporate taxes is borne by labor. Thus, a reduction in the tax burden will free companies to create new jobs, increase real wages and income, and improve standards of living for U.S. workers. With the unemployment rate holding above 9 percent, this is a critical opportunity for Congress and the Administration to reverse the job losses that have occurred over the past several years.

Moreover, our current high corporate tax rate hinders retailers' ability to maintain their existing operation and invest for the future. Especially in the current economic environment where the flow of private-sector capital has been constrained, a lower tax rate would free up essential corporate earnings for investments in new equipment, facilities and products. Similarly, it would enable retailers to retain more of their earnings to reinvest for the long-term growth of their companies, which will contribute to nation's economic recovery and ultimately to sustained economic expansion.

Looking beyond the domestic benefits, a lower corporate tax rate also holds significant potential for improving the competitiveness of U.S. businesses. In recent years, a growing number of U.S. retailers have expanded into the global marketplace through the establishment of both retail operations in other countries as well as subsidiaries that strengthen the supply-chain of goods and services they provide to their customers. Unfortunately, the United States is set to have the highest corporate tax rate in the world once Japan enacts its proposed rate reduction, and this country remains one of the only countries with a system for taxing worldwide income. As a result, the United States has created a difficult environment for its multinational businesses to compete in the global economy. And, further exacerbating this situation, other members of the Organization of Economic Cooperation and Development (OECD) have been pursuing measures to reduce their tax rates. Lowering the U.S. corporate tax rate would help level the playing field for U.S. multinationals and encourage companies to keep jobs and investments in this country.

At the same time, it is important to recognize the tremendous growth in the number of businesses operating as pass-through entities (e.g., partnerships, limited liability companies, S corporations, and sole proprietorships), including some RILA members. These business taxpayers are critically important to the U.S. economy and must be taken into consideration in the tax-reform debate if overall tax reform is to be successful.

For the foregoing reasons, RILA encourages the Committee to endorse a significant reduction in the rate applicable to U.S. corporations and other forms of business as a step toward improving the business climate for retailers, both domestically and internationally, which will help the retail industry continue creating jobs, investing in new equipment and technologies, and contributing to the nation's long-term economic growth.

#### **Anti-Growth Tax Reform: National Sales Tax**

While tax reform is important and can contribute to economic growth and job creation, we strongly believe that adoption of a national sales or value-added tax (VAT) would be antithetical to those goals. Regardless of whether this tax is imposed through the manufacturing process or at the point of retail sale, the victim of this tax will ultimately be the American consumer who will face higher prices at the register.

Sales taxes are highly regressive and pose particular harm for low- and middle-income consumers who spend a higher percentage of their earnings on basic necessities such as food, clothing, and household products. In addition, state and local governments already apply sales taxes to many goods and services—which a number of states have increased in recent months to address revenue shortfalls resulting from the current economic situation. A similar tax at the national level would simply add to the tax burden consumers are increasingly asked to shoulder.

**Moreover, the retail industry represents the third largest employer in the United States—behind only government and healthcare. A national sales or value-added tax would significantly depress retail sales and have a dev-**

**astating impact on this important sector of our national economy and the critical jobs it provides. Such a tax would also create significant administrative burdens for retailers already responsible for complying with the complex federal income tax system and the remittance of disparate state and local sales taxes.**

Finally, from the perspective of leveling the international playing field, a VAT would only worsen the competitiveness of American businesses. As noted above, the United States will soon have the highest corporate tax rate while our major trading partners are actively lowering their tax rates. As a result, adding a VAT in this country would increase the tax burden on American businesses and intensify the competitive disadvantage they already face in trying to compete in a global economy.

With the nation's economy continuing its slow recovery, the last thing this country—our businesses and our consumers—needs is a new supplementary tax system that will increase retail prices and threaten American jobs. Accordingly, we do not believe there is any room at the table for a national sales or value-added tax.

#### **Conclusion**

Thank you for this opportunity to present our views on tax reform. RILA and its members look forward to working with the Committee to implement meaningful tax reform that includes provisions that support the retail industry and help it create jobs and grow.

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#### **Novogradac & Company LLP, Statement**

We are writing to you on behalf of the LIHTC Working Group. Our group is made up of low income housing tax credit (LIHTC) industry participants including non-profit and for profit developers, syndicators, investors, accountants and lawyers. The Committee has begun a series of hearings on the costs imposed on families, employers, and the economy at large by the current structure of the Federal income tax, and we would like to submit this statement for consideration by the Committee.

Both the use and types of tax expenditures promise to be a large part of what the committee considers during these hearings. We believe that any discussion about tax expenditures should include a distinction between those tax expenditures that benefit the recipient of the subsidy and those tax expenditures that benefit a third party and promote a social good. For example, LIHTCs are claimed by investors to help developers build housing that benefits people who could not normally afford it. Tax expenditures that benefit a third party and promote a social good should be considered separately as they benefit someone other than the taxpayer and benefit someone in need (low income individual). Changes to these programs could hurt the dynamics of what makes the program successful and in turn primarily hurt the third party beneficiaries (low income individuals).

The Committee has an enormous task in front of it, and we are pleased you are approaching it as a dialogue with the American people. We look forward to being a part of the process. Thank you for your time, and we are available if there is any way we can be of assistance.

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#### **Phillip J. Bond, Statement**

I write today on behalf of TechAmerica on the importance of fundamental tax reform and the need to create a globally competitive system that spurs capital investment and job growth and to caution against piecemeal modifications to the corporate tax rules. Unless Congress acts now, and in a comprehensive manner, the United States will surpass Japan to have the highest statutory corporate tax rate in the developed world.

TechAmerica is the leading voice for the U.S. technology industry, which is the driving force behind productivity growth and jobs creation in the United States and the foundation of the global innovation economy. Representing approximately 1,200 member companies of all sizes from the public and commercial sectors of the economy, it is the industry's largest advocacy organization. It is also the technology industry's only grassroots-to-global advocacy network, with presence in state capitals around the United States, Washington, D.C., Europe (Brussels) and Asia (Beijing).

As consideration of fundamental tax reform begins, we urge Congress and the Administration to stay focused on the goal of developing a globally competitive taxation system that fosters innovation and job creation. We urge you to avoid any interim proposals that would make our taxation system even less competitive, create further uncertainty, or hinder future investment. Chipping away at the Tax Code while the

tax reform debate gets underway would also be counter to the President's goal of creating a system that supports economic growth and investment in the United States.

According to TechAmerica Foundation's "Cyberstates 2010" report, the U.S. high tech industry directly employs 5.8 million people at 375,600 establishments with a payroll of \$516 billion, accounting for 10 percent of total U.S. private sector payroll. Indirectly, the U.S. tech industry supports over 20 million jobs. U.S. high-tech workers are paid an average wage of \$84,400, which is 86 percent higher than the average private sector wage. The vitality of this industry is inextricably tied to its competitiveness worldwide, and the United States would benefit from a modernized Tax Code that accounts for innovation and is designed to compete globally with other countries that are effectively recruiting more business and investment through favorable business and tax policies.

As the United States continues to focus on entrepreneurship, global competitiveness and job creation, tax reform should embrace the principles of an "innovation economy." Those principles include recognizing the valuable contribution of incentives such as those for research and development, tax law stability, and the recognition that in a global economy, expanding operations overseas enhances U.S. productivity and is essential for future growth in the nation's GDP.

U.S. high-tech companies of all sizes operate overseas to be near their customers. Some small and mid-sized companies generate as much as 97 percent of their revenues overseas, with many large companies earning more than three-quarters of their income outside the United States. As global competition has grown, other countries have adopted taxation systems that bolster the ability of their companies to compete in foreign markets and increase investments at home. As the United States undertakes an effort to fundamentally reform the Tax Code, we must recognize the reality of a global economy—and the positive connection between strong overseas operations and U.S. investment.

TechAmerica urges Congress and the Administration to resist any piecemeal reforms to the international tax rules that would make U.S. companies less competitive. In order to grow and create jobs in the United States, U.S. companies must invest, operate and compete for business all around the world. Overseas investment leads to greater success selling goods and services globally, which under the right tax structure, should significantly fuel domestic capital investment, domestic job creation and increased domestic investment in research and development activities.

In recent years, other countries have recognized the inverse relationship between corporate tax rates and capital flows, and have successfully increased capital investment by lowering corporate tax rates and enacting incentives that attract high-paying jobs. This spring, after Japan lowers its statutory corporate tax rate, the United States will have the highest rate among the OECD countries. In 1986, the United States lowered its top corporate tax rate to one of the lowest in the world, and other countries followed suit. Not only does a lower rate help U.S. companies compete, but it also encourages foreign companies to invest in the United States, resulting in increased employment and higher wages for American workers.

Even as other countries have lowered their corporate tax rate, they also have recognized the importance of investment and job creation by adopting incentives for research and development (R&D) activities. Again, the United States once had the most generous R&D credit among the OECD nations; however, the U.S. credit currently does not even rank in the top ten among those countries. With more than 70 percent of credit dollars being attributable to the wages and salaries of workers in the United States, the R&D tax credit is a domestic jobs credit. In an increasingly competitive global environment, reforming the Tax Code to include a stronger and permanent credit would help make the United States a more attractive location to perform R&D.

The Tax Code should help facilitate business decisions that benefit the U.S. economy, but in order to make long-term planning decisions, companies need clarity and certainty in the regulatory system. There has been significant bipartisan support for incentives such as the R&D credit over the years; however, there have also been proposals that would actually encourage companies to perform R&D elsewhere, creating uncertainty for companies. In addition, the credit has been allowed to expire more than a dozen times, also depriving companies of the ability to make long-term decisions relating to how much R&D they can perform in the United States.

Undertaking a tax reform effort provides a rare opportunity to examine our current system and consider how it can be made more competitive by fostering innovation and job creation rather than deterring it. The greatest challenge is to understand and anticipate the effects that any change has on the overall tax burden. Reform is inherently an exercise in interwoven and interdependent features such that any change needs to be viewed in light of overall compliance and total tax burden

concerns. TechAmerica urges this Committee to keep these issues in mind when considering tax reform proposals—or any interim proposals that could make our current system less competitive.

In conclusion, TechAmerica would like to emphasize two points. First, to summarize, we believe the ultimate goal should be to avoid a piecemeal effort that would hinder innovation and investment. Instead, Congress should focus on developing a globally competitive taxation system that fosters innovation and job creation. Second, because our member companies have substantial operations in countries all over the world, they know the ingredients for success in the technology sector, and they know how to compete. Please feel free to consider the experience and expertise of our members as an ongoing resource available to your committee in your work on tax reform.

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**John Pettengill**

*January 19, 2011*

Dear Committee,

Please consider my understanding of the FAIRTAX as expressed below. It seems clear to me that the FAIRTAX is a win..win for both the government and the taxpayers. Thanks so much for your time.

John Pettengill, Richmond, VA

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Under the **FAIRTAX** you will pay **over 4 percent less for everything** and still pay the Federal Government the same amount in taxes as you pay today . . . plus no April 15th tax preparation.

Today the one dollar shelf price of a loaf of bread includes 23% business taxes that are passed on to you. Consequently, under the FAIRTAX, the bread's shelf price will be reduced to just 77 cents. At the register, a 24% FAIRTAX will be added making the total cost to you 95.48 cents or 4.52% cheaper than a dollar. Of course, state and local taxes will still apply as they do today.

Under the **FAIRTAX**, we will have a whole group of **New Taxpayers:**

- Criminals (pimps, prostitutes, gang members, mobsters etc.)
- Tourists . . . since the prices will be the same/less, why not let them help.
- Tax Dodgers . . . those who purposefully avoid the current income tax.
- Those who now work for cash.
- Rich persons with high priced tax lawyers.
- Illegal immigrants (only those who do not pay income taxes now.)

Under the **FAIRTAX**, investment in business, savings and stocks would be free of government taxes and could provide more and better profits . . . and more jobs.

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**Bobby L. Austin, Statement**

I contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle.

—Winston Churchill

Recent news articles clearly show that America is losing jobs to overseas countries and is losing billions of dollars in tax revenue as a result of our convoluted, anti-business tax structure.

*Huntsville Times* (AL), 15 December 2010. "Sleeping bag maker may close." Exxel Outdoors, a Haleyville, Alabama sleeping bag manufacturer may close because it cannot compete with sleeping bags produced more cheaply in Bangladesh. Because the sleeping bags do not qualify as textile or related products the Bangladesh manufacturer is able to ship the bags tariff-free to America. The unemployment rate in Winston County is 18%. Exxel is the last manufacturer of this type of sleeping bag in America.

*Huntsville Times* (AL), 29 December 2010, "U.S. firms hiring overseas." Sales are up in other countries more than in America. The Economic Policy Institute says American companies have created 1.4 million jobs overseas this year compared with less than 1 million in the United States.

*Huntsville Times* (AL), 25 October 2010, "Tax loopholes let Google save \$3.1 billion." Google uses a strategy known as Double Irish or Dutch Sandwich to drastically reduce taxes. This technique involves "Transfer Pricing," transferring profits, through paper transactions, from countries with high tax rates (such as America with a 35% tax, highest of industrialized nations), through Ireland, to countries with zero tax rate, such as Bermuda. Facebook is preparing a similar strategy to transfer funds to the Cayman Islands. Hundreds of multinational companies use some version of the method according to Richard Murphy, director of Britain-based Tax Research, avoiding most taxes in all countries.

America needs to be one of those countries with a zero corporate tax rate. The Fair Tax Act, H.R. 25, will make that reality. The Fair Tax does all of the good things that other proposed tax plans do, and more. Neither the flat tax nor the VAT provide a zero corporate tax rate and at the same time lowers the tax rate paid by individuals, protects low income families from a regressive tax system, and fully funds Social Security and Medicare.

The Fair Tax is a nonpartisan tax plan based on \$22 million of privately funded research under the auspices of Americans for Fair Taxation. It was developed, independently of any other proposal, over the course of several years by noted economist after extensive market research was conducted into what the public desired in the way of a national tax system. An extensive account of the development of the plan can be found in the book, *FairTax: the Truth*, by Neil Bortz and Congressman John Linder.

The Fair Tax eliminates all income based taxes for both corporations and individuals. It **replaces** those taxes with a 23% sales tax, which is **included** in the price of items and is shown on the sales receipt. Income, Social Security, Medicare, capital gains, interest, AMT, gift, and estate taxes are all eliminated. Thus, individuals take home more pay and are encouraged to save and invest. Only new goods and services are taxed at the ball final consumption only . . . used goods are not taxed. Business-to-business sales that are used in the production of a product or service for final consumption are not taxed.

All taxes ultimately are paid by the consumer. Nobody else pays the taxes. Corporations don't pay taxes. They collect them, but they don't play them.

Dr. Milton Friedman. Comments to the President's advisory panel on Federal tax Reform, March 31, 2005.

Corporations do not pay taxes . . . consumers pay taxes; therefore, it is reasonable and logical to tax at the consumer level.

International Competition—A non-government and a government study show that business taxes and tax preparation add 22% and 24%, respectively, to the cost of American products and services. Thus, the cost of American products and services will decrease by about 22%.

Consumers actually pay the "corporate" taxes, record keeping, and filing costs embedded in the cost of products and services. Moving collection of these costs to the point of consumption makes American companies 22% more competitive on the international market. Further, \$12 to \$13 trillion held by American companies in offshore accounts will flood to America with the elimination of the current 35% tax (second highest of the industrialized nations).

One study concluded that American exports would increase by 18%. Another study concluded that exports would increase by \$100 billion per year.

While former Fed Chairman, Alan Greenspan, out of respect for the new chairman, will not formally endorse the Fair Tax, however, he concurs with the plan.

<http://www.youtube.com/watch?v=tp2ycmMR-fs>

Referring to the off shore funds. Allen Greenspan said that these funds would come to the U.S. in months if the corporate tax rate were zero. And he was right!

Congress approved a one-year tax rate reduction to 5.25% for 2005. A government agency estimated that \$200 billion would be repatriated and would yield \$2.8 billion in revenue. However, the IRS concluded that eight hundred companies brought \$362 billion back to America, 1.8 times the estimate, with revenue of \$18 billion, 6.4 times the estimate. U.S. business investment rose 9.6% in 2005—the highest rate in more than a decade.

Wall Street Journal, 1 July 2008, p. A16

Just imagine the tremendous long-term growth to the American economy and job creation if companies knew the corporate tax rate would be zero . . . permanently!!!

Superior to Alternatives.—The FairTax plan is indeed the ultimate tax reform and economic stimulus without investing a single tax dollar. A 1997 government taxation committee reports that in a study by many economists, of differing persua-

sions, ALL agreed that the FairTax Plan is superior for long term growth. The FairTax addresses issues that no other plan touches. Neither the Flat Tax nor the Value Added Tax (VAT) addresses: fairness, simplicity, withholding taxation, cost of administration, cost of compliance, and cost of enforcement. Further, both Flat Tax and VAT stifle growth of the economy and place American companies at a tremendous disadvantage on the international market.

In an informal survey of 500 CEOs of international companies, 400 said that they would build their next facility in the United States and 100 said they would move corporate headquarters to the United States, if the tax rate were reduced to zero.

Professional Endorsement—Upon submission of the FairTax legislation 76 professional and university economists wrote an open letter of endorsement to the President, Congress, and Fellow Americans.

[www.okfairtax.org/Open\\_Letter.pdf](http://www.okfairtax.org/Open_Letter.pdf)

Former Treasury Secretary John Snow said to the framers of the FairTax Plan, “You have just proposed the biggest magnet for capital and jobs in history.”

Economist Milton Friedman, told the 2005 President’s Advisory Panel on Federal Tax Reform, that he helped the Treasury design the withholding tax to fund WWII, but said, “. . . it has been a mistake in the post war era and we would be better off if we did not have a withholding.”

Ideological Issue—“In America, cutting tax rates is an ideological issue. In the former Soviet satellites of Europe, it is increasingly not an issue at all—so obvious is it that it gives people better lives.”

Ireland—With its 50% corporate tax rate; near 20% unemployment; and the GDP of 1.9%, Ireland’s economy was known as “the poor man of Europe” Since reducing its corporate tax rate, in increments, from 50% to 12.5% in 2003, and passed other laws conducive to attracting industries, the economy has exploded and quickly became known as “the Celtic Tiger.” Four American international companies contribute 90% of Ireland’s exports. In addition, two other companies have major facilities. Microsoft, alone, holds \$4.1 billion in cash to avoid the 35% tax if brought to the U.S.

(NOTE: Cap and Trade is a major disincentive, rather than incentive, to attract companies to come from abroad to America.)

[www.washingtontimes.com/news/2008/mar/21/the-emerald-isle/](http://www.washingtontimes.com/news/2008/mar/21/the-emerald-isle/)

Ireland’s low corporate tax rate of 12.5% on trading profits has been a magnet for multinational companies who are responsible for 90% of Irish exports and a significant contributor to the success of the modern Irish economy, commonly known as the Celtic Tiger.

[www.finfacts.ie/irelandbusinessnews/publish/article\\_10003995.shtm](http://www.finfacts.ie/irelandbusinessnews/publish/article_10003995.shtm)

Low corporate tax rates and business friendly legislation moves jobs and stimulates economic growth. In a 2009 survey of 220 CEOs, two thirds from international corporations, 88% said the tax regime is the most important factor influencing the decision to continue to operate in Ireland.

[www.internationaltaxreview.com/Article/719831/Latest-News/Article.html](http://www.internationaltaxreview.com/Article/719831/Latest-News/Article.html)

Switzerland—One state reduced its tax rate to 6.66%. Two U.S. multinationals, Procter & Gamble and Colgate, relocated their European headquarters to Switzerland and Biogen Idec, transferred from Paris to Switzerland when the corporate tax rate was reduced.

[www.finfacts.com/irelandbusinessnews/publish/printer\\_1000article\\_10004879.shtml](http://www.finfacts.com/irelandbusinessnews/publish/printer_1000article_10004879.shtml)

#### Other Benefits:

FairTax is indeed fair. All industries and services are treated the same, no exclusions or exceptions. All consumers pay the same rate while low income families are protected from a regressive tax. The 23% (included in the price of goods and services) tax rate replaces 11 corporate and individual federal taxes.

Low income families are protected with a progressive tax. No registered (legal resident) family pays tax on income up to the poverty level, regardless of total income. Each registered family receives a “first of the month “pre-bate” of the tax on the poverty level of income for the family. The pre-bate will be less than the \$345 billion dollars of uncollected income tax. Untaxed used goods provides another tax break for low income families. Further, analysis shows that charitable giving increases directly with the growth of the economy.

Charitable Contributions—Charitable contributions are directly related to the state of the economy. Thus, as the economy grows, charitable contributions will grow. Churches will no longer have to worry about maintaining tax exempt status.

Social Security and Medicare are fully funded with a fixed percentage of the tax collected. Each worker's gross income is reported to the Treasury for the purpose of calculating SS benefits.

The FairTax stabilizes the Tax Code, since the influence of lobbyist will be essentially eliminated. No more special interest, back room deals. Highly visible congressional legislation will be required to change the tax rate.

Low income families are protected as no legal resident pays tax on expenditures up to the poverty level (\$10,830 of one adult, \$21,660 for two adults, and \$3,740 for each child).

Individuals will pay less tax than under the current IRS system because of four primary factors:

- (1) Individuals will take home more pay;
- (2) Individuals are taxed on what they spend rather than income . . . save or invest 10% and reduce tax paid by 2.3% (23% of 10%)
- (3) Due to the "pre-bate" no legal resident pays tax on expenditures up to the poverty level . . . tax rate is negative up to the poverty level, 11.5% at twice the poverty level, and 15.3% and never more than 23% regardless of expenditures)
- (4) The tax base is doubled. Every consumer pays tax, including those in the underground "cash only" economy and 40 million annual visitors to America.

In addition, tuition for education and training is considered an investment, rather than final consumption; therefore, is not taxed. Further, used goods are not taxed.

Implementation and collection cost will be minimal as states will collect the tax and submit to the treasury. Forty-five states already collect sales tax. Businesses and states will receive one quarter of one percent as a service fee.

Enforcement cost will be lower than under the current power system is the IRS will be abolished; no individual tax returns to audit; and the number of states and businesses to be audited will be greatly reduced.

Neutral Revenue—The 23% tax rate is calculated to initially provide the same income as the current tax system. However, as the economy grows tax revenue will increase.

If reform is necessary, what are the criteria for tax reform—

In December 2004 the House leadership wrote a letter to the President with these recommendations on tax reform:

- It is urgent . . . we must reform the Tax Code now
- It must be progressive . . . No increase on mid-income families
- Avoid the unintended consequences of the AMT
- Must be simple . . . Far less complex than the IRS code
- Must be revenue neutral . . . bring in the same revenue as currently collected

A Congressional tax committee report states that—

Tax reform is necessary, and . . . to be successful legislators must . . .

- Minimize administrative costs
- Apply low marginal tax rates to . . .
- A broad economic base.
- Meeting these objectives should reduce disincentives to work, save, and invest.

Of the currently proposed tax systems, the Fair Tax is the only one that meets all eight objectives.

Opportunity Squandered—The FairTax Plan, has been pending congressional approval since 1999. The evidence is overwhelmingly clear that tax cuts are a better economic stimulus than "bailouts," which put an unbearable tax burden on future generations. The FairTax is the ultimate tax reform and economic stimulus and job creator which requires no expenditure of tax dollars, while reducing the tax burden on individuals. The FairTax Plan has strong endorsements from highly qualified individuals. The FairTax legislation should have been passed 10 years ago.

Time for Non-partisan Action—Particularly, given the more recent undeniable history of economies flourishing following tax cuts, it is inconceivable that the opportunity for historic American economic growth has been ignored by presidents and congress. Given the current need to do everything possible to stimulate the econ-

omy; it is now time for all legislators to do “what is best for America” and immediately pass the FairTax legislation, H.R. 25.

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### Neil G. Rogers, Statement

More than ever we need the FairTax

As we deal with the worst financial situation in generations, we are going to need bold, new thinking to address how Washington and our economy function. For that reason, I hope you’ll give proper consideration to the FairTax, which is the answer that America needs now more than ever.

Here are some key reasons why the FairTax is critical to the American economy:

1. Rescue the homeowner and you rescue the economy

The FairTax will end the harmful practice of withholding taxes from paychecks, and millions of Americans will see a huge boost in their take home pay—enough to save their homes and pay mortgage bills.

2. A \$10 trillion dollar stimulus program funded with private investments

Economists say the FairTax will attract literally trillions of dollars into our economy from offshore. That means new jobs right here in America (a point I know you readily appreciate), higher wages and a stock market that goes up instead of down.

3. Bring Back the “Made in America” Label

The FairTax ends the retail price disadvantage American producers suffer under the income tax system. The income tax system adds up to 20% to the price of American products and that chases our manufacturing and service industries offshore. The FairTax gives American companies—and jobs—a fair chance.

4. Our economy works when wage earners prosper

The FairTax makes our economy work again and restores consumer confidence by putting more money in wage earners’ pockets. It attacks the problem at the base of the pyramid where average people live—not at the pinnacle. It ends the tax disincentives to upward mobility, savings, investment and capital formation.

For these reasons and more, I urge you to consider the FairTax. This comprehensive reform plan is embodied in H.R. 25 and S. 296. The taxpaying public—individuals, farmers, schoolteachers, seniors, small business owners, and others—will thank you for it.

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### Alvin S. Brown, Statement

Chairman Camp, Ranking Member Levin, and distinguished Members of the Committee on Ways and Means, thank you for the opportunity to provide comment on “fundamental tax reform,” as a consequence of the complex burdens imposed by the Internal Revenue Code on U.S. taxpayers and also the IRS.

The burdens of the current tax system require an evaluation of the many problems of the IRS in collecting revenue, and conducting examinations. Tax reform can be justified or supported to the extent it can be demonstrated that the IRS does not administer the tax law with integrity or fairness, consistent with the IRS Mission Statement.<sup>1</sup> Tax reform is also necessary to correct actions of the IRS that are counterproductive to the collection of revenue, contribute to business failures and reduce American jobs. The identification of IRS administrative, managerial and technical problems is the best foundation from which to validate tax reform.

I have an informed opinion of the “complex burdens imposed by the Internal Revenue Code” based on my thirteen years of experience as an interpretative tax attorney, specializing in IRS controversies, and representing taxpayers throughout the United States and abroad. I had a full career in the office of the IRS Chief Counsel as an interpretative tax attorney/manager, and I have been representing taxpayers before the IRS since 1998. My experiences within the IRS and my current specialized IRS tax practice provide unique insight into the IRS and the problems of the IRS in its administration of the Internal Revenue Code that are intended to be helpful to this Committee in its consideration of fundamental tax reform.

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<sup>1</sup> **The IRS Mission:** Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness.

The issues dealing with tax reform have largely been **divisive political issues**. The classic argument against tax reform is that it benefits the “rich.” That argument dissipates against a database of documented case histories of taxpayers with problematical experiences with the IRS, mismanagement and actions taken that are contrary to law. Although there have been small incremental changes in the direction of simplification, the Code has nevertheless grown in complexity along with the corresponding administrative problems and burdens of the IRS.

A focus on various forms of IRS administrative deficiencies and failures creates “talking points” that support tax reform. The goal of having an IRS that administers the tax law effectively is a **nonpartisan issue**. IRS deficiencies and failures create a nonpartisan platform that supports fundamental tax reform. The public and every Member of this 112th Congress, without exception, want improved administration of the law by the IRS in strict compliance with its Mission Statement to apply the tax law with “integrity and fairness.” The legislative proposals recommended by this Committee will get far larger acceptance with information made to the public identifying the nonpartisan administrative deficiencies of the IRS. The platform of documented IRS tribulations makes it far easier to reduce the political rancor from any tax reform proposal recommended by the Committee on Ways and Means. After the data platform of IRS problems are identified and documented, the issue then becomes how to best facilitate fundamental tax reform to resolve the IRS deficiencies. I will identify some IRS policies and activities that are counterproductive to the current economic policies to stimulate job growth and business growth. I will also identify some IRS activities that contrary to the intent of Congress under current law. Support for tax reform will increase to the extent the public and the media understand that something needs to be done to correct the distortions to the economy caused by inept administration of the tax law by the IRS. In this way the nonpartisan goal to have a better IRS can be blended into the need for tax reform.

#### ***IRS tax lien filing counterproductive practices***

The IRS has the plenary power to file a “Notice of Federal Tax Lien” (NFTL) tax lien in the public records on a taxpayer if there is “any tax” liability.<sup>2</sup> The IRS Internal Revenue Manual requires the filing of a tax lien for tax assessment balances of \$5,000 or more and states that the tax lien should be filed even if the tax balance is less than \$5,000 if the filing of the tax lien will promote payment compliance.<sup>3</sup> The tax lien will not be released until the tax debt is paid or otherwise discharged. The NFTL has severe negative economic consequences on individual and business taxpayers often initially and long after any tax obligation is resolved.

Tax liens destroy individual and business credit ratings. Most businesses cannot function profitably or grow their business with a tax lien on their credit report. It is very difficult for any business to remain viable after their credit reports reflect IRS tax liens. When the businesses close, jobs are lost, and taxable revenue is lost.

All of the U.S. credit agencies record tax liens in their credit reports and that tax lien remain in place until the tax debt is discharged. Even if the IRS tax lien has a short life, the credit agencies will still keep that tax lien in their credit reports for seven years after the IRS releases its tax lien. For this reason IRS tax liens are a long term economic disaster for individual and business taxpayers. At the present time, credit reports are instantly available and they are commonly referenced for most commercial and employment practices.

The IRS will file a credit-destructive and business-destructive tax lien even if the taxpayer agrees to fully pay the outstanding tax liability with interest and penalties in an Installment Agreement, documenting the financial ability to fully pay that tax liability. When a business sustains a federal tax lien, they suffer loss of credit, eventual business failure and loss of jobs, which further affects the IRS through loss of taxable revenue. The federal loss is exacerbated because those who lose jobs must survive on federal and local assistance provisions for the unemployed. In this chain reaction of events, creditors of the business reduce profit with even a greater loss of tax revenue collected by Treasury. Consequently, the capricious and mechanical filing of tax liens under current IRS administrative practices cause irreparable economic harm, especially in situations where the business taxpayers have the ability to make payments on their tax debt.

In the case of individual taxpayers who have received IRS tax liens, the loss of credit impacts negatively on their ability to get employment and housing. Employers and landlords commonly take into account IRS tax liens identified in credit reports. This credit impairment means that the individual taxpayer is less likely to buy a car, a home and other items that stimulate economic activity and grow taxable busi-

<sup>2</sup> Section 6321.

<sup>3</sup> IRM 5.12.2.4.1 (10-30-2009).

ness income. The counterproductive policy of the IRS for filing tax liens is one haplessly ignored by the IRS and Treasury.

On the other hand, there are reasons that justify a tax lien filed in the public records in some cases. A tax lien gives the IRS a secured priority interest against other unsecured creditors. If a taxpayer has a large equity interest in real estate and has a large tax debt, an IRS tax lien is justified to give the IRS priority status ahead other creditors. In other cases where there are no serious assets (e.g., no real estate with more than nominal equity) a tax lien makes no economic sense when balanced against the economic harm it causes to an individual or business. There may be businesses that are just service businesses, yet the IRS will still file a tax lien even in these cases where there are no assets to give the IRS a secured creditor preference. In these circumstances, the tax lien only serves the purpose of destroying the credit of the business and the individual taxpayers. Tax liens filed in these circumstances are frivolous, punitive and imprudent. In some cases, the filing of a tax lien, when it will obviously cause irreparable harm, is malicious.

Any IRS revenue officer has the unencumbered statutory authority to file a tax lien on any individual or business even if the taxpayer has agreed to pay the tax debt quickly. The strong tax policy of Congress is to encourage taxpayer to repay their tax debt at the earliest possible time. When the full amount of the tax debt cannot be paid, taxpayers are authorized to pay their tax debt in an Installment Agreement. The IRS will normally not agree to allow a taxpayer to enter into an Installment Agreement without the filing of a NFTL. When the IRS agrees to the taxpayer's offer to pay the outstanding tax debt, the IRS will then punish that taxpayer with a tax lien that destroys the taxpayer's credit. The tax lien is perverse in this situation because bad credit reduces the ability of the taxpayer to make installment payments and fully pay the outstanding tax debt. These tax liens are required even in cases with the taxpayer does not have property that could be seized in any kind of an enforced collection action; in these cases a security interest in property owned by the taxpayer is meaningless and counterproductive. The National Taxpayer Advocate (NTA) has the power and authority to use Taxpayer Assistance Orders (TAOs) to stop the filing of capricious and counterproductive tax liens.<sup>4</sup>

***The \$5,000 threshold for a mandatory filing of a tax lien is contrary to the law***

**The \$5,000 standard for mandatory tax liens is contrary to law. The authority of the IRS to file tax liens in the public records is discretionary, as decreed by Congress. Congress made that authority discretionary. Section 6321 which provides:**

*If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.*

The language drafted by Congress under § 6321 creates an unperfected lien, and not one that requires that the tax lien be perfected. When the IRS created a mandatory filing of tax liens in the public records in its Manual, it converted a discretionary power to a mandatory rule that is in conflict with the intent of Congress. If Congress wanted to write a mandatory lien statute, requiring that unperfected tax liens be filed in the public records, that would be an easy addition to §6321. The IRS mandatory tax lien policy is direct conflict with the intent of Congress under §6321 to make the public-record filing of tax liens discretionary.

***IRS abuse of §6323(j)(1) authorizing the withdrawal of tax liens***

Section §6323(j)(1) of the Code provides discretionary authority to the IRS to withdraw a tax lien for the withdrawal of a tax lien in certain: *if the filing was premature and not in accordance with IRS administrative procedures; if the taxpayer has entered into an installment agreement under section 6159; if the withdrawal of the notice of lien will facilitate the collection of the tax liability; or, with the consent of the taxpayer or the National Taxpayer Advocate, with withdrawal of such notice would be in the best interests of the taxpayer (as determined by the National Advocate) and the United States.*

If tax liens are withdrawn from the public records, the result would be the same as if the tax liens were never issued and the tax liens will be expunged from the

<sup>4</sup> §7811(a)(1)(A) authorizes the NTA to issue Taxpayer Assistance Orders to prevent a *significant hardship as the result of the manner in which the internal revenue laws are being administered by the Secretary.*

credit reports. Withdrawn tax liens restore credit but will not restore a business that has closed as the consequence of a tax lien.

It is anomalous that § 6323(j) provides statutory standards to withdraw a tax lien, but IRS revenue officers file economically destructive tax liens on businesses and individuals that eliminate or substantially reduce IRS collection potential. The standard that permits the withdrawal of a tax lien under § 6323(j) should apply as a statutory threshold before the IRS has the authority to file a tax lien. I view this as a legislative drafting error. It makes no sense for Congress to draft a statutory standard to have a tax lien withdrawn, but no statutory standard of filing a notice of tax lien in the public records. This is an additional argument that supports my observation that the IRS has misused its plenary authority to file tax liens in the public records.

The standards in § 6323(j) are quite clear, yet the IRS rarely uses its authority to withdraw a tax lien when the facts are within the standards of § 6323(j). The withdrawal of a tax lien by the IRS is rare and unusual even in cases with strong documentation of economic hardship (e.g., documentation that the tax lien will result in the loss of a profitable business). Neither the IRS nor the NTA support tax lien withdrawal applications even where severe economic hardship is documented. Generally, applications for tax lien withdrawal are granted only in cases where the tax liability was assessed by the IRS in error. It is my experience that the IRS will not withdraw a tax lien even if: the tax lien will result in employment discharge; employment is available only with lien withdrawal; or only if it is the only way a person can get work as a contractor. In short, the IRS and the NTA do not follow the statutory standards of § 6323(j) where there is a mutual benefit to the IRS and the taxpayer and it will allow the taxpayer to generate taxable income sufficient to repay the person's tax debt. Here again is one more example of an IRS and the NTA, ignoring the intent of Congress under the clear language of a tax statute.

#### ***Counterproductive tax levies***

The tax policy of § 6343(a)(2)(D)<sup>5</sup> to prevent or stop a levy in the case of an “economic hardship” is explicit and unqualified. The regulations under this statute provide objective standards to determine economic hardship.<sup>6</sup> Under Reg. § 301.6343-1(b)(4), there is “economic hardship” for individuals if the levy denies a family, food, housing transportation, medicine, health insurance, child care, court ordered payments, and other reasonable and necessary living expenses. Since “economic hardship” has a clear definition, it should be easy to stop.

The IRS does not make an “economic hardship” determination before they file the levy. To the contrary, in most cases, the levy is invariably excessive. This hardship is exacerbated because levies on wages and gross income are continuous. If the levy is excessive, the employee will leave the job rather than work for any residual amount that is insufficient for necessary living expenses. Excessive levies force employees to go jobless or work in the underground economy and not disclose income that would be subject to levy. The obvious intent of § 6343(a)(2)(D) is to prevent excessive levies and permit a levy to the extent it does not deny a taxpayer basic necessary living expenses.

Levies on businesses include continuous levies on one or more accounts receivable (i.e., gross income). Most small businesses struggle to survive. Therefore, a levy on even a small portion of business gross income will likely result in closing the business along with the resulting job losses of employees. In these circumstances, an excessive tax levy on gross income will create job losses, business failure, and a loss of tax revenue. It is important for the IRS to make sure that any levy does not create the kind “economic hardship” described in § 6343(a)(2)(D) because the net effect of the excessive levy will create an accelerated business failure with all of its pyramiding negative ramifications on the economy.

In the case of IRS wage levies, the IRS does not inform employers about the “economic hardship” prohibition under § 6343(a)(2)(D). For that reason, employers think their entire employee wages must be handed over to the IRS, with one exception that is misleading to employers. Each request for levy of wages is accompanied by Publication 1494,<sup>7</sup> which identifies the amounts excluded from levy under § 6334.<sup>8</sup> When employers receive the chart within Publication 1494, the erroneous impression they have (and the impression left by the IRS) is that the employer can give

<sup>5</sup> § 6342(a)(2)(D) states that the IRS *shall release the levy* if the IRS *has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer.*

<sup>6</sup> § 301.6343-1(b)(4).

<sup>7</sup> Publication 1494 (2011).

<sup>8</sup> These are statutory exclusions that include wearing apparel, school books, workmen's compensation and other items specified in this statute.

over to the IRS all of the wages of the employee in excess of the amount in the chart. The statutory exclusions from income under § 6334 are quite limited and are essentially summarized in the chart within Publication 1494. For example, in the case of a family of four, the exemption is \$2,200 per month, well below the median family income of families that size. That family of four would have to pay for housing, food, transportation, medical and similar necessary living expenses. That \$2,200 is insufficient to pay the fixed support a family of four in most cases. Nevertheless, the real issue is that the use of the Publication 1494 chart ignores the mandatory language of § 6343(a)(2)(D) that the IRS shall not levy if it creates an “economic hardship.” Publication 1494 does not test for economic hardship (e.g., whether or not there is a serious health issue in the family) and it ignores the statutory exclusions from levy under § 6634 (e.g., workman’s compensation). The IRS use of Publication 1494 is not accompanied with instructions to the employer that will allow the employee to receive the full amount of income necessary to for reasonable and necessary living expenses. This IRS misapplication of its statutory responsibilities of § 6343(a)(2)(D) generates job losses and economic hardship, contrary to the intent of Congress. A large part of the requests for assistance to the NTA deal with abusive tax levies. If the IRS is compelled refrain from any levy prohibited by § 6343(a)(2)(D), that would relieve the NTA of a major part of their workload.

The NTA and the IRS have taken the position that a business cannot have an economic hardship<sup>9</sup> within the meaning of section 6343(a)(2)(D).<sup>10</sup> The IRS and NTA positions are each wrong because § 6343(a)(2)(D) and Reg. § 301.6343-1(a) do not distinguish between individual and business economic hardship. Here again, the IRS and the NTA take positions inconsistent with clear and unqualified statutory language. The IRS and the NTA cannot deny the reality in our present economy, or at any other time, that businesses can suffer an economic hardship.

Individual and business taxpayers severely suffer due to the inability of the IRS and the NTA to properly administer the law on “economic hardship” levies. The administration of the law on tax levies by the IRS is not only technically incorrect, as noted, but also counterproductive to the objectives of the Congress and the Administration to grow businesses and grow jobs.

***Refusal of the National Taxpayer Advocate to comply with the language of § 7811***

The heading of § 7811 is “Taxpayer Assistance Orders”. Congress identifies TAOs as the primary task and function of the NTA. Under § 7811(a)(1)(a), the NTA is authorized to issue a *Taxpayer Assistance Order* if the NTA *determines the taxpayer is suffering or about to suffer a significant hardship* as the result of the manner in which the IRS is administering the tax law. A TAO<sup>11</sup> would require that the IRS not levy or file a tax lien if those actions would create a significant hardship. The definition of a “significant hardship” is a *serious privation*.<sup>12</sup>

The primary function and purpose of the NTA under § 7811 is to have the NTA issue a TAO to prevent the IRS from taking any collection action against a taxpayer if that action will create a “significant hardship.” Congress intended the NTA use TAOs to prevent the IRS from causing taxpayers any economic hardship. As noted from the prior discussion on tax liens and tax levies, the IRS does indeed cause widespread economic hardship contrary to law, and the NTA does not issue TAOs to stop the IRS from the creating “economic hardship” in most cases. If I get a call from a taxpayer stating: “The IRS is levying my income, how to I feed the kids?” that call will not generate a TAO from the NTA, but it should under a basic analysis of the law that I have previously identified. I can document the fact that the NTA is not using the authority it was empowered to do under § 7811. Instead, the NTA case worker offers liaison services with the IRS Revenue Officer or is helpful providing information about the case. The NTA case workers do everything but stop levies or tax liens that create economic hardship, which results in closed businesses and jobs lost.

In my tax practice, I see onerous and economically destructive tax liens and tax levies regularly if not every day. I see businesses close, job losses, and significant hardship. I regularly file Form 911s, an appeal for a TAO, in these cases. I have worked with these issues since 1998 and in all of the years to the present time; I

<sup>9</sup> Section 13.1.18 of the Internal Revenue Manual deals with administrative positions of the National Taxpayer Advocate in dealing with “hardship.” The provisions apply to individuals and not to businesses.

<sup>10</sup> TD 9007 that published the final OIC regulations on July 23, 2002. TD 9997 states that the economic hardship standard of Section 301.6343-1 if the regulations “specifically applies only to individuals.”

<sup>11</sup> The application for a Taxpayer Assistance order is made on Form 911.

<sup>12</sup> Reg. § 301.7811-1(a)(4).

have never received a TAO from the office of the NTA. As a tax expert, interpretative tax attorney, with a 27 year career in the office of the IRS Chief Counsel, I have no difficulty interpreting §7811 to require the NTA to issue a TAO in every case where there is a documented significant hardship determination.<sup>13</sup> In effect, the NTA has refused to use the authority Congress intended her to use under the plain language of that statute to issue TAOs to prevent the IRS from causing taxpayers significant economic hardship.

In the recent NTA Report to Congress (over 600 pages in two volumes with supplements), she did not even discuss TAOs. In one appendix, it states that the NTA issued 95 TAOs in 2010. My small boutique law firm sent the NTA more than 100 requests for TAOs in 2010, a negligible portion of the requests received by the NTA. The Form 911 is a one page form that permits one to identify the economic hardship. All that the NTA case worker needs to do is sign that Form 911 and forward it to the IRS to stop the verified hardship. TAOs are not issued even when the hardship is fully documented.

The underutilized TAOs have the effect of reducing taxable revenue caused by closed businesses and lost jobs. In these instances the NTA does not stop clear IRS "misconduct" for abusive tax liens and abusive tax levies that, in each instance, cause job losses and business failure.

***Recommendation to reduce the size of the office of the National Taxpayer Advocate***

The NTA's substantive non-use of the statutory authority to issue TAO's is at the same time a statement by NTA that TAOs are not needed to prevent a significant hardship. That premise leads to the conclusion that there is no need for the 65 local taxpayer advocate offices and the 10 area offices. The elimination of that function would permit the reduction of 2,000 IRS employees. Other residual services of those offices pertain to incidental services and are not necessary.

There are legislative and administrative solutions available to replace the need to use the office of the NTA. It is possible to draft objective standards to prevent IRS abuses of its authority to file tax liens in the public records as well as objective standards creating a statutory threshold before the IRS can file a levy on individual and business taxpayers. The excesses of IRS Revenue Officer and Revenue Examiners can be fixed either by legislation or by Treasury Department regulations. It would be easy to construct some new guidelines to prevent tax lien, tax levy and other IRS abusive conduct, that undercuts the intent of Congress, on issues of integrity and fairness or are counterproductive to the intent of Congress to promote economic growth for both business and individual taxpayers who are willing to resolve their tax issues under current law. These are issues that should be considered by the Department of Treasury. It is my recommendation that this Committee hold hearings to determine the extent to which the office of the NTA is not essential to the effective operations of the IRS.

***The Need for IRS "Transparency" to Facilitate IRS Oversight***

Many of the distortions I have identified occur because there is presently **no effective IRS oversight** and there is **no IRS transparency**. The Senate Finance Committee held IRS abuse hearings in 1997, and the result of those hearings was the IRS Reform and Restructuring Act of 1998, a very pro-taxpayer body of legislation. IRS oversight hearings are needed and will be constructive in promoting tax reform. Although I have only addressed a few topics, my statement highlights the apparent need for IRS oversight by this Committee. **IRS hearings are needed** to properly evaluate the extent the IRS meets or fails to meet its responsibility to apply the law with integrity and fairness and the extent to which the IRS misapplies the law. The other reason for hearings, as I previously noted, is to publicize the inefficiencies and ineffectiveness of the IRS in its administration of a very complex body of tax law and thereby support tax reform. Congress needs to know "what is broken" in the IRS before making legislative decisions to provide fundamental tax reform.<sup>14</sup> Hearings are also needed to evaluate the effectiveness of the Office of the Treasury Inspector General for Tax Administration to consider the need to improve sanctions for IRS employee misconduct.

<sup>13</sup> Form 433A for individuals and Form 433B for businesses provide financial statements that can be completed by taxpayer to show significant hardship. Those forms require attachments documenting the relevant financial data. These forms are used for Offers in Compromise, Installment Agreements, and they can also be used to document significant hardship.

<sup>14</sup> The Senate Finance Committee held IRS abuse hearings in 1997, and the result of those hearings was the IRS Reform and Restructuring Act of 1998, a very pro-taxpayer body of legislation.

***“Transparency”—National Database—Voluntary Taxpayer Submissions***

Congress is largely aware of the IRS abuses I have identified in this statement. Due to privacy law, very few know what the IRS does because of the statutory prohibition on disclosing taxpayer information. In the cases I work, the only people who know what happens are the IRS employee, my client and myself. Congress and the public do not get the kind of insight that I have provided to this Committee on just a few topics. I am a witness to many other IRS misapplications of law in other areas, for example, in IRS civil and criminal examinations.

Every Member of Congress gets complaints about the IRS regularly. Constituents complain about IRS abuses of power, IRS misconduct, erroneous applications of law, and hardship. This data is not saved. Those constituent complaints are not archived into any kind of a database to provide IRS transparency to provide helpful information about the IRS to this Committee. The complaint traffic to the NTA is also not saved into a national data base of IRS issues and problems. There is a need for a national database for IRS complaints. The IRS will be hesitant to be overly aggressive on a tax matter, or to engage in the counterproductive practices I have described, if IRS actions were more “transparent” to the public, to the media, and to Congress.

The Subcommittee on Oversight will be able to execute its oversight function over the IRS more effectively if it has access to a national database reflecting IRS interactions with taxpayers. Taxpayers throughout the U.S. voluntarily voice their IRS experiences constantly to all Members of Congress as well as to the members of this Subcommittee. That empirical data is available but it is neither organized nor saved. There is also no platform to upload that data to a combined database. A national database of taxpayer and constituent experiences, if collected, organized by issue and analyzed would give this Committee and its Oversight Subcommittee the IRS transparency that is presently lacking.

***The IRS Forum as a Vehicle to Provide IRS Transparency and Oversight***

The IRS Forum, [www.irsforum.org](http://www.irsforum.org), has been approved by the IRS as a 501(c)(3) educational organization. The IRS Forum presence on the internet encourages the uploading of taxpayers’ experiences with the IRS. The sole purpose of this is to provide a national data base of taxpayer experiences with the IRS. This “transparency” facilitates oversight of the IRS because the data is openly available for all to see and evaluate.

Using tax liens as an example, if a Member gets a complaint from a constituent that a profitable business was closed and jobs lost attributable to the tax lien, that data is wasted. On the other hand if constituents uploaded 1,000, 10,000 or some other number, in each instance, blaming the business and job losses on abusive conduct of the IRS, that data would eventually hit critical mass and get the attention of the media, the public, educators and Members of this Committee. The data can be analyzed to identify and resolve administrative and legal issues that would provide this Committee with current data about how the IRS is administering the tax law.

Taxpayers can upload data without using their identity at the IRS Forum. The data can be collected by issue (e.g., tax liens, levies, examinations, etc). One constituent complaint to any Member of Congress becomes wasted data but becomes valuable when made a part of a larger database with similar content on similar issues. The only goal and purpose of the IRS Forum is to provide IRS transparency that is presently lacking. With that transparency, the public and this Committee would be a witness to IRS abuses as they occur.

The accumulation of a national database of taxpayer experiences with the IRS is a very simple idea. The IRS Forum is located on the internet to receive and organize taxpayer data as well as maintain a perpetual database about taxpayer experiences with the IRS. The nonpartisan IRS Forum is not a commercial venture. There are no membership fees, and the IRS Forum does not accept advertising. The IRS Forum functions only as a nonprofit educational organization on IRS positions and administrative practices. The immediate goal of the IRS Forum is to provide assistance to the Congress in conducting oversight of the IRS by accumulating and making publicly available data regarding IRS practices. Funding of the IRS Forum is expected to come from voluntary contributions. It is a low maintenance organization. At the present time it exists without any office with just its presence on the internet.

The IRS Forum would be able to create a formidable national database of taxpayer interactions with the IRS, if Members of Congress made constituents aware of that institution. Once constituents and the public are aware of the purpose and function of the IRS Forum to archive a perpetual database of taxpayer experiences with the IRS, it would then be able to reach its potential to provide ongoing IRS

transparency. The problems I have identified in this statement could not occur, in my opinion, if the actions of the IRS are transparent to this Committee, the public and the media.

The IRS Forum is available as needed by the Committee to help initiate a national database of taxpayer experiences with the IRS and provide IRS transparency that would otherwise not exist. Ongoing uploads by taxpayers of their IRS experiences will correspondingly assist this Committee in ongoing oversight of the IRS and its administration of the tax law. The IRS Forum is also available to Committee staff to collect taxpayer experiences that will be helpful to staff when looking for data to help draft legislation to correct IRS abuses reported to the IRS Forum in addition to its function to educate the public about the IRS.

As the world's largest retail trade association, the National Retail Federation's global membership includes retailers of all sizes, formats and channels of distribution as well as chain restaurants and industry partners from the U.S. and more than 45 countries abroad. In the U.S., NRF represents the breadth and diversity of an industry with more than 1.6 million American companies that employ nearly 25 million workers and generated 2010 sales of \$2.4 trillion.

#### ***Summary of Comments***

Members of NRF believe that the most important aspect of any tax reform measure is its impact on the economy and jobs. The U.S. economy is coming out of the worst recession since the Great Depression, but economists predict that economic growth may continue to be slow because of high unemployment, which will also continue to depress consumer spending. It is vitally important that any tax reform measure do no harm to our economy, which is likely to remain fragile for several years to come.

Consumer spending represents two-thirds of GDP. During the past few years, consumer confidence has hit its lowest levels since records have been kept, and consumer spending has dropped precipitously. One of the most harmful things that could be done to our economy at this time would be to place a direct federal tax on consumption.

NRF believes that a reform of the income tax, by providing a broad base and low rates, will bring the greatest economic efficiency and will not cause the economic dislocations inherent in the transition to a consumption based tax system. Reforms of the income tax could be designed to eliminate some of the major complications in the current Internal Revenue Code and stimulate economic growth, without causing major economic dislocation.

NRF also opposes using tax reform as a guise to fund increases in government spending, as would be true if the United States adopted a value added tax (VAT) in addition to the current income tax system. NRF believes policymakers need to be forced to make choices with respect to how taxpayer dollars are spent, rather than being provided with a money machine to finance entitlements and other government programs.

#### ***Reform of the Income Tax***

NRF supports income tax reform that would broaden the income tax base and lower the income tax rates. The elimination of many special deductions and credits in exchange for lower rates will bring about a more economically efficient tax system that is simpler for taxpayers and will ease enforcement.

Reform of the corporate tax system is particularly important. The United States has the second highest corporate tax rate in the OECD. In a global economy, higher U.S. corporate tax rates serve as a disincentive for investment in the United States. The U.S. corporate tax rate needs to be lowered to make us more competitive, and the lower rates should be paid for by eliminating various tax preferences in the Internal Revenue Code. Lower tax rates reduce the incentives for entering into tax motivated business strategies. Lower rates combined with the elimination of various tax preferences will cause businesses to structure transactions to their most productive use, rather than spending inordinate amounts of resources on tax planning.

#### ***Consumption Taxes***

Whenever fundamental tax reform is considered, policy debates generally turn to whether the United States should move from its current income-based tax system to a consumption-based tax system or to a hybrid tax system, which would impose a value added tax (VAT) in addition to the income tax, similar to the European model. NRF opposes the adoption of a consumption tax because it would have a chilling effect on our already weak economy.

Consumption taxes can be imposed in various ways including a National Retail Sales Tax (NRST), Value Added Tax (VAT), Flat Tax, and consumed income tax.

Economists generally agree that the economic impact of various forms of consumption taxes is similar, although the application of the taxes may differ.

In 2010, Ernst & Young and Tax Policy Advisors conducted a study for NRF on the Macroeconomic Effects of an Add-on VAT enacted for deficit reduction. The study found that following the enactment of a VAT, the economy would lose 850,000 jobs, GDP would decline and retail spending would decline. By contrast, the study found that following the enactment of comparable deficit reduction through a reduction in government spending, the economy would add 250,000 jobs, GDP would increase and there would be a much smaller drop in retail spending. A copy of the NRF study can be found at [www.nrf.com/VAT](http://www.nrf.com/VAT).

An earlier study,<sup>15</sup> prepared for the NRF Foundation by PricewaterhouseCoopers, examined the impacts of replacing the income tax with a consumption tax (either an NRST or a Flat Tax). The study concluded that although replacing the income tax with a consumption tax might bring *long-term* economic growth, there could be very harmful short-term and mid-term economic results.<sup>16</sup> The study also found that the economic growth that occurred during the ten-year modeling period was relatively modest compared to the disruptions to the economy during the transition years. Specifically, the study found that following the enactment of an NRST, the economy would decline for three years, employment would decline for four years, and consumer spending would decline for eight years. The study found that following the enactment of a Flat Tax, the economy would decline for five years, employment would decline for five years and consumer spending would decline for six years. Given the fragile state of the current economy, the United States cannot afford to see further declines in consumer spending for several more years.

In addition to the overall impact of consumption taxes on the economy, retailers are particularly concerned with the impact of consumption taxes on our customers. Consumption taxes are highly regressive and will raise the tax burden on lower and middle-income Americans. This occurs because lower-income households tend to spend a higher portion of their incomes, so they will pay a higher tax relative to income level under a consumption tax than will upper income households.

Consumption taxes also impose an unfair tax increase on senior citizens. Senior citizens generally live off of previously-taxed earnings that they have saved from their working years. They now are at a stage where they consume far more than they earn. An increase in the tax burden on consumption would be extremely difficult for seniors.

A consumption tax, whether as a replacement to the current income tax system or as an addition to the income tax system, will not meet President Obama's goal to not impose higher taxes on Americans with less than \$250,000 a year of income.

A federal consumption tax will also wreak havoc with state budgets. Forty-five out of fifty states depend on sales taxes as a major source of revenue. In fact, much of the current short fall in state budgets is as a result of the sharp decline in consumer spending, and hence sales tax collections, during this weak economic period. If a consumption tax is added at the federal level, it will be far more difficult for the states to increase sales taxes to address budget short falls.

Enforcement issues are likely to increase if the Federal Government adopts a consumption tax either in addition to the current income tax or as a replacement to the current income tax. Studies have shown that when the rate of tax on consumption exceeds certain levels, tax evasion grows. The level of tax on consumption that would be imposed if a federal tax were added to state and local sales taxes would probably exceed these levels. They certainly would be exceeded if a federal consumption tax were to replace the income tax.

Adding a bureaucracy within the Internal Revenue Service to enforce a federal consumption tax will necessitate large start up costs, as well as additional ongoing costs to operate.

Adding a federal consumption tax to the income tax will also greatly increase the overall level of complexity of our tax system. Complications will result because of the differences between the federal sales tax base and state and local tax bases. The dual tax system may be particularly burdensome for small businesses, which have enough trouble meeting the burdens of collecting and remitting payroll and income tax withholdings.

<sup>15</sup>PricewaterhouseCoopers LLP, *Fundamental Tax Reform: Implications for Retailers, Consumers, and the Economy*, April 2000. A copy of the study can be found at: [http://nrf.com/modules.php?name=Documents&op=viewlive&sp\\_id=3965](http://nrf.com/modules.php?name=Documents&op=viewlive&sp_id=3965).

<sup>16</sup>The PwC model was developed specifically to analyze tax reform plans. It combined micro-simulation models for individual and corporate income taxes with a macro-economic forecasting model, which allowed it to provide short-term transition results on an annual basis. Id at p. 119.

**Conclusion**

We urge the Committee to move forward with corporate income tax reform that will lower tax rates and broaden the tax base. The United States currently has the highest corporate income tax rate in the developed world, which hampers the ability of U.S. companies to compete and deters business investment in the United States. This type of tax reform will simplify administration of the tax system and encourage economic growth without shifting the burden to those that can least afford to pay.

Transitioning to a consumption tax system will lead to a decline in the economy and a loss of jobs for many years. Given the impact that weak consumer spending is having on the ability of the U.S. economy to recover from the Great Recession, we urge the Committee to reject any tax reform measures that would impose a direct tax on consumer spending.

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**Matt Lykken, Statement**

I am the Director of SharedEconomicGrowth.org. I thank the Committee for the opportunity to submit this statement with regard to the economic burdens imposed by the current tax system and the possibilities for helpful reform.

I am an international tax attorney with 24 years of government and corporate experience. I have worked for U.S. corporations in the U.S. and abroad, and for a foreign corporation following the acquisition of my U.S. employer. I have advised several foreign governments on how to structure their tax systems in a manner that would provide strong and secure revenue while at the same time encouraging investment. My colleagues in SharedEconomicGrowth.org are likewise tax attorneys of broad experience. As tax professionals and parents, we have become alarmed by the clear negative effect that the U.S. corporate tax system is having upon the U.S. economy. The current system discourages U.S. employment, inhibits repatriation of hundreds of billions of dollars, and strongly interferes with efficient investment. Further, compared with taxation of the same earnings at the individual level, corporate tax is regressive, imposing the same 35% levy on earnings allocable to the IRA of a minimum wage worker as it does on earnings allocable to a billionaire. The United States can no longer afford this efficiency burden. We seek to offer an alternative that is revenue neutral in the short term, revenue positive in the longer term, and helpful to the working, saving middle-income families who have been suffering from artificially low interest rates on their savings and have been standing aghast as our government commits their hard-earned money to helping the rich and the spendthrift.

**A Right and a Wrong Way to Reform Deferral**

The Administration is right to wish to reform deferral. Under the current system, a corporation can increase its after tax manufacturing profits by 54% simply by choosing to locate a plant in the Dominican Republic ("D.R.") rather than in the United States. Further, when the corporation then determines how best to invest \$1,000,000 of that D.R. profit, it must consider that it can invest the full \$1,000,000 if it does so in any country except the United States, but can only invest the after tax amount of \$650,000 if it brings the cash here. Clearly, we should seek to alter this incentive. However, attempting to do so by simply taxing foreign earnings at 35% would have an extremely destructive effect given the existence of global competition.

**The Wrong Way**

The United States does not have a monopoly on technology, creativity, or capital. Virtually all U.S. multinationals have strong foreign based competitors. Those competitors are free to set up their plants in the D.R. and pay no tax, and under their home country territorial tax regimes they will never pay tax on those earnings. (As one Example, Bayer AG in 2007 had tax expense of € 72 million on income of € 2,234 million). In the global economy, shareholders demand an equivalent post-tax return from any corporation having an equivalent growth and risk profile. If a fully-taxed U.S. corporation is forced to compete with an untaxed foreign rival, then, two things can be expected to happen. First, the foreign company may choose to compete on price, relying on the fact that it would only need to earn \$65 of pre-tax profit to be equivalent to a 35% taxed U.S. rival earning \$100. The U.S. company may not be able to make a reasonable profit in the face of that disadvantage, and may be crushed or seek to withdraw from the competition. This raises the second effect. If the D.R. operations would be worth \$1,000 on a 0% tax basis, they would be worth only \$650 on a 35% tax basis. Therefore, a 0% taxed rival could buy the D.R. operations of a U.S. parent without tax friction. In other words, it could pay \$1,000 be-

cause the operation would be worth \$1,000 to it, the U.S. seller would receive \$650 after tax, and so both sides would be content. Faced with the choice between hopeless competition or a frictionless sale, which would the U.S. corporation choose? Could a 35%-taxed U.S. corporation buy out its 0% taxed D.R. rival? No. Going in that direction, the fact that tax basis can only be recovered over time imposes a level of friction that would be impossible to overcome. Using a typical 15 year recovery period and a typical 15% discount rate, the U.S. company would be paying \$1,000 for an operation worth only \$796 to it. In short, existing foreign operations of U.S. parents would die or be sold, new operations would not be acquired, and U.S.-based operations would labor under the burden of unfair price competition. Many U.S. corporations would be acquired by foreign rivals, with the consequent elimination of prime U.S. headquarters jobs and elimination of U.S. export operations, further aggravating our balance of payments. This is not a formula for American success.

#### The Right Way

This Committee may hear a number of proposals for corporate tax reform. They will have various known flaws. The Committee will be asked to lower corporate tax rates. That is an extremely prudent suggestion given that the U.S. tax rate is now a global outlier, but substantial rate reduction will increase the earnings lock-in effect and will bring back all of the personal income sheltering issues that were suppressed when corporate and individual rates were brought into harmony. The Committee will hear calls for conversion to the type of territorial tax regime used by essentially all of our trading partners, but that also has recognized issues. The Committee may receive radical reform proposals that raise the risk of a fresh “arms race” between tax planners and the government, losing the protection of a long-tested system of extracting revenue. But there is one proposal that would eliminate the deferral problem in a manner that would encourage U.S. investment and strengthen U.S. corporations. It would make corporate tax-shelter and transfer-pricing issues a thing of the past. It would eliminate corporate cash lock-in and free funds for investment in the best opportunities available in the overall economy. It would drive true corporate transparency and accountability, reduce corporate power and “too big to fail” consolidations, and shift focus from mindless growth to solid profitability. It would reduce the hidden harvest of corporate profits by executives and give those funds back to the shareholders. It would improve the progressivity of the U.S. tax system and reward middle-income savers, increasing the value of their hard-hit IRA and 401(k) accounts. It would do this in a manner that would be revenue neutral on a static basis, and strongly revenue positive in the future as increased after-tax earnings are withdrawn from retirement accounts. And it would do all of this with a three page bill, included here.

The Shared Economic Growth proposal is simply a corporate dividends paid deduction with the revenue offset at the individual shareholder level. The United States has always sought to achieve corporate integration by reducing tax at the shareholder level, a highly regressive technique that pleases large campaign contributors. Shared Economic Growth instead allows corporations to reduce their tax only if and when they pay out their earnings as dividends, and simultaneously taxes those dividends in the hands of the shareholders at full ordinary rates. Certain other changes to the system that are possible only with the introduction of a dividends paid deduction (i.e. not with a corporate rate reduction or shareholder level relief) make this work in a revenue neutral manner. Shared Economic Growth could be implemented in two alternative ways, offering a policy choice. Because a portion of corporate dividends flow to tax-deferred savings vehicles such as IRAs and 401(k)s, there would be a current revenue loss. The version of the bill attached here assumes that this Committee would prefer to allow that deferral and to make it up through a levy on individual income over \$500,000 a year equal to the individual employment tax levy that ordinary wage earners pay. Under this version, as the IRAs and 401(k)s pay out their enhanced earnings in the future, the government would harvest substantial incremental revenues that could be used to reduce the deficit. Alternatively, one could enact the proposal with a withholding tax that would hold tax-deferred savings accounts neutral while still obtaining all of the incentive-correction and efficiency effects of the proposal and still somewhat increasing progressivity.

Further information on the proposal, and on the impact of the current system on our economy, can be found at <http://www.sharedeconomicgrowth.org/home/summaryslideshow.html>.

Given This Option, Enacting Destructive Changes Would Be Inexcusable

Shared Economic Growth is a viable option. It is simple. The static numbers are based on IRS Statistics of Income and Federal Reserve data and are valid. It is safe. It would strengthen the American economy, bring home hundreds of billions of dollars of corporate cash, and enhance the market power of American employees, all while satisfying the Administration's revenue requirements over time. With such an option available, there is no good reason to further damage U.S. stock values by even considering the destructive alternative of attacking deferral under our current flawed system.

This is a critical moment in America's history, one where the choices made by Congress will determine whether our children will have a chance for a joyous and prosperous future or will be doomed to fight for their share of a wounded and diminished economy. I thank you for investing the time to ensure that you have thoroughly considered all of the options so that you may make the right choices for America.

**A Bill**

To amend the Internal Revenue Code of 1986 to remove incentives to shift employment abroad, and to remove hidden taxes on retirement savings and provide equitable taxation of earnings.

**SECTION 1: SHORT TITLE**

This Act may be cited as the "Shared Economic Growth Act of 2011".

**SECTION 2: PROVIDING INCENTIVES TO LOCATE HIGH-VALUE JOBS IN AMERICA AND TO INJECT CASH INTO THE AMERICAN ECONOMY**

(a) Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding the following new section:

"251. (a) General Rule. In the case of a corporation, there shall be allowed as a deduction an amount equal to the amount paid as dividends in a taxable year of the corporation beginning on or after January 1, 2012.

(b) Limitation of benefit to tax otherwise payable.

1) The deduction under this section may not exceed the corporation's taxable income (as computed before the deduction allowed under this section) for the taxable year in which the dividend is paid, decreased by an amount equal to 2.85 times any tax credits allowed to the corporation in the taxable year.

2) Where the deduction otherwise allowable under this section in a taxable year exceeds the limitation provided in paragraph 1 of this subsection, the excess may be carried back and taken as a deduction in the two prior taxable years or forward to each of the 20 taxable years following the year in which the dividends were paid. However, the total deduction under this section for dividends paid during the taxable year plus carryovers from other taxable years may not exceed the limit provided in paragraph 1 of this subsection. Rules equivalent to those provided in paragraphs 2 and 3 of subsection 172(b) of this subchapter shall govern the application of such carryover deductions.

3) No amount carried back under paragraph 2 of this subsection may be claimed as a deduction in any taxable year beginning on or before December 31, 2011.

(c) Consolidated groups. In the case of a group electing to file a consolidated return under Section 1501 of this Subtitle, the deduction provided under this section may be claimed only with respect to dividends paid by the parent corporation of such consolidated group."

(b) Subparagraph (b)(1)(A) of Section 243 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows.

"(A) if the payor of such dividend is not entitled to receive a dividends paid deduction for any amount of such dividend under Section 251 of this Part, and if at the close of the day on which such dividend is received, such corporation is a member of the same affiliated group as the corporation distributing such dividend, and".

(c) Section 244 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is repealed for tax years beginning after December 31, 2011.

(d) Subparagraph (a)(3)(A) of Section 245 of Part VIII of Subchapter B of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows:

“(A) the post-1986 undistributed U.S. earnings, excluding any amount for which the distributing corporation or any corporation that paid dividends, directly or indirectly, to the distributing corporation was entitled to receive a deduction under Section 251 of this Part, bears to”.

(e) Subsection 1(h) of Part I of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is repealed for tax years ending after December 31, 2011.

(f) Subsection (a) of Section 901 of Part III of Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended to read as follows:

“(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of Section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. However, in the case of a corporation, no credit shall be allowed under this section or under Section 902 for foreign taxes paid or accrued, or deemed to have been paid or accrued, in tax years beginning after December 31, 2011. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).”

This amendment shall override any contrary provision in any existing income tax convention.

### **SECTION 3: PREVENTING WINDFALL BENEFITS FOR FOREIGN INVESTORS**

(a) Section 1441 of Subchapter A of Chapter 3 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding at the end of subsection (a) thereof:

“, and except that in the case of dividends, the tax shall be equal to 35 percent of such item.”

The imposition of this 35 percent withholding tax on dividends shall override any contrary restriction in any existing income tax convention.

(b) Section 1442 of Subchapter A of Chapter 3 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding at the end of the first sentence of subsection (a) thereof:

“, except that in the case of dividends, the tax shall be equal to 35 percent of such item.”

The imposition of this 35 percent withholding tax on dividends shall override any contrary restriction in any existing income tax convention, except that any treaty limiting the imposition of U.S. tax on dividends paid from a U.S. resident corporation to a foreign parent corporation shall not be overridden where the foreign parent owns, directly or indirectly, at least 80 percent of the voting stock of the U.S. corporation and where the foreign parent is 100 percent owned, directly or indirectly, by a corporation whose ordinary common shares possessing at least 51 percent of the aggregate voting power in the corporation are regularly traded on one or more recognized stock exchanges.

### **SECTION 4: FAIR FUNDING FOR RETIREMENT SECURITY**

(a) Section 1 of Part I of Subchapter A of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986 is amended by adding the following new subsection:

“1(h)(1)(a) Tax imposed. There is hereby imposed a tax of 7.65 percent on so much of the adjusted gross income for the taxable year of that exceeds—

(A) \$500,000, in the case of

- (i) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013;
- (ii) every surviving spouse (as defined in section 2(a)); and
- (iii) every head of a household (as defined in section 2(b)), ;

(B) \$250,000, in the case of

(i) every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 7703); and

(ii) every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013;

(C) \$7,500, in the case of every estate and every trust taxable under this subsection.

(b) Credit for hospitalization tax paid. There shall be allowed as a credit against the tax imposed by this subsection so much of the amount of hospitalization tax paid by the individual with respect to his wages under subsection 3101(b) and to his self-employment income under subsection 1401(b) of this Title as exceeds the following amounts:

A) In the case of individuals described in subparagraph (1)(A) of this subsection, \$14,500; and

B) In the case of individuals described in subparagraph (1)(B) of this subsection, \$7,250.

#### Shared Economic Growth—Bill and Computations Summary

The Shared Economic Growth bill allows a corporate dividends paid deduction, restricted to taxable income otherwise reported decreased by 2.85 times any credits claimed, so that the deduction may only reduce tax to zero. Excess reductions could be carried back 2 years and forward 20, so there would be incentive to pay out earnings with 2 years. Subsection 2(a) of the bill makes this change, with Subsections 2(b), (c) and (d) making certain conforming changes to the existing corporate dividends received deduction provisions.

In 2006, a normal year, corporations paid tax of \$353 billion, so offsets of up to \$353 billion would be required for static revenue neutrality. The first and most natural offset is individual tax payable on the dividends paid. In order for the proposal to work, special rates for dividends and for capital gains on equity would need to be eliminated, so that these dividends would be taxed at full 2013 individual rates. Subsection 2(e) repeals these special rates. Per the Joint Committee on taxation 2006–10 tax expenditure report, this would have provided an offset of \$92.2 billion for 2006 without altering the various special capital gains exemption and rollover provisions. As a practical matter, this offset is only feasible in conjunction with the allowance of a dividends paid deduction, since such a deduction eliminates double taxation on the corporate side and thus eliminates any legitimate argument in favor of the capital gains rate benefits. As is noted below, the bill provides substantial excess offsets, so select non-equity capital gain rate benefits could be retained if desired.

Subsection 2(f) provides an offset mechanism that is only possible in conjunction with enactment of a dividends paid deduction. Because the deduction would effectively eliminate taxation of corporate income, including foreign income, it would no longer be necessary to allow a corporate credit for foreign taxes paid. A deduction could be permitted instead with the same bottom line effect. However, allowance of a deduction would impel corporations to pay out more dividends in order to eliminate the corporate level tax on the foreign income, which in turn increases the offset at the individual level. With this provision, the individual level offset from full 2013 rate taxation of the dividends needed to reduce corporate tax to zero would be some \$153.6 billion, after factoring out shareholders not subject to tax.

Section 3 provides another offset only feasible in conjunction with a dividends paid deduction. Foreign investors are effectively paying the 35% U.S. corporate level tax on their investment earnings. Congress would not have to let them have the benefit of the dividends paid deduction, since U.S. resident shareholders would have to pay full rate tax on such dividends. So, Section 3 imposes a 35% incremental withholding tax on dividends paid to foreign portfolio holders, exemption certain qualified foreign parent companies. This offset figure is somewhat inflated because I lack data to sort out the portion attributable to qualifying foreign parents corporations versus portfolio investors.

Section 4 provides the final offset, which the draft bill sets at a much higher level than necessary, since there is a certain attraction in subjecting individual income over \$500,000 a year to an AGI tax equivalent to the individual portion of the FICA taxes that ordinary wage earners pay. **The minimum level needed for this levy is some 2.65%.** At a 7.65% level, this levy would offset the revenue attributable to dividends paid to non-taxable retirement plans, so in effect this levy is requiring high income individuals to pay a supplemental tax similar to FICA taxes that sup-

ports non-social security private and state pension savings, thereby taking pressure off of the social security system. **Moreover, because these retirement savings will ultimately be paid out and taxed (at an average rate of some 17.66% after exclusions (as computed from the 2006 IRA/pension/annuity distribution income by AGI class), this would increase revenue by some 22.2 billion per year on a static basis as the pension income is paid out.** Use of a 7.65% rate provides an excess offset of \$67.6 billion that can be used to reduce the other offsets or to provide other compensating benefits or deficit reduction.

The static computations, based on 2006 IRS, JCT and Federal Reserve data, are reproduced in summary below and are available in full on request. I should note a computation relating to a variant from the static model. The static model ignores the fact that if corporations pay out a higher share of their earnings as dividends, capital gains taxes that would otherwise be payable under current law would be reduced, since a portion of capital gains tax collections pertain to gains flowing from the increment in share values attributable to retained earnings. The sensitivity computation below shows that at worst this effect would not be large enough to invalidate the model. The static model already conservatively accounts for taxes payable under current law on dividends that are normally distributed. The maximum effect of the above-described capital gains interaction is thus computable based upon the incremental taxable dividends as computed in the model. This results in the following computation.

Maximum reduction in capital gains tax due to elimination of capital gains attributable to earnings that would otherwise be retained	
Incremental dividends subject to tax	\$454,991,419
Times 65% to account for earnings reduction from corp tax under current law	\$295,744,423
Times 20% maximum capital gains rate	\$59,148,885
This is less than the excess offset	

**This computes the necessary offsets, based on IRS 2006 SOI data and Federal Reserve ownership data**

Total corporate tax collected	\$353,083,862
Foreign tax credits used	\$78,183,457
Incremental tax if FTCs replaced by deductions	\$50,819,247
Adjusted corporate tax for computation	\$403,903,109
Grossed up by dividing by 35% to obtain value of dividends required to reduce corporate tax to zero	\$1,154,008,883
Qualifying taxable dividends reported by shareholders	\$137,195,800
Percentage of stock held by retirement funds	31.14%
Percentage of stock held by state & local gov't	0.52%
Percentage of stock held by foreigners	17.02%
Total dividends % not subject to income tax	48.68%
Implied non-taxable dividends paid	\$130,160,817
Incremental dividends to reduce corporate tax to zero	\$886,652,266
Incremental dividends subject to tax	\$454,991,419
Individual tax on those incremental dividends	156,287,339
Remaining offset needed	\$196,796,523
35% withholding on foreign shareholders	\$68,747,233
Remaining offset needed	\$128,049,290
Capital gains & dividends rate benefit	\$92,200,000
Remaining offset needed	\$35,849,290
2.65% AGI tax on income > \$500,000	\$35,849,290
Remaining offset needed	\$0
Note: At an AGI tax of 7.65% on income over \$500K, there would be an excess offset of allowing plenty of room to tweak the other offsets	\$67,550,274
<b>Based on 2006 IRA/pension/annuity distributions, the dividends going to pension funds will ultimately be taxed at a weighted average rate after exclusions of</b>	<b>17.66%</b>
Producing tax of	\$63,474,391
<b>Of which the incremental amount produced by SEG would be</b>	<b>\$22,216,037</b>

**ACA**  
 American Citizens Abroad  
 The Voice of Americans Overseas  
[www.americansabroad.org](http://www.americansabroad.org)

**AARO**  
 Association of Americans  
 Resident Overseas  
[www.aaro.org](http://www.aaro.org)

**FAWCO**  
 Federation of American  
 Women's Clubs Overseas, Inc.  
[www.fawco.org](http://www.fawco.org)

The Honorable David Camp, Chairman  
 The Honorable Sander M. Levin, Ranking Member  
 U.S. House of Representatives Ways and Means Committee

January 31, 2011

**Testimony to the Ways and Means Committee Hearings on Fundamental Tax Reform**

Dear Chairman Camp and Congressman Levin,

American Citizens Abroad (ACA), the Association of Americans Resident Overseas (AARO) and the Federation of American Women's Clubs, Inc. (FAWCO) are non-profit, non-partisan associations representing the interests of American citizens residing and working abroad. With more than 20,000 members in over 90 countries, including an umbrella network linking over 75 independent American, international volunteer organizations in 39 countries and a vast information network reaching out to the American community abroad, our organizations are a forceful voice for overseas Americans. We appreciate the opportunity to submit written testimony, as requested by the First Ways and Means Hearing of the 112<sup>th</sup> Congress to *Examine the Burdens Imposed by the Current Federal Income Tax System and the Need for Reform*.

**EXECUTIVE SUMMARY**

**In order to promote exports, simplify taxation and acknowledge the global nature of the world economy, overseas Americans recommend that Congress abandon citizenship-based taxation and tax both the self-employed and employed exclusively on the basis of their residence in the United States, as is the general policy in other nations.**

- **The United States is the only country in the world imposing citizenship-based taxation.**<sup>1</sup> In theory, citizenship-based taxation means that all Americans, irrespective of their domicile, within or outside the borders of the United States, shall pay the same U.S. taxes. It is an anomaly in today's global economy. In practice, citizenship-based taxation means that Americans resident overseas pay taxes in both their country of residence and in the U.S., the latter however under deduction of the Foreign Earned Income Exclusion and of credits for the taxes paid abroad. This has numerous undesirable side effects.
- **Negative impact of citizenship-based taxation on U.S. competitiveness:** Most U.S. corporations severely restrict deployment of Americans abroad because of the prohibitive tax burden borne by the employer to provide a U.S. citizen with equal take-home-pay. International work experience for U.S. citizens is a vital component to an active U.S.A.

<sup>1</sup> Eritrea is possibly the only other country to apply citizenship-based taxation.

- **The current situation restrains employment opportunities for U.S. citizens:** For all other overseas Americans, i.e. those without a so called “expat package”, citizenship-based taxation means either standards of living lower than those of their U.S. counterparts with similar circumstances, or lower than their counterparts in their country of residence. At a time of high unemployment in the U.S., it is not in the interest of the country, the U.S. government or U.S. citizens to artificially limit employment opportunities overseas. Actually, overseas employment relieves the fiscal burden of high unemployment, as well as provides a competitive edge for future exports.
- **U.S. citizens abroad are valuable to the United States as unpaid private sector diplomats:** U.S. citizens abroad are much more likely to mingle and interact on a daily basis with foreign nationals than many U.S. government employees and thus provide the U.S. with a valuable uncompensated public relations service as private sector diplomats.
- **Benefits argument:** U.S. citizens residing abroad do not receive, by a wide margin, anywhere near the same level of benefits as those residing in the United States. Indeed, many receive no benefits at all from the U.S. government.
- **Ability to pay:** U.S. citizens residing abroad pay taxes to the country of residence, often paying higher total taxes than Americans residing in the United States with comparable income or non-U.S. citizens in similar circumstances in their country of residence.
- **Administrative burden:** The administrative burden and cost to the tax payer and the IRS is out of proportion with the tax revenue collected by the IRS from such taxpayers.
- **Citizenship-based taxation leads to unfair taxation and double taxation:** Most Americans residing abroad pay higher total taxes abroad and yet still owe U.S. taxes. Incompatibilities between tax systems of different countries and specific discriminations in the U.S. tax code always work in disfavor of Americans resident abroad.<sup>2</sup>
- **Citizenship-based taxation is encouraging U.S. citizens to expatriate:** Instead of focusing on making expatriation more difficult or expensive, Congress should adopt residence-based taxation to reduce the increasing number of U.S. citizens that are abandoning their U.S. citizenship and severing all ties with the U.S. due to tax burdens.<sup>3</sup>

#### Compensating tax measures if residence-based taxation is adopted

- If residence-based taxation is adopted, bona fide overseas American residents should be taxed in the same manner as nonresident aliens. Most U.S. source income paid to citizens abroad should be subject to U.S. withholding tax at the standard withholding or applicable treaty rate. As a corollary, the new law should supersede the “savings clause” written in the current tax treaties which excludes U.S. citizens from treaty benefits. Taxing capital gains on the disposition of U.S. real estate would be maintained in accordance with general international tax practice.
- Today the U.S. does not withhold taxes on the interest earned on U.S. bank deposits held by individual foreigners. Congress may consider initiating a withholding tax on individual bank deposits held in the United States by foreigners and nonresident Americans.

<sup>2</sup> Annex 1 lists the most obvious discriminations in the U.S. tax code against Americans resident abroad.

<sup>3</sup> Bryan Knowlton, “More American Expatriates Give up Citizenship”, New York Times/IHT, April 25, 2010 - [http://www.nytimes.com/2010/04/26/us/26expat.html?\\_r=1&src=me&ref=general](http://www.nytimes.com/2010/04/26/us/26expat.html?_r=1&src=me&ref=general) ; Martin Vaughan, “More Americans Sever U.S. Ties as IRS Gets Tougher”, Wall Street Journal, April 5, 2010 - <http://online.wsj.com/article/SB10001424052702304017404575166211517964090.html?m>; Helena Bachman, “Why More U.S. Expatriates are Turning in their Passports”, TIME Magazine, April 20, 2010 - <http://www.time.com/time/world/article/0,8599,1983238,00.html?xid=rss-topstories>

**Recommended minimum tax reforms applicable to U.S. citizens who are bona fide residents abroad if residence-based taxation is not adopted by Congress**

- Eliminate the cap on the foreign earned income exclusion in recognition of differing living standards around the world, as was the case prior to 1962.
- Allow foreign net asset taxes to be creditable against U.S. taxes.
- Recognize VAT as a consumption tax that is equivalent to U.S. sales taxes.
- Allow use of a non-U.S. dollar functional currency for calculating capital gains, as is the case with corporations.
- Recognize foreign pensions not as passive income but as foreign earned income subject to foreign earned income exclusion. Alternatively, allow foreign pensions to be taxed only in the country of residence.
- Exempt American citizens who are bona fide overseas residents from the requirement to file the new FATCA Form 8938 with their 1040 in addition to the FBAR filing.
- Eliminate the requirement in the FBAR filing to report on foreign bank accounts where the American citizen has only signatory authority, but no financial interest.

\* \* \*

**RECOMMENDATION THAT CONGRESS ABANDON CITIZENSHIP-BASED TAXATION AND TAX INDIVIDUALS' WORLDWIDE INCOME EXCLUSIVELY ON THE BASIS OF THEIR U.S. RESIDENCE**

**Competitiveness argument**

Citizenship-based taxation restricts the free movement of Americans abroad and is based on the false premise that such individuals compete with other U.S. citizen residents for employment or business opportunities. The playing field of overseas Americans is with foreign nationals and foreign businesses, not U.S. residents. In today's global economy where more Americans should be working to promote American business and exports abroad, the number of Americans working for American corporations abroad is very limited and has been sharply cut back due in large part to the unique U.S. tax burden.<sup>4</sup> Compared with other OECD countries, the United States has a very small proportion of its citizens residing abroad.<sup>5</sup> China is known to use its vast international network of Chinese citizens working throughout the world to promote its exports. Restricting job opportunities for Americans abroad leads to insufficient international experience among American managers and also eliminates a fiscal safety valve for the U.S. during periods of high domestic unemployment. With the United States aiming to double its exports in five years, it is essential that Americans obtain overseas experience.

**A foreigner representing a foreign company can reside in the United States and pay only U.S. taxes. Any U.S. citizen representing a U.S. company in a foreign country is subject to the taxes of both the country of residence and the United States. Herein rests a unique competitive disadvantage that the United States has created for itself.**

<sup>4</sup> "U.S. Employees Overseas at U.S. Multinational Corporations Update", prepared by Andy Sundberg, January 2011, based on Department of Commerce data.  
<http://www.aca.ch/joomla/images/pdfs/usemploy.htm>

<sup>5</sup> Report prepared by American Citizens Abroad based on OECD Data Base on Immigrants and Expatriates, from the OECD Report on Trends in International Migration and Migration Policies, January 2005.  
<http://www.aca.ch/joomla/images/pdfs/diaspora.htm>

Congress wants jobs, economic sustainability and increased exports. All of these are impossible as long as the U.S. maintains its citizenship-based tax system and hinders competitiveness. There are 155 million in the workforce in the U.S.A. producing a GDP of roughly \$15 trillion. Hence each job's average contribution to the GDP is roughly \$95,000. The U.S. current trade deficit of \$600 billion equals more than 6 million lost jobs. That \$600 billion also represents lost tax revenue to the Treasury. At the average tax share in the GDP of 18%, U.S. taxes forgone amount to \$108 billion. Maintaining citizenship-based taxation, which brings in limited tax revenue, is actually costing the Treasury through lost trade. Increasing tax pressure on Americans abroad initiated in the late 1970s coincided with the beginning of the U.S. chronic trade deficits that have accumulated a foreign debt exceeding \$7.7 trillion. When we cannot compete via American presence in foreign markets, we lose sales, markets, domestic jobs and revenue to the Treasury.

**Government and professional studies have systematically concluded that eliminating America's citizenship-based tax burden would increase exports.**

A 2005 report by PricewaterhouseCoopers, entitled "Economic Analysis of the Foreign Earned Income Exclusion"<sup>6</sup>, concluded: "Section 911 is a provision of the U.S. tax code designed to offset the competitive disadvantage U.S. taxpayers face working abroad. Repeal of Section 911 is estimated to reduce the number of Americans working abroad, causing an \$8.1 billion loss in U.S. manufactured exports that support 77,115 U.S. domestic jobs. By contrast, removing the \$80,000 cap on the foreign earned income exclusion is estimated to increase U.S. manufactured exports by \$14.4 billion supporting 137,319 U.S. domestic jobs." The cap adjusted for inflation since 2006 is \$91,500 in 2010.

Following the debacle of the U.S. Tax Reform Act of 1976 when the foreign earned income tax exclusion was eliminated and tens of thousands of Americans were forced to return to the United States, the GAO and the President's Council studied the relationship between U.S. exports and American citizens working abroad.<sup>7</sup> All studies concluded that U.S. tax policies on American citizens abroad negatively impacted U.S. exports and reduced U.S. employment. They concluded that it is essential to maintain a large force of U.S. citizens abroad to promote and service U.S. products and operations. They recommended the adoption of tax policies comparable to those of all other industrial nations, none of which taxes citizens who meet overseas residency criteria.

Developing a true export policy, which aims to generate domestic jobs, will undoubtedly require a multifaceted approach on broad fronts. Tax policy is one of the key issues. Tax reform for U.S. corporations as recommended by the President's Tax Reform Panel is certainly an important step. However, exports are realized through efforts of teams of people and the United States needs more American feet on the ground around the world to represent U.S. business interests, whether corporate or non-corporate. This requires fundamental reform of U.S. tax policy towards American citizens working and residing abroad, such as eliminating citizenship-based taxation, to allow Americans to compete abroad on a level playing field with their foreign country competitors. Today, the tax laws discourage American companies from employing American staff in their overseas operations and discourage American citizens from accepting overseas posts with foreign employers on their own. U.S. tax reporting policies with respect to foreign business interests discourages small- and medium-sized companies from setting up sales operations abroad and seriously penalizes the American entrepreneur working and residing abroad.

<sup>6</sup> Pricewaterhouse Coopers, *Economic Analysis of the Foreign Earned Income Exclusion*, prepared for The U.S. Chamber of Commerce, The American Business Council of the Gulf Countries (ABCGC), and the Asian Pacific Council of American Chambers of Commerce (APCAC), November 7, 2005.

<sup>7</sup> GAO, February 21, 1978, *The Impact on Trade of Changes in Taxation of U.S. Citizens Employed Abroad*; President's Export Council, December 10, 1979, *Task Force to Study the Tax Treatment of Americans Working Overseas*; GAO, ID-81-29, *American Employment Abroad Discouraged by U.S. Income Tax Laws*.

**U.S. citizens residing abroad represent a vital asset for the United States:** The informal ambassador role that American citizens inevitably exercise when they reside abroad represents an immense free resource for the United States, not only through the goodwill created in schools, communities and businesses but also through the contacts and information acquired by these citizens that are beneficial in the long-term to the United States in terms of security, technological research and business developments.

**Benefits argument:** U.S. citizens residing abroad do not receive the same benefits, if any at all, as those residing in the United States, since they do not use U.S. infrastructure and cannot claim Medicare benefits abroad. The often cited benefit of U.S. consular services is now significantly financed by user fees. In fact, the U.S. consular service is a profit center for the U.S. government and provides services almost exclusively to non-U.S. citizens and to U.S. citizen tourists and business travelers. For most Americans residing abroad, the sole tangible benefit derived from U.S. citizenship is the right to carry a U.S. passport (once again, for a fee in addition to any taxes paid.) Other countries do not tax their citizens for the right to hold a passport. Overseas Americans pay taxes in their countries of residence because they obtain benefits there, such as roads, schools, health services, social security, court systems, law and order, etc.

**Ability to pay argument:** Since the United States recognizes that the country of residence has first right to tax U.S. citizens abroad, the amount of revenue collected by the United States is the marginal difference due to either higher tax rates in the United States or incompatibilities between tax definitions of the United States and foreign countries. A third of the Americans abroad who file Form 2555 owe no U.S. taxes and those that do pay U.S. taxes do so based on differences in marginal tax rates and tax definitions. Since foreign governments claim the bulk of tax revenue, the U.S. in effect has secondary taxing jurisdiction and limited claims. Certain overseas Americans pay higher total taxes abroad than the U.S. domestic equivalent for their income level and yet may still owe taxes to the United States due to differing types of taxes.

**Administrative burden argument:** The administrative burden for the taxpayer and the IRS is out of proportion with the tax revenue generated. Compliance for Americans residing abroad is much more complicated than for U.S. residents due to foreign exchange calculations and the need to file Forms 2555 and 1116 for individuals or even Form 8621<sup>8</sup> for those who own foreign mutual funds. Calculating tax credits on Form 1116 is so complicated that nearly all Americans abroad must hire a highly qualified professional tax preparer. For those who run foreign businesses, Forms 5471, 8865 and/or 8858 are a nightmare. Form 5471 alone is described by professional tax preparers as an administrative horror; the IRS estimates 80 hours to complete this one form. The cost of professional tax preparer services already easily exceeds \$2,000 per year for the simplest personal returns and can reach in the tens of thousands of dollars for those who operate businesses abroad. Moreover, the recent FATCA legislation<sup>9</sup> will henceforth require anyone with foreign financial assets exceeding \$50,000 to report those assets on a new Form 8938, in addition to the current FBAR filing on financial assets, rendering compliance even more costly and burdensome. This compliance burden adds to the requirement for Americans overseas to file tax returns in the country of residence as well as in the U.S.

<sup>8</sup> The IRS time required estimates for Form 8621 are 8.5 hours to learn the law and the form, 13.5 hours for record keeping and 9.25 hours for preparing the form.

<sup>9</sup> Foreign Account Tax Compliance Act, included in the HIRE Act passed in March 2010. FATCA aims to track down U.S. citizens evading taxes by hiding assets overseas, essentially Americans residing in the United States. The same organizations undersigned here addressed detailed comments on the difficulties involved with filing form 8938 to the IRS in a letter dated December 17, 2010 requested by Treasury.

**Fairness argument:** Citizenship-based taxation is fundamentally unfair as most U.S. citizens abroad already pay higher total taxes abroad than a person in a comparable economic situation in the United States, receive few direct benefits from the U.S. and yet can still owe U.S. taxes.

First, incompatibilities between U.S. and foreign tax law systematically penalize and lead to double taxation, despite mitigating measures in Section 911 and application of foreign tax credits.

Second, the U.S. tax code specifically discriminates against U.S. citizens residing abroad. Some of the more blatant examples of discrimination are listed in Annex 1 at the end of this document.

Third, citizenship-based taxation has become a tax on those willing and/or knowledgeable, i.e. a tax on those American citizens residing abroad who are aware of and willing to file tax returns annually with the IRS. When the U.S. government reaches beyond its territory to tax citizens, it does not have the same administrative authority over enforcement that it has in the U.S., nor does it provide the same level of outreach or support to its taxpaying citizens. Hence, not all American citizens residing abroad file with the IRS, essentially either through ignorance of the law or because they think the paperwork useless since they would in any case owe no taxes to the U.S. government. Those who do file therefore carry an exceptional administrative and fiscal burden. A tax on those willing to pay certainly does not meet recognized criteria for fair and equitable taxation. As stated by Professor Avi-Yonah, "*A law that cannot be enforced is a bad law.*"<sup>10</sup>

Fourth, due to the growing complexities of U.S. tax compliance and consequent severe restraints on their professional and work-related activities abroad, an increasing number of Americans overseas are renouncing their U.S. citizenship and severing all ties with the United States despite the cumbersome procedure, potentially high expatriation tax cost put in place under IRC 877A and the personal sacrifices this entails for most individuals. Americans married to foreigners now hesitate to register their children born abroad for U.S. citizenship because of the life-time tax implications. Laws that cause individuals to feel it is necessary to sever all ties with the United States are ultimately not in the best long-term interests of the country. Such laws constrain U.S. export growth. The solution to these expatriations is not to make expatriation more difficult, but rather to change the U.S. tax system to a system that taxes based on residence.

This trend is particularly disturbing as we know of many instances where our own children who have been brought up and educated abroad have returned to the United States to pursue their studies and carry out extremely productive careers which create U.S. jobs and lead to technological leadership in the United States. Cutting off this source of contributing U.S. citizens is counterproductive and shortsighted.

Equally disturbing, those who have not been compliant (either unintentionally or intentionally) are now becoming aware of the risks of their illegal position due to the publicity of the recent aggressive policies of the IRS abroad. They are faced with the prospect of paying the price to admit their failures to the IRS and suffer a highly punitive tax of 20% or more on their financial assets for not having filed the FBAR, even if they never owed income taxes to the United States, or to try to fade out of sight of the IRS and never return to the United States.

At the same time that the United States encourages educated foreigners to immigrate into the country to fulfill the needs of industry, the nation pushes away its own citizens residing abroad for reasons of administrative tax compliance. It is absurd and self-defeating, particularly since the population of Americans overseas has the international experience and foreign language mastery that is so needed by the United States in today's global market, as well as innate high loyalty to

<sup>10</sup> Professor Reuven S. Avi-Yonah, "The Case Against Taxing Citizens", Working paper No 190, March 2010, p. 10. – [http://www.law.umich.edu/centersand programs/elsc/abstracts/pages/papers.aspx](http://www.law.umich.edu/centersandprograms/elsc/abstracts/pages/papers.aspx).

the country. This negative impact for the United States cannot be overstated. **If the U.S. were to give up its citizenship-based tax policy, it would significantly enhance its competitiveness by allowing free movement of its citizens in the world, to acquire international experience and to reinforce America's presence in the world.** As Professor Avi-Yonah stated, "In a globalized world, citizenship-based taxation is an anachronism which should be abandoned."<sup>11</sup>

#### COMPENSATING TAX MEASURES WITH RESIDENCE-BASED TAXATION

The amount of U.S. taxes paid by all citizens residing overseas is not known to us as the published IRS data does not separate those residing abroad from those residing in the U.S. for citizens who file Form 1116. The vast majority reside in the United States. However, in 2006 (the latest year for which data is publicly available), the U.S. income taxes paid by Americans filing Form 2555 to claim the Foreign Earned Income Exclusion amounted to \$5 billion.

Eliminating citizenship-based taxation does not mean that U.S. citizens would stop paying U.S. taxes altogether. We recommend certain modifications in the tax law that could significantly reduce, or even eliminate altogether, any short-term revenue gap.

**First, we recommend that in conjunction with the elimination of citizenship-based taxation, non-resident U.S. citizens be taxed in the same way as non-resident aliens.** For example, U.S. securities held by Swiss taxpayers are subject to a 30% U.S. withholding tax, half of which can be reclaimed under the terms of the U.S.-Swiss tax treaty. In the absence of citizenship-based taxation, the same would apply to U.S. citizens residing in Switzerland who owns U.S. securities. The system is already in place and brings money into the U.S. Treasury.

To ensure that the United States receives taxes due from U.S. citizens residing abroad on U.S. source income, the U.S. would logically impose a withholding tax at the applicable treaty rate on the following categories of U.S. sourced income:

- Portfolio income, i.e. interest and dividends paid by U.S. companies: Americans residing abroad would be taxed as are foreign investors today under tax treaties.
- U.S. Social Security payments destined to U.S. citizens resident abroad
- U.S. pension or insurance annuities paid to U.S. citizens resident abroad
- Employment-related income earned from a source based in the United States
- Income attributable to the conduct of a U.S. trade or business
- U.S. sourced royalty payments
- Rental income on U.S. real estate
- Capital gains on the disposal of U.S. real estate.

American citizens residing abroad in countries which tax on worldwide income would apply the U.S. withholding taxes as credits against the taxes due in their country of residence, in accordance with bi-lateral tax treaties and tax laws of the resident country. American citizens residing in tax-haven countries would de facto pay the withholding tax to the United States with no recourse.

**Second, the United States may initiate a withholding tax on U.S. bank interest payments made on bank deposits held in the United States non-resident foreigners.** In light of the above proposal, American citizens with a bona fide residence abroad would also be subject to that withholding tax on personal bank deposits held in the United States. The fact that today the United States does not tax the interest on U.S. bank deposits held by non-resident foreigners makes the United States a tax haven. Changing that policy would provide significant tax revenue for the United States.

<sup>11</sup> Professor Reuven S. Avi-Yonah, *Ibid.*, p. 2.

**It is possible, and even probable, that with these changes eliminating citizenship-based taxation would be tax revenue neutral for the United States.** Retirees with largely U.S. source retirement income but resident in a country with low-taxes, may pay more taxes to the United States through the withholding taxes mentioned above than they do under the current system. Withholding taxes on foreign bank deposits in the United States would bring in significant new revenue to the U.S. Treasury.

**Finally,** it is important to emphasize that increased participation of U.S. citizens in foreign trade should bring about significant growth for the U.S. economy, compensating many times over any short-term loss of tax revenue from citizens residing abroad. Every \$1 billion of additional exports, according to Secretary of Commerce Gary Locke, would create 6,250 direct manufacturing jobs and a substantial additional number of indirect jobs. It would also raise approximately \$180 million dollars in domestic tax revenue. Just \$30 billion of additional exports due to policy changes would compensate for potential tax revenue loss from the elimination of citizenship-based taxation and create 187,500 new manufacturing jobs.

**We highly recommend that the Ways and Means Committee request the GAO to include in its studies on the tax revenue implications of Fundamental Tax Reform the net tax revenue impact of eliminating citizenship-based taxation combined with the treatment of bona fide overseas residents comparable to non-resident aliens and the initiation of taxation of U.S. bank deposits held by foreigners and non-resident citizens as well as the expected increase in U.S. exports from the new tax treatment of Americans abroad.**

#### **MINIMUM TAX REFORMS NECESSARY IF CONGRESS DECIDES NOT TO ELIMINATE CITIZENSHIP-BASED TAXATION.**

In absence of fundamental reform eliminating citizenship-based taxation, there are urgent measures which Congress should enact to allow Americans to be competitive working abroad and to attenuate the unfair double taxation and serious administrative burden presently on the shoulders of Americans residing abroad.

**Eliminate the cap on the Foreign Earned Income Exclusion,** as was the case before 1962. Although the foreign earned income exclusion (Section 911 of the Tax Code) is listed among “tax expenditures”, the terminology is incorrect in this specific case. The anomaly is not the exclusion as such, but the fact that the United States taxes its citizens residing abroad. The foreign earned income exclusion was introduced to mitigate the negative affects of citizenship-based taxation on the competitiveness of Americans abroad. Eliminating the cap on the foreign earned income exclusion would not eliminate the double reporting burden, but it would allow more Americans to compete for jobs abroad. It would recognize that salaries abroad take into account foreign cost of living expectations, which vary widely, rather than U.S. cost of living expectations.

**Allow foreign net-worth taxes to be creditable against U.S. taxes.** In some countries net-asset taxes replace capital gains taxes. These taxes can be substantial, almost 1% per year of total assets or more in many countries, often exceeding U.S. income taxes. If the foreign asset taxes are not creditable, as is the case currently, there truly is double taxation.

**Allow individual taxpayers residing abroad and operating in a non-U.S. dollar environment to calculate capital gains in the currency of their country of residence, i.e. using that currency as a non-U.S. dollar functional currency.** This should apply to all foreign-held assets but at a minimum to their primary residence and bank financing linked to that residence. Under a functional currency, the gain on any asset sale would be calculated in local currency and translated into U.S. dollars at the exchange rate applicable on the sale date. Currently, the foreign purchase and sale price must be calculated in U.S. dollars at the exchange rates applicable on the respective dates of purchase and sale. Since the dollar has lost value against foreign currencies,

U.S. citizens who buy and sell a home abroad or other foreign assets at the same local currency price face a very real capital gains tax in the U.S. on a fictitious gain in their own functional currency. This is terribly penalizing and violates a basic tenet of tax policy that taxes be based on an ability to pay. Adding to this punitive treatment, mortgages on real estate are treated as separate transactions. Foreign exchange losses on a mortgage cannot be deducted from the gain on the related property. But foreign exchange gains on mortgages, or any debt instrument, are taxable by the U.S. even when there has been no true monetary gain for the debtor. The use of a foreign functional currency is already allowed for U.S. business operations abroad. The option to use a functional currency should be extended to American citizens residing abroad.

**Permit foreign pensions to be treated as foreign earned income.** In general, contributions by the employee to U.S. pension funds are deductible and contributions by the employer are not taxable. But foreign pension contributions by the employee are not deductible and contributions of the foreign employer must be added to the gross income of the U.S. taxpayer overseas. The U.S. then also taxes the foreign pension payments to retirees as passive income. This is clearly discriminatory to overseas Americans. The U.S. government has attempted to correct this discrimination in specific tax treaties with Canada, Great Britain and perhaps other countries to allow foreign pensions to be taxed only by the country of residence. If residence-based taxation is not generalized for all foreign pensions, foreign pensions should be treated as foreign earned income, thereby allowing the foreign earned income exclusion to be applicable.

**Exempt Americans who are bona fide overseas residents from the requirement to file the new FATCA Form 8938 with their 1040.** This will greatly simplify filing for Americans abroad and will reduce the burden on the IRS for reports which are of doubtful value since the U.S. imposes taxes on income and not on assets. Americans residing abroad are already required to file the FBAR. Administrative jurisdiction for both of these forms should be integrated to eliminate duplicate filing requirements.

**Eliminate the FBAR filing requirement for foreign bank accounts where an American has signature authority but no financial interest.** This will open up job opportunities for Americans abroad. The current FBAR reporting requirement obligates the U.S. citizen whose employment responsibilities include payment and treasury functions for a foreign company to violate the confidence of that employer and foreign laws which consider revealing confidential employer information to third parties as a criminal offense.

#### **ENCOURAGE AMERICANS TO GO ABROAD TO PROMOTE U.S. EXPORTS**

Overseas Americans sincerely hope Congress will enact measures that allow U.S. citizens to be fully competitive with foreigners when working abroad to defend the interests of the U.S. economy. It is this dynamic, free movement of citizens which will strengthen the United States.

We thank you for your consideration.

Sincerely yours,

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#### Annex 1

#### Examples of U.S. tax code discrimination against U.S. citizens residing abroad

- In the absence of a tax treaty provision, contributions to foreign pension plans are not deductible on a US tax return. Contributions to US qualified pension plans, other than US Social Security and some IRAs, are deductible on the US return. Foreign social contributions for health, unemployment, etc. are added to the net salary income and declared by an American working abroad on the US tax return. The total of all contributions can exceed 20% of the salary. Americans employed in the US by US companies do not have this problem.
- Foreign taxes on net worth (which are in several countries a substitute for capital gains taxes) are not creditable against U.S. taxes; however, any capital gain realized is subject to U.S. capital gains tax.
- Most other countries raise a larger proportion of their tax revenue through VAT and other consumption taxes, which are also not creditable against U.S. taxes. This is a direct cause of double taxation. Citizens residing in the United States can deduct sales taxes on Schedule A whereas foreign VAT cannot be deducted.
- Education credits for students are applicable only if the university qualifies for U.S. government loans, which, in practice, requires attendance at U.S. universities.
- Energy saving credits for solar panels and hybrid cars are available only for a principal residence in the United States and for cars used in the United States.
- The 2010 Health Care legislation imposes a surtax on incomes in excess of \$250,000 to finance Medicare benefits, yet Americans working and living abroad permanently will never benefit from Medicare.
- The IRS requires all reporting for U.S. tax purposes in U.S. dollars. With the U.S. dollar in steady decline over the past 40 years, reportable income is artificially inflated for U.S. citizens earning their incomes in foreign currencies.
- Fluctuations in the dollar cause taxes on fictive capital gains on foreign investments. If a U.S. citizen residing abroad sells any asset abroad without realizing any economic gain, he/she may still owe a capital gains tax in the United States if the dollar declined from the date of purchase. Furthermore, if that citizen had taken a mortgage in local currency to finance the house, repayment of the mortgage would lead to a nondeductible capital loss when translated into dollars. Yet a foreign exchange gain on a foreign debt repayment would be taxable, even if it resulted in no economic gain to the debtor.
- Arcane rules imposed by IRS, not SEC regulations, make reporting requirements prohibitive for foreign ETFs denominated in local currencies (total IRS time estimate is 31 hours), thus limiting foreign investment opportunities for Americans abroad.
- The recently passed Foreign Account Tax Compliance Act (FATCA) prejudices Americans abroad, as it requires individuals with foreign financial assets in excess of \$50,000 to report those assets on a new Form 8938. Most living abroad will fall under this reporting requirement while few Americans in the United States will be affected. FATCA has turned Americans abroad into pariahs for the international banking system and many banks refuse to maintain investment accounts of Americans residing abroad unless they are wealthy and able to pay higher banking fees.
- FATCA also requires reporting to the IRS by any company or partnership in which an American citizen has 10% or more of the equity; this ruling shuts out Americans from business opportunities and entrepreneurial ventures overseas.