REPLACING THE FEDERAL INCOME TAX

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

VOLUME IV

Impact on International Competitiveness of Replacing the Federal Income Tax

JULY 18, 1996

Impact of Replacing the Federal Income Tax on Manufacturing and Energy and Natural Resources

JULY 31, 1996

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CONTENTS

IMPACT OF REPLACING THE FEDERAL INCOME TAX ON MANUFACTURING AND ENERGY AND NATURAL RESOURCES

JULY 31, 1996

WITNESSES

SUBMISSIONS FOR THE RECORD

IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX

THURSDAY, JULY 18, 1996

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

The Committee met, pursuant to notice, at 10:08 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
June 26, 1996
No. FC-18

CONTACT: (202) 225-1721

Archer Announces Hearing on the Impact on International Competitiveness of Replacing the Federal Income Tax

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing to examine the impact of the proposed replacement tax systems on the international competitiveness of American workers and businesses. **The hearing will take place on Thursday, July 18, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

BACKGROUND:

As part of its hearings on replacing the Federal income tax, the Committee on Ways and Means has begun to examine how the proposed replacement systems would affect specific segments of society and the economy. Witnesses will be asked to focus on the advantages and disadvantages of some of the proposed replacement tax systems using the following guidelines:

1. The basic alternatives are: an income tax (with one or more rates); a flat tax (such as the one introduced by House Majority Leader Dick Armey); a national sales tax (such as the one introduced by Reps. Schaefer and Tauzin); a value added tax (both invoice-credit and subtraction methods); and an income tax system with an unlimited savings deduction (such as the USA tax system introduced by Senators Domenici and Nunn).

2. The alternatives, whenever possible, should be considered in their pure, conceptual form (i.e., witnesses are discouraged from focusing exclusively on all the permutations of a so-called "flat tax" or on which items should (or should not) be exempted from a tax).

3. Any new tax system would replace the individual income tax, the corporate income tax, and estate and gift taxes. Witnesses could also consider replacement of payroll taxes and excise taxes, as long as they consistently considered such replacement for all proposed tax systems.

4. Replacement must be deficit-neutral, both in the short-term and the long-term.

Following this hearing, the Committee will continue to examine the impact of the proposed alternatives, including the effects on: individuals and families; employee benefits and retirement and personal savings incentives; home ownership and real estate generally; agriculture; domestic manufacturing; energy and natural resources; retail sales; financial services; service industries; and health care. Dates for hearings on these topics will be announced in one or more future press releases.

FOCUS:

The focus of this hearing will be limited to the impact of fundamental tax reform on the international competitiveness of American workers and businesses, particularly the effects on imports and exports.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business Monday, July 8, 1996. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff at (202) 225-1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Committee office, 1102 Longworth House Office Building, no later than 10:00 a.m. on Tuesday, July 16, 1996.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, August 1, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

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

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

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

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

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

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

Note: All Committee advisories and news releases are now available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS_MEANS/' or over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

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Chairman ARCHER. The Committee will come to order.

Today, our hearing is going to focus on the impact of fundamental tax reform on international competitiveness, a subject I believe is critical to the future of this country in the next century.

Over the last decade, the world has developed and is continuing to develop into a truly global economy. At no time during our Nation's history has our economy been more dependent on the economies of other countries.

While our trade policies have been constantly changing to accommodate this globalization of the world's economies, our tax policies, in my judgment, have not.

The two most recent tax initiatives in 1986 and 1993 created obstacles to international trade and development rather than a facilitation of U.S. competitiveness. To this day, I have not been able to find any valid reason for enacting the 1986 and 1993 international tax provisions. This is one of the reasons I felt that adjustments to the 1986 and 1993 tax provision should be undertaken at the earliest possible date.

I view today's hearing as the first steps toward developing a tax system that will not only serve this country's revenue needs, but one that will also stimulate and encourage the all-important international trade and development.

As the world's economies continue to become more interrelated, the need for a tax system that is compatible with our country's international trade objectives becomes crucial.

In addition to being compatible with our international trade objectives, our new and revised tax system will, of course, have to take into account the increasing amount of electronic commerce that is being conducted on the Internet and other forums. Unless these electronic commercial transactions are addressed, our future tax system could face serious problems.

I am, of course, fully aware of the vital role income, estate, and gift tax treaties play in today's world. Unfortunately, the Founding Fathers decided to give another Committee jurisdiction over tax treaties. Despite this unfortunate oversight, I would welcome any comments our witnesses may have on how our international tax treaty network could be improved to better reflect the changing world in which we now live.

I now recognize Mr. Gibbons for any comments he would like to make.

Mr. GIBBONS. Mr. Chairman, I commend you for holding these hearings. They are very important.

I have come to the conclusion that America's future welfare depends upon how well we train our brains and how well we organize our economy. I look at a part of our economy and notice the tremendous drag our revenue system imposes upon our economy, and I hope these hearings will help us find a way to improve that economy and efficiency.

Thank you.

Chairman ARCHER. Thank you, Mr. Gibbons.

[The opening statement of Mr. Ramstad follows:]

STATEMENT OF REP. JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON REPLACING THE FEDERAL INCOME TAX
July 18, 1996

Thank you, Mr. Chairman, for convening this critical hearing on the international implications of reforming our tax system.

The hearings we have held last year and this year under your leadership have reinforced the need for a tax system which is simple and fair for all Americans.

In the context of a global economy, the defects in our current system have put American companies at a competitive disadvantage with their foreign competitors who don't have the same burdens with their tax codes. We have heard the horror stories about the complexity of computing the foreign tax credit and the huge compliance costs of computing the tax on foreign source income.

It is absolutely critical to consider the impact of tax reforms on U.S. trade, keeping in mind that exports make up about 11 percent of America's gross domestic product. We must consider how other countries will react to U.S. tax reform, and how our efforts might affect the 50 bilateral tax treaties currently in effect with our trading partners.

I am looking forward to the testimony of our distinguished panelists, who will help us understand these challenges.

Thank you, Mr. Chairman.

Chairman ARCHER. We have outstanding witnesses to give us their views before the Committee today, and we will start off with Carol Dunahoo, international tax partner of Price Waterhouse.

Let me say for the benefit of all the witnesses that the Committee operates on the basis of requesting your oral testimony be limited to 5 minutes and that any more lengthy written statement will be inserted in full in the record. We would appreciate your effort to cooperate on the 5-minute time presentation.

Ms. Dunahoo.

STATEMENT OF CAROL A. DUNAHOO, INTERNATIONAL TAX PARTNER, PRICE WATERHOUSE LLP; ON BEHALF OF INTERNATIONAL TAX POLICY FORUM

Ms. DUNAHOO. Good morning. I am a partner with Price Waterhouse's Washington National Tax Service. However, I am testifying this morning on behalf of the International Tax Policy Forum, which is a diverse group of 26 U.S.-based multinationals, including manufacturing, service, energy, and financial service companies.

The International Tax Policy Forum sponsors research and education on the U.S. taxation of income from cross-border investments. A list of the member companies is appended to my written statement.

We welcome the opportunity to testify today on the potential tax policy and competitiveness issues under the various tax reform proposals before the Committee.

As Chairman Archer has noted, the markets for our companies have become increasingly global. Yet, our tax rules continue to differ in significant respects from those of other major industrialized countries, such as France, Germany, and Japan. These differences can place U.S. companies at a serious disadvantage when competing with their foreign-based counterparts.

In addition, as the Chairman has noted, the existing U.S. rules for taxing in foreign-source income have been developed in a patchwork fashion dating back, for the most part, to the sixties. The resulting rules are among the most complicated in the world, and the cost of complying with those rules is a hidden tax on U.S.-based multinational companies. This is why the Forum believes it is so important to review the international tax provisions of U.S. law in connection with fundamental tax reform.

This Committee is now considering several fundamental tax reform proposals, including the unlimited savings allowance, or American tax proposal, sponsored by Senators Nunn and Domenici, a flat tax sponsored by House Majority Leader Armey, and the national retail sales tax, sponsored by Representatives Schaefer and Tauzin.

In addition, several other important fundamental tax reform proposals have been articulated during the past few years, including the subtraction method VAT, a value-added tax proposal, of Congressman Gibbons, which shares many of the features of the American business tax.

All of these proposals would eliminate the Federal income tax and replace it with a new consumption-based tax system. Each of the three recently introduced proposals would tax only U.S. operations. They would repeal most of the U.S. withholding taxes on income paid to foreign investors. U.S. businesses operating abroad would not be taxed on their foreign-source income, nor would dividends paid by the foreign subsidiaries back to the U.S. companies be subject to tax.

Because foreign operations would be excluded from the U.S. tax base, our complex foreign tax credit rules and numerous regimes taxing the unrepatriated income of U.S.-controlled foreign corporations would be eliminated.

In attempting to simplify the current system dramatically and to enhance competitiveness, all of these proposals represent serious efforts to address some of the gravest shortcomings of the present tax system. However, each raises new international tax issues that have not yet been fully explored.

One of the most significant questions is how foreign governments would react to a decision by the United States to repeal its income tax system and replace it with a consumption-based tax system. On the one hand, some countries might respond negatively by terminating treaties with the United States in the belief that internal U.S. law would confer adequate tax relief unilaterally. This, of course, could seriously disadvantage U.S. firms, which would become subject to higher foreign tax rates in the absence of treaties.

Foreign governments might also feel compelled to enact stricter pricing rules and other antiabuse measures, simply to protect their tax base. Indeed, the United States could become a preferred tax jurisdiction from the perspective of other countries if its income tax were eliminated and replaced with a system that exempts portfolio income.

For this reason, it is possible that foreign governments might even consider nontax measures, including capital controls, to stem the potential flow of capital into the United States.

Alternatively, foreign governments might try to capture revenue foregone by the United States, so that both U.S. multinationals and foreign investors in the United States simply would end up paying more income taxes to other countries.

On the other hand, it is quite possible other countries may simply opt to leave their tax treaties with the United States in place and perhaps even lower their own taxes to attract continued U.S. investment.

The reaction to the enactment by the United States of fundamental tax reform could vary from country to country and is difficult to predict with any certainty.

Another issue in evaluating the leading tax restructuring proposals is the treatment of exports and imports. The national retail sales tax proposal and the USA tax both are "destination-based" taxes, meaning that imports are taxed and exports are exempt. Destination-based taxes are imposed on the consumption of goods and services within the United States.

By contrast, the flat tax is an "origin-based" tax, which taxes exports but not imports, and the tax base of an origin-based tax is domestic consumption plus net exports.

Destination-based taxes offer several advantages over origin-based taxes, in particular greater administerability in the area of transfer pricing. In fact, multinationals would have an incentive to shift profits into the United States under a destination-based consumption tax, which, of course, would be helpful to U.S. tax administrators, but equally disconcerting to their foreign counterparts.

Another potential issue is whether a move to a consumption-based tax system with border tax adjustments would pass muster under international trade rules. The answer to this question is not yet clear. It has been raised with respect to at least one proposal, the USA tax.

International trade rules, of course, generally permit border adjustments for indirect taxes, but bar such adjustments for direct taxes. The issue is that although the USA business tax is similar to a VAT, it is drafted as a direct tax and could, therefore, be challenged. It also provides a credit for payroll taxes, which is atypical of foreign VAT systems and might be viewed as violating GATT requirements. However, the answer to this question is not clear.

Finally, each of the major tax reform proposals could have a major impact on USA research and development, technology, and exports. I will leave this issue to other members of the panel to comment on.

If no immediate consensus can be reached on a more ambitious reform, changes to our current international tax regime should be seriously considered. At a minimum, any reform in this area should address the foreign tax credit rules, the antideferral rules, and the alternative minimum tax as applied to the foreign tax credit, and it should be undertaken in a comprehensive fashion.

The International Tax Policy Forum recommends that any changes to the current system be carefully considered for their potential international consequences before adoption. While each of the leading restructuring proposals offer some advantages over the current system, each also involves an element of risk.

The International Tax Policy Forum looks forward to working with the Committee as it explores these issues and applauds the Committee's leadership on these difficult matters.

Thank you.

[The prepared statement follows:]

STATEMENT OF CAROL A. DUNAHOO
INTERNATIONAL TAX PARTNER
PRICE WATERHOUSE LLP
ON BEHALF OF INTERNATIONAL TAX POLICY FORUM

I. Introduction

I am Carol A. Dunahoo, a partner with Price Waterhouse's Washington National Tax Service, and I am testifying today on behalf of the International Tax Policy Forum. Founded in 1992, the International Tax Policy Forum is a diverse group of U.S.-based multinationals, including manufacturing, service, energy, and financial service companies. The Forum sponsors research and education regarding the U.S. taxation of income from cross-border investments. John M. Samuels, Vice President and Senior Counsel for Tax Policy and Planning of General Electric, is chairman of the Forum. Price Waterhouse's Washington National Tax Service acts as consultant to the Forum. A list of member companies is attached as Appendix A of this testimony.

The Forum welcomes the opportunity to testify today on the potential tax policy and competitiveness issues that arise under the various fundamental tax restructuring proposals being considered by the Committee. The companies that make up the ITPF are committed to developing a system for taxing U.S. companies that promotes the international competitiveness of the United States. Increasingly, the markets for our companies have become global, and our competitors are foreign-based companies operating under tax rules that are much more favorable than our own.

The existing tax law, as the Committee well knows, has been developed in a patchwork fashion over many years. In many instances, current law creates barriers that harm the competitiveness of U.S. companies. These rules also are horribly complex for U.S. companies and the Internal Revenue Service. That is why the Forum believes it is so important to the Committee to review the foreign tax rules in the context of fundamental tax reform.

II. International trade and investment in the U.S. economy

The ability of U.S. businesses and workers to compete in an increasingly integrated world economy has become an issue of vital importance in recent years. The value of international trade (imports plus exports) as a percentage of GDP has more than doubled -- from 7 percent in the 1960s to 17 percent during the first half of the 1990s. The share of U.S. corporate earnings attributable to foreign operations similarly has jumped -- from 6 percent to 16 percent over the same period. Despite the net debtor status of the United States, *direct* investment by U.S. companies abroad continues to exceed foreign direct investment in the United States -- by $180 billion in 1994.

In 1995, U.S. exports of goods and services totaled $805 billion, or 11.1 percent of the nation's gross domestic product.[1] U.S. multinationals play a critical role in encouraging exports. In 1993, 58 percent of the $465 billion of U.S. merchandise exports were associated with U.S. multinational corporations: they shipped $110 billion of exports to their foreign affiliates and another $139 billion directly to unaffiliated foreign buyers.[2]

III. Important differences between U.S. and foreign taxation of income from international operations

U.S. international tax rules differ in a number of respects from those of other major industrialized countries such as France, Germany, and Japan. These differences can place U.S. multinational

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[1] U.S. Department of Commerce, "Survey of Current Business," April 1996.

[2] U.S. Department of Commerce, "U.S. Multinational Companies: Operations in 1993," June 1995, p. 39.

corporations at a serious disadvantage when competing with their foreign-based counterparts. The following are some of the more important differences:[3]

- The United States taxes the worldwide income of U.S. businesses and U.S. citizens. Many other countries exempt foreign source business income either by statute (*e.g.*, France) or by treaty (*e.g.*, Germany).

- The U.S. foreign tax credit system requires complex calculations of separate limitations for different categories of income. The systems of other countries are frequently simpler or offer benefits to their multinational corporations that the U.S. system denies to U.S. companies seeking to compete globally.

- Most countries' anti-deferral regimes do not tax active business income but instead are limited to passive types of income. In contrast, the United States imposes current U.S. tax on several types of active business income as well as on passive income, to the detriment of its companies seeking to compete with their foreign counterparts.

- Unlike other major industrial countries, the United States treats a loan from a foreign subsidiary to its domestic parent as a deemed dividend, potentially triggering current U.S. tax on foreign income. Current U.S. law also deviates from that of other countries by treating as deemed dividends certain transactions entered into in the ordinary course of business by financial intermediaries and other companies.

- The United States has more detailed and complex rules for allocating and apportioning expenses between domestic and foreign source income than does any other major industrialized country. These rules often conflict with provisions adopted by other countries, giving rise to the risk of double taxation.

- Unlike other countries, the United States imposes an alternative minimum tax that can result in U.S. tax being imposed on foreign income that has borne foreign income tax in excess of the U.S. rate.

The U.S. rules for taxing foreign source income are among the most complicated in the world. The cost of complying with these rules represents a hidden tax on U.S.-based multinational companies. Recent research has confirmed that the international provisions of the U.S. tax code impose disproportionately high compliance burdens -- both relative to U.S. tax rules for domestic income and relative to foreign countries' taxation of international income.[4] For example, one survey of firms in the IRS's large-case audit program found that compliance costs amounted to $1.5 million for a typical large-case business. The survey found that nearly 40 percent of total federal tax compliance costs was attributable to foreign source income. This is disproportionately large compared to the average fraction of assets (21.1 percent), sales (24.1 percent), and employment (17.7 percent) abroad.[5]

Our foreign-based competitors enjoyed a much different situation, according to a survey conducted for the European Community's Ruding Committee.[6] That survey of 965 European firms found no evidence that compliance costs were higher for foreign source income than for

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[3] From Financial Executives Research Foundation, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, 1996, Ch. 9.

[4] See Marsha Blumenthal and Joel B. Slemrod, "The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications," in *National Tax Policy in an International Economy: Summary of Conference Papers*, (International Tax Policy Forum: Washington, D.C., 1994).

[5] *Id.*

[6] *Id.*

domestic source income. Thus, while U.S.-based firms are subject to disproportionately high compliance costs when they attempt to compete abroad, European-based competitors are free from similar obstacles.

The cumulative effect of the U.S. tax code's more restrictive provisions and higher compliance costs is to subject U.S. multinationals to higher effective tax burdens on their cross-border investments than their foreign competitors must bear on similar investments and operations. A number of recent studies have quantified the importance of these factors.[7]

IV. Fundamental tax reform: Key international issues

Among the recently introduced proposals before the Committee are several fundamental tax reform proposals -- the Unlimited Savings Allowance (USA) Tax, sponsored by Sens. Sam Nunn (D-GA) and Pete V. Domenici (R-NM); the Flat Tax, sponsored by House Majority Leader Dick Armey (R-TX); and the National Retail Sales Tax, sponsored by Reps. Dan Schaefer (R-CO) and Billy Tauzin (R-LA). In addition, several other important fundamental tax reform proposals have been articulated in recent years, including the subtraction-method value-added tax (VAT) proposal of Ways and Means Committee ranking Democrat Sam Gibbons (D-FL).[8]

All of these proposals would eliminate the federal income tax and replace it with a new consumption-based tax system. Each of the three recently introduced proposals would tax only U.S. operations. These bills would repeal most U.S. withholding taxes on income paid to foreign investors. U.S. businesses operating abroad would not be taxed on their foreign source income, nor would dividends paid by foreign subsidiaries back to their U.S. parents be subject to U.S. tax. Because these systems generally exclude foreign operations from the U.S. tax base, they would eliminate the foreign tax credit rules and the complex series of rules taxing certain unrepatriated income of U.S.-controlled foreign corporations.

By attempting to dramatically simplify the current system and to enhance competitiveness, all of these proposals represent serious efforts to address some of the gravest shortcomings of the present tax system. The degree of interest and time devoted to these proposals shows an awareness of some of the current system's most serious defects, which exact a heavy toll on the ability of U.S. firms to compete abroad.

Each of the major fundamental reform proposals also raises certain new issues in the international context that have not yet been fully explored. Important international issues to be examined include:

A. Reactions of other countries

It is not clear how foreign governments would react to a decision by the United States to repeal its income tax system and replace it with a consumption-based tax system. They might respond negatively -- by adopting new anti-abuse rules or terminating existing tax treaties with the United States -- or simply opt to leave their treaties with the United States in place, and perhaps even lower their own taxes, to attract continued U.S. investment.

One of the features that may concern our trading partners about the pending consumption tax proposals is their proposed elimination of taxes on virtually all savings and investment -- including income from the portfolio investments of foreign residents. As some commentators

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[7] See Financial Executives Research Foundation, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, 1996, Ch. 10.

[8] For purposes of our discussion, Rep. Gibbons' subtraction-method VAT shares many of the same features as the USA Business Tax.

have observed, all of the proposals would exacerbate the difficulty many countries already have in taxing the foreign source portfolio income of their residents.[9] This problem would be made worse if the United States decided unilaterally to forego withholding tax on portfolio interest and dividends, royalties, and other types of portfolio income. Indeed, eliminating the income tax system and replacing it with a system that exempts portfolio income could well turn the United States into a tax haven of sorts from the perspective of other countries.

In addition, while the pending proposals could actually alleviate U.S. concerns regarding transfer pricing practices and earnings stripping, they likely would exacerbate foreign concerns about these same issues. This is because none of the leading replacement tax proposals would tax income, so both U.S. and foreign multinationals would have a strong incentive to shift otherwise taxable profits into the United States.[10]

In response to these concerns, foreign governments might either pursue an approach similar to that of the United States -- that is, lower their taxes on savings and investment as well -- or attempt to capture the revenue foregone by the United States.[11] This latter option could involve taxing their resident multinationals on worldwide profits, including U.S. source profits.[12] In addition, foreign governments could impose new anti-abuse rules; for example, they might enact earnings-stripping rules limiting the deduction of interest paid to U.S. affiliates. Foreign governments also might deny a foreign tax credit for U.S. taxes under a new consumption tax system.

If foreign governments were to adopt such tax measures, foreign investors in the United States could end up paying more income taxes to their home country in lieu of paying income tax in the United States. Foreign governments also might consider non-tax measures, including capital controls, to stem the potential flow of capital into the United States.

B. Risks to the U.S. tax treaty network

If the United States were to replace its current income tax system with one of the leading consumption-based tax reform proposals, it is not clear how the U.S. tax treaty network would be affected. The United States now has bilateral income tax treaties with nearly 50 countries. The treaties provide numerous benefits to investors, including reduced withholding tax rates on income flows between the United States and the treaty partner.

Under the USA Tax, the Flat Tax, and the National Retail Sales Tax, U.S. withholding taxes on income of foreign corporate investors would be repealed. Therefore, the reduced withholding tax rates under the treaties no longer would confer a special benefit to foreign treaty partners. As a result, U.S. tax treaty partners -- all of which have some form of income tax system -- may view themselves as providing benefits to U.S. investors, while their own investors receive few benefits from the United States under these income tax treaties. Accordingly, treaty partners may believe they have little to gain by continuing their existing tax treaty relationships with the United States or by reducing cross-border withholding tax rates in future treaty negotiations.

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[9] See Reuven S. Avi-Yonah, "The International Implications of Tax Reform," *Tax Notes*, November 13, 1995, at 913, 922.

[10] Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal* 48 No. 4, December 1995, at 619; and Reuven Avi-Yonah, "Comment on Grubert and Newlon," *National Tax Journal* 49 No.2, June 1996, at 259, 262.

[11] Avi-Yonah, *supra* note 10, at 262.

[12] *Id.*

On the other hand, it is possible many treaty partners may wish to maintain their treaties with the United States to preserve certain other benefits provided under the agreements. In addition to lowering withholding rates, tax treaties also include guidance on a number of important issues, such as rules for determining each country's jurisdiction to tax multinational business income, as well as on numerous industry-specific questions. In addition, treaty partners might decide to maintain a treaty relationship with the United States because imposing the higher statutory withholding rates on U.S. investors would make foreign jurisdictions less attractive as locations for U.S. investment.

C. *Trade issues: Transfer pricing and the "origin" and "destination" principles*

The leading tax restructuring proposals differ in their treatment of exports and imports. The National Retail Sales Tax proposal and the USA Tax both are "destination-based" taxes. Under the destination principle, imports are taxed and exports are exempt. Destination-based taxes are based on consumption of goods and services within the United States. By contrast, the Flat Tax is an "origin-based" tax. Under the origin principle, exports are taxed and imports are not. The tax base of origin-based taxes is domestic consumption plus net exports.

Some observers believe destination-based taxes, such as the National Retail Sales Tax and the USA Tax, promote exports and discourage imports. Despite the intuitive appeal of this idea, economists generally believe that destination-based taxes offer no long-term export incentives.[13] In any event, destination-based taxes do offer other advantages over origin-based taxes. Foremost among those advantages is greater administrability -- particularly in the area of transfer pricing.

Under a destination-based tax, transfer prices no longer would be relevant to determining U.S. tax liability because a company's tax base would be equal to its domestic sales less its domestic purchases. Because export sales -- and presumably also royalty receipts from abroad -- would be exempt, and imports -- including royalty payments to foreign parties -- would be non-deductible, the prices set for such transactions would not affect the U.S. tax base. Accordingly, there no longer would be any opportunity to use transfer prices to reduce U.S. taxes. Rather, multinationals actually would have an incentive to shift profits out of other countries that impose income taxes and into the United States.[14]

By contrast, under an origin-based tax, such as the Flat Tax, transfer pricing would continue to be a concern from a U.S. perspective, because export sales would continue to be taxable and imports would be deductible. The elimination of transfer pricing concerns under a destination-based consumption tax makes a strong case for using a destination basis should Congress choose to adopt a consumption-based tax system.

Destination-based taxes hold another potential advantage over origin-based taxes: Experience has shown destination-based taxes (such as the VAT) are more easily harmonized among nations than are origin-based taxes (such as the income tax). Despite the efforts of the Ruding Commission, the European Union has, for example, had much greater success in harmonizing the VATs of member countries than the income taxes.

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[13] Grubert and Newlon, *supra* note 10 at 628. See also Gene M. Grossman, "Border Tax Adjustments: Do They Distort Trade?" *Journal of International Economics 10*, February 1980, 117-128; Avinash Dixit, "Tax Policy in Open Economies," from *Handbook of Public Economics*, eds. Alan Auerbach and Martin Feldstein, Amsterdam: North-Holland, 1985; Martin Feldstein and Paul Krugman, "International Effects of Value-Added Taxation," from *Taxation in the Global Economy*, ed. by Assaf Razin and Joel Slemrod, Chicago: University of Chicago Press, 1990, 263-278.

[14] Grubert and Newlon, *supra* note 10 at 637; Avi-Yonah, *supra* note 9 at 917.

It is important to note that all of the major consumption-based tax alternatives would eliminate certain export incentives provided under our current income tax system. Repeal of the foreign sales corporation (FSC) and export source rules could have a major impact on companies that manufacture in the United States for export to foreign markets. To ensure that such a major policy shift is not made inadvertently, any examination of consumption-based tax alternatives should consider collateral effects of this sort very carefully.

D. Legality under international trade rules

Another issue is whether a move to a consumption-based tax system with "border tax adjustments" would pass muster under international trade rules. This question already has been raised with respect to at least one fundamental tax reform proposal -- the USA Tax. International trade rules generally permit border adjustments for indirect taxes, such as value-added taxes, but they bar such adjustments under direct taxes, such as income taxes.

Although the USA Business Tax is similar to a value-added tax, it is drafted as a direct tax and therefore might be challenged under trade rules. Another feature of the USA Tax that might cause concerns is the credit it provides for payroll taxes -- a feature not present in foreign VAT systems. It is possible that a payroll tax credit could be viewed as inconsistent with GATT requirements.[15]

E. R&D and technology issues

The leading proposals to restructure the U.S. tax system could have a significant impact on decisions relating to the development and use of technology. All three leading tax reform proposals -- the USA Tax, the Flat Tax, and the National Retail Sales Tax -- would represent a major break from the current law treatment of R&D. None of the three proposals would retain the R&D tax credit and none would provide any incentive for performing R&D activities.[16]

Moreover, the Flat Tax could increase the tax burden on R&D substantially. Under the Flat Tax, foreign source royalties would be treated as payments for the export of intangible property and, therefore, would be subject to tax. Because the Flat Tax, like other major reform proposals, eliminates the opportunity to credit or deduct foreign taxes on royalties, foreign source royalties could end up bearing a sharply higher tax burden. As a result, a wide range of intangible licensing arrangements -- including royalties for the use of U.S.-developed technology -- would be subject to higher tax burdens under the Flat Tax. In comparison, foreign source royalties generally would be exempt under the USA Tax and National Retail Sales Tax.

These and other effects of the various proposals on R&D expenditures should be weighed carefully to ensure that one of the main goals of tax restructuring advocates -- increasing the national rate of economic growth -- is not undermined by inadvertently causing a decline in R&D spending in the United States.[17]

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[15] See Victoria Summers, "The Border Adjustability of Consumption Taxes, Existing and Proposed," in *Tax Notes International*, June 3, 1996, at 1793, 1800. Summers's article cites a letter from the Assistant Secretary for Tax Policy, U.S. Department of the Treasury, to Senator Sam Nunn (D-GA), February 1995.

[16] Section 174 of the Internal Revenue Code, enacted in 1954, provides a deduction for qualified research and experimentation (R&E) expenditures. Since 1981, section 41 of the Code also has provided a 20-percent tax credit for certain qualified research expenditures; this credit expired June 30, 1995, but pending legislation would restore it.

[17] See "Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century," The National Commission on Economic Growth and Tax Reform, January 1996. According to the report, "attention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."

V. Incremental reform of the income tax system

Many proponents of fundamental tax reform would like to replace the current tax system entirely with a consumption-based tax. However, if no immediate consensus can be reached on a more ambitious reform, incremental changes to the existing income tax system should be adopted to alleviate the ills of that system in the interim. Reforms to the current system could help address numerous areas of complexity in the international provisions of the tax code.

At a minimum, any incremental reform effort should address the following issues:

A. Foreign tax credit

The United States taxes its citizens, residents, and domestic corporations on a worldwide basis and seeks to alleviate international double taxation through the foreign tax credit. The foreign tax credit, however, is subject to significant limitations. While foreign rules will determine the amount of foreign tax imposed (subject to U.S. currency translation rules), foreign source income must be redetermined under U.S. rules for purposes of the foreign tax credit. The differences between the U.S. and foreign definitions of taxable income -- particularly the rules on the sourcing of income and the allocation of deductions -- create complexity and increase the risk of double taxation. Other countries with foreign tax credit systems frequently seek to promote harmony, minimize complexity, and avoid double taxation by using the foreign jurisdiction's definition of taxable income for foreign tax credit purposes.

In addition, the U.S. rules impose numerous limitations on the availability of foreign tax credits, which bring their own complexities and further erode the effectiveness of the foreign tax credit mechanism in reducing double taxation. For example, separate limitations apply to eight special categories (or "baskets") of income. In addition, U.S. taxpayers that own interests of between 10 and 50 percent in foreign companies must compute a separate foreign tax credit limitation for each such company. These separate limitations generally are intended to prevent foreign taxes on one type of income from offsetting U.S. taxes on other types of foreign income. As a result, however, companies often are prevented from utilizing their foreign tax credits fully, increasing the likelihood of international double taxation. Moreover, these separate limitations impose substantial administrative complexity on U.S. firms attempting to calculate the amount of foreign tax credit to which they are entitled. Measures to simplify and streamline the foreign tax credit rules could greatly reduce the compliance burdens faced by U.S. businesses competing abroad.

B. Anti-deferral rules

The United States generally does not tax U.S. shareholders on foreign source income earned through a foreign corporation until such income is repatriated to the United States, just as it does not tax individual U.S. taxpayers on the earnings of corporations in which they own stock until dividends are declared and paid. This deferral is intended to permit U.S. taxpayers to compete internationally by reinvesting their foreign earnings without subjecting such earnings to current U.S. income taxation.

The United States, however, has adopted significant anti-deferral regimes that generally tax U.S. shareholders currently on certain types of undistributed foreign income, as if such income were repatriated. Although other developed countries also limit the extent to which their taxpayers may defer tax on certain income earned by affiliated foreign corporations, the U.S. rules are considerably more far-reaching and complex.

For example, the anti-deferral regimes of other developed countries generally eliminate deferral only for passive income. In contrast, the U.S. anti-deferral regimes also eliminate deferral for many types of <u>active</u> trade or business income, including financial services income, refining income, international shipping and aircraft income, and certain other types of income. One important example is the fact that, since 1987, the United States generally has denied deferral for income from active foreign business operations of U.S. banks, insurance companies, and other financial intermediaries. This denial of deferral has hamstrung these key sectors of the U.S. economy as they seek to compete effectively with their foreign-based counterparts. Similarly, under section 956A as added to the U.S. tax code in 1993, deferral is now limited for CFCs with "excess" amounts of passive assets. The United States is the only major country that imposes such limitations on its taxpayers operating abroad.

Unlike other developed countries, which generally have only one anti-deferral regime, the United States has six anti-deferral regimes. These regimes, enacted piecemeal over the last half-century, reflect a series of responses to perceived shortcomings in the deferral rules existing at the time of enactment. The aggregate result is a "patchwork" system that requires current taxation of certain types of income by reference to different factors and criteria (or imposes an interest charge on certain actual or deemed dispositions). The multiplicity and complexity of these anti-deferral regimes imposes significant compliance costs for U.S. taxpayers and heavy administrative burdens for U.S. tax administrators.

C. *Alternative minimum tax*

The stated purpose of the alternative minimum tax (AMT) is "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits."[18] This purpose is accomplished by imposing an AMT to the extent that AMT liability exceeds regular tax liability.

Under regular income tax rules, a U.S. taxpayer may have a foreign tax credit equal to 100 percent of its U.S. tax liability on foreign source income. This result acknowledges that the taxpayer already has paid tax to the jurisdiction where the income was derived at a rate equal to or greater than the rate of tax that the United States would impose on that income.

For taxpayers subject to the AMT, however, the foreign tax credit may offset no more than 90 percent of a taxpayer's AMT liability. Not only does this limitation on the foreign tax credit lack any clear tax policy rationale, it also appears inconsistent with certain U.S. treaty obligations.

D. *Time for a more comprehensive approach?*

If an effort at incremental income tax reform is to succeed where others have failed, however, policy makers will have to think more comprehensively about such issues. They will need to consider not only specific amendments that have been proposed to current U.S. income tax rules, but also more far-reaching reforms that have not yet received serious consideration in the United States.

For example, in response to complaints about the anti-deferral rules of current U.S. law, policy makers should give serious thought to consolidating the existing regimes and modifying their scope to achieve greater consistency with the anti-deferral rules imposed by our major trading partners. However, even with such changes, the U.S. anti-deferral rules would still be far more complex and burdensome than those of many other countries, which apply a much simpler effective foreign tax rate test or impose current tax only on active business income from specified low-tax countries. Such alternatives may not ultimately prove preferable to the basic U.S. approach of imposing a current tax only on specified types of income, but they should be given serious consideration in any fundamental reform process.[19]

As another example, it has become increasingly clear since our current foreign tax credit system was adopted in 1986 that it imposes unacceptable compliance and enforcement burdens on taxpayers and tax authorities alike. Large companies must devote substantial resources each year

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[18] S. Rep. No. 99-313, 99th Congress, 2d Sess. 518-519 (1986).

[19] See U.S. Department of Treasury, *International Tax Reform: An Interim Report*, January 1993.

to obtain and process from sources all over the world the information that is needed for the foreign tax credit computation. It has become impossible for U.S. multinationals to perform the actual computations without the aid of sophisticated computer software, and it is impossible for the Internal Revenue Service to audit those computations without relying on such software. These tasks certainly would be simplified by proposals to reduce the number of foreign tax credit "baskets" required by current law. However, perhaps it is time to consider replacing the basket approach entirely with some simpler foreign tax credit system, or perhaps even with a territorial income tax system (described below).

VI. Territorial income taxation

Another option would be to retain an income tax system but move from worldwide taxation to a territorial tax system for taxing foreign income. A "territorial" or "exemption" tax system is used in some form, either by statute or by treaty, by more than a dozen major industrialized countries, including the Netherlands, France, Germany, and Canada. Rather than merely deferring tax until foreign-source income is repatriated, countries with territorial income tax systems exempt the active business income earned abroad by their multinationals. Multinationals based in such countries, therefore, pay only the local tax imposed in countries in which they do business.

A move to a territorial income tax system could promote the competitiveness of U.S. multinationals by exempting foreign source dividends and branch income. This could help ensure that foreign subsidiaries do not pay more tax in the aggregate on corporate income than do their foreign-based competitors in foreign markets.

However, it is not clear that a move to a territorial income tax system would greatly simplify current law for all taxpayers. Because passive investment income presumably would be taxed, look-through, anti-deferral, and foreign tax credit rules generally would remain necessary for passive foreign income. Moreover, source rules and rules regarding allocation and apportionment of expenses would be needed to limit the territorial exemption to active foreign income.

Transfer pricing issues would be at least as important under a territorial income tax system as they are today. Finally, it is important to note that a territorial income tax could actually increase U.S. tax on foreign-source royalties and export income as compared to current U.S. law. Under a territorial system, excess foreign tax credits on dividends no longer would be available to reduce U.S. tax on foreign source royalties and export income.

VII. Conclusion

While the international tax impact of the various fundamental tax reform proposals thus far has not received the same attention as have the domestic aspects of these proposals, they could have profound effects on the ability of U.S. companies and U.S. workers to compete in the global marketplace. Lawmakers must be careful to give full consideration to these international issues as they weigh replacement tax alternatives.

A switch to a consumption-based tax system could provoke undesirable reactions from our trading partners. A unilateral move to a consumption tax system could prompt trading partners to impose anti-abuse rules and other measures aimed at capturing the taxes foregone by the United States. Our trading partners may feel compelled to take these steps to prevent taxpayers from shifting profits into the United States and, thereby, eroding their tax bases. In addition, our tax treaty partners may consider terminating tax treaties because those agreements no longer would confer significant benefits from the United States. This could result in serious hardships for U.S. firms, which in the absence of the treaties would become subject to higher foreign withholding tax rates. Both of these possibilities -- the expansion of foreign taxing jurisdiction and the abrogation of tax treaties -- should cause policy makers to think carefully before undertaking any radical overhaul of the current tax system.

In addition, each of the leading fundamental tax reform proposals could increase tax burdens on U.S. technology and U.S. exports, with potentially harmful effects to the economy.

If a consumption tax is adopted, a destination-basis system, such as the USA Tax or the National Retail Sales Tax, would have some advantages over an origin-basis system (such as the Flat tax) -- namely the elimination of transfer pricing disputes from the U.S. perspective and consistent tax treatment for exports of goods and intangible property.

Incremental reforms also may offer a possible alternative to the various fundamental tax reform proposals. Such incremental reforms could go a long way toward addressing many of the more serious tax barriers to improved competitiveness, particularly if policy makers take this opportunity to rethink some of the basic assumptions of the current U.S. income tax system.

A territorial income tax system is another alternative worthy of serious consideration if a consumption-based tax system is not adopted. However, it is not yet clear whether a move to such a system would be an improvement. While a territorial income tax system would appear helpful in theory to multinational business, it may not be a panacea. In practice, this approach could result in stiffer taxes on foreign source royalties and exports, while retaining existing compliance burdens for foreign source passive income.

The International Tax Policy Forum recommends that any changes to the current system be carefully considered for their potential international consequences before adoption. While each of the leading restructuring proposals offers some advantages over the current system, each also involves an element of risk. The International Tax Policy Forum looks forward to working with this Committee as it examines these issues.

Appendix A. ITPF Member Companies

American Express Company
AT&T
Caterpillar, Inc.
CIGNA Corporation
Citicorp
Dow Chemical Company
Eastman Kodak Company
Emerson Electric Co.
Exxon Corporation
Ford Motor Company
General Electric Co.
General Motors Corporation
Goodyear Tire & Rubber Company
Hewlett-Packard Company
Honeywell, Inc.
IBM Corporation
ITT Industries, Inc.
Johnson & Johnson
Levi Strauss & Co.
Merrill Lynch
Morgan Stanley Group, Inc.
Philip Morris Companies, Inc.
Premark International, Inc.
Tenneco, Inc.
Tupperware Corporation
United Technologies Corporation

Chairman ARCHER. Thank you, Ms. Dunahoo.

I should have mentioned earlier that the Committee would appreciate each witness identifying himself or herself for the record prior to testifying. Ms. Dunahoo, you did that.

Thank you very much.

Our next witness is Kevin Conway.

STATEMENT OF KEVIN G. CONWAY, CHAIRMAN, COMMITTEE ON TAXATION, FINANCIAL EXECUTIVES INSTITUTE; AND VICE PRESIDENT, TAXES, UNITED TECHNOLOGIES CORP., HARTFORD, CONNECTICUT

Mr. CONWAY. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Committee, my name is Kevin Conway. I am the vice president of taxes at UTC, United Technologies Corp., in Hartford, Connecticut.

I am here today as the chairman of the tax committee of FEI, the Financial Executives Institute. FEI is a leading trade association whose membership includes 14,000 senior financial officers of 8,000 U.S. member companies.

The international issues relating to fundamental tax reform are a vital issue to FEI and its membership, and I am pleased to submit for the record a written statement which we have prepared, which we think describes many of the issues that need to be considered.

The key point I wanted to emphasize for the Committee this morning is that under the current system, U.S. multinational corporations are at a serious competitive disadvantage in competing in the global marketplace, and the main reason for this disadvantage is that a U.S. multinational's profits are subject to two levels of taxation.

When UTC operates outside the United States, and we operate in all but six countries of the world, our profits are subject, first, to a local income tax. After we pay the local income tax, there is a second tax, the U.S. tax, and the issue we have to deal with is our competitors are either subject to territorial taxes; that is, they only pay one tax where they operate locally, and their home jurisdiction doesn't subject them to a second level of tax; and the rest of our competitors have a worldwide system like the United States, but they don't tax their international profits to the extent or degree that the U.S. system does.

This was recognized long ago, and under our worldwide system of taxation, the adverse impact of double taxation was mitigated by two key tax policies. One was the foreign tax credit system and the other was the deferral system. Deferral and foreign tax credits are not corporate benefits and they are not corporate welfare. They are international tax policy mechanisms designed to avoid the significant adverse impact if $100 of international profits were taxed, say, to a 35-percent rate offshore and a second time at a 35-percent rate in the United States. We would be totally noncompetitive under that type of a system.

So we enacted the foreign tax credit system and the deferral system to mitigate the adverse tax consequences and level the playingfield for U.S. multinationals.

What has happened, Mr. Chairman, as you have pointed out, is that over the past decade, there have been a series of essentially exceptions to deferral and to the foreign tax credit system, so that we have undercut the important protection policies that those rules were designed to produce, and we increasingly find ourselves today in a situation of being subject to double taxation.

We are not merely talking about having to file additional tax forms and tax returns. We are talking about our ability to compete abroad. A foreign tax credit mechanism was essentially designed to ensure that if we earned foreign income offshore, if we paid a tax at the U.S. rate, we would get a credit up to that rate.

The overall system was critical and key to that. We could average the taxes from high and low tax jurisdictions. So, if we paid tax at a 50-percent rate in one jurisdiction and a 20-percent rate in another jurisdiction, we are going to get an average overall rate of 35 percent.

Since 1986, there have been a series of changes which have dramatically impacted our ability to average foreign tax credits. The most famous example, the most well known, is the 10–50 basket rule. Essentially, what this means is when UTC acquires an ownership interest in a foreign corporate joint venture that is less than 50 percent but greater than 10, we have to do a separate foreign tax credit calculation for that entity.

The practical impact of that is not merely that we have to file a separate tax return and do a separate computation. It is a real inhibition on our ability to compete against other companies from other countries who aren't subject to those rules.

So, when we are trying to expand in a market and make acquisitions, very often we have to do that. One of our companies, for example, the Otis Elevator Co., is in the elevator service business, and 80 percent of the elevators are located outside of the United States. So, if you want to be in the elevator service business, 80 percent of the market is outside of the United States. You are going to have to do business offshore.

When we go into a foreign jurisdiction and try to increase our market share through an acquisition, when we are looking at an acquisition, we are subject to this 10–50 basket rule. I can tell you that our competitors, the Schindler Co. from Germany, they don't have to worry about the 10–50 basket rule. So it is not merely a question of increased taxes, or an increased compliance burden, but it is directly affecting our ability to expand in international markets.

The policy of deferral is key to our ability to expand because we use the profits from non-U.S. operations to invest in expansion outside the United States.

After 1993, if we accumulate more than 25 percent of total assets in cash, it is deemed to have been repatriated and we are subject to U.S. tax. We want to use foreign cash for foreign acquisitions.

We have a lot of expenses in the United States. UTC spends $1 billion a year on R&D, and over $700 million of that is in the United States. We want to fund that with U.S. cash and not have to use U.S. cash on foreign acquisitions.

The net effect is that, I would say, we either have to adopt the territorial approach that is set forth in the consumption tax proposals or go back to a de facto territorial approach by reinvigorating the foreign tax credit rules and the deferral rules, so they can perform as they were designed to.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

**STATEMENT OF KEVIN G. CONWAY, CHAIRMAN
COMMITTEE ON TAXATION
FINANCIAL EXECUTIVES INSTITUTE
AND VICE PRESIDENT, TAXES
UNITED TECHOLOGIES CORP.**

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

The FEI Committee on Taxation is pleased to present its views on the impact of fundamental tax reform on the international competitiveness of U.S. businesses and workers, including the effect of fundamental tax reform on imports and exports.
FEI is a professional association comprising 14,000 senior financial executives from over 8,000 major companies throughout the United States. The Tax Committee represents the views of chief tax officers from over 30 of the nation's largest corporations.

Due to the myriad of complexities found in the international tax area of our current income tax system, FEI has consistently supported various foreign tax simplification proposals that have been introduced in Congress over the last few years. Some leaders in the Executive and Legislative branches have suggested that the current Internal Revenue Code ("Code") can be repaired, or at least improved to an acceptable level with some modifications (both major and minor). Others, like yourself Mr. Chairman, have argued that our current tax system must be pulled out by its roots and replaced with an entirely new system, such as one that taxes the consumption of goods and services.

The leading consumption tax proposals would greatly simplify the international area for most taxpayers by moving from the current system that taxes "worldwide" income, to approaches that are "territorial" in nature, meaning they exempt most types of foreign income (passive investment income being a major exception). These proposals would also promote the competitiveness of U.S. multinationals versus foreign based competitors by their exemption of foreign source dividends and branch income. This would help ensure that foreign subsidiaries of U.S. companies do not pay more tax on their corporate income than their foreign competitors do in foreign markets. These proposals are also uniform in reducing the tax rates for corporations, which again helps U.S. companies compete against their foreign competitors.

In any event, we believe that the current tax system as it impacts the international area has much room for improvement. Therefore, to assist you in deciding whether to retain the current tax system with modifications, or whether to implement fundamental tax reform, we have provided a sampling below of the many inequities that currently exist in our tax system regarding the international area:

A. Improve U.S. Competitiveness

1. Retain Current § 863(b) Source Rules

Current tax law allows taxpayers who manufacture goods in the U.S. and sell the goods outside the U.S. to treat 50% of the income arising from the sale as foreign source income. The intent of this provision was to enhance the competitiveness of U.S. businesses in the global market place and generate additional jobs in the U.S. The Department of Treasury, and most recently the Administration, however, have sought in recent years to significantly curtail or eliminate this provision as a way to raise revenues for other programs. It is this sort of "rob Peter to pay Paul" approach, without regard to a coherent tax policy that has brought us to the point that we're at today.

2. Increase Allocation of R & E to U.S. Source Expense

Taxpayers that perform research and development ("R& E") in the U.S. who generate foreign source income must allocate a portion of their U.S. incurred R & E against their foreign source income in determining their foreign source income. The allocation ratio has changed numerous times over the last 20 years. For example, when the Regulations became effective in 1977, there was a phase in period during which the allocation went from 50% to 30%. In 1981 a moratorium was put in place that lasted for five years because o the controversy surrounding the allocation methodology and impact on US corporations' competitiveness. In 1987 taxpayers were allowed to apply 50 percent of their R&E against their U.S. source income and foreign source income based on sales or gross income; from January 1, 1988 through April 30, 1988 the rate was 64%. From May 1, 1988 through 1989 the allocation was 30% and from 1990 through 1993 64% was allocated to domestic source income, the remaining 36 percent allocated between U.S. and foreign. From 1994 forward, taxpayers again may only apply 50 percent of U.S. source R&D against U.S. source income, with the remainder allocated between U.S. and foreign source.

Research programs require long-term planning and foreign jurisdictions are not likely to recognize research expenses incurred in the U.S. as proper deductions for foreign local tax purposes (in fact, the net effect may encourage taxpayers to perform research outside the U.S. in order to secure full local tax deductions). A permanent solution to the R&E allocation is required. Therefore, the law should be amended to permanently provide that 64 percent of U.S. incurred R&E is to be allocated against U.S. source income, with the remainder allocated based on gross sales or gross income.

3. *Amend Rules for Allocating State and Local Income and Franchise Taxes*

Treasury Regulations issued in March, 1991 (§ 1.861-8(e)(6)) generally require U.S. multinational companies to allocate a portion of their deduction for state and local taxes to foreign source income in determining their foreign tax credit limitation. This requirement ignores the fact that the U.S. Constitution proscribes State taxation of foreign source income, and results in adversely impacting the competitiveness of U.S. multinationals in world markets. It adds an additional cost of doing business that is not incurred by foreign multinationals, even if those foreign competitors are doing business in the U.S. (because they are generally able to obtain a full deduction against U.S. source income for such state taxes, while U.S. companies generally are unable to fully deduct the portion of taxes source foreign). Thus, the law should be amended to allocate all deductions for state and local income and franchise taxes against U.S. source income for FTC purposes.

4. *Use Earnings & Profits (E & P) Depreciation for Asset Bases when Allocating Expenses*

Taxpayers may elect to allocate interest between U.S. and foreign source income on the basis of tax book value. U.S. based assets are generally depreciated on an accelerated basis while foreign based assets utilize slower depreciation methods. U.S. based assets, therefore, will typically have lower tax bases than similar foreign based assets. This results in a disproportionately higher amount of interest being allocated against foreign source income. To correct this problem, the law should be amended for purposes of allocating interest expense to permit taxpayers to use the same depreciable methods and lives for both U.S. and foreign based assets, as used for E & P purposes.

B. Eliminate Double Taxation and Simplify Computation of the Foreign Tax Credit

1. *Extend FTC Carryforward and Carryback Periods*

Currently, FTCs that are not used against U.S. tax in the current year may be carried back 2 years and carried forward 5 years. The effect of the short time periods has been to cause FTCs to expire unused, thus subjecting foreign source income to double taxation and frustrating the purpose of the credit. The current rules are especially onerous for taxpayers in cyclical industries which experience substantial operating losses. In contrast, the rules for net operating losses ("NOLs") provide a 3 year carryback and 15 year carryforward period. This time frame recognizes the fact that utilization of NOL's is not a short term proposition. What the foreign rules fail to recognize is the fact that a U.S. taxpayer must have domestic taxable income in order to utilize its FTCs. Thus, we believe that the FTC carryback and carryforward periods should be amended to conform with the time periods for NOLs, i.e., 3 years carryback and 15 years carryforward.

6. *Amend Treatment of Prior Year Deficits under Subpart F*

Currently, certain foreign base company shipping income, oil related income, insurance income, and FPHC income may be reduced by post-1986 accumulated deficits in E & P attributable to activities that give rise to that same category of income. In 1988, the law was amended to allow accumulated deficits for pre-1987 years to be carried forward and reduce post-1986 foreign base company sales and services income, as well as allow 1983 to 1986 accumulated deficits to be carried forward and reduce post-1986 oil related income. Although post-1986 deficits may be carried forward indefinitely, pre-1987 accumulated deficits associated with shipping, insurance, and FPHC income may not be carried forward to reduce subsequent Subpart F income even if it is of the same type. Similarly, pre-1983 accumulated deficits associated with oil related income can not be carried forward. This is illogical and not sound tax policy. Therefore, the law should be amended to allow all pre-1987 accumulated deficits post-1962 to offset similar Subpart F income earned subsequent to 1986.

7. *Exempt Foreign Entities from the Uniform Capitalization Rules*

The uniform capitalization rules ("UNICAP") under Code Section 263A require certain costs to be capitalized to inventory and certain interest to be capitalized as a production cost. Although the legislative history to this section does not compel its application to foreign corporations not doing business in the U.S., the Treasury Regulations specifically apply such rules to foreign corporations with U.S. shareholders. However, U.S. multinationals already incur significant costs at both the head office and affiliate level to bring foreign E & P into conformity with U.S. tax principles for purposes of computing FTCs. Requiring the determination of UNICAP adjustments to such earnings merely adds additional compliance costs that are not borne by foreign based multinationals. Since UNICAP really has no relevance to foreign corporations not conducting business in the U.S., and since the revenue generated by applying these rules to foreign entities is small in relation to the administrative burden they cause, Code Section 263A should be amended to exempt foreign entities not doing business in the U.S.

C. Source Income Based on Underlying Income or Assets

1. *Extend Dividend Treatment to Disposition of Lower Tier CFCs*

Under current law, if a controlled foreign corporation ("CFC") sells its stock in another CFC, any gain is treated as passive (i.e., separate basket) Subpart F income to the U.S. shareholder. This is illogical since dividends from that same CFC to its U.S. shareholders would be given look-through treatment or, if the first tier CFC was sold, the entire gain would be dividend income. Thus, the law should be changed so that if a CFC sells or exchanges stock in a foreign corporation, any gain is treated as a dividend to the same extent that it would have been so treated under Code Section 1248 if the selling CFC were a U.S. person. As a result, these lower-tier CFC stock gains would also be eligible for look-through treatment, so that if the lower-tier CFC's earnings were general limitation income, the gain would also be treated as general basket income.

2. *Apply Look-Through Treatment on Gains from Sales of CFC Stock*

Currently, foreign source capital gains arising from the sale of a CFC's stock is separate basket income passive income. However, as stated above, it is illogical that dividends from these CFCs qualify for look-through treatment that may result in general basket treatment, while gains from sales of these CFCs do not. Thus, current law should be changed so that gains and losses from the sale of foreign corporation stock is also eligible for look-through treatment.

3. *Apply Look-Through Treatment on Gains from Sales of Partnership Interests*

Currently, gains from sales of partnership interests are also treated as separate basket passive income, even though U.S. partners owning 10 percent or more of the value of foreign partnerships can apply look-through treatment for their distributive shares of such partnership income. Consistent with the arguments above concerning sales of foreign corporation stock, gains or losses associated with the disposition of a partnership interest should be treated as a disposition of the partner's proportionate share of each of the assets of the partnership for purposes of characterizing the income or loss from the sale of the partnership interest. Moreover, in cases where less than 10 percent of the partnership is owned, look-through treatment should be allowed if the partnership interest is held in the ordinary course of the partner's active business.

4. *Amend Source Rules for Stock Sales*

Currently, gains resulting from the sale of foreign affiliates in which the U.S. shareholders have an interest of 80 percent or more is considered foreign source if the sale occurs in the foreign country in which the affiliate is actively engaged in business and the affiliate derives more than 50 percent of its income therefrom. Gain by U.S. corporations from stock sales of U.S. affiliates that are less than 80 percent owned foreign affiliates is sourced foreign only if the sale is through a fixed place of business outside the U.S. and the gain is taxed abroad at an effective tax rate of no less than 10 percent. Although it may be appropriate to source sales of portfolio stock interests based on the seller's residence, it is illogical to extend such a rule to stock sales of foreign subsidiaries representing active businesses. The better rule is to source gains on such foreign subsidiary stock sales by reference to the subsidiary's underlying income. This is the rule for more than 80 percent owned foreign corporations, and it should be extended to situations where at least 10 percent ownership is reached (consistent with the rules for claiming indirect FTCs). Therefore, the law should be amended to source all gains from stock sales of at least 10 percent owned foreign entities to that foreign jurisdiction if the sale occurs there, the affiliate is actively engaged in business there, and more than 50 percent of its income is generated therefrom.

5. *Amend Source Rules for Sales of Partnership Interests*

Currently, if a U.S. corporate partner sells its interest in a foreign partnership, any gain is generally treated as U.S. source income. However, if that partnership disposes of its foreign assets, gains will generally qualify as foreign source. Thus, the law should be amended to provide that for sourcing purposes, gains or losses associated with dispositions of 10 percent or larger partnership interests are treated as dispositions of the partner's proportionate share of each of the partnership assets. This would be consistent with the rule regarding the characterization of income from sales of partnership interests for FTC limitation purposes discussed above. Moreover, in cases where less than 10 percent of the partnership is owned, look-through treatment would be allowed if the partnership interest is held in the ordinary course of the partner's active business.

6. *Provide Look-Through Rules for So-called "10/50 Companies"*

Current law (resulting from changes provided by The 1986 Tax Reform Act ("TRA")) requires that U.S. companies who own an interest of at least 10% but not more than 50% of foreign joint ventures corporations (as opposed to foreign partnerships) must calculate separate "FTC" limitations for income earned from each joint venture corporation. Thus, a U.S. corporation owning many 10/50 Companies must calculate separate FTC limitations for each and every company that falls into this 10/50 category. Not only does this result in substantial complexity and higher costs, but it may also result in double taxation versus the situation where the U.S. shareholder has a controlling interest in the venture (i.e., 51 percent). That is because owners who receive dividends, interest, rents or royalties from controlled foreign corporations ("CFCs") can "look-through" such income to the nature or character of the payor corporation's underlying income, and include it in these general limitation basket categories instead of into separate FTC limitation baskets.

U.S. shareholders of foreign joint ventures often are unable either due to government restrictions or business practice to acquire controlling interests, especially in cases where the foreign joint venture partner is a foreign government, or the activity involved in is a government regulated industry. It is patently unfair to penalize such non-controlling joint venture owners. Instead, current law should be changed to equalize the treatment for both types of joint venture owners, by requiring look-through treatment for income (dividends, interest, rents, and royalties) earned joint ventures in which the U.S. shareholders owns at least 10% of the stock.

On a related matter, current Treasury Regulations (§ 1.904-5(h)(1)) require that payments of interest, rents, and royalties from partnerships to partners not acting in that capacity must also treated as separate basket passive income unless U.S. partner owns more than 50 percent of the partnership. Again, this result is not good tax policy. However, by extending look-through treatment to 10/50 companies as proposed above, this problem involving partnerships will be corrected.

7. *Amend Rules Relating to the International Securities Industry*

Current law (resulting from changes provided by The 1986 TRA) denies so-called "deferral" on dividends, interest, and capital gains on stock or securities derived from a banking or financing business or derived from insurance company investments of unearned premiums, reserves, or investments. However, it appears that this change affects not only taxpayers that intentionally "routed income through foreign countries to maximize U.S. tax benefits", but also innocent regulated insurance companies. The law should be revised to treat income earned in the active conduct of a securities dealer or banking business by a CFC of a U.S. domiciled securities dealer in the same manner as the active income of CFCs of their U.S. parents.

D. Anti Deferral Provisions

1. *Treat The European Union as One Country for Subpart F Purposes*

The Subpart F provisions of the Code, were enacted to deter U.S. corporations from establishing companies with minimal substance in tax haven countries. Under these provisions, U.S. corporations can be subject to taxation on deemed distributions of the foreign subsidiaries' earnings. This is in contrast with the general rule of no taxation until dividends are distributed to the U.S. parent from the foreign subsidiary. Deemed taxation can occur under Subpart F, for example, on foreign subsidiary earnings generated from cross border sales or services with the European Union ("EU"). However, this rule overlooks developments in world trade and the critical needs of U.S. global companies competing within the EU marketplace. The member countries of the EU are not tax haven countries therefore, in order to recognize the legitimate business requirements of U.S. companies operating in the EU, the Subpart F rules should be amended to allow the EU to be treated as one country.

2. *Apply Same Country Exception to PRC/Hong Kong in 1997*

Current U.S. tax law permits taxpayers with CFCs to distribute dividends within the same country without incurring U.S. tax on the distribution assuming that certain criteria are met. The basic purpose of this provision was to effectively allow the movement of capital within a country so that the U.S. taxpayer could reinvest the funds without needlessly incurring an additional U.S. tax burden. In July 1997, Hong Kong will revert back to the PRC. Because Hong Kong is the financial capital of the region, many businesses have established their headquarters and holding companies for their PRC operations there. Thus in order to reinvest profits and expand business, U.S. taxpayers in many instances are required to pay tax on distributions up to the holding company, only to be reinvested in the PRC, thus effectively increasing the cost of capital. We believe that the same country exception should be applied to distributions between companies incorporated in both the PRC and Hong Kong assuming that the requisite ownership rules, etc. are met. Such treatment would, in many instances, significantly increase the competitiveness of U.S. businesses operating here.

3. *Repeal* Section 956A

Code Section 956A, implemented with the 1993 Tax Act, was intended to eliminate so-called "deferral" of U.S. income tax for U.S. shareholders of CFCs to the extent that the CFC's earnings are invested in excess passive assets rather than in active business assets. However, this section has instead had the effect of adding an additional layer of complexity to the already existing anti-deferral regime of the Code, while providing taxpayers an incentive to engage in costly, non-economical transactions in order to avoid its application. Contrary to earlier estimates, this provision has not created a positive impact on cash flows from foreign companies to U.S. parents, or resulted in more U.S. manufacturing jobs. Rather, it has created incentives for investing in assets outside the United States and should be repealed immediately.

4. *Apply Look-Through Rules for De Minimis Amounts of Separate Category Income*

Code Section 904(d)(3)(E) exempts U.S. shareholders from having to categorize income from a CFC into separate limitation categories if the CFC is considered as having a de minimis amount of so-called "Subpart F" income under the anti-deferral rules. An amount is considered as de minimis if it does not exceed the lesser of 5 percent of the CFC's gross income or $1 million. However, once that de minimis threshold is exceeded, all income, expenses, and taxes of the CFC must be categorized into the respective separate FTC categories. The problem with present law is that what constitutes Subpart F income for purposes of applying the anti-deferral rules is different from what constitutes income in the separate FTC limitation categories. As a result, the CFC may exceed the de minimis threshold for Subpart F purposes even though its income in the various separate limitation categories is insignificant or "de minimis", requiring full application of the complex FTC separate limitation rules.

This increased administrative burden applies disproportionately to those multinational companies whose CFCs' Subpart F income, although relatively small compared to their remaining incomes, nevertheless regularly exceed the annual $1 million threshold. Thus, current law should be changed so that categorization into separate FTC limitation categories is not based on Subpart F income amounts but, rather, is imposed where the aggregate amount of gross income in such separate categories exceeds a de minimis amount, defined as 5 percent or more of the CFC's gross income.

5. *Exclude CFCs from the PFIC Rules*

The Subpart F rules of the Code currently provide exceptions to the general rule of so called deferral for tax haven and foreign personal holding company ("FPHC") type income (i.e., passive income) from CFCs. The 1986 TRA added certain provisions called the Passive Foreign Investment Company ("PFIC") rules that effectively tax all income currently from foreign subsidiaries that have more than a designated amount of passive income or assets, even though the balance of the income is from active manufacturing operations. In other words, all income can be effectively tainted even though only a portion of it is from passive type activities that would have been currently taxed under the Subpart F rules. Although the PFIC rules were intended to eliminate certain identified abuses relating to U.S. investors in overseas mutual funds, they were inadvertently drafted in a manner to also cover CFCs (even though CFCs were already sufficiently regulated by the Subpart F rules). To correct at his error, the PFIC provisions should be amended so that companies subject to Subpart F (i.e., CFCs) are exempt from their application.

6. Amend Definition of PFICs

The PFIC provisions currently apply where 75 percent or more of a foreign corporation's gross income is passive, or where at least 50 percent of the foreign corporation's assets produce passive income. By using a gross income test, a foreign corporation will become a PFIC even though 99 percent of its gross receipts are from the active conduct of a trade or business, so long as its cost of goods sold exceeded its gross receipts that year and it had a dollar of passive income (like working capital interest income). This result is illogical. The PFIC provisions should be amended so that they only apply where the predominant character of the business is passive or the majority of assets is passive. This can be accomplished by changing the test to look to gross receipts rather than gross income, for example, by defining foreign corporations as PFICs if at least 75 percent of their gross receipts are passive.

E. Other Provisions and Considerations

1. Clarify Straddle Rules for Business Payables and Receivable

Although deductions are currently allowed for foreign exchange losses incurred during the year, no deduction is allowed for certain loss incurred with respect to "straddles" in order to prevent taxpayers from using commodity trading as a tax shelter. In other words, if a taxpayer takes essentially equal and offsetting positions in a commodity (i.e., a straddle), it can not recognize a loss on one position in the current year and defer the gain on the offsetting position until a subsequent year. Instead, any deduction for the loss of the straddle is deferred until there are no unrecognized gains in the other leg.

The problem with this is that the Code definition of "straddles" (under Section 1092) is so unclear that taxpayers who had no intent to enter into the types of tax-motivated transactions that led to these rules are being challenged on audit as having straddles. Specifically, some IRS agents have argued that certain payables and receivables are affected even though they were entered into in the ordinary course of business, had no tax motivation, were unrelated to each other, and were held by different tax consolidation members of a multinational company. Thus, Code Section 1092(c)(3)(B) should be amended to provide the presumption that a nonfunctional currency denominated receivable is not an offsetting position to a nonfunctional currency denominated payable if the receivable and payable were entered into in the ordinary course of business.

Additional Provisions

This is by no means an exhaustive list of all the problems currently existing in the international area of the current U.S. income tax system. In fact, both Congressmen Houghton and Levin through H.R. 1690, and Senator Pressler in his recently circulated discussion draft entitled International Tax Simplification for American Competitiveness Act of 1996, have proposed many additional provisions that would help bring some simplification to the foreign area. Some of those provisions would:

- Allow shareholders of PFICs to make mark-to-market elections, provided that the PFIC stock is regularly traded on a national securities exchange or otherwise treated as "marketable" under Treasury Regulations;

- Clarify the definition of passive income for PFIC, so that the same-country exceptions from the definition of FPHC income under Code Section 954(d) do not apply in determining passive income for purposes of the PFIC definition, and passive income does not include Foreign Sales Corporation ("FSC") income;

- Allow intangible assets for PFIC purposes to be valued at fair market value (if value can be readily obtained);

- Modify Subpart F so that (1) the Subpart F inclusion of an acquirer of CFC stock would be reduced in the year of acquisition by a portion of the deemed dividend recognized by the transferor under Code Section 1248, (2) the income inclusion to U.S. shareholders resulting from upper tier CFC stock sales in lower-tier CFCs earning Subpart F income would be adjusted to account for previous inclusions, and (3) regarding dividends out of earnings of CFCs that were previously included in the income of U.S. shareholders under Subpart F, in order to avoid multiple income inclusions, the IRS should be given regulatory authority to modify the Subpart F rules so that such dividends would be treated as distributions of previously taxed income with appropriate basis adjustments;

- Repeal the excise tax under Code Section 1491 on outbound transfers of assets to foreign corporations and replace it with full gain recognition "subject to Code Section 367 gain recognition agreements);

- Reduce the compliance burden for U.S. taxpayers under Code Section 6046 by raising the foreign corporation stock ownership threshold from 5 to 10 percent, for which ownership and other financial data has to be reported to the IRS; and

- Clarify that computer software qualifies as export property that is eligible for FSC benefits, even if the software is accompanied by a right to reproduce or is protected by patent or copyright.

Treaty Issues

The impact of tax reform on our existing tax treaty network must not be overlooked. Of course, the most recognized function of tax treaties and the principal reason they are negotiated is to eliminate double taxation of the same income, which occurs when two jurisdictions attempt to tax the same income or assets due to overlapping exercise of authority. However, most of the tax systems being proposed to replace the current U.S. income tax would be territorial in nature and exclude foreign source income from taxation (e.g., a 'flat" tax or a "goods and services" tax). Thus, the issue of double taxation would be reduced considerably if not entirely under such regimes. Nevertheless, many other benefits resulting from our tax treaty network would be jeopardized no matter what alternative tax system is chosen to replace the current one. For example, several of the more significant benefits of tax treaties include–

1) Facilitate business transactions between countries that might otherwise be inhibited by overly intrusive national taxation.

Beyond the actual tax cost, the mere exposure to another country's tax system may impose significant transactional complexities on a company venturing outside its own national borders, e.g., protracted dealings with various tax authorities. To alleviate some of these problems, treaties include a notion of "permanent establishment" ("PE") as a threshold to taxation. Under this concept, the business profits of an enterprise of one county will not be deemed to be subject to taxation by the other country unless it does business there through such a PE, i.e., unless there is a sufficient connection between the enterprise and the taxing country in terms of having a fixed place of business there, dependent agents, etc. Moreover, most of the recent treaties negotiated by the U.S. have limited the imposition of tax to the business activities attributable to the PE, as opposed to items unrelated to the PE itself (such as passive investment income and capital gains). In addition, tax treaties sometimes exempt residents of one country who visit the other for a limited period of time. This eliminates the need to prorate small amounts of income and file foreign tax returns (often more irritating than paying taxes), and encourages interaction of visitors between countries.

2) Withholding Taxes

The tax systems of most countries impose withholding taxes (at often high rates) on payments to foreigners of items such as dividends, Interest, rents, and royalties. Lowering of these withholding taxes is another important function of tax treaties. If U.S. companies operating abroad can not receive reduced withholding tax rates offered by tax treaties, they often suffer excessive levels of foreign tax. This puts such U.S. companies at a competitive disadvantage relative to companies headquartered in other countries that do provide such treaty benefits. Thus, it is clear that tax treaties measurably reduce the barriers to U.S. participation in international commerce.

3) Anti-Discrimination Provisions

Almost all treaties forbid discrimination against the nationals of a treaty partner. One general effect of this is to prohibit U.S. tax on residents of treaty countries that is more burdensome than the tax imposed on similarly situated U.S. persons. Likewise, U.S. persons operating in treaty countries would also be protected under such a non-discrimination type clause. A nondiscrimination clause would generally only permit differences in the treatment of domestic and foreign taxpayers if justified by significant differences in the circumstances of those taxpayers.

4) Tax Equity

Another function of tax treaties is to ensure that equity is served and tax is imposed at least once, i.e., by targeting tax avoidance schemes such as the use of tax havens. Most U.S. tax treaties contain explicit provisions called "anti-treaty shopping". These provisions identify the group of taxpayers entitled to benefit from the treaty relief while, at the same time, also preventing other taxpayers (generally from countries not party to the treaty) from enjoying such treaty benefits. To help support enforcement, income tax treaties generally provide for exchanges of information between the tax authorities of the treaty countries. In addition, most provide a mechanism known as "competent authority", which permits a taxpayer of one country to seek the assistance of that countries tax authorities for support against adverse interpretations of the treaty by the other country's taxing authorities. Even if the U S. moves to a territorial system of taxation, such needs may not be muted since our treaty partners may still require such information exchanges.

Summary

We trust that this has given you a better understanding of the many problems that currently exist in the tax law as it applies to the international area. We sincerely hope that this will help you in your decision whether to save the current system or move toward a completely new tax framework. Thank you for this opportunity to provide our comments.

Financial Executives Institute,
Committee on Taxation

By Kevin G. Conway
Kevin G. Conway

Chairman ARCHER. Thank you, Mr. Conway.
Mr. Kaufman.

STATEMENT OF JEFFREY KAUFMAN, DIRECTOR, SERVICES TO EXECUTIVES ABROAD, COOPERS & LYBRAND L.L.P.; ON BEHALF OF SECTION 911 COALITION

Mr. KAUFMAN. Thank you very much.

My name is Jeff Kaufman. I am a partner with Coopers & Lybrand. I lead our practice of servicing Americans when they work overseas. I have been involved in this area of international tax and human resource issues for 15 years; in fact, I spent 5 years myself in Europe.

Today, I represent the Section 911 Coalition, the section of our code which represents our exclusion for foreign-earned income. The Section 911 Coalition is a group that represents a number of companies with their operations overseas, U.S. chambers of commerce overseas, and many foreign schools. These are all organizations that represent and recognize the importance of having Americans overseas and the value that brings to our economy.

I want to begin by thanking you, Mr. Chairman and Mr. Gibbons, for the support you have given to section 911 over the years, recognizing the value this brings to our economy.

It is also supported by the administration. Under the new proposals that are now before your body, there are a number of different ways foreign-earned income will be treated, including total exclusion under the Armey flat tax or under the sales tax proposal. Congress has also been looking at partial exclusions similar to what we have today under the Nunn-Domenici USA tax, as well as a situation where there would be no exclusions at all under the Bingaman proposal.

The way we tax Americans overseas is very important to our competitiveness. The United States stands alone as the only industrialized country that taxes our citizens when they work overseas. This puts us at a disadvantage.

When I work with some of my clients, for example, on proposals for a large contract in Saudi Arabia to build a factory, I work with them to build in the cost factor of the 500 U.S. engineers that might go to that plant. I have to build in the tax on their U.S.-based salary and many other costs. They receive cost of living. They will receive housing. They will receive education for their children. All of these costs are taxed in the United States.

When my client prepares a bid against a German or a Japanese or an English company, we are at a great disadvantage because of this U.S. tax. These other countries will not tax that, and there is no tax in Saudi Arabia.

The 911 exclusion helps us make up some of that loss, but since it hasn't been tied to inflation, it is beginning to be eroded in its value in giving us a more level competitive playingfield.

It is not just those 500 jobs we might lose in that contract. There have been many studies that show when that American is overseas, if they are going to bring in the equipment that is going to go into that factory, if they are going to bring in the equipment that is going to build that factory, they will go to companies they have worked with that are very likely the U.S. companies.

If we save those 500 American jobs in Saudi Arabia, it will have an exponential effect on more manufacturing jobs in America.

The Section 911 Coalition has developed two different studies, one by the accounting firm, Price Waterhouse, and the other by two professors, that emphasize the importance of the American overseas. It is going to help us to have more U.S. jobs.

Section 911 itself helped to raise revenue because it gets our people in the field selling our goods, so that we, in effect, continue to generate more jobs in the United States.

This is important for companies of all sizes. I have been working with small, medium, and large companies. Especially in the case of the small and medium-sized companies that go overseas, they need those first Americans to act as their sales representatives to get that first sale. We are not going to be competitive in the next century if America can't compete on a global basis. If we don't send the American overseas, we are not going to be competitive.

So, in conclusion, what is important to the Section 911 Coalition and to so many of our U.S. companies is that if we choose a new taxing regime, we have to consider how it will tax Americans overseas. The more Americans we send overseas, the more we increase our exports, which are a very important component of the growth of our economy. We must take that into consideration and keep at least the exclusion we have today or perhaps tie it to inflation so that in the future we don't have a reduction in the ability of our American companies to compete.

Thank you.

[The prepared statement follows:]

STATEMENT OF JEFFREY KAUFMAN, DIRECTOR
COOPERS & LYBRAND L.L.P.
ON BEHALF OF SECTION 911 COALITION

I am Jeff Kaufman Director of Services to Executives Abroad which is the group within Coopers & Lybrand that assists clients with managing the cost of relocating employees around the world and complying with tax laws here and abroad. I have worked on international tax, compensation and human resource issues affecting U.S. expatriates for over fifteen years , five of which were in Europe where I was an expatriate myself. It is a privilege to testify before this Committee and to be here on behalf of the 911 Coalition to discuss an issue of such importance to U.S. international competitiveness and the development of goodwill toward U.S. citizens and U.S. businesses around the world.

The Section 911 Coalition is a group of like-minded companies, business organizations, non-profit associations, and individuals that has come together in the past few years to call attention to the importance of the Section 911 foreign earned income exclusion for U.S. citizens working abroad. The Coalition currently has some 70 members, including representatives of more than 70 American chambers of commerce overseas and over 500 American and international schools abroad.

In recent years, exports have been the most impressive engine of growth for America's economy. Between 1986 and 1993, according to the U.S. Department of Commerce, nearly 40 percent of the growth of America's Gross Domestic Product resulted from exports of goods and services.[1] Commerce Department statistics also indicate that every $1 billion in U.S. exports creates or sustains 17,000 man-years of direct domestic employment.[2] The United States exported $701.2 billion worth of goods and services in 1994, which translates into nearly 12 million American jobs.[3]

Exports don't just happen by themselves. Independent studies and raw statistical data show a direct correlation between the number of Americans working overseas and the level of U.S. exports. You've got to put your sales people in the field. Americans abroad are the best sales people for U.S. goods and services overseas. The bottom line, is this: **Americans Abroad = U.S. Exports = U.S. Jobs.**

In the ongoing pursuit of international market share, the Section 911 exclusion has proved to be a very important factor. U.S. sales forces and service providers can only go where it is cost effective. The current Section 911 exclusion for income earned abroad is the mechanism by which the Internal Revenue Code reduces U.S. tax barriers to the deployment of sales and service industry personnel around the globe. It has a direct impact on the U.S. based support operations of the companies they work for, U.S. based suppliers and service companies that do business with their employers, as well as many other unrelated U.S. companies that develop relationships once the markets abroad grow more comfortable with our culture and learn the benefits of seeking out U.S. businesses.

<u>Fundamental Tax Reform Alternatives' Treatment of Income Earned Abroad</u>

The major tax reform alternatives provide widely different levels of exclusion for income earned abroad. For example:

100 % exclusion -- Armey Flat Tax & Schaeffer/Tauzin Sales Tax

Partial exclusion *(similar to current Section 911)* -- Nunn/Domenici USA Tax

No exclusion -- Bingaman R Corp Tax

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[1] Trade Promotion Coordinating Committee, *National Export Strategy*, Report to the U.S. Congress, October 1994, p. 5.

[2] U.S. Department of Commerce, The Advocacy Center, July 1995.

[3] U.S. Department of Commerce. *U.S. Foreign Trade Update*, July 18, 1995.

Section 911 -- Our Earned Income Exclusion in Current Law

Internal Revenue Code Section 911 provides for a foreign earned income exclusion of up to $70,000 annually to Americans working overseas, thereby assisting them to compete against comparably qualified non-Americans (who pay no taxes in their home country on income earned abroad). A U.S. citizen or resident alien whose tax home is outside the United States and who is a *bona fide* resident of a foreign country or who is present in a foreign country for 11 months out of 12 (330 days in any 365 day period) may exclude from gross income up to $70,000 per year of foreign earned income, plus a housing cost amount. Originally unlimited for *bona fide* residents of a foreign country, the foreign earned income exclusion has been part of the Internal Revenue Code since 1926. Congress enacted the exclusion nearly 70 years ago in an effort to "encourage citizens to go abroad and to place them in an equal position with citizens of other countries going abroad who are not taxed by their own countries."[4]

Short History of the Current Law Exclusion -- Learning from our Mistakes

The Tax Reform Act of 1976 generally reduced the exclusion to $15,000 per year. While this cut in the exclusion did not take effect in the end, it nevertheless had a chilling effect on U.S. companies' efforts to send American workers abroad. A 1978 General Accounting Office (GAO) survey of 183 U.S. companies found that more than 80 percent of these companies felt that reducing the exclusion along the lines of the 1976 Act would result in a reduction of U.S. exports by at least five percent.[5]

Two years after the 1976 Act, the situation went from bad to worse. The Foreign Earned Income Act of 1978 repealed the foreign earned income exclusion and put in its place Section 913, composed of five factors: 1) a cost-of-living deduction based on the differential between U.S. and overseas costs of living; 2) a housing deduction; 3) a deduction for schooling expenses where a U.S.-type school was not within a reasonable commuting distance; 4) a travel expense deduction for an annual round-trip visit to the United States; 5) a deduction for work in a hardship area.

The 1978 Act, compared to prior law, represented a 23 percent reduction in the tax benefit of the exclusion. To determine the impact of this reduction, the GAO conducted a survey in 1980 of 33 key firms in four industries. The GAO found that additional costs attributable to the 1978 Act was a primary reason why these firms had decreased their employment of Americans abroad. The numbers decreased absolutely from 1979 to 1980 in three of the industries and, during the period 1976 to 1980, the relative number of Americans abroad dropped compared to third country nationals.[6]

As a result of these findings, the GAO produced the following recommendation:

> "We believe that the Congress should consider placing Americans working abroad on an income tax basis comparable with that of citizens of competitor countries who generally are not taxed on their foreign earned income."[7]
>
> The GAO went on to say that "complete exclusion or a limited but generous exclusion of foreign earned income for qualifying taxpayers . . . would establish a basis of taxation comparable with that of competitor countries and, at the same time, be relatively simple to administer."[8]

Findings in a 1980 report by Chase Econometrics provided more evidence of the dangers for U.S. competitiveness of restricting the foreign earned income exclusion. As a result of the

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[4] *Senate Report No. 781*, 82nd Congress, 1st Session, 1951, pp. 52-53.

[5] U.S. General Accounting Office, *Impact on Trade of Changes in Taxation of U.S. Citizens Employed Overseas*, ID-78-13, February 21, 1978.

[6] General Accounting Office, *American Employment Abroad Discouraged by U.S. Income Tax Laws*, ID-81-29, February 27, 1981, p. 28.

[7] Ibid.

[8] Ibid.

changes in 1976 and 1978, Chase noted, a significant number of Americans working overseas would be forced to return home. Chase determined that a ten percent drop in Americans overseas would lead to a five percent drop in U.S. exports. The study went on to say that the "drop in U.S. income due to a five percent drop in real exports will raise domestic unemployment by 80,000 [persons] and reduce federal receipts on personal and corporate income taxes by more than $6 billion, many times the value of increased taxes on overseas workers."[9]

The U.S. & Overseas Tax Fairness Committee, an *ad hoc* group established in the late 1970s to defend the foreign earned income exclusion, noted in 1980 that "of all the current U.S. disincentives that discourage trade, none is easier to eliminate than the U.S. practice of taxing foreign earned income . . . and none will produce faster or more substantial results for our balance of trade."[10] In an effort to show what damage the 1976 and 1978 Acts had done as of 1980, the Committee cited the example of the U.S. construction and engineering industry operating in the Middle East. American companies in this sector "had over ten percent of the construction volume in the Middle East four years ago and now has less than two percent -- almost entirely due to the current U.S. tax treatment of overseas Americans," the Committee noted, "and industry is finding it very difficult to recapture its former standing."[11]

The message is as clear today as it was in 1980: Changes in the foreign earned income exclusion have a substantial and direct impact on the ability of U.S. companies to compete in overseas markets.

Why an Exclusion for Income Earned Abroad is Important

America's trade competitors realized long ago that encouraging their citizens to work overseas has a pronounced, salutary impact on their domestic economies. Sending their workers abroad has become an integral part of these nations' export strategies. To facilitate this "export" of their citizens (and thus the export of products and services), other governments do not tax their citizens on the money they make while working abroad. This makes these citizens extremely competitive in foreign markets.

U.S. Government tax policies, by contrast, have generally *discouraged* Americans from working abroad. Alone among the world's industrialized nations, the United States still taxes its citizens on the basis of citizenship rather than residence. Further, overseas Americans must also pay U.S. income tax on benefits, allowances, and overseas adjustments. The practical effects of this tax policy are clear: Americans overseas are at a significant competitive disadvantage and are being priced out of foreign markets because prospective employers must provide more income to compensate American workers for these additional tax burdens.

Overseas employers are faced with a choice: They must pay an American worker more than they would pay other comparably qualified nationals (so that the American may keep a comparable after-tax income) ***or*** they must utilize a tax equalization program to keep the employee whole for his or her additional tax burden. Both approaches involve additional costs to the employer -- a burden that many employers are unwilling to accept even if the American worker is more productive and has better professional qualifications than the competition.

For those companies that have a tax equalization program in place, where the company pays any actual taxes for its overseas employees, the current Section 911 exclusion helps to mitigate the tax burden mentioned above -- thereby cutting company costs and enabling it to be more competitive abroad. For companies that do *not* utilize a tax equalization program -- and most small and medium-sized companies working overseas fall into this category -- the Section 911 exclusion is most helpful to the *employee*, who is responsible for paying his own taxes. The current exclusion helps to make a difference in both cases, but the difference may still not be substantial enough to enable an American worker overseas to defend his or her job against foreign nationals.

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9 Chase Econometrics, *Economic Impact of Changing Taxation of U.S. Workers Overseas*, June 1980, p. 2.

10 U.S. & Overseas Tax Fairness Committee, Press Release, June 16, 1980, p. 4.

11 Ibid., p. 3.

The cost of hiring or maintaining an American worker is inordinately high because *non-salary*, quality-of-life items must be included in the worker's taxable income, often adding as much as 50 - 100 percent of base pay. Such "income" includes reimbursement for the cost of children's schooling, cost-of-living allowances, home leave, emergency travel, and other necessary and often expensive aspects of living overseas. Because so many overseas contracts today are decided on the basis of cost, and when companies' profit margins grow tighter and tighter, many employers (including American employers) simply aren't prepared to cover the additional tax burden to "Hire American."

A Section 911 Coalition member offered this case in point:

> A large American company recently won a multi-billion dollar, multi-year overseas contract to supply telecommunications equipment and services. The U.S.-based company would prefer to have Americans heading its overseas operations but, because the U.S. tax system effectively prices Americans out of the international job market, the company tends to hire Europeans instead.
>
> The President of this company's international operations is British, and his Vice President is Dutch. Not surprisingly, the Human Resources Director, who answers to the Vice President, is also from Holland. He has hired approximately 2,000 technical employees for this project, most of whom are Dutch. In addition, Volvos were purchased instead of U.S.-made vehicles because they are considered "more suitable" for the technical employees. If the U.S. tax system were more like those of America's trade competitors who maintain an unlimited foreign earned income exclusion, most of these 2,000+ jobs would have gone to Americans rather than Europeans, and a large number of American cars would have been exported instead of Volvos.

Section 911 makes a substantial difference in our nation's efforts to compete on the international business playing field. Without this exclusion, there is good reason to believe that many thousands of Americans currently overseas would be priced out of the global marketplace. This would be a devastating blow to America's national interests because Americans abroad:

+ Direct business and jobs to the United States;
+ Carry America's culture and business ethic to other nations;
+ Specify and purchase U.S. goods and services for overseas projects;
+ Set standards and shape ideas which guide future policies in the development of infrastructures and economies overseas.

In addition, for U.S. companies to continue expanding their market share worldwide, they must think and act globally. To stay competitive internationally, American managers need the kind of "hands on" experience that can only be gained by living and working abroad. In recent years, for example, two of the Big Three automobile companies promoted their CEOs directly from European positions to corporate headquarters. This clearly demonstrates recognition by these companies of the role that international experience plays in their economic futures.

In short, the foreign earned income exclusion for Americans working abroad helps to protect against replacement of Americans by third country nationals who pay no taxes at all in their home country on their overseas income. Given the tens of thousands of overseas business opportunities that are of interest to U.S. companies and U.S.-based institutions each year, the exclusion stands to make a substantial difference for American influence abroad, U.S. exports, U.S. jobs, and overall American competitiveness.

Who is Affected by the Foreign Earned Income Exclusion for Americans Abroad?

The loss of U.S. market share and the cutback in American jobs overseas represent a setback for American competitiveness. However, this tells only part of the story. The other part, of more immediate concern here at home, is the impact felt in communities all across the United States as jobs created or sustained by exports would disappear. ***All*** Americans abroad, whatever their background, are helping to fuel the economy in the United States. By securing employment overseas, they free up jobs for other Americans back home, thereby reducing unemployment. They also support the American economy by repatriating much of their overseas earnings back to the United States.

Most important of all, perhaps, Americans working overseas serve as the front-line marketing and sales force for U.S. exports. Unless all Americans support competitiveness through exports, our nation's trade deficit will surely continue. As noted earlier, exports are the engine of growth for the U.S. economy, and it is generally accepted that small and medium-sized companies provide the fuel for this engine. When the engine of growth is stalled out by constrictive U.S. tax laws that are no longer appropriate, Americans everywhere pay the price.

For years, supporters of the current Section 911 have emphasized that the exclusion is especially important to small and medium-sized companies operating in overseas markets. "Real world" experience has borne out that:

1) Small companies, when trying to gain a foothold overseas, are more likely than large companies (many with an established overseas presence already) to draw on U.S.-based personnel to penetrate foreign markets.

2) Small and medium-sized companies, because they lack the world-class name recognition that might provide them with open access to foreign customers, traditionally rely very heavily on Americans overseas to specify and purchase their products.

3) Small and medium-sized companies are, by necessity, much more sensitive to individual cost elements and the financial bottom line. Without the foreign earned income exclusion to help make overseas Americans more competitive with foreign nationals, relatively few of these small and medium-sized companies would be able to hire Americans to fill overseas slots.

How the Foreign Earned Income Exclusion Works for Companies that Employ Americans Abroad

The cost of hiring an American varies widely around the world depending on such factors as local housing costs, local standards of living, availability of schools and recreation facilities, remoteness and hardships, and so forth. Nevertheless, it may be instructive to look at a typical example of how the foreign earned income exclusion works. The American Business Council of the Gulf Countries, an Executive Committee member of the Section 911 Coalition, provided the following example.

> The cost for a grade school student to attend the American School in Dubai is approximately $10,000 per year -- not for an exclusive private school, but for the *only* American curriculum school there. If an employer reimburses this cost for two children, the employee has an additional $20,000 of imputed taxable "income." This places an additional tax burden on the individual of up to $8,000.
>
> If the employer chooses to make the reimbursement of this schooling cost tax-neutral to the employee, the total reimbursement cost to the company could exceed $33,000 (including the compounding effect of tax reimbursements, which are also considered taxable "income" to the employee). This represents a $13,000 (65 percent) additional cost *to the company* to provide education for the American employee's children

(compared to providing the same education for children of a comparable European employee) -- simply because of U.S. tax policy.

If the employer provides an annual trip back to the United States for home leave for the employee and family (spouse and two children), the employee has an additional $10,000 or more of taxable "income." Emergency and sympathy travel generate taxable income; cost of living adjustments are considered taxable income; hardship allowances are taxable income; tax reimbursement is taxable income.

In other words, as this typical example shows, taxable compensation that does not represent either "perks" or disposable income to the employee typically absorbs a very large part of the current $70,000 exclusion. This is a burden borne solely by Americans, significantly hampering their ability to compete in the international arena.

Conclusion

The foreign earned income exclusion for Americans working abroad is an important component of U.S. business competitiveness and will help reduce the federal deficit in the long run. Current law Section 911 generates tens of thousands of American jobs, strengthens our export position, and ***increases*** the U.S. standard of living.

Perhaps more than any other provision of law, the foreign earned income exclusion for Americans working abroad helps to put U.S. citizens "in the field" around the world where they *buy* American, *sell* American, *specify* American, *hire* American, and *create opportunities* for other Americans. It has a direct impact on the competitiveness of American workers and U.S. companies operating in foreign markets -- a substantial growth area for the United States now and as we move into the twenty-first century.

To help place America on an equal footing with our trade competitors, real tax reform should provide a full exclusion for earned income abroad. If Congress ultimately decides instead to make only minor adjustments to current law then it should provide an exclusion that is no less than the current Section 911 with indexing against future inflationary losses. American jobs are on the line, especially for small and medium-sized businesses.

Chairman ARCHER. Thank you, Mr. Kaufman.
Mr. Warren.

STATEMENT OF WILLIAM WARREN, VICE PRESIDENT, TAX, TRW INC., CLEVELAND, OHIO; ON BEHALF OF EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. WARREN. Mr. Chairman and Members of the Committee, my name is William Warren. I am vice president of tax for TRW, Inc., a U.S. company based in Cleveland, Ohio, which provides advanced technology products for the worldwide automotive, space, and defense markets.

I am here today representing ECAT, the Emergency Committee for American Trade. ECAT represents over 50 large U.S. corporations with vital interests in promoting American trade through competitive U.S. tax practices and tax laws. Its members employ over 4 million people and generate over $1 trillion in annual sales. A written statement has been prepared and is submitted for the record.

The American business community must increasingly compete in a global environment. The competition is foreign companies who often receive preferential treatment from their home countries. With a U.S. Tax Code that often penalizes or discourages U.S. international business, competition is extremely difficult, and since 1986, we have grown increasingly concerned with U.S. tax policies that affect this ability.

There is particular concern with the perception by some in Congress that U.S. investments abroad are harmful to the U.S. economy. This is incorrect. International investments by U.S. companies gain worldwide market share and are essential to serve non-U.S. customers. These investments, by building U.S. competitive strength, help build a solid base for the U.S. economy, as shown in an ECAT study referenced in my written submission.

A presence in a foreign country does not mean lost employment in the United States. Because overseas operations are good customers of U.S. operations, international expansion often results in more employment in the United States. Generally, a company, such as TRW, could not compete in a foreign market by expanding operations in the United States. In our business, we must be near the customer.

TRW, like many ECAT companies, grew up in the United States and is today in the Fortune 100 with a presence in 21 countries. TRW is proud of this ability to compete globally. Our employees gain from this success. Thus, it is important that tax policies enhance the ability of U.S. companies to invest and compete globally.

Taxation of U.S. international business under the current U.S. Tax Code was developed around the basic principle of avoidance of double taxation. Fundamental tax reform must retain this concept. Unfortunately, since 1986, we have seen constant attacks on and significant erosion of this basic principle, along with an enormous rise in tax complexity in the U.S. Tax Code's international provisions.

Fundamental tax reform must take a different course. Although there are many unknowns on the effect of any specific fundamental tax reform plan on U.S. international competitiveness, we encourage the study of this area. We also urge that international tax reform efforts begin immediately to simplify the current Code and return to basic principles.

While we offer no specific endorsement of any outstanding fundamental tax reform proposal, we do offer the following principles. Any new tax system: Must avoid double taxation of international earnings; must be simple, practical, well considered; must replace rather than add to the present income tax burden; must have a fair transition from the current system; should encourage exports and direct foreign investments; should ensure that imports and foreign-owned businesses operating in the United States are taxed no less than our participants; and should be revenue-neutral.

In terms of immediate tax reform needs, we urge that Congress begin with the following simplification and reform efforts: Halt the expansion of subpart F and attempts to tax foreign-source income through a tax on what is commonly referred to as deferral; repeal section 956A; treat the European Economic Community as a single economic region for tax purposes; repeal the Private Foreign Investment Corp. provisions; protect the current Foreign Sales Corp. and export source rules; reverse the resourcing of U.S. expenses, such as U.S. interest expense; make the R&D tax credit permanent and ensure foreign royalties remain foreign sourced; and last, avoid tax treaty overrides through legislation.

My written testimony elaborates on these areas. Again, we appreciate this opportunity to testify.

[The prepared statement follows:]

TESTIMONY ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE BEFORE THE COMMITTEE ON WAYS AND MEANS HEARING ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX PRESENTED BY WILLIAM WARREN, VICE PRESIDENT, TAX, TRW INC.

THURSDAY, JULY 18, 1996

The Emergency Committee for American Trade ("ECAT") is pleased to offer this testimony on fundamental tax reform and international competitiveness to the Ways and Means Committee. ECAT is an organization that represents over 50 large U.S. corporations with vital interests in international tax and trade. Its member companies employ over 4 million people and generate over $1 trillion in annual sales. Its membership includes American companies who are among our largest and best competitors for world markets. I am William Warren, Vice President for Tax at TRW, Inc., an Ohio-based company which provides advanced technology products for the worldwide automotive, space, and defense markets. TRW's annual sales exceed $10 billion and its worldwide employment is in excess of 66,000.

As we approach the tenth anniversary of the 1986 Tax Reform Act, it is a particularly fitting time to consider fundamental tax reform. The Tax Reform Act was the last time Congress flattened tax rates and broadened the tax base. This was certainly a praiseworthy, albeit a somewhat temporary, accomplishment.

The Tax Reform Act's treatment of international business, however, was considerably less praiseworthy. The Act added enormous complexity and a host of new provisions which greatly increased the risk of double taxation. This was done for a number of reasons -- for example, to raise revenues and in recognition that the employees of an American-owned plant in a foreign country do not vote. But perhaps most important was the notion harbored by some in Congress that American investment abroad was tax-motivated and harmful to our economy.

This notion is *wrong*. American companies invest abroad for business reasons -- that is where the oil is, for example, or where the timber grows, or where huge infrastructure contracts are being awarded. In short, that is where the resources and markets are that spur the growth and undergird the prosperity of the American economy. America needs its companies to sell computers and software in the EU; trucks, autos, and parts in the booming economies of Southeast Asia; turbines, boilers, pipeline and engineering services for construction projects in China and the Mid-East; consumer goods in Canada and Mexico; and pharmaceuticals to the sick and elderly of the world. To do this, American business must have -- directly in the markets in question -- marketing and distribution systems, warehouses and parts depots, assembly and manufacturing operations, service and repair facilities, and the like. American business must have these things locally to meet regulatory rules, to avoid tariffs and quotas, and, most importantly, to get the customer or contract. Taxation is an after-the-fact consideration. Once it is clear an operation is needed within the EU, for example, in order to compete for European market share and serve European customers, it is appropriate to site that operation in a European tax-advantaged "development area," "coordination center," or "international zone." Our European competitors certainly do.

In addition to foreign operations, American business needs one other thing to compete effectively abroad. It needs its Government not to shackle it with tax burdens not faced by its competitors -- particularly double taxation. American companies bidding to sell, say, turbines, boilers, structural steel, engineering and construction services, and so on in connection with a hydroelectric project in, say, India, need to be taxed no more than the Japanese, Korean, German, Italian, and French companies bidding for the same business. The American bid will be too high if it must take into account both an Indian tax and double taxation imposed by the United States. Or, if we nevertheless get the business the first time, our margins will be too thin, if double taxed, to attract the capital necessary to mount the next bid.

If American business done abroad is taxed fairly here, it will be able to compete with anyone in the world. And this will be good, not bad, for our economy. The notion that domestic jobs or domestic capital are lost when American business invests abroad is wrongheaded. After all, the United States is a mature economy approaching zero population growth, and its citizens comprise only 4% of the world's population. Much of the action fueling our economy lies with the other 96%.

In 1993, ECAT published a study entitled "Mainstay II" which amply demonstrates the positive impact of foreign direct investment on the U.S. economy, based on an analysis of U.S. Department of Commerce data. The key findings of the study were that:

1. The net return on the foreign investment of American companies operating internationally is the most positive single element in the U.S. balance of payments account. In 1992 alone, the amount returned to the U.S. was almost $50 billion -- $50 billion of additional capital for jobs formation, research, and capital improvements.

2. Exports accounted for fully 89% of U.S. economic growth in a recent three-year period, and American companies with foreign operations and foreign facilities accounted for fully two-thirds of this.

3. Industries with the highest levels of foreign investment have the highest rate of exports and export growth.

4. The higher the share of U.S. direct investment in a foreign country, the more likely the U.S. is to have a merchandise trade surplus with that country. (It is no accident that Japan, whose markets are largely closed to our investment, is also largely closed to our exports -- with the resultant trade imbalance of which we are all aware.)

5. The total number of jobs created by the exports of American companies which operate abroad reached five million by 1990, according to the Department of Commerce.

A copy of the executive summary of "Mainstay II" is attached to this testimony.

With the foregoing in mind, what can Congress do to insure America's competitiveness abroad? It should certainly analyze and debate new methods of taxation, such as consumption, sales, or other flat taxes. But such reform must be well-conceived, thoroughly considered, and finely executed. That not one of our major trading partners relies exclusively on any such tax serves fair warning on the difficulties involved. A hasty mistake could dislocate a major sector or region of our economy. Accordingly, it is unlikely that fundamental reform can come quickly. In the meantime, simplification and reform of the income tax as it applies to international business, particularly reform of those provisions borne of the 1986 Tax Reform Act and its suspicions of international business, would be a major contribution. Such reform would:

(1) Halt the expansion of subpart F -- that is, halt attacks on "deferral": U.S. tax policy has always recognized that earnings produced abroad by a foreign corporation generally are not taxable in the United Sates until paid to a U.S. shareholder. Critics of this policy describe it as "deferral," and brand it a "loophole" which stimulates the "runaway" of American business to foreign locations. But American companies invest abroad for business reasons, as explained above, which are essential to the well-being of our economy. Accordingly, the premature taxation of foreign earnings hurts our competitiveness, and should not be extended.

(2) Repeal section 956A. This provision was passed in 1993 as a continuation of the attack on deferral begun in 1986. It has remained controversial since its enactment, and is almost universally opposed by American industry.

(3) Treat the EU as a single economic region for subpart F purposes. Many provisions of subpart F do not apply to operations within a single foreign country. As Europe unifies, American business has responded by operating regionally, not country-by-country. Our Internal Revenue Code should recognize this.

(4) Repeal (or revise substantially) the so-called PFIC provisions as they apply to corporations. The 1986 Tax Reform Act added a whole new statutory regime that further eroded "deferral." These provisions were originally thought to apply only to individual investors. Later they were "discovered," in what was at first described as a technical drafting error, to apply to corporations. Now American companies must run the twin gauntlets of subpart F and PFIC with respect to the earnings of their foreign affiliates. If they fail either, money generated by a foreign company in a foreign site and still residing in that foreign business is taxed in the U.S. currently.

(5) Protect the export source and FSC rules. These provisions are among the few GATT neutral, export incentives in the current Internal Revenue Code. They are understood and effective, with the export source rule in particular operating in an administratively convenient manner for both taxpayers and the IRS. These provisions are very important to many of our largest exporters, yet come up year-after-year as a potential source of revenue.

(6) Reverse the "resourcing" of U.S. expenses, particularly interest. The 1986 Tax Reform Act added new rules to sections 861-865 of the Code, which have produced hundreds of pages of 861 regulations. These rules treat expenses incurred in the U.S. "as if" they were incurred abroad. No major country permits U.S. expenses -- for example, interest paid on a U.S. loan to a U.S. bank -- to be deducted

just because complex U.S. rules "deem" **them to be partially "foreign." The so-called 861** rules are one of **the major causes** of double taxation, **and for many companies they are perhaps the** major tax impediment to **competitiveness.**

(7) Encourage R&D. American companies compete through innovation, which should be encouraged by stable, long range tax policies which stimulate investment in research and experimentation. To this end, Congress should make permanent the R&D credit, and continue treating foreign royalties and license fees as foreign source.

(8) Avoid legislative treaty overrides. Our tax policies are coordinated with a number of other countries, via treaty. General legislative pronouncements which fail to account for the integration and cooperation necessary to avoid double taxation between major trading partners are ill-considered. Congress must remember that when it announces broadly that it will "level the playing field," it is not in unilateral control of the field internationally.

(9) Recharacterize income in certain loss situations. U.S. source income should be recharacterized as foreign source income where a taxpayer has suffered a reduction in foreign tax credit limitation in a prior year as a result of an overall domestic loss. This treatment would be symmetrical with that currently accorded overall foreign losses.

We know that many ECAT companies will write separately and in greater detail to the Committee about these issues.

Returning to the Committee's longer-range goal of replacing the income tax with a wholly different tax system, we note that there are a number of competing proposals, each with its benefits and detriments, and each supported by different economists and theoreticians. In other words, the Committee work in this area is just beginning. Nevertheless, ECAT believes that any fundamental reform must be based on the following principles:

1. Any new tax must avoid double taxation of the earnings produced abroad by American affiliates competing in world markets.

2. Any new tax must be practical and well-considered, not theoretical or experimental. The Committee must not trade the frying pan for the fire, and must adjust with prudence and foresight an economy measured in trillions of dollars and an income tax that raises over $800 billion.

3. Any new tax must replace (in whole or part) -- but not add to -- our present income tax burden.

4. Any new tax should provide for fair transition from our current system -- for example, the new system cannot tax historical overseas earnings on which foreign taxes have already been paid.

5. Any new tax should encourage exports and direct American investment in foreign markets.

6. Any new tax should insure that imports and foreign businesses participating directly in our marketplace are taxed no less than our own participants.

7. Any new tax should be essentially revenue neutral, because prudent budget policies remain fundamentally important to economic expansion.

8. Any new tax should insure that the after-tax return on U.S. R&D is not undermined.

ECAT and its member companies will be pleased to assist the Committee and to participate in the dialogue as this very important initiative proceeds. We ask that this initial statement be included in the record.

Executive Summary

This study examines the role of U.S. multinational corporations in the U.S. economy from 1980 through 1991, with an emphasis on the manufacturing sector. Most of the data relating to U.S. multinational companies and their foreign affiliates are derived from official U.S. Government statistics, principally the U.S. Department of Commerce's annual survey, "U.S. Direct Investment Abroad: Operations of U.S. Companies and Their Foreign Affiliates." Comprehensive benchmark surveys were completed in 1982 and 1989. Data for intervening years are based on slightly less detailed annual surveys. Data on international financial flows related to direct investment were obtained from U.S. balance-of-payments statistics, as reported quarterly in the "Survey of Current Business."[4] International comparisons are based primarily on Organization for Economic Cooperation and Development (OECD) data.

The study shows conclusively that multinational companies made strongly positive contributions to the U.S. balance of payments throughout the 1980's and into the 1990's. They did so during a decade characterized by a massive deterioration of the U.S. trade balance, its international payments balance, and its global financial position. Indeed, multinational companies are now the single most positive factor in the U.S. balance of payments. Had it not been for the outstanding performance of multinational companies during the 1980's, the international economic position of the United States would have been far worse, given the weaker performance of corporations oriented primarily toward the domestic market.

The report's principal factual findings are as follows:

- ***The overseas business operations of U.S. multinational companies contributed a record net surplus of $130 billion in 1990 to the U.S. balance of payments.***

- ***For the total period, 1982 to 1990, U.S. multinational companies contributed an average net surplus of $83 billion annually to the U.S. balance of payments.***

The report demonstrates that overseas investment by U.S. multinational companies contributes to the health of the companies, to U.S. domestic employment and to the overall strength of the U.S. economy. Following are the detailed findings of the report.

I

American Companies With Overseas Investments Have Been Waging A Hard Fight — And A Successful One — To Keep Exports Flowing From The United States.

- *On the merchandise trade account, their surpluses rose from a net surplus of $46 billion in 1984 to a net surplus of $80 billion in 1990.*

- *These trade surpluses were earned in almost every industrial sector.*

By contrast, the overall U.S. trade balance for manufactures deteriorated steadily to a deficit of $125 billion in 1987, ending the decade in 1990 with a deficit of $73 billion. Without the enormous balance of payment surpluses of multinational companies, the state of the U.S. balance of payments would have been truly calamitous with concomitant adverse effects on the U.S. economy.

- *The dramatic deterioration of the U.S. merchandise trade balance in the first half of the 1980's was driven by clearly identifiable macroeconomic forces.*

The most important factors were the overvaluation of the U.S. dollar, up 37 percent in real terms against 40 leading international competitors from 1980-1985, and a rapid growth in U.S. domestic demand in 1982-1985 relative to other industrialized countries. Similarly, the subsequent recovery in U.S. exports and welcome improvements in the merchandise trade balance can be traced to a reversal in these macroeconomic trends. Had U.S. multinational firms not made foreign investments, the trade balance would have been far worse.

- *Exports by U.S. multinational companies have risen sharply since 1985. (Real U.S. export growth averaged 14 percent annually from 1986-1991, the highest for any five-year period in U.S. history.)*

- *U.S. exports accounted for 89 percent of U.S. economic growth during 1989-1991.*

- *U.S. multinational companies accounted for approximately two-thirds of U.S. manufactured exports.*

II

The Net Return On The Foreign Investments Of U.S. Multinational Companies Is The Most Positive Single Element In The U.S. Balance Of Payments Account With The Rest Of The World.

Not only have multinational firms achieved huge surpluses on trade account, the net repatriated earnings from their overseas investments have also been consistently positive as have their overall financial transactions.

- *For 1992, their net repatriated earnings reached $48 billion. These earnings — the share actually brought home to the United States — have been the most positive single entry in the U.S. balance of payments.*

* *While returning substantial trade and balance of payments surpluses to the United States, multinational companies continue to build their operations abroad, thereby assuring future returns. They do this primarily through the reinvestment of overseas earnings and not through the exports of funds from the United States.*

III
Investments Abroad Keep American Companies Competitive.

* *Investments overseas enable multinational companies to enjoy greater economies of scale, to solidify access to foreign markets, and to sustain the worldwide research and development activities indispensable to maintaining competitiveness in an increasingly global environment.*

U.S. firms and industries that have been the most aggressive in expanding global investments have also been the most successful in expanding both their U.S. exports and global market shares.

* *Industries with the highest levels of foreign investment have the highest rate of exports and export growth.*

Exports to overseas affiliates accounted for a steadily rising share of total exports by multinational companies and are correlated strongly and positively with growth in foreign affiliate sales. This demonstrates a critically important aspect of foreign investment by multinational companies, i.e. that exports follow investment.

* *The higher the share of U.S. direct manufacturing investment in a foreign country, the more likely the U.S. is to have a merchandise trade surplus with that country. (The relative paucity of U.S. direct investments in Japan, for example, is a major reason why U.S. exports to that country are relatively small.)*

IV
Foreign Investment Serves Foreign Markets.

* *The underlying motivation for foreign direct investment is to penetrate markets otherwise commercially inaccessible to U.S. firms and then to protect or expand market share. U.S. foreign affiliates thus predominantly serve the foreign markets where they are located — or third-country markets.*

* *Excluding Canada, only 7.2 percent of total sales by U.S. foreign manufacturing affiliates were to the U.S. market in 1990 — a percentage that was remarkably stable throughout the 1970's and 1980's.*

These numbers show that the increasing imports that have been entering the United States in the period covered are rarely being produced by affiliates of American companies. Accordingly, any restrictions on U.S. investment overseas would not meaningfully reduce imports as is often contended by opponents of foreign investments. Rather than replacing domestic production, foreign manufacturing by U.S.-based multinational companies has increased the volume of American exports.

Foreign investments result in exports of intermediate parts and components and may even produce an immediate foreign demand for U.S. capital goods for new facilities or modernization. These investments establish a market for exports of products associated with the goods produced abroad and for exports where local demand exceeds local productive capacity but does not warrant major expansion. Foreign investment helps popularize U.S. trademarks and brand names and to customize products to local need. It enables U.S. companies to put in the kind of service and distribution networks that could not be supported by exports alone.

V
The Growth In U.S. Multinational Companies' Exports And International Investments Has Generated Increased Employment For Their U.S. Workers.

* *In addition to their critical contribution to the U.S. balance of payments noted above, U.S. multinational companies have been and continue to be responsible for significant employment in the U.S. economy — much of which is generated by their foreign investment.*

* *The total number of U.S. jobs created directly or indirectly by the manufactured exports of U.S. multinational companies reached 5 million in 1990, based on U.S. Department of Commerce estimates of the number of manufacturing and nonmanufacturing jobs generated per billion dollars of manufactured exports.*

During the 1980's, manufacturing multinational companies had a better record on employment than the typical large U.S. manufacturing firm. With the economic downturn and increased pressure from foreign competitors, employment by U.S. multinational company parents fell slightly from 1982-1989. That decline, however, was substantially smaller than the decline in employment by Fortune 500 companies as a whole.

Findings

The above findings demonstrate that the simple contention that multinational companies are harming the U.S. economy by shifting jobs abroad and importing cheaper products into the United States does not bear up under scrutiny. Rather, the exact opposite is true. Investment abroad by multinational companies provides the platform for growth in exports *and* creates jobs in the United States.

The study provides data to back up the fact that companies that think and act globally set the pace for U.S. exports. For such companies, their foreign investments create a constant awareness of market opportunities for U.S. exports, which might otherwise go unnoticed.

As the business and consulting economists who prepared the earlier ECAT "Mainstay" study stated: "The conclusions ... about the operations of the multinational corporation are based on sound statistics. If they clash with judgments derived from a combination of isolated incidents and intuition, they can stand their ground."

And a Renewed Warning

There are, however, clouds on the horizon. As the U.S. economy continues its slow recovery and unemployment rates continue to be a concern, proposals have been put forward to limit the ability of multinational companies to invest abroad. Proposals have also been made to restrict the economic activities of foreign multinationals in the United States.

Enactment of such measures could cripple the international competitiveness of the U.S. economy. On the one hand, the proposals would curtail needed foreign capital for the U.S. economy. On the other, they would limit the ability of U.S. multinational companies to compete globally with firms from Japan, Germany and elsewhere — firms that are increasing their global market share at the expense of U.S. firms. The U.S. share of annual outflow of direct investment has dropped from two-thirds of the worldwide total in 1967 to one-fifth in 1988-1989. Over the same period, Japan's share grew from 2 percent to 28 percent. The share of the European Community grew from 28 percent to 48 percent.

This study — by measuring the benefits that flow to the U.S. economy from the exports and foreign earnings of multinational companies — shows:

> *First, that investment restrictions could cut into our major surplus balance of payments account with the rest of the world; and*
>
> *Second, by its analysis of how the exports of multinational companies exceed imports by tens of billions of dollars each year, that limits on investment would reduce U.S. exports. This could lead to a chain reaction, lowering the level of world trade, and diminishing the welfare of all participants.*

The numbers in the report establish the positive correlation between investments abroad by multinationals and the propensity of foreign countries to import American products. This gives statistical support to the view that investments mean more access to markets.

Perhaps the most important conclusion validated by the report's data is that multilateral approaches to international trade and investment issues work well. In a foreword to an early ECAT study (and reiterated in ECAT's first "Mainstay" publication) President Dwight D. Eisenhower warned against a return to "an inept, selfish and self-defeating system of economic nationalism." The data in this new study makes even clearer the importance of maintaining the hard-won open system of global trade and investment. In particular, it details the improvement in the U.S. balance of trade that began in 1985 when governments worked together on the problem of the overvalued dollar. And it then shows how American multinationals set the pace in the turn-around in trade that followed —making the case that other difficulties can also be dealt with in a similar fashion without undue or unnecessary risk to U.S. competitiveness, domestic jobs or international economic progress.

Chairman ARCHER. Thank you, Mr. Warren.

We do have to go to vote, and I am going to have to excuse myself shortly, but I want to quickly ask a question or two and hopefully get some brief answers.

Is it true foreign countries tax their own corporations' foreign-source income only if they are operating in countries which have an income tax?

Mr. CONWAY. I would say, Mr. Chairman, that I would like to take a crack at that. The answer is no. There are situations like Japan, for example, where they have tax sparing. So that, if a Japanese company is able to take advantage of a local tax incentive, they will essentially be able to preserve that.

When they repatriate the income back to Japan, they can preserve the low taxed income. They aren't taxed up to the full Japanese rate. So they can take advantage of lower taxes outside of their jurisdiction.

Japan has a double system like the United States but it is far more business oriented and designed to encourage foreign and direct investment.

Chairman ARCHER. Then, would it be fair to say that most European countries tax foreign-source income only when their corporations operate in foreign countries that have an income tax?

Ms. DUNAHOO. I think it is impossible to make a blanket statement on that question.

Chairman ARCHER. Are there a number of countries that operate that way?

Ms. DUNAHOO. The law varies from country to country. For instance, in the Netherlands, they have a territorial system and just exempt foreign-source income, even when it is brought back and paid as dividends to the Netherlands' parent from other countries.

Chairman ARCHER. Maybe I am not making my question clear. Most all of our industrial competitors do not tax foreign-source income. But is it not also true that there is a provision in their law that says that that applies only where the foreign country in which the income is earned has an income tax? Since offshore countries have income taxes, the foreign-source income is not taxed. Is that not generally a fair statement?

Ms. DUNAHOO. That is probably true in the case of most countries.

Chairman ARCHER. OK. Mr. Warren, although you said you were not going to take a position between the various proposals, I listened carefully to what you said. I thought you said replace the current income tax. Now, that says to me that a flat tax doesn't qualify because it is still an income tax.

Mr. WARREN. Well, our position was that if you are going to enact a new tax system, it should be a complete replacement for the old system. Let us not have two systems simultaneously taxing with the added complexities.

Chairman ARCHER. So complete replacement does not mean discontinuing taxing income as the base and perhaps having two rates and having a number of deductions. But it would still be considered to be a replacement of the current income tax.

Mr. WARREN. What we are urging is simplification. Simplification is not achieved by having multiple tax systems.

Chairman ARCHER. You are hedging all of your bets. I just wanted to be sure I understood.

I am going to go vote, but I would like for you to submit for the record or perhaps testify about, how PFIC and 956A work against investment in this country, and promote investment in foreign countries because I don't think that the majority of my colleagues understand that. I personally agree with you that we should repeal PFIC and 956A. However, we need the information in the record as to precisely how these provisions work against the best interests of this country.

Mr. WARREN. Thank you, Mr. Chairman.

[The following was subsequently received:]

SUPPLEMENTAL STATEMENT
OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE
TO THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 13, 1997

At hearings last July on fundamental tax reform, Chairman Archer commented critically on the PFIC provisions of the Internal Revenue Code in questioning ECAT's witness. Staff of the Ways and Means Committee recently contacted ECAT requesting a short, supplemental statement expressing ECAT's views on PFICs. ECAT is pleased to respond as follows:

"In hearings on July 18, 1996, Chairman Archer expressed his personal view that the PFIC provisions of the Internal Revenue Code should be repealed because they work negatively against the best interest of this country. ECAT agrees.

The PFIC provisions levy a current U.S. tax on a foreign corporation with U.S. shareholders if the foreign corporation has "too much" capital or makes "too much" non-operating income. The PFIC provisions are another "anti-deferral" regime. American companies competing abroad are already subject to the anti-deferral regime of Subpart F. Now they must run the twin gauntlets of Subpart F and PFIC with respect to the earnings of their foreign affiliates. If they fail either, money generated by a foreign affiliate in a foreign site and still residing in that foreign business is taxed in the U.S. currently. This is a complicated and costly burden not borne by our competitors.

The PFIC provisions were borne of the misguided notion that American investment abroad is tax-motivated and harmful to our economy. Of course, American companies invest abroad for business, not tax reasons -- that is where the resources and markets are that spur the growth and undergird the prosperity of the American economy. America needs its companies to sell computers and software in the EU; trucks, autos, and parts in the booming economies of Southeast Asia; turbines, boilers, pipeline, and engineering services for construction projects in China and the Mid-East; consumer goods in Canada and Mexico; and pharmaceuticals to the sick and elderly of the world. To do this, American business must have -- directly in the markets in question -- marketing and distribution systems, warehouses and parts depots, assembly and manufacturing operations, service and repair facilities, and the like.

Most importantly, to do all this so as to compete effectively abroad, American businesses need *capital*. The PFIC provisions are offbase in adjudging that a U.S.-controlled foreign corporation can have "too much" capital. These provisions make no allowance for the accumulation of capital necessary, for example, to build state-of-the-art manufacturing facilities to service foreign markets, or to purchase the sophisticated equipment necessary to compete against the best the Germans, Japanese, or others have to offer.

Congress recognized a similar misstep when it repealed section 956A last year. Now it should repeal the application of PFIC to American businesses already covered by Subpart F. Or, at a minimum, repeal the portion of the PFIC provisions that apply to the accumulation of capital, while retaining that portion that applies to the generation of "too much" non-operating income (as a safeguard against the rare abuse).

If American business done abroad is taxed fairly here -- with non-duplicative, administrable provisions that recognize the legitimate capital needs inherent in a global marketplace -- American business will be able to compete with anyone in the world."

Mr. HANCOCK [presiding]. The subject is quite obvious, but there are some questions we would like to get some comments on and become part of the record.

Ms. Dunahoo—is that right, "Dunahoo"?

Ms. DUNAHOO. "Dunahoo," right.

Mr. HANCOCK. Your testimony raises an interesting issue, and that is, How will foreign governments respond to our tax restructuring efforts?

As a practical matter, how do you think it will be for the United States to enact tax restructuring legislation that is acceptable to most, if not all, of our major trading partners?

Ms. DUNAHOO. Well, I think, as I mentioned briefly in my oral statement, it is very difficult to predict how other countries will react, and they all are not likely to react in the same way.

What we have done is identify some of the major possibilities, but I think it will depend to a great extent on exactly how the fundamental tax reform is structured; for instance, whether the United States not only repeals its income tax, but also repeals withholding taxes on portfolio investment income paid out to foreign persons. If we repeal both of those, then the United States becomes, from the perspective of other countries, a potential magnet for investment capital, and it is not hard to imagine that other countries might be unsettled by a sudden outflow of capital from their countries. Obviously, the degree to which that is a risk depends on exactly how the tax system is structured.

It is difficult to predict how other countries would react in the case of treaties because treaties fulfill so many different functions in the international tax system. The one that receives the most play, really, is the reduction of withholding taxes on cross-border flows of income, and those reductions are normally negotiated as a reciprocal matter.

If the United States moved to unilaterally repeal its withholding taxes on all investment income leaving the country, then the other countries might very well feel that they have nothing additional to gain in that regard by entering into a treaty or by maintaining a treaty relationship with the United States.

On the other hand, they may think, Well, we have to reduce what are typically very high statutory withholding rates in order to continue to attract U.S. capital to their countries.

So I am afraid we aren't really in a position to offer any assurances on this issue either. I think it is something that deserves a lot more exploration and perhaps discussion with other countries.

Mr. HANCOCK. Mr. Warren, in your testimony, you cautioned the Committee against passing any legislative treaty overrides. Would you share with the Committee some of the practical problems caused by legislative treaty overrides?

Mr. WARREN. In international business, part of the international business community, we rely on the existing tax treaty network to build a system not only of fair taxation between countries based on country-to-country negotiation, but also a system to resolve international tax audit disputes through what is commonly referred to as the competent authority process.

Tax treaty overrides through legislation based on, let us call it, broad principles of overriding issues, lead to a great deal of tension between countries. Our fear is it will make it more and more difficult to resolve existing audit issues and interpret existing statutes.

We rely on and invest in foreign countries in anticipation of certain tax rates applying to dividend flows coming back to the United States.

For a treaty to be entered into, again, based on bilateral negotiations and then overridden after 3, 4, or 5 years, or perhaps later, simply leads to tension between the two countries and trade barriers we think are not in the best interest of the United States from an economic standpoint.

Mr. HANCOCK. Also, in your testimony, you note that a restructured tax system should encourage exports and U.S. investments. I think we are all trying to get there.

Do you have any specific proposals you feel would achieve either or both of these objectives, and if so, would you share it with the Committee?

Mr. WARREN. As a company, TRW exports a number of parts and services to our foreign affiliates.

The existing Tax Code through the sourcing rule, what is commonly referred to as the 863(b) foreign sourcing rules for export sales, is certainly an incentive. We use those rules in doing sourcing studies, and it does result in direct exports from the United States.

The foreign sales corporation rules, again, go into the same studies. For example, if we have an opportunity or a need for a German affiliate to buy parts, we might be able to source those parts out of Spain, out of the United Kingdom, or out of the United States. The existing Tax Code does encourage U.S. exports of related parts, and it does generate exports. I think that is the type of rules that need to be solidified. From time to time, they do come under attack through different proposals being offered within the Congress, and I think it is important Congress understand that those rules do work, they are used, and they do generate U.S. exports.

Mr. HANCOCK. Thank you, Mr. Warren. Mr. Kaufman, how important a role does the section 911 exclusion play when U.S. businesses are recruiting employees for work in a developing country?

Mr. KAUFMAN. The section 911 exclusion plays a very important role when we are moving into developing countries. Many developing countries might have a lower tax rate in order to try to get investment within their country. So, therefore, foreign tax credits alone won't remove the U.S. tax. We need the section 911 exclusion or else the American simply costs more to go into that developing country than the German or the Japanese or the Swede or the citizen of any other country in the world. This is a very clear situation. In comparison to any other industrialized country, we are the only ones that would tax the American while they work abroad. So, without section 911, we are putting ourselves at a disadvantage when we are trying to move into those emerging markets.

Mr. HANCOCK. Mr. Conway, your testimony briefly referred to section 956A and the PFIC rules. Can you tell the Committee how these provisions have affected your particular company's business?

Mr. CONWAY. Sure. The 956A rule requires essentially that the U.S. company, like UTC, do a calculation at the end of every quarter of business to determine how much cash we have accumulated in our corporations outside of the United States, and these companies are operating companies that are generating active income outside the United States Now, with the enactment of 956A, what happens is we have to do a computation to determine whether or not we exceed the 25-percent threshold because, if we do, deferral has been terminated, and we have experienced this second level of taxation.

The problem here, as I said before, is we want to use the cash generated from these offshore operations to fund our expansion into these emerging markets, and the fact of the matter is, for example, we are in the elevator service business. When we enter into these emerging markets, the way we can obtain business is through partnerships. We just can't go in and construct new buildings, so there will be new elevators. We have to compete for the existing contracts.

So we use cash to do that, and once we are in the market and we are increasing the business, we want to use the cash generated in the foreign market. We don't want to have to repatriate it back to the United States, incur an additional level of taxation, withholding tax, and then have to reinvest it back outside of the United States.

By the same token, we want to make sure that the U.S. cash that we generate is available for our U.S. needs. I refer to our research and development expenditures.

So 956A has the effect for us of partially repealing deferral, and it means that at the end of every quarter, UTC has to do a calculation. We have 300 corporations operating outside the United States who are potentially impacted by this rule, and it involves not only the tax people. You have to get finance people, business people involved in looking at the numbers to see if 956A applies. There is a tremendous opportunity cost that is associated with the complexity of our foreign international tax system that needs to be recognized. It is a major detriment to U.S. companies.

Mr. HANCOCK. Thank you very much.

Mr. Gibbons, the Ranking Member.

Mr. GIBBONS. Thank you very much.

I appreciate all of you coming here and telling us about your problems. I hate to throw cold water on anybody's parade, but having been around here a while, I don't think Congress possesses the ability to go back and to really readjust all of these very complex income tax problems that you all are concerned with and that we largely created here.

I have watched the deterioration of the process over the years, and I have become pretty convinced that Congress just will not go back and undo all the horror stories we have imposed upon you, but that we may take a chance and go for something brandnew that will give you an opportunity to compete more fairly in the international marketplace. So that is where my remarks are directed.

Ms. Dunahoo, I think you were wise to say that whatever we do, there is going to be some kind of international response to it. So I think that what we should try to do is to join the international parade as far as taxes are concerned and to be in a position where there will be the least amount of criticism of what we do in all of that, and that is why I have gone to a destination-principle, subtraction-method, value-added tax because I think it will be the cleanest.

I don't see how any of our foreign competitors can really oppose our applying it or treat us unfairly because of that. Essentially, I think they are heading in that direction.

Mr. Warren, I would like to think Congress could go back and correct all of the horror stories that you lay out there, but it is just not in the cards. I know these folks really well. I respect them all, but I just don't think we have got the desire to go back and fight all of those battles, those rearguard actions, but I do think that there is a growing groundswell within Congress here to do that.

Mr. Kaufman, I realize we have made the American worker the most expensive to hire, the last hired, the first fired, and not only does it have an impact on American employment, but it has a huge impact on our trade position because Americans, when they are hired, tend to purchase from American concerns. They tend to design into the product, the American product, the American subcomponents, and we have played a stupid game in taxing Americans' personal income, so that we make Americans very unattractive as far as hiring is concerned in foreign environments.

So I applaud each of your coming here. I hope we can all join hands somewhere down the road and realize that we have got to move forward and we can't go back and repair the horror stories we have imposed upon you.

Thank you very much for coming and helping us with this.

Mr. HANCOCK. Thank you.

Mr. Laughlin, the gentleman from Texas.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Conway, how difficult does the Tax Code's current international tax rules make it for U.S. companies to compete overseas, and would you tell us why?

Mr. CONWAY. I think there are essentially two aspects, one procedure and one substantive.

Number one, we have to have a mechanism in place to deal with our second layer of taxation. So we have to have a tax department. We have to collect a significant amount of financial information from our overseas operations in order to comply with the laws.

In addition, we have to get the business people involved to focus on that information to make sure it is accurate, to update it, and when we have tax audits, inevitably, we get them involved in verifying all of this information. So there is a tremendous amount of time and effort that is involved in making sure we comply with the system, but more importantly, where we suffer, I think the major competitive disadvantage is when we are trying to compete in the market with, say, a company from Germany, like the Schindler Co.

If we are competing in an emerging market somewhere in Latin America or in the Far East and we are both looking at an acquisition, there are many cases where our people will come in with projects that are impacted by these rules.

Recently, I was involved in such a project. We were going to acquire a 49-percent interest in an existing business that had a good market share in a market that is important to us. I pointed out to our business people that we were going to be at an economic disadvantage because, in doing the foreign tax credit calculation, there would be inefficiencies. We would have to do a separate calculation for this particular entity, and there are 30 entities we have to do that calculation for each year.

I am not complaining about the fact we have to do the calculation, but there is a built-in inefficiency in putting this company in a separate foreign tax credit calculation basket. If the taxes are higher than the U.S. rate, we are precluded from averaging them in. If they are lower than the U.S. rate, we wind up paying the additional U.S. tax.

Our average tax burden on that particular acquisition goes up dramatically, and I can tell you the Schindler Co., a German-based competitor, is not subject to that. So it is inhibiting our ability to compete. It is an economic factor in competing against these other companies.

The other thing we are talking about is double taxation. In fact, what we have is triple taxation. Most of our competitors outside the United States have imputation systems where the corporate tax is a credit to the shareholder tax, so that they tax income earned by a business once.

In the United States, our income is taxed potentially three times, and I recognize there is a need to raise revenue, and we can adjust the rate, but we have three levels of taxation, three tax systems to maintain. When you look at this on an operating basis, it does have a significant material adverse impact. It is not just the people in the tax department who are affected by this. It affects our ability to compete as a business.

Mr. LAUGHLIN. Mr. Kaufman, your testimony states that studies and statistical data are available to show a direct correlation between the number of Americans working overseas and the level of U.S. exports. Could you furnish the Committee with some of these statistics and the data?

Mr. KAUFMAN. Yes, I would be very pleased to, and I will make available to the Committee both of our full studies.

A number of studies were done in the seventies and also in the eighties. We have now completed two additional reports in the nineties with the most recent data available. As Congressman Gibbons commented, when you have the American overseas who is there designing that plant, bringing over the heavy equipment to dig out the area and build that plant, they are going to purchase equipment from the companies they are most familiar with. These studies show how many people benefit from Americans abroad buying from the American companies they are used to, and how that generates an enormous number of additional new jobs. We will supply these reports to the Committee.

[The following was subsequently received. The studies are being retained in the Committee's files.]

SECTION 911 SURVEY RESULTS ARE IN

Survey Finds Exclusion is Especially Important to Small & Medium-Sized Companies

The Section 911 Coalition recently announced the findings of its "American Competitiveness Survey" undertaken in 1995. With nearly 150 companies and associations responding to the survey, it represents the largest and most broad-based Section 911 survey ever conducted.

The six-page survey examined the importance of the $70,000 foreign earned income exclusion (under Section 911 of the U.S. Tax Code) and its impact on America's global competitiveness. A report prepared by economists at the Johns Hopkins University School of Advanced International Studies, Drs. Charles Pearson and James Riedel, found that:

- The Section 911 exclusion is especially important to small and medium-sized firms (including International and American schools abroad), which are at least ten times more dependent on Section 911 than are the large firms that were surveyed. Eighty-two percent of small and medium-sized firms said that a loss of the exclusion would result in a moderate (6 to 25 percent) or major (above 25 percent) change in their ability to compete abroad.

- Nearly two-thirds (65 percent) of respondents felt that their ability to secure projects and compete abroad would be improved if the current exclusion ($70,000) were raised to $100,000 -- as proposed in H.R. 57 by Rep. Bill Archer, Chairman of the House Ways and Means Committee.

- Americans abroad showed a strong tendency to source goods and services produced in the United States. Seventy-seven percent of respondents said that nationality has an effect on sourcing decisions. Among small and medium-sized firms, the number is even higher: 89 percent said their American expatriate employees prefer to Buy American.

- Compensation costs are significant in determining whether or not to hire U.S. nationals overseas, and the Section 911 exclusion is important in holding down compensation costs. Eighty percent of respondents said elimination of Section 911 would have a moderate or major negative effect on compensation costs, with 66 percent saying elimination of the exclusion would have an important negative impact on future hiring practices.

The survey results strongly suggest that the Section 911 exclusion plays a key role in America's competitiveness and the creation of U.S. jobs through exports. For further information, please contact the Section 911 Coalition.

HIGHLIGHTS OF THE PRICE WATERHOUSE STUDY

An Economic Analysis of the Section 911 Foreign Earned Income Exclusion

Price Waterhouse LLP, in a recent study prepared for the Section 911 Coalition, found that:

- The U.S. is the only major industrial country that does not completely exempt from taxation the foreign earned income of its citizens working abroad.

- Because the Section 911 exclusion is not adjusted for inflation, its real value has dropped by 43 percent since 1982. If the exclusion had been adjusted for inflation since it was set at $70,000 in 1987, the exclusion would be $94,000 as of 1995, rising to over $111,000 in the year 2000. If the exclusion is not indexed for inflation, its value will continue to decline.

- Without the Section 911 exclusion, compensation levels for Americans abroad would need to increase by an average of 7.19 percent to preserve after-tax income. Section 911 was shown to provide benefits in both low tax and high tax nations. Moreover, the exclusion represents a larger share of the compensation of *low* income than of *high* income Americans working abroad.

- A 7.19 percent increase in required compensation would result in a 2.83 percent decrease in Americans working abroad. Without Section 911, U.S. exports would decline by 1.89 percent or $8.7 billion. This translates into a loss of approximately 143,000 U.S.-based jobs. [N.B.- These figures do not include service-related jobs or indirect employment, which would likely double the number of jobs lost.]

- From a tax policy standpoint, the 911 exclusion meets the traditional standards for evaluating income tax provisions: *Fairness* -- Absent Section 911, Americans working abroad would pay much higher taxes than U.S.-based workers with the same base pay. *Economic efficiency* -- Absent 911, U.S. tax law would discourage U.S. companies from hiring Americans in overseas positions, causing foreign nationals to be hired even where Americans would, but for taxes, be preferred. *Simplicity* -- The current structure of Section 911 was specifically enacted by Congress in 1981 in reaction to the unmanageable complexity of the rules enacted in 1978.

- Section 911 also adheres to three additional tax policy standards often used to evaluate provisions that affect international income: *Competitiveness* -- The competitiveness standard, that U.S. capital and labor employed in foreign markets bear the same tax burden as foreign capital and labor in those markets, would be achieved if the U.S. excluded *all* foreign earned income (without the $70,000 cap). *Protecting the U.S. tax base* -- Section 911 applies only to income that is earned abroad for activities that are performed abroad by individuals who are not residents of the USA. *Harmonization* -- True harmonization with other nations would require an unlimited exclusion, as was in effect in the USA from 1926 to 1952.

Mr. LAUGHLIN. If our new restructured tax system adopted a territorial system of taxation, wouldn't that be preferable to the current 911 exclusion?

Mr. KAUFMAN. Yes, it would because then you would put us on an even footing with the non-American companies. So that, if we are to compete against the Japanese or the British or anyone else, we would be in the same position, and therefore, we wouldn't have a disadvantage.

Section 911 only covers some of the increased cost, not the full amount.

Mr. LAUGHLIN. To anyone on the panel, what country or countries do you think have tax and trade policies that have been developed to allow their businesses and individuals to compete most effectively in today's global markets?

Mr. WARREN. I guess I would like to answer that, if I could. For example, Germany, I might point out, does not tax foreign-source income. So German competitors that we work against and with every day can expand overseas, can compete head to head with us in the United States, for example, but when those earnings they make in the United States are repatriated back to Germany, there is no additional tax. They are excluded from further tax in Germany.

There are many other countries. Japan is an example, although it has a worldwide system of taxation. It encourages foreign investments. We have seen the results of that.

We aren't afraid to compete with companies from these countries, but the fact that they receive preferential treatment in their home countries, whereas international investments by U.S. companies are discouraged by the U.S. Tax Code, makes it very difficult to compete.

Mr. LAUGHLIN. To anyone else on the panel, as a matter of tax and trade policies, do you think our current tax restructuring effort should take into account tariffs or should it only focus on the income tax, and what is the reason for the position you take in answering this question?

Mr. CONWAY. I would suggest that we would want to take tariffs into account. I don't think we should consider taxes in isolation. I just think you have to look at the whole trade picture.

I would think we would want to take it into account, but I think in looking at taxes, what we need to do is view U.S. business as competing in the global Olympics, and we want to level the playingfield. We want to take into account tariffs, but we don't want to put American companies at a disadvantage with respect to other multinationals.

Mr. WARREN. If I could just elaborate on that, too, I would also agree that any reformation of the tax system needs to look at all taxes, not just single taxes in an isolated format. The objective needs to be to create a balanced system and raise the proper amount of revenue, of course, in a fair and simple manner, but also encourage U.S. economic activity, including international activity.

Mr. LAUGHLIN. Ms. Dunahoo, you were nodding your head. Would you like to add to the comments?

Ms. DUNAHOO. I was just agreeing with what Mr. Conway said about tariffs. I think it makes good sense to look at the systems together.

In the context of tariffs, of course, you have additional considerations regarding international trade agreements, but in the context of fundamental tax reform, it is a good suggestion.

Mr. LAUGHLIN. You have brought up the last area, and you may not want to answer, but the others or all of you may want to, and that is within international trade agreements. Do you think the impact of international trade agreements, such as GATT and NAFTA, should be reviewed as a part of our tax restructuring efforts, and why?

Mr. WARREN. I don't think it can be separated. Again, the study of tax, the existing Tax Code, is very much tied to the study of the international provisions, in particular, the overall treaty and trade agreements process, whether we are talking about trade agreements such as NAFTA or specific tax treaties.

I think all of it needs to be taken into account. Again, the objective of the United States needs to be to develop a system and encourage a system that results in increased economic activity, both in the United States and with foreign investments.

As I have indicated, we invest globally to meet the demands of customers. We can't sell to Volkswagen in Germany, for example, by building a plant in the United States, shipping the product to the east coast, putting it on a ship, shipping it to Germany, transporting it by train to a Volkswagen plant somewhere in the remote part of Germany for just-in-time inventory.

Nevertheless, our investment in Germany, in a plant in Germany, to sell to Volkswagen results in increased economic activity in the United States through sales of parts. That is the type of activity that needs to be encouraged and not discouraged, and all factors, whether we are talking tariffs, income taxes, or other trade policies, need to be considered.

Mr. CONWAY. I would just like to add that we export over $3 billion a year in goods. We are the country's 15th largest exporter. So free trade is critical to us, as important as taxes, and we want to make sure the markets are open and that that is taken into account in looking at our tax system.

Mr. HANCOCK. The gentleman's time has expired.

Mr. LAUGHLIN. Thank you, Mr. Chairman, and thank you, Mr. Gibbons, for allowing me to complete these questions.

Mr. HANCOCK. Mr. Houghton, from New York.

Mr. HOUGHTON. Yes. Thank you very much.

Ladies and gentlemen, I am delighted you are here. Thank you very much. I am sorry I have been sort of peripatetic, in and out of here, but because of the votes, I have had to do that.

I understand what you are saying. You want to be competitive and you don't want to be at a disadvantage when you are doing business overseas, but let me take the opposite approach for 1 moment.

Clearly, although you used Germany as an example, you wouldn't want to live in Germany. They have 12 percent unemployment. They have a social net that makes their competitive situation even worse than ours.

Now, are there any advantages? I know there are a lot of disadvantages of our tax system. Are there any advantages of our international tax system, any compared to Germany at this moment?

Mr. WARREN. Going back to my German example, it is very difficult to point to a net advantage of the U.S. tax system.

I can point to specific provisions of the U.S. Tax Code that make it possible for us to compete on certain types of sales, certain types of markets.

I mentioned earlier the 863(b) sourcing rules and the foreign sales corporation rules, both of which encourage U.S. exports and make a difficult, complex U.S. tax system environment possible to work in for particular types of sales.

On the other hand, we look around at our German competitors that also compete here in the United States against us on specific markets, and we know from our study of the German tax law that they can earn the income in the United States, and repatriate the earnings back to Germany without any further tax. I think that is a net disadvantage of the U.S. Tax Code.

Mr. HOUGHTON. I just have one other question, Mr. Chairman.

Maybe you could tell me in dollar amounts or percentage amounts what the impact is on your business vis-a-vis competing with a German company and an American company. In other words, is it a 10-percent disadvantage? Is it a 5-percent disadvantage? Is it a 20-percent disadvantage? Is it a wash? What is it? Tell me in specific terms.

Mr. WARREN. I have never quantified it as a percent. I think the part that is most significant to us from a financial standpoint on a bottom-line basis is the resourcing of U.S. interest expense—25 percent of our U.S. interest expense, and we have about $1 billion in debt.

Mr. HOUGHTON. Could I just interrupt? In other words, you don't have sort of a net figure?

Mr. WARREN. I do not have a net figure.

Mr. HOUGHTON. Does anyone have a net figure?

I am not trying to cut you off. I am just interested in this.

Does anybody have a net figure? Do you have any sense of what competitive dollar or percentage disadvantage this gives you?

Does Coopers in terms of any of the companies it does business with? Do you have any feeling?

Mr. KAUFMAN. If I narrowed it down to the area that I am speaking of, of the American overseas, and if you put someone into a zero tax jurisdiction, such as Saudi Arabia, you would often be putting the American company at perhaps as high as a 20-percent disadvantage when they are bidding for a contract. Employment is a large percentage of that major contract and with the $70,000 exclusion, some of the American's tax will place the U.S. firm at a cost disadvantage, but on all those other things——

Mr. HOUGHTON. So you are saying in Saudi Arabia for an American company, it has a 20-percent tax disadvantage versus a Germany company doing business in Saudi Arabia?

Mr. KAUFMAN. To have the American in Saudi Arabia, it could cost you as much as 20 percent more than the company that sends a German in, not their total tax structure, but just about the idea of moving the American expatriate in.

Mr. HOUGHTON. Is that the worst example? Are there other examples?

Mr. KAUFMAN. When you go into the lowest tax countries or zero-tax countries, like Saudi Arabia, that is where the percentage is higher. If you go into other countries, if you send them to Hong Kong with a 15-percent tax rate, there you may be down to a 10-percent differential. Every place you go, there is a detriment.

Mr. GIBBONS. Would the gentleman from New York yield?

Mr. HOUGHTON. Yes, sir.

Mr. GIBBONS. I have calculated that we spend more money trying to collect taxes on foreign income—I am talking about the Federal Government—than we actually collect. So we have a 100-percent loss here. We penalize our businesses. We penalize our jobs. We penalize our profits, and we spend more money trying to collect the foreign tax than we actually collect.

Mr. HOUGHTON. Right. That is sometimes true here in this country, also.

Mr. GIBBONS. Well, I realize that, but we are just talking about foreign countries.

Mr. HOUGHTON. That is right. That is right.

Really, I have to run. That is the end of my questions, and I appreciate it very much, unless the other two gentlemen or lady has any comment.

Mr. CONWAY. The only thing I would add is that to the extent that a company has excess foreign tax credits, I think in some years in United Technologies, we have had excess foreign tax credits. We haven't been able to use all of our foreign tax credits, and the situation that that leads to is that the interest allocation, the allocation of interest expense and the allocation of research and development, effectively, R&D becomes nondeductible to the extent we have excess credits, and there has been some years where that has been several millions of dollars. So there is a direct measurable impact in that regard.

The thing that concerns me more are the transactions and the market opportunities that we are not pursuing because of some of these impacts.

Mr. HOUGHTON. Right. Thank you very much.

Thank you, Mr. Chairman.

Mr. HANCOCK. The gentleman from Ohio, Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman, and thank you all for being here.

It is critical we get into this. Obviously, I think there are a lot of problems in our current tax system as it relates to our international competitiveness.

Speaking as a former international trade lawyer, I used to run into those problems constantly, and it is also important that as we have this opportunity to reform our Tax Code, overhaul it in a major way, that we look at the international aspects and see what we can do to encourage exports and our competitiveness.

Amo Houghton has looked at the foreign tax issues a lot, and Mr. Gibbons has looked a lot at the international trade issues. So I am very pleased we are having this hearing.

I would like to follow up with Mr. Kaufman for 1 minute on section 911. As you noted in your testimony, it exempts $70,000. In the Saudi example, then you are assuming that the U.S. executive is receiving in excess of $70,000. Whatever that excess is, he is being taxed at a U.S. rate. Whereas, the foreign national from Germany or somewhere else has no income tax because it is territorial, and the Saudis don't have an income tax.

Mr. KAUFMAN. That is absolutely correct.

Mr. PORTMAN. OK. If we were to move to some kind of consumption tax, let us say a type of VAT tax, or a national sales tax even, what would you recommend we do with regard to 911?

Mr. KAUFMAN. Well, as I understand those taxes, we are looking at a territorial consumption tax, and therefore, if we do keep it at the borders, then when that American is in Saudi Arabia, there will not be any U.S. consumption upon which to tax them. That, then, puts us on a level playingfield with, using your example, the German.

So now when I send that engineer to work in the plant, yes, they get their base salary, they get their cost of living, housing, education, clearly above $70,000, but now it is not going to be taxed, and they are going to be in the same position as the German or the Japanese. Now we are on a level playingfield, and the American companies can be competitive.

Mr. PORTMAN. So, in all of those instances, whether it is the VAT tax or any kind of consumption tax, it doesn't apply to income. You would recommend not applying any U.S. tax; in other words, having, in essence, a territorial tax treatment.

Mr. KAUFMAN. Territorial. Then we would be in the same position as all of our competitors, and therefore, we would be removing an impediment to us to be competitive.

Mr. PORTMAN. I assume you would recommend the same thing with a flat tax?

Mr. KAUFMAN. Yes.

Mr. PORTMAN. Even though there would be the calculation of income and some mechanism to do that.

Ms. Dunahoo, under the current system, we have tax incentives for corporations. I think you have addressed this some in your testimony, as I saw, and I just wonder what your view was as to criteria we should use under, again, either a consumption-type system or a flat tax-type system, a simpler flat tax without getting into the specifics of what deductions might be available. Should we do anything special with regard to our exporting companies or with regard to our foreign investments in terms of tax incentives?

Ms. DUNAHOO. I think it is clear the consumption-based proposals that are on the table today don't contemplate an explicit export incentive, and those export incentives that are provided by current U.S. law are very important in encouraging exports, that is domestic production with exports offshore.

The point of our testimony, I think what we would like to stress, is that the potential effects of moving away from those incentives should be very carefully considered. It would be a pity if those proposals were repealed inadvertently without serious consideration of .e effects.

Mr. PORTMAN. Specifically, which ones do you think should survive in an era of either a flat tax or a consumption-type tax?

Ms. DUNAHOO. Well, the proposals that are included in current law relative to exports are the foreign sales company rules and the export source rules of section 863(b).

The International Tax Policy Forum is not advocating any particular proposal going forward. I think the Committee should take a very broad view and look at matters systemically. So I don't believe that we are taking the position that those exact provisions would need to remain. However, I think it should be carefully considered before a system is adopted that does not provide any export incentive.

Mr. PORTMAN. Any other comments about existing incentives and whether they should survive in a new era?

Mr. CONWAY. Yes, Mr. Portman. I would like to add that I think research and development is a critical area that we have to take a good look at.

As I said, we spend $1 billion a year on research and development at United Technologies, $700 million in the United States, and although we don't get the R&D credit currently because of the rules, that is something from an international standpoint that we may need to take a look at because a number of jurisdictions have R&D incentives, not only deductions, but greater than 100 percent deductions, flat-rate credit systems, and I think certainly for United Technologies and FEI member companies, R&D is the key, we think, to the future and the ability to compete not only in the United States, but around the world. So we would think that R&D would be right up at the top of the list in terms of things to look at in moving away from the current income tax system. If we need a special incentive, that would be high on the list.

Mr. PORTMAN. And the allocation for foreign research, you would like to see clarified as well. Is that 861?

Mr. CONWAY. Yes, 861–A.

Mr. PORTMAN. Any other comments?

Mr. WARREN. No. I would just also like to emphasize the importance of R&D from an international competitiveness standpoint and urge that Congress ensure that U.S. R&D is encouraged and fairly treated, both from an allocation, 861 standpoint, and from an R&D credit standpoint.

Mr. PORTMAN. The R&D comments were, of course, very timely. We are about to go into conference on that, and I appreciate your statements.

Thank you.

Mr. GIBBONS. May I ask a question here? I have listened to all of this with a great interest, and I understand the need for preserving R&D tax credits as long as we have income tax system, but I think what Chairman Archer is talking about and what I am talking about is getting rid of an income tax system. Now, under a consumption-type system, to draw a parallel, you would be expensing all of your R&D immediately under a consumption-type tax system, which beats a deduction as far as that is concerned.

So, Ms. Dunahoo, the concerns that you raised and the concerns that, I think, all of the panel shares, if you go to the proposal I am putting forward, you wouldn't have to worry about all of those things because there would be no income tax, and you would, in effect, be expensing all of those things immediately.

From Mr. Kaufman's point of view, you wouldn't make the American the last hired, the first fired, the most expensive employee on your payroll.

I think that is where we need to go. Is there dissent on that?

Mr. CONWAY. I think I agree. Directionally, I agree with you. The only thing I would suggest is that in looking at the deduction for R&D or the immediate expensing of it, we need to be mindful that we don't need a foreign tax credit if we don't have an income tax system, but we might want to consider some kind of increased expensing recognition for R&D because of its special nature.

In other words, in Australia, it is immediately expensed, but the level of expense is 150 percent of the expenditure. So there is an additional incentive for R&D. It is given in the form of an added benefit on the expensing, not a credit. So there is a mechanism to do it, and I just think that, certainly, it is far preferable to be able to know that you are going to be able to immediately deduct the R&D that you are doing today than the situation under the current system. We just might want to see if there is a way to think about R&D as a special type of expense deduction and go beyond even 100 percent.

Mr. GIBBONS. Thank you.

Mr. HANCOCK. The gentleman from Louisiana.

Mr. MCCRERY. I just have a quick question, and I apologize. I was over on the floor debating the welfare bill, but if this has already been asked, please just say so and I will ask somebody else for the answer.

I would like for Mr. Warren, if you don't mind, to just explain how foreign investment by American companies benefit American citizens. You alluded to that in your testimony, and I think it is an important point. Would you just explain to all of us how foreign investment by American companies benefit American citizens?

Mr. WARREN. I would be happy to. Again, I am talking from the TRW perspective, our own perspective.

We have an opportunity to serve lots of customers on a worldwide basis. We compete globally for these customers. The customers are not all in the United States. Many, 25 percent of our customers are outside the United States. It is those customers that we are going after when we invest internationally.

Getting back to my German example, to serce Volkswagen in Germany, or to serve Fiat in Italy, or to sell to a Japanese company in Japan, it is not always possible, or even feasible, to build a plant in the United States and try to export the product.

Mr. MCCRERY. If I can interrupt you, I understand the business reasons for setting up shop where the market is. I want you to explain to us how that benefits American citizens in this country.

Mr. WARREN. Once we have the investment overseas, more likely than not, there are parts and services that need to be supplied to that foreign operation. Many of those parts and services come out of the United States.

We export somewhere between $500 and $600 million of parts and a number of services each year. Those lead to U.S. jobs. Those are jobs that would not be in the United States had we cited that market to our foreign competitors. So there is a direct relationship, an absolute direct relationship.

Mr. MCCRERY. Thank you.

Does any other panel member want to expound on that?

Mr. CONWAY. Yes. I would like to add to that. At United Technologies, we have annual revenues of $22.8 billion. Of those, 55 percent are from business outside the United States. Exports are a big part. It is $3.1 billion.

As I mentioned before, if you look at our main technology base, it is here in the United States. Of that $1 billion annually of R&D, $700 million is in the United States and 60 percent of the $700 million is U.S. salaries and wages paid to U.S. engineers and researchers.

So here we have a case where a company has one-half of its revenues from the international marketplace, but its technology base is clearly in the United States. So I think we have generated a significant number of high-tech jobs, research jobs from these international tax revenues.

With Otis Elevator Co., 80 percent of the elevator market for servicing elevators is outside the United States because 80 percent of the elevators are outside the United States, and 80 percent of Otis' revenues are outside the United States, but there is significant R&D that Otis does. The United States is the number one country in terms of Otis for R&D. So I think it has had a significant positive impact in that regard.

Mr. MCCRERY. Are you saying your research and development operations here in the United States are supported in part by revenues from foreign operations?

Mr. CONWAY. There is no question about it in terms of the cash that we generate. The Otis business, for example, supports not only Otis research, but a lot of other research as well.

Mr. MCCRERY. So, in other words, the bottom line is when you invest overseas, you create jobs overseas, but you probably save jobs over here and create jobs over here as well.

Mr. CONWAY. That is right, and we charge royalties, by the way, when we license the technology and we increase the tax base.

Mr. MCCRERY. Thank you very much. I hope that clears up why we encourage American companies to invest overseas, to expand their operations, to grow, to create jobs here in the United States. Thank you.

Mr. HANCOCK. The gentleman from New York.

Mr. HOUGHTON. I would be interested after all is said and done where do you come down on the flat tax or the consumption tax or variations of the flat tax? Because what we are trying to do is put the income tax system side by side with another tax system, not only to help American citizens here in the United States, but also to help businesses compete abroad so that we can continue to have this extraordinary increase in international business.

Maybe each one of you would say one sentence—where are you on this?

Mr. WARREN. As I indicated in my testimony, both TRW and the organization I am representing today, ECAT, have no definitive position at this time. We are looking at these proposals. We encourage the study of the issue. We hope to work with this Committee as that study progresses.

My message today was that we are concerned about the effect of change in this area and urge an appropriate level of study be conducted before any significant changes are adopted.

We are encouraged that studies are taking place, but we are not convinced that we understand the effect of these proposals on our ability to compete internationally in order to have a position at this time.

Mr. HOUGHTON. Mr. Kaufman.

Mr. KAUFMAN. As a representative of the Section 911 Coalition, focusing solely on how we tax Americans overseas, the best situation is the one that treats us on a territorial basis, and puts us on an even playingfield with the foreign competition. So, whichever one we choose, if it has a territorial approach, that puts us even in competition. If it doesn't go territorial, we would want at least the level of exclusion we have today and perhaps have that tied to at least inflation so it is not eroded going forward.

How will they tax the American overseas, a territorial approach is the one that is the most advantageous.

Mr. HOUGHTON. I am not quite sure what you fellows have said.

Mr. Conway, can you help us a little bit? Can you be a little more specific? Even if you are dangling by a rope by yourself, I will be with you.

Mr. CONWAY. OK. I think it is time to move forward and away from the current system we have and go to a territorial-based tax, destination-based tax. I think we need to move the debate to looking at a system that will tax income once or impose a single tax, not tax income, but impose a single tax so that we can have a tax system that is simple, manageable, and understandable, and I think definitely it has to be territorial. I would favor destination, and it has to take into account the revenue needs.

The tax system we have now, if you look at it, at these provisions in isolation, they are not bad. They represent sound tax policy. The problem we have had is when you add up all the changes we have had over the last decade. That is the problem we have today, and we can solve that with a destination-based territorial tax.

Mr. HOUGHTON. Ms. Dunahoo.

Thank you.

Ms. DUNAHOO. I am afraid we are not in a position to recommend any particular proposal at this time. The International Tax Policy Forum is a broad-based group of companies and is not a traditional trade association or lobbying organization.

I would say we very strongly support the Committee's efforts to reexamine the current system. There is a broad consensus that the current system is not ideal, but as far as whether you should move to a consumption-based system, and if so, to which one, we are undecided ourselves at this point.

Mr. PORTMAN. Mr. Houghton, I recommend you ask Mr. Gibbons. You might get the answer, a definitive answer.

Mr. GIBBONS. Mr. Houghton, could I impose on your time?

Mr. HOUGHTON. Yes.

Mr. GIBBONS. I recognize we have a group of very well-qualified people, but their principals have not made up their minds yet. I am talking about their bosses. I think we need to do a little work.

We are all talking about the same thing. We need a territorial system if we are going to compete. We need a system that is much simpler, and we do, unfortunately, have to raise revenue.

I frankly don't know how we get there with the current mess we have, and I really don't think it is possible to straighten out the current mess by going back and reforming it. I have spent 27 years trying to reform the current system. It just gets worse instead of better.

Mr. HANCOCK. Will the gentleman yield momentarily?

Mr. GIBBONS. Yes.

Mr. HANCOCK. Are you talking about the mess on the income tax or the other messes we have created?

Mr. GIBBONS. No. Well, the income tax mess right now is the main thing, but we have created a pretty good mess also with our payroll taxes, and we need a good clean change. Maybe I can contribute something after I get out of here.

Mr. HOUGHTON. Thank you.

Mr. HANCOCK. I have one final question but I am a little curious about. We are looking at something, and I have been reading a lot of investment articles in the paper, about a balanced portfolio and how people need to invest in foreign companies to balance American investments. When foreign industry stocks are down, American stocks are up, and vice versa and that type of thing.

I also have been reading a lot of information stating basically that you need to be cautious with foreign countries because they don't have any standardized accounting principles and you don't know for sure.

My question is, Is there any forum of international standardized accounting principles? Mr. Kaufman, you came up with statistics, but I understand the accounting principles are not standardized, which could very well lead to a pretty substantial margin of error in your figures. Am I correct on that?

Mr. WARREN. That has certainly been our experience as we have looked at accounting systems worldwide. They are different. They are varied, and it is then possible to compare the printed results coming in from one company from one country with another.

Mr. HANCOCK. Then I will ask another question. If, in fact, you are going to try to solve this problem of what type of a tax structure we should have, don't you first have to solve the accounting procedure approach, so you know what you are dealing with to solve the problem?

Mr. WARREN. Well, we think we can look at the existing Tax Codes, and if we understand how our competitors are taxed, even though we might not be able to precisely translate that into percentage benefits, country to country, we think we do understand the different tax systems well enough to understand there are some net advantages in these other systems, particularly the territorial-based systems.

Mr. GIBBONS. I think, Mr. Chairman, if you look at Ms. Dunahoo's constituency and Mr. Conway's constituency, they have done a fine job in analyzing the bottom line on what happens on an international basis. I am really impressed with what they have done.

I think through OECD, the Organization for Economic Cooperation and Development, and through the fact that accounting is pretty much controlled by seven or eight major firms on international accounting, we do understand what we are doing. We can judge that our tax system is badly out of step with the rest of the world and that in order to compete, we need to get it in step with the rest of the world and perhaps lead the rest of the world as far as business practices are concerned.

Mr. HANCOCK. I would like to thank the panel for your testimony. It is very interesting. It definitely points out some additional problems, since we are just talking about the international competitiveness, and that is not getting into all of the other subjects having to do with the change of the tax law.

Thank you very much for your testimony.

Will the next panel please come forward. I want to welcome you to the Committee. We have present Barbara McLennan, Martin Armstrong, and David Raboy. For your testimony, the Committee will start with Dr. McLennan.

STATEMENT OF BARBARA N. McLENNAN, PH.D., J.D., VAN SCOYOC ASSOCIATES, INC., McLEAN, VIRGINIA

Ms. MCLENNAN. Thank you, Mr. Chairman.

My name is Barbara McLennan. I am a vice president with Van Scoyoc Associates. I am here because I have about 20 years of experience in the international trade and international tax arenas. I have worked for the Treasury Department, the Commerce Department, and in the private sector. I have a written statement for the record.

In considering the effect of taxation on international competitiveness, it is important to remember that taxes are costs. They are a burden to individuals and to business taxpayers. They do not stimulate economic activity.

Different kinds of tax, however, may vary in terms of weight and incidence of the burden, as well as in complexity and difficulty of compliance.

In addition, the effect of a new tax will vary depending on whether it is an added burden or a partial or complete replacement for other taxes. My oral remarks today will focus on consumption taxes and the purpose of border tax adjustments in international trade.

In my view, border tax adjustments in the absence of changes in U.S. investment patterns are unlikely to affect U.S. international competitiveness.

U.S. firms trade internationally because they produce goods and services that are highly valued worldwide. Export sales abroad, just as domestic and import sales, finance the expansion of value-producing jobs in the United States.

Tax policy can affect trade and competitiveness if it leads to changes in savings and investment patterns. For example, if a consumption tax is substituted for current income taxes, international business in the United States may end up being taxed more lightly because the cost of a new tax will be borne by consumers. That is what a consumption tax is.

In this situation, the basic pattern of U.S. savings and investment may be altered. Economic growth may increase, reflecting expanded production of competitive products. The United States will then export more and receive well-earned returns on its investments.

The United States and our major trading partners have long recognized that taxation should not be a tool used by countries to effect the terms of trade. This understanding has been embodied in trade agreements for which the United States has long been a major supporter.

Current U.S. trade agreements draw a distinction between direct and indirect taxes. Direct taxes such as income and Social Security taxes may not be rebated to exporters or importers. On the other hand, indirect taxes that operate through their effect on prices, like value-added or sales taxes, may be rebated.

If the United States were to adopt a new and indirect tax to replace part or all of the current income tax, it would have the right to rebate tax paid by importers or exporters.

For example, if the United States were to adopt a tax similar to a European-style value-added tax, the U.S. money supply would need to expand to avoid an economic contraction.

Firms in the short run would have difficulty passing the cost of the tax back to workers by lowering wages, so they would try to pass it forward to customers by raising prices. Monetary expansion would allow a one-time increase in the U.S. price level, and companies would be able to sell their products for higher prices.

Under a VAT, each firm would credit taxes paid on intermediate supplies against their VAT liability. Consumers would feel the burden of this tax because wages, pensions, and liquidated assets used to purchase consumer goods would not receive credit against tax liability.

If the United States should decide to allow exporter rebates, exporters would sell their products at unchanged prices, since with rebates they would avoid the burden of the new tax. Imports would also be purchased at unchanged prices, but they would be taxed the same as domestically produced goods. All goods consumed domestically, whether of foreign or U.S. origin, would be taxed the same via higher prices. There would be no effect on the exchange rate or on the dollar volume of sales due to the impact of the tax, although the substitution of a tax on consumption for all or part of our current income tax could affect investment flows.

If rebates were not allowed and imports not taxed, such as with a sales tax, exports would initially rise in price due to the tax. Imports would initially be cheaper relative to domestic goods. This would have a direct effect on exchange rates.

U.S. exports would become more costly, reflecting the tax, and, thus, in the short term, less attractive. Foreign suppliers to the United States would earn more dollars as their sales initially increase. The overall effect would be to cause the price of the dollar to fall in comparison to foreign currencies. The dollar would fall until the market again achieves equilibrium, where U.S. exports earn the same amount of foreign currency as before the imposition of the tax, and where import goods in the United States cost the same as domestic goods.

Thus, the international trading system will operate to maintain equilibrium whether or not the United States adopts a border tax adjustment as part of a new system of indirect taxation. Border tax adjustments are a mechanical means by which value-added taxes are collected and audited. Unless savings and investment patterns change, they cannot operate to give U.S. firms a competitive advantage in the international trading system.

For this reason, Mr. Chairman, I believe that fiscal policy should encourage savings and investment, and a consumption tax would likely be an improvement over the current system.

I have addressed the issue of transfer pricing in my written statement, and I will be happy to answer any questions.

[The prepared statement follows:]

Potential Impact of Consumption Taxes on International Trade and Competitiveness

by

Barbara N. McLennan

Mr. Chairman and members of the Committee, I am grateful for this opportunity to present my views on how adopting a flat tax or other consumption tax will affect US international trade and competitiveness. I have been involved in the development and execution of US international tax and trade policies over the last twenty years. As a Congressional staff member in the early 1980's and Treasury Department employee, I helped to develop legislative proposals to simplify the income tax. I was a contributor to the 1984 Treasury Department Report to the President, *Tax Reform for Fairness, Simplicity and Economic Growth,* particularly Volume 3, "Value Added Tax". At Treasury, I also conducted a number of microeconomic studies of different industries, related to the development of new regulations for intracompany transfer pricing.

Between 1989 and 1991, I served as Deputy Assistant Secretary for Trade Information and Analysis, in the US Department of Commerce. While there I testified before the Subcommittee on Oversight of the Committee on Ways and Means on possible transfer pricing abuses by foreign companies with US domestic subsidiaries. I also published a paper on "The Process of Harmonization of the Value-Added Tax in the European Community," in the *Columbia Journal of Transnational Law.*

Over the past several years I have been an attorney in the private sector, and a trade association executive in an industry dominated by large multinational corporations (both US and foreign owned). Based on this experience, I am very familiar with international tax and trade issues as seen from the private sector perspective.

Today, I am a Vice President with Van Scoyoc Associates, Inc., a Washington legislative relations firm. I am here neither on behalf of this firm, nor of any client. On the basis of my experience, I believe the effort to replace the federal income tax with a system that is simpler, fairer, and more efficient is a worthy goal for this Committee. Bearing this in mind, I wish to share with you my personal perspective on the effects of tax policy on international trade.

I. International Trade and the US Economy

The United States is the world's largest industrial economy, where people enjoy very high average living standards. The strength of our economy and the wealth it has created are the product of a free and vibrant private sector. The US economy has grown to its present size and strength because business (domestic and foreign) has provided goods and services that Americans want and for which they are able and willing to pay. Investment in productive enterprise—that is, in businesses that create goods and services that people value—creates economic growth. Growth is simply another term that describes an economy that creates jobs and high living standards.

Increasingly in recent years the US domestic economy's ability to grow has become intertwined with our ability to export and to be competitive in international trade. US firms trade internationally because they produce goods and services that are highly valued world-wide. Export sales abroad, just as domestic sales, finance the expansion of value-producing jobs in the United States.

The products and services which we export are generally our most competitive; they represent what our economy is good at producing. For the economy to grow, our most competitive sectors must lead the way. They earn the highest rates of return and profits, whether sales are made in the US or abroad. When US firms expand by producing in those areas in which we have a comparative advantage, we earn returns that can be reinvested to create new productive enterprise elsewhere in our economy.

Policies which permit the free flow of trade and investment favor economic growth, and the United States has historically been a place that welcomes productive trade and investment. Indeed, policy makers from all walks of life and both political parties have long understood that the US economy grows and our living standards improve to the extent that our leading productive sectors keep expanding. Policies that favor less productive, less competitive industries, whether tax or trade policies, do not enhance the overall economy. Policies designed to help only the few owners and employees in the less competitive industries are essentially subsidies and are widely recognized as such by international trade agreements. Indeed, the US was a leader in attempting to restrain the growth of subsidies in the recently concluded GATT agreement, to which the US is a signatory.

II. International Trade and Tax Policy

A. The Underlying Issue of Currency Exchange Rates

The United States is the world's largest importer and exporter, and the terms of international trade are often denominated in US dollars. When a US producer sells abroad, it will contract with its customers for a defined rate of exchange. US goods and services are produced by workers, plant and equipment, the costs of which are in US dollars. Foreign sales should cover these costs and also provide a reasonable rate of return, in dollars.

The value of the US dollar rests on the stability and productivity of the US economy. Assuming that supply and demand and all other factors remain equal, when the dollar weakens, US exporters selling the same amount of foreign goods would receive fewer dollars for them. This is equivalent to selling at a discount. US exporters in a depreciated dollar environment may sell more products, but they receive less in exchange for each product sold.

Normally, exporters will consider taxes paid as part of the cost of production. In a stable world trading system as envisaged by the GATT, taxation should not be a tool used by countries to affect the terms of trade. The GATT draws a distinction between direct and indirect taxes. Direct taxes, such as income and social security taxes may not be rebated to exporters or importers. On the other hand, indirect taxes that operate through their effect on prices, like value-added or sales taxes, may be rebated.

If the United States were to adopt a new indirect tax to replace part or all of the current income tax, it would have the right to rebate tax paid by importers or exporters. The fundamental impact on trade of such border adjustability will derive more from the economic impact of the change in the tax system, than the fact of its border adjustability. If a new consumption tax is substituted for current income taxes, international business in the US may end up being taxed more lightly, because the costs of the new tax will be borne by consumers. In this circumstance, the basic pattern of US saving and investment also may be altered. Economic growth may increase, reflecting expanded production of competitive products. The US will then export more, and receive well-earned returns on its investments.

The mere fact of border adjustability cannot by itself affect the terms of international trade. This is because of the automatic adjustment mechanisms of world currency markets to the change in US taxation.

For example, if the US should adopt a new consumption tax of 20 per cent on all products and services (such as a VAT), the US money supply would need to expand to avoid an economic contraction. Firms in the short run would have difficulty passing the cost of the tax back to workers by lowering wages, so they would try to pass it forward to customers by raising prices. Monetary expansion would allow a one-time increase in the US price level of 20 per cent, and companies would be able to sell their products for 20 per cent higher prices. Under a VAT, each firm would credit taxes paid on intermediate supplies against their VAT liability. Consumers would feel the burden of the tax, as wages, pensions and liquidated assets used to purchase consumer goods would not receive credit against tax liability.

If the US should decide to allow rebates to exporters, in the manner of our European trading partners, this would not necessarily change the terms of trade. In this circumstance, exporters would sell their products at the original price (since sellers would not pay the tax), and imports would be purchased at unchanged prices. Imports, however, would be taxed on a par with domestically produced goods; all goods consumed domestically, whether of foreign or US origin, would be taxed the same via higher prices. There would be no effect on the exchange rate or the dollar volume of sales due to the direct impact of the tax, although the substitution of a tax on consumption for all or part of the current income tax could affect investment flows. Increased saving and investment could result in higher economic growth.

If rebates were not allowed and imports not taxed, exports would initially rise in price due to the tax. Imports would initially be cheaper relative to domestic goods. This would have a direct effect on the exchange rate. US exports will become more costly, reflecting the tax, and thus, in the short term, less attractive. Foreign suppliers to the US will earn more dollars as their sales initially increase. The overall effect will be to cause the price of the dollar to fall in comparison to foreign currencies. The dollar will fall until the market again achieves equilibrium—where US exports earn the same amount of foreign currency as before imposition of the tax, and where import goods in the US cost the same as domestic goods. If the US price were to increase by twenty per cent, the US dollar would be able to purchase 20 per cent less in foreign currency due to the dollar depreciation in exchange rates. After this adjustment, there would be no effect on the terms of trade, unless savings and investment patterns are altered.

In overall macroeconomic terms, international trade must balance. The US current account balance always, by definition, will be equal to the excess of investment over saving, whether or not there is a new consumption tax. If the new indirect tax does not change basic patterns of saving and investment, it will not change the balance of trade.

B. *Border Tax Adjustability: its Major Purpose in International Trade*

Other countries, particularly our European trading partners and Japan, raise substantial revenue from value-added taxes. Typically, these countries apply their taxes to exports, and exporters may apply for border tax adjustments, i.e., reimbursements for indirect taxes paid. Border tax adjustability is part of the normal, technical means by which a VAT is enforced; it is not instituted for economic reasons.

Value-added tax systems in Europe are the major source of revenue for the European Community. These are large complex tax systems, imposing different and sometimes multiple rates and exemptions on different products and at different levels of the production process. They require the frequent filing of numerous forms and invoices, and are costly and difficult to administer.

Under the invoice method VAT (the system used in Europe), exporters receive their rebates by filing claims for the refunds for which they are eligible. It is consistent with the VAT invoice system of "self-policing," to require taxpayers to file claims for rebates. The VAT is an indirect tax and must rely on taxpayers to produce the paper flow on which tax collection is assessed.

Theoretically, it is not necessary for economic reasons to establish a rebate system. Indeed, much might be saved in paperwork, audits, and compliance costs if a rebate system were not established. As already noted, the automatic effect on the exchange rate of the dollar would work to insulate the normal operation of the international trading system from a new US tax. Even without a rebate system, US exporters would not pay the costs of the new tax, but they would receive depreciated dollars for their export goods. Ultimately, currency markets will adjust so that US exporters will be in the same situation as before institution of the tax.

III. Trade among Multinationals: Why Pricing Issues Will Not Go Away Under a Flat Tax.

Among the areas singled out as most complicated under the present tax code by the National Commission on Economic Growth and Tax Reform, chaired by Jack Kemp, is international taxation. The Kemp Commission has called for a territorial tax system, that is, one which does not tax the foreign earnings of resident businesses or individuals. It has urged Congress to seek a clearer, simpler, more certain determination of what is foreign income and what foreign transactions are taxable. Specifically, the Commission has singled out the need to clarify tax treatment of foreign source license fees, royalties and other intangibles so as not to discourage research and development in the United States.

If the business income tax is replaced by a flat tax, much complexity will disappear. Under a direct flat tax, there would be no research and experimentation tax credit and no foreign tax credit. Businesses would be required to pay a single tax on the difference between revenue and expenses. The costs incurred for research and for foreign tax paid would be deductible under a flat tax as expenses.

Multinational companies manufacture, buy, sell, conduct research, and own intangibles in many locations and tax jurisdictions. Under a flat tax, as under current law, they will need to determine which revenues and which expenses properly should be reported to US tax authorities.

When large multinational corporations set internal prices for transactions among controlled subsidiaries, there always will be a possibility that these internal company prices differ from the arm's length prices of the free market. Without careful rules with respect to transfer pricing, multinationals will be able to shift revenues from one jurisdiction to another to minimize their tax burdens.

Likewise, income and revenues attributed to intangibles (the license fees and royalties singled out by the Kemp Commission) will still pose a problem of definition under a flat tax. The issue of where revenues should be reported—to the US head office that owns the patents, or to subsidiary laboratories in foreign countries which perform final manufacture—will remain.

Transfer pricing will remain a problem under a consumption tax, much as it is under current law. If the US should adopt lower rates of tax than in other jurisdictions, other factors remaining equal, multinationals likely will find an incentive to place more valuable aspects of their operations here than in higher tax areas. In the absence of tax rules to the contrary, they can do this by shifting internal company revenues and expenses so that more of their profits are reported to the US tax jurisdiction. Clearly, such a situation would invite response and possibly retaliation from our major trading partners.

The United States has been grappling with transfer pricing issues for many years. Some observers believe that the current transfer pricing rules are a disadvantage for US businesses and investors, but many of these rules have been copied by tax authorities in other countries.

The 1994 revision of the Section 482 transfer pricing regulations, placed much more reliance on taxpayers. Companies with transnational business dealings are now encouraged to provide the IRS with their own transfer pricing methodologies, through voluntary advance pricing agreements. At the same time there has also been an increased emphasis on the use of penalties for failure by taxpayers to document pricing transactions. Potential IRS intrusiveness into company business affairs remains a serious issue.

IV. Conclusion

According to a Joint Committee on Taxation document issued on March 14, 1996, the vast majority of all corporate income taxes collected in 1993 came from relatively few corporations. Only four thousand companies, those with over $250 million in assets, accounted for more than 75 per cent of all corporate income tax collected. Most, if not all, of these companies are multinationals heavily engaged in international trade. As pointed out by the Kemp Commission, though the tax system is complex, international business is profitable and expanding.

Though border adjustability and transfer pricing issues will remain problems under a consumption tax, moving to such a tax from the current system may stimulate savings, investment and economic growth. Whether or not there is a border tax adjustment, increased economic growth will mean increased investment, increased international trade, more and better jobs, and an improved standard of living for our people.

Economic growth stimulated by a change in the tax system will not fall evenly across different industries. Though a new tax may be simpler and fairer in conception, it is unlikely to effect all forms of business in the same way. Numerous transition rules likely will be required to equalize the impact of various provisions. Some of these rules will undoubtedly have to devised for the international sector, today a rapidly growing source of investment, technology and employment.

Mr. HANCOCK. Thank you very much. Also, without objection, your written testimony will become a part of the record, and also for Dr. Raboy and Mr. Armstrong.

Mr. Armstrong.

STATEMENT OF MARTIN A. ARMSTRONG, CHAIRMAN, PRINCETON ECONOMICS INSTITUTE, PRINCETON, NEW JERSEY

Mr. ARMSTRONG. I am the chairman of Princeton Economic Institute. We are actually more than just merely an academic adviser. We take active roles in advising corporations around the globe. We have offices in Australia, Hong Kong, Tokyo, and London. We also have a subsidiary which is the largest foreign brokerage operation in Japan. For example, we have participated in over 250 underwritings last year in that country, and we also do a lot of direct hedge management in foreign exchange for corporations around the globe.

I would like to thank you for inviting me here to speak today. What we find is very significant, I think, from a global perspective: That the two primary causes of moving capital around today is, number one, the foreign exchange movement, and number two, taxation.

Countries have to become much more competitive, but the first issue, I think, to illustrate taxation is really the impact of foreign exchange and how it is creating changes in the domestic economy as global.

The foreign exchange movement has been as much as 40 percent over a 2-year period, ever since the Plaza Accord of 1985. I have offered an illustration of the capital flow movement from the basis of OECD data since the 1987 stock market crash. The brain wave patterns we see of the market is almost like schizophrenic since then. The volatility in everything has gone up since 1987, since we first made a G–5 attempt at using currencies to effect trade.

That has caused, number one, a significant increase in volatility and also significant changes in the way corporations are operating.

For example, it was the decline in the dollar that made our U.S. real estate bond markets and everything appear much cheaper to foreign investors; i.e., the Japanese coming in and buying U.S. companies, like Rockefeller Center, and so forth.

As they lost money on the foreign exchange, most of the assets were then sold and taken back. If you look at the actual losses that were incurred by a lot of the foreign investment in those areas, the bulk of it was foreign exchange, not the actual depreciation in the Rockefeller Center itself.

The second aspect of the foreign exchange movement we have to consider is that of total world capital flows; trade only really represents about 10 percent. The balance of that is really investment income which is tax driven.

One of the major points I would like to make today in understanding the Tax Codes is that the first panel testified to the double and triple taxation of U.S. corporations. That is absolutely paramount.

There are other things that are taking place. If you had foreign companies discussing issues here, you would find foreign operations are often taking over U.S. companies. U.S. companies are being forced into mergers, acquisitions, and partnerships to avoid U.S. taxation on an international level.

What we see in this area is absolutely astounding on a global basis. Three of the first section-listed companies in Japan have actually stood up and resigned their citizenship in Japan and now have moved to Hong Kong. That is as if General Motors were to stand up and say we are no longer American. This is what the Tax Codes are causing on an international scale. It is absolutely monumental.

The other aspect we have to realize is how this is impacting everything also on the investment side. For example, we tax our American citizens not only on worldwide income, but also on interest income.

Prior to World War II, our government bonds were always tax free. Now we tax our American citizens if they buy a government bond. If I buy a bond, I pay 39.6 percent. If a Japanese buys it, he gets it tax free. What is taking place in the international side of capital movement is that it is like a game of musical chairs. Everyone is buying government bonds from somebody else, but nobody is buying their own.

Even the Wall Street Journal reported the holding period of a 30-year bond in the marketplace is now below 90 days. This is very serious. It is impacting volatility on a global scale.

Taxation is very, very important in this area, and one of the biggest concerns we have and criticisms we find from overseas companies, both from an investment standpoint as well about the United States, is that the U.S. Tax Code—we have provided a table in here. It looks, quite frankly, like the brain wave of a schizophrenic.

We have the most volatile Tax Code of any country in the world. You can see when corporate tax rates hit an effective rate of close to 70 percent in the sixties, I can tell you virtually every U.S. company jumped on whatever ship they could out of town.

Besides that factor, we have to really take into consideration how all of this comes back. If we look at our deficit situation and National debit, we have actually had a balanced budget in this country since 1980 from a revenue and spending perspective. If you look at Ronald Reagan's first 8-year period, you will see the national debt doubled by $1 trillion, which was exactly equal to the interest expenditures in that period. At 8 percent compounded, you double the national debt or any money in the bank in less than 10 years.

Since Ronald Reagan, the national debt has more than doubled. We went from under Reagan from 1 to 2. Now we have gone from 2 to 5. We lower taxes under Reagan. We have raised taxes since. It is not tax policy. It is simple compound interest that is absolutely killing us.

The total accumulative interest expenditures of this country since 1950 now equals 68 percent of the national debt.

Today, we collect close to $100 billion more in revenue than we actually spend on programs. It is all being absorbed by interest, and taxation is a very important role in this because up to times 40 percent of our National debt has been held by offshore investors, which means that money no longer stimulates the domestic economy, but those interest expenditures are being exported to Japan or elsewhere.

If you do a study of Japanese companies and institutions, you will find the Japanese made far more money off the investments of interest, and so forth, in the United States over the last 16 years than they did off of trade.

These are the issues I think are very critical. We do have a lot of recommendations that, briefly, we feel a consumption tax would be overwhelmingly beneficial to the Nation. You also have to seriously address the international double taxation that companies have. We believe that that should be eliminated to make the playingfield fair and even for everyone; that U.S. companies are seriously disadvantaged in the global side. We see it every day, and we are acting on a consulting role.

So those are the things we believe should be done. We do believe perhaps a merger of a flat tax and a consumption tax would be more plausible; for example, a consumption tax on the personal side eliminating all personal income taxes. On the corporate side, we feel if you were to match the income tax rate of Hong Kong of 15 percent, eliminate worldwide income, provide immediate expensing, and so forth, that would be internationally competitive, would not raise the dangers of having our operations here suddenly viewed as operating in a tax-free zone, particularly under British tax law, a lot of other European countries, also.

We do have to be a little bit respectful of how that would take place. If you did that, a lot of the foreign companies that have come here to establish plants would suddenly find out whatever plants they established here would suddenly be 100 percent taxable back home if there was a zero level of an income tax. So there are serious implications.

We would recommend, more or less, a split system, going back to the way this country really was run for the first 120 years where you do have a corporate income tax, but there were no personal income taxes.

Thank you.

[The prepared statement follows:]

July 18, 1996

Testimony of:
Martin A. Armstrong
Chairman Princeton Economic Institute
214 Carnegie Center
Princeton, NJ 08540

Mr. Chairman, members of the committee. I would like to thank you for inviting me here today to offer what information PEI has gathered from our experience in dealing with the multinational corporate and institutional sector of the global economy. As a brief background, PEI maintains offices in the US, Tokyo, Hong Kong, Sydney and London. We currently provide corporate and institutional advice under contract on global assets exceeding US$2.5 trillion, an amount equal to about half of the US national debt.

In our capacity as an advisor serving the international community in real life decision making rather than theory, PEI may be uniquely qualified in providing insight as to how and why both investment and business capital flows are affected by a nation's domestic policy objectives.

It has been our experience, that there are five key factors that provide the core stimulus behind capital flows internationally.

- **1) Foreign Exchange**
- **2) Taxation**
- **3) Labor Costs**
- **4) Inflation & Interest Rates**
- **5) Security (geopolitical & financial)**

Let me begin with foreign exchange as an illustration of how capital is being affected before discussing taxation.

Foreign Exchange fluctuations have become the number one cause of corporate losses. The percentage movement in the exchange value of currencies has become as high as 40% over a two year period. Exchange losses have impacted every sector of business in every nation to the point that the very way multinationals operate today is dramatically shifting from that of only 10 years ago. Multinationals have been forced to change pricing policy as well as the location of manufacture in an effort to reduce extreme financial risks for their shareholders. Transactions such as Rockefeller Center, MCA etc resulted in significant losses to the Japanese investors, more so by the 40% depreciation of the dollar than the actual decline in value of the underlying assets. Japan Airlines was forced to lay-off 25% of its work force last year due to the fact that their cost base was Japanese yen while their revenue was largely foreign currency denominated. In Germany, Mercedes has been forced to restructure their pricing policy as of July 1st, 1996 due to foreign exchange. Instead of pricing the product in DMarks around the world, which has cost them market share, products will now be priced in local currency thereby transferring the currency risk back to Germany.

These are but a few examples of how the more recent extreme fluctuations in the exchange value of currencies has impacted business and investment decisions on a global scale. While it may be politically preferable to manipulate currency values in an attempt to impact trade flows, in reality, trade accounts for less than 10% of the total world capital flow movement. Our warnings delivered in a letter to Congress and the White House back in 1985 cautioned against such intentional currency manipulation as enacted in the G5 September Plaza Accord. The net result of attempts to influence trade through currency manipulation led to the 1987 Stock Market Panic. PEI's research was requested by the Brady Commission and we would like to think that we had some impact upon its findings since two of our clients were on the Commission itself. Mr. Brady later stated that he believed that currency fluctuations had played a role in the Panic of 1987. Offered here is a graphic illustration **(figure #1)** of the net capital flow movement for that period. The upper portion of the graph plots trade and the lower portion capital movement which included, stocks, bonds and real estate investment. What is important to note is that ever since 1987, the fluctuations in net capital movement have become more than 10 times as volatile when compared to the pre-1987 era.

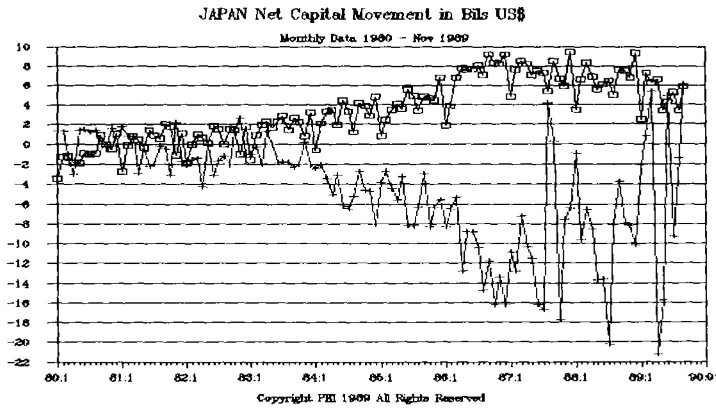


Figure #1

The second most important factor influencing net capital flow movement is none other than taxation. However, taxation is more than a pure income tax. Taxation contributions imposed on business based upon social objectives involving labor are of greater importance than the mere superficial level of corporate income tax rates alone.

It is wrong to assume that manufacturing jobs flow to merely the lowest possible labor cost. If this were true, then all manufacture should be conducted in Mexico, South East Asia or better still - Africa. In our capacity as a corporate advisor helping to make such strategic decisions as to where companies should or should not locate, there are 5 primary considerations that go into the final decision process on this level.

- **1) Rule of Law**
- **2) Labor Skill availability**
- **3) Taxation Contributions Required on Labor**
- **4) Corporate Tax Rate**
- **5) Regulation**

We have clients who have turned down what appeared to be lucrative business ventures in 3rd world nations as well as Russia or China based upon the lack of a Rule of Law that is required to secure the capital at risk. Without a solid Rule of Law, business cannot operate. Such ventures that do develop in those parts of the world depend upon government guarantees from their native country of origin in an effort to underwrite the political risk at hand.

While it is obvious that labor costs are closely associated with labor skills, what is largely overlooked are the social taxation and regulations associated with a work force. We found Asian companies who wished to open manufacturing plants within the EC made their decision based upon the level of skills available and then secondly chose the lower total cost of labor. For example, the UK attracted more than 40% of all foreign investment into Europe due to the fact that it had a skilled labor force but its cost was much less compared to that of Germany or France. This cost factor was determined not by mere wages, but included the social taxation that companies were required by law to provide. On that score, the labor costs in the UK were 40% less than Germany.

When a company did **NOT** require a major work force but instead merely needed a legal entity within the EC, then the primary deciding factor became the corporate tax rate. While the UK corporate tax rate was 19% less than Germany, they were still more than twice that of nations such as Spain and Ireland. Therefore, corporate headquarters or low skilled labor requirements tended to gravitate to the lowest possible corporate rate within the EC. This is illustrated by the impressive Irish economic growth rates of 9% compared to European economic growth rates of 2.5%. We have found that there is a correlation between high unemployment and high total taxation and regulation costs across Europe today.

Of course, regulation was a major factor as well. This we can see within our own US borders as well. Southern States are actively competing for Northern corporations and jobs. If we look at those states where regulation is the least intrusive and taxation is the most favorable, you will find the highest number of corporate relocations and new foreign business ventures within the United States.

Domestic Taxation policy must take into consideration our new global economy. We must be sensitive to being competitive not merely on labor costs, but also on the total taxation and regulation costs if we hope to avoid the dismal European example with its chronic unemployment in excess of 10% year after year. We must also keep in mind that taxation itself is largely influenced by philosophical decisions made by governments without considering the true total economic impact. For this reason, taxation has been a major factor in altering world capital flows as well as economic growth levels. When the US corporate tax rate hit nearly 70% during 1968-1969, virtually every American company began shifting manufacture offshore. Today, over 65% of the US trade deficit is made up of US companies importing their own goods manufactured somewhere else. In fact, if we allocate world trade according to the flag a company flies instead of the last port of assembly, you will find that the US has a net trade surplus in excess of $150 billion.

Much of the economic turmoil in Japan today is being caused by excessively high tax rates. In fact, three of the first section listed companies on the Tokyo Stock Exchange have renounced their Japanese heritage and moved to Hong Kong due to a 15% tax rate compared to nearly 70% in Japan. Our economy contracted from the 1960s for 12 years. Japan appears to be facing the very same long-term trend. After 6 years, the Japanese economy remains in the throws of a near depression and taxes have still not been reduced. Despite the fact that interest rates have fallen in Japan to 0.25%, there remains no interest in borrowing for domestic economic expansion.

The method of taxation through domestic social objectives is also a key factor in shifting global capital flows. For example, the US is one of the very few nations that seeks to tax their citizens and corporations on worldwide income. Most British Commonwealth nations tax worldwide income if earned in a tax free zone. Therefore, if the US were to totally eliminate the corporate income tax, we would run the risk of corporate earnings in the US being considered as income from a tax free zone.

Furthermore, US tax code classifies income made overseas as if any overseas income is derived solely to avoid domestic taxation. The 50% and/or control rule for US companies as the sole criteria for taxation penalizes US enterprises forcing many into joint ventures simply to avoid double taxation in the US. We also discriminate against American companies trying to enter foreign markets by passing the tax burden directly to personal income even if such earnings are not distributed. Our tax code assumes that any offshore entity is merely trying to avoid taxes without testing whether or not an actual business is being developed as compared to an offshore account for investment purposes.

In addition, our prejudice against capital gains versus short-term income within our tax code provides a incentive to manufacture and develop domestic products offshore. The US is one of the few nations whose tax system punishes long-term investment while rewarding short-term speculation. Again, the capital gains taxation has exported more American jobs not because of the mere rate, but due to the fact that losses have been treated differently from short-term income while disallowing the impact of inflation indexing. Consequently, while virtually every electronic product from VCRs, CDs and assorted appliances were designed and patented in the US, their final development and manufacture have been more fairly treated by nations such as Japan. This uncompetetive social philosophy inherent within American tax code has been one of the major causes of forcing US companies offshore into joint ventures than even the net level of income tax itself.

While many will argue that corporations pay little in income tax, what is grossly ignored is the taxation of labor that is a huge direct cost to business. If we look at our own revenue statistics, you will find that the taxation contributions to the payroll tax paid by corporations is substantial - generally twice the level of corporate income taxes.

We must also take into consideration the net cost of taxation upon the nation as a whole. While it is true that the national debt doubled under Ronald Reagan moving from $1 to $2 trillion, this alone does not mean that lower taxes or Reaganomics failed. Under Bush and Clinton, the national debt has now more than doubled from $2 to $5 trillion despite raising taxes.

We must honestly review the economic facts of the past 16 years in order to understand our future. Since Ronald Reagan, we have actually had a balanced budget from the perspective of revenue vs spending. At 8% compounded, you double your money in a bank in about 8 years. The interest expenditures during the Reagan period were equal to nearly $1 trillion. Today, we actually collect about $100 billion more in revenue than Congress actually spends on programs. This is being absorbed by our interest expenditures. In fact, since 1950, the total interest expenditures paid now equal 68% of the total outstanding national debt. We are indeed becoming a Banana Republic.

At times, up to 40% of our national debt has been held by offshore investors who pay no income tax in the US. This means that domestic spending from Congress is no longer stimulating our domestic economy. If fact, an analysis of capital flows reveals that the Japanese earned more from the US on their investment income in the past 16 years than they did on trade.

By taxing interest income, we penalize Americans and overpay foreign investors exporting more capital than would otherwise take place. If we eliminate the income tax on government bonds, we could reduce the interest rate to the actual net return after taxation. This alone could result in an instantaneous balanced budget since we currently collect more in revenue than we spend on programs with the excess being consumed by interest.

Capital is rushing around the globe today much in the same manner as it did going into the Great Depression. Herbert Hoover wrote in his Memoirs that ***"capital acted like a loose cannon on the deck in the middle of a torrent."*** In 1985, the largest futures mutual fund was $100 million. Today, $1 billion funds are a dime a dozen. Everyone is investing somewhere else to avoid local taxation. It is now estimated that over $2 trillion sits offshore, untaxed and unregulated emanating from all nations. If we eliminate the personal income tax, then America itself will become the international magnet for this vast pool of capital. Our interest rates would decline as it always does whenever excess capital emerges. This single step alone, combined with creating a tax free government bond structure, could spark untold economic growth and help to actually begin reducing our national debt rather than waiting for everything to go bust beyond the year 2000.

SUMMARY

There have been two schools of thought on debt and taxation since government was first conceived. In modern times, these two schools of thought have never stood in more contrast than by the words of two very famous men.

- **"The principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale."**

THOMAS JEFFERSON, 1789

- **"The only part of the so-called national wealth that actually enters into the collectives possessions of modern peoples is their National Debt."**

KARL MARX, 1873

If the purpose of this Committee is to fairly reflect upon how our tax code can be used to attract jobs and stimulate economic growth rather than employ gimmicks such as currency manipulation, special one-off tax deals or the continued denial of the damage caused by Marxism in the postwar era, then it is clear from our experience that there can be only one conclusive path.

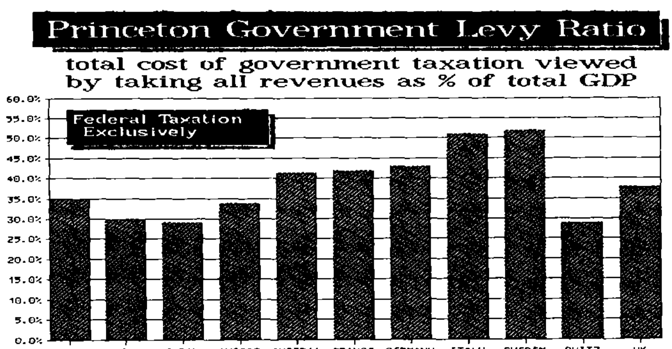
- **1) End the discrimination against long-term investment by at least allowing capital gains to be indexed to inflation retroactively.**
- **2) Promote honest reform of the Social Security System whereas contributions made should be privately managed as is the case in many other nations. The Postal Savings System in Japan actually has on deposit in real funds nearly $10 trillion which is then managed by the private sector under the watchful eye of government. This will help reduce the cost of labor in the US, create jobs through increased savings, and result in lower payroll tax contributions for business over the long-term while safeguarding the long-term viability of these critical social programs.**
- **3) Eliminate the taxation on government bonds.**
- **4) Eliminate the personal income tax and replace it with a national sales tax of 10% as originally intended by the founding fathers with just cause.**
- **5) Reduce the corporate tax rate to 15% matching Hong Kong thereby transforming the US to the international magnet for capital. Allow interest paid to be deducted as a part of the cost of doing business.**

Mr. Chairman, members of the Committee:

This is a brief overview of our experience in dealing around the world on a first-hand observation basis. We strongly believe that the replacement of the current income tax system on individuals with a national sales tax in combination with a corporate tax rate of 15% will prove not merely to be revenue neutral, but also a major economic stimulus that will help our domestic economy grow while forcing major economic change around the world restoring the beacon of hope and liberty by our example.

"It is the highest impertinence of kings and ministers to pretend to watch over the economy of private people and to restrain their expense, either by sumptuary laws, or by prohibiting the importation of foreign luxuries. They are themselves always, and without exception, the greatest spendthrifts in the society. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will."

Adam Smith
Wealth of Nations 1776



Federal Corporate Income Tax Brackets and Rates

1909-1994

Year	No Tax Below	Rate1	$	Rate2	$	Rate3	$	Rate4	$	Rate5	$	Rate6	$	Rate7	$	Rate8	$
1909-13	5t	1%															
1913-15	0	1%	(No exemption after 03/01/13)														
1916	0	2%															
1917	0	6%															
1918a	2t	12%	War Profits and Excess-Profits Tax: Profits over 3,000 plus 8% of invested capital subject to graduated rates:														
First Bracket: 30% Second Bracket: 65% Third Bracket: The sum, if any, by which 80% of the amount of the net income in excess of the war-profits credit exceeds the amount of the tax computed under the first and second brackets.																	
1919-21a	2t	10%a															
1922-24	2t	12.5%															
1925	2t	13%															
1926-27	2t	13.5%															
1928	3t	12%															
1929	3t	11%															
1930-31	3t	12%															
"0 Exemptions after 1931"																	
1932-35b		13.75%															
1936-37b		8%	2t													15%	over 40t
Graduated Surtax on undistributed profits ranging from 7-27%b																	
1938-39b		12.5-16%	25t													19%c	over 25t
1940b		14.85-18.7%	25t									38.3%	31,964	36.9%	38,565	24%	over38,656
1941b		21-25%	25t											44%	38,964	31%	over38,964
1942-45b		25%	5t							27%	20t	29%	25t	53%	50t	40%	over 50t
1946-49		21%	5t							23%	20t	25%	25t	53%	50t	38%	over 50t
1950d		23%	25t													42%	over 25t
1951d		28.75%	25t													50.75%	over 25t
1952-53d		30%	25t													52%	over 25t
1964		22%	25t													50%	over 25t
1965-67		22%	25t													48%	over 25t
1968-69e		24.2%	25t													52.8%	over 25t
1970e		22.55%	25t													49.2%	over 25t
1971-74		22%	25t													48%	over 25t
1975-78		20%	25t											22%	50t	48%	over 50t
1979-81		17%	25t							20%	50t	30%	75t	40%	100t	46%	over 100t
1982		16%	25t							19%	50t	30%	75t	40%	100t	46%	over 100t
1983-86		15%	25t							18%	50t	30%	75t	40%	100t	46%	over 100t
1987-92f		15%	50t							25%	75t	34%	100t	39%g	335t	34%	over 335t
1993		15%	50t	25%	75t	34%	100t	39%h	335t	34%	10m	35%	15m	38%h	181/3m	35%	over 18m
1994		15%	50t	25%	75t	34%	100t	39%h	335t	34%	10m	35%	15m	38%h	181/3m	35%	over 18m

t=thousand m=million

a. In 1919 and 1920, the war profits tax was repealed and the excess profits tax was 20%-40% of the profits over 3,000 plus 8% of invested capital (not to exceed 20% of net income over 3,000). (See Revenue Act of 1918 for details on the excess-profit & war profit taxes and credits.)

b. From 1933 to 1935, 5% of the profits above 12.5% of adjusted declared value of capital stock was imposed. From 1936 to 1939, the tax ranged from 6% to 12% on profits over 10% of adjusted declared value. From 1940 to 1945, these tax rates were 6.6% to 13.2%. In addition, profits exceeding 95% of the average net income for 1936-1939, plus adjustments, were taxed at graduated rates of 25-50% in 1941, 35-60% in 1942-43, 90% in 1944, and 95% in 1945.

c. Less adjustments: 14.025% of dividends received and 2.5% of dividends paid.

d. Additional tax of 30% of profits exceeding 85% of net income (average of 3 highest years, 1946-49) adjusted by changes in capital stock (1946-49) was imposed in 1950 (83% of next income in 1951-53). Total tax limited to 62% of excess profits net income before deduction of excess profits credit ($25,000) In 1951, the maximum excess profits tax limited to 17.25% of excess profits net income before deduction of excess profits credit of $25,000. For 1952-53 the limit was 18%

e. Includes surcharge of 10% in 1968 and 1969, and 2.5% in 1970

f. Rates shown effective for tax years beginning on or after 7/1/87. Income in tax years that include 7/1/87 (other than the first date of such year is subject to a blended rate.

g. This provision phases out the benefit of graduated rates for corporations with taxable income between $100,000 and $335,000. Corporations with taxable income above $335,000, in effect, pay a flat rate of 34%.

h. The 39% and 38% rates are imposed to phase out the benefits of the lower brackets for high-income corporations.

Source=ACIR (Advisory Commission on Intergovernmental Relations, US Government)

Outline:

The impact of taxation and foreign exchange on international net capital movement, investment trends and corporate decisions as to the location of manufacturing and business decisions and the need for government to consider domestic policy objectives on the flow of jobs and capital in the global context of our economy.

Suggestions:

- **1) End the discrimination against long-term investment by at least allowing capital gains to be indexed to inflation retroactively.**
- **2) Promote honest reform of the Social Security System whereas contributions made should be privately managed as is the case in many other nations. The Postal Savings System in Japan actually has on deposit in real funds nearly $10 trillion which is then managed by the private sector under the watchful eye of government. This will help reduce the cost of labor in the US, create jobs through increased savings, and result in lower payroll tax contributions for business over the long-term while safeguarding the long-term viability of these critical social programs.**
- **3) Eliminate the taxation on government bonds.**
- **4) Eliminate the personal income tax and replace it with a national sales tax of 10% as originally intended by the founding fathers with just cause.**
- **5) Reduce the corporate tax rate to 15% matching Hong Kong thereby transforming the US to the international magnet for capital. Allow interest paid to be deducted as a part of the cost of doing business.**

Mr. HANCOCK. Thank you for your testimony.
Dr. Raboy.

STATEMENT OF DAVID G. RABOY, PH.D., CHIEF ECONOMIC CONSULTANT, PATTON BOGGS, L.L.P.

Mr. RABOY. Thank you, Mr. Chairman.

My name is David Raboy. I am the chief economic consultant to the law firm of Patton Boggs, L.L.P. I am pleased to testify today on the implicatations for international competitiveness of fundamental tax reform.

I will discuss the choice of tax base and structure as it applies to international transactions, investigate the importance of border tax adjustments, and describe the effects on competitiveness from narrowing the base of taxation to achieve social goals.

My primary conclusions are as follows: The current tax structure contains an inherent artificial bias against capital investment. This results in an erosion of productivity rendering U.S. companies less competitive.

The current tax structure also impedes competitiveness through an artificial bias against private savings. There is substantial empirical evidence that even in the presence of world capital markets, a country's investment is constrained by its domestic savings rate.

In addition, when there is a domestic investment savings inbalance, the savings deficit must be made up by capital inflows from foreign savers, which increase demand for the dollar, causing a currency depreciation, and in turn making U.S. goods relatively more expensive in world markets.

Removing artificial tax distortions to private savings decisions will allow increased productive investment without countervailing currency changes.

In the savings and investment area, the flat tax, the USA tax, the VAT, and the sales tax would all have qualitatively similar positive effects on competitiveness. This is true, despite all the attempts at product differentiation and the deification of one's own proposal while simultaneously demonizing all others. These four proposals are all based on the taxation of consumption and would eliminate the current law biases. A broad-based income tax, however, would retain the distortion.

There is an area of real difference, however, and that concerns border tax adjustments. There is conventional wisdom in the economics profession that border tax adjustments are irrelevant with regard to international trade. While this may be technically true in the long run under a set of very highly restrictive assumptions, as Keynes said, "in the long run, we are all dead." To me, the more interesting analysis from a policy standpoint applies to the sectoral changes that occur in the short run.

Now, the near-term consequences of shifting to a border adjustable tax would appear to be significant. Switching from an origin-based system, like our current Code, to a destination principle will result in more exports and/or increased investment in export-producing companies during the adjustment period, and I can elaborate in the question period.

Similarly, there will be fewer imports and/or more investment flowing to import-sensitive companies. Since the system will ultimately be trade neutral, if the United States were to undergo fundamental tax reform, it would seem wise to avail itself of these benefits.

There are other reasons why a destination principle tax is preferred to an origin-based one. Some of the most contentious and frustrating controversies in international taxation concern related company transfer prices. With an origin-based consumption tax, these controversies will remain. In a destination-based system, however, transfer pricing issues would be largely eliminated.

Another issue has to do with incentives regarding production facility location, the so-called runaway plan issue, and I want to stress that there are many, many influences that affect where a company will locate its facilities, but taxes are part of that mix.

Under an origin-based tax system, to the extent that there are existing incentives to locate facilities in low tax countries, they would remain. These incentives are eliminated under a destination principle consumption tax.

If Congress decides to initiate fundamental tax reform, it should choose to shift from an origin principle to a destination principle. A broad-based income tax is obviously ineligible for a border tax adjustment under GATT rules. Similarly, the flat tax would be viewed as a direct tax and, therefore, ineligible as well. The sales tax, the VAT, and the business portion of the U.S. tax would all be considered indirect taxes and, therefore, could be made adjustable at the border.

Regardless of which system is ultimately chosen, affording preferential treatment for social or other reasons to certain classes of goods or industries could result in a deterioration of international competitiveness. The economic literature concludes that a consumption tax will have adverse trade effects if preferential tax treatment such as exemption, zero rating, or lower tax rates is afforded to goods that don't enter international trade, while goods that are either appropriate for export or compete with imported goods bear the full tax burden.

Many of the goods in existing consumption tax systems that receive preferential treatment do not enter international trade, such as medical care, housing, education, and categories of food.

Real or perceived, regressivity should be dealt with outside of the consumption tax system if we are to avoid damage to the trade-sensitive sector of our economy.

Thank you, Mr. Chairman.

[The prepared statement and attachment follow:]

STATEMENT OF DR. DAVID G. RABOY
CHIEF ECONOMIC CONSULTANT
PATTON BOGGS, L.L.P.

I. Introduction

My name is David G. Raboy and I am the Chief Economic Consultant to the law firm of Patton Boggs, L.L.P. I am pleased to testify today on the implications for international competitiveness of replacing the existing Federal income tax with one of several variants of fundamental tax reform initiatives. These variants are a broader-based, flatter-rated income tax; the consumption-based tax that has come to be known as the "flat tax;" a cash flow tax similar to the USA tax; a VAT (either in subtraction or credit-invoice form); and a national sales tax (NST).

In my testimony I will 1) discuss the fundamental choice of tax base and structure as it applies to international transactions; 2) investigate the importance of border-tax adjustments; and 3) describe the effects on competitiveness from narrowing the base of taxation to achieve social goals. Each reform variant will be considered in the context of these three areas.

The primary conclusions of my testimony are:

- The current tax structure impedes competitiveness because of an inherent bias against capital investment. This results in an erosion in productivity, rendering U.S. companies less competitive.

- The four tax reform proposals that are based on the taxation of consumption -- the flat tax, the USA tax, the VAT, and the sales tax -- would all increase competitiveness by eliminating the current-law bias against capital investment. A broad-based income tax would retain the anti-capital bias.

- The current tax structure also erodes competitiveness through an artificial bias against private saving. Because international capital is not entirely mobile, a country's investment is constrained to some extent by its saving rate. In addition, when there is a domestic investment/savings imbalance, the saving deficit must be made up by capital inflows from foreign savers. Capital inflows increase the demand for the dollar, all else constant, which causes a currency appreciation, making U.S. goods relatively more expensive in world markets.

- The four tax reform proposals that are based on the taxation of consumption would all increase competitiveness by eliminating the current-law bias against private saving. A broad-based income tax would retain the anti-saving bias.

- There is conventional wisdom that states that border-tax adjustments are irrelevant in the long-run with regard to international trade. While this is technically true in the long-run under a set of highly restrictive assumptions, probably the most interesting analysis applies to sectoral changes in the "short run."

- The "short-run" consequences of shifting to a border-adjustable tax would appear to be significant indeed. Switching from an origin-based system to a destination principle will result in more exports and/or increased investment in export-producing companies during the adjustment period. Similarly, there will be less imports and/or more investment flowing to import-sensitive companies. Since the system will ultimately be trade neutral, if the United States were to undergo fundamental tax reform, it would seem wise to avail itself of these short-term benefits.

- There are other reasons why a destination principle tax is preferred to an origin-based one. Some of the most contentious and frustrating controversies in international taxation concern transfer prices. With an origin-based consumption tax, these controversies remain, indeed may be exacerbated. In a destination-based system, however, all transfer pricing issues are eliminated.

- Another issue has to do with the differential incentives regarding production-facility location (often labeled the "runaway plant" issue) under alternative border-tax adjustments. Under an origin-based tax system, even one levied on a consumption base, there remain incentives to locate facilities in low-tax countries. These incentives are eliminated under a destination principle consumption tax. Indeed, investment may relocate to the United States.

- If the Congress decides to initiate fundamental tax reform, and shift the base of taxation from income to consumption, it should also choose to shift from an origin principle to a destination principle. This shift will be beneficial to the trade sector, will eliminate transfer-pricing controversies, and will remove distortions that encourage companies to move facilities overseas.

- A broad-based income tax is obviously ineligible for a border-tax adjustment under current GATT rules. Similarly, the flat tax would be viewed as a direct tax and therefore ineligible as well. The sales tax, the VAT, and the business portion of the USA tax would all be considered indirect taxes, and therefore could be made adjustable at the border.

- Regardless of which system is ultimately chosen, affording preferential treatment to certain classes of goods or industries which narrows the tax base could result in a deterioration of international competitiveness. The economic literature concludes that a consumption tax will have *adverse* trade effects if preferential tax treatment -- such as exemptions, zero-rating, or a lower tax rate -- is afforded to non-traded goods. Many of the goods in existing consumption-tax systems that receive preferential treatment do not enter international trade.

II. Basic Structure and Competitiveness

The current tax system has eroded the ability of U.S. industry to compete internationally by imposing artificial tax biases whose effect is to lower total factor productivity in general, and labor productivity specifically. The primary bias in the tax code is one that discourages investment and saving in our economy.

Investment

There are many factors that affect worker productivity, but most economists would agree that increased productivity requires a healthy rate of capital investment. The current tax system artificially increases the cost of capital through multiple layers of taxation on productive investment. This discourages investment, lowers labor productivity, and renders the economy less efficient than it would be were market forces not distorted.

Although the anti-capital bias is exacerbated by the complexities and arbitrary nature of the existing tax code, it is an inherent part of any tax levied on an income base. A fundamental switch to a consumption-based system would not, as some believe, subsidize investment or give the owners of capital a free ride. Rather, switching to a tax system that employs a consumption base would simply restore neutrality to society's collective decision as to how much of the nation's output to consume, and how much to invest.

This concept of neutrality regarding investment decisions appears to be one of the most misunderstood aspects of the tax reform debate, as has been most evident in arguments regarding the flat tax. The popular perception is that capital income is "exempt" under various consumption-base tax variants, and therefore workers bear the entire burden of government. This is simply not true.

Under a consumption based-tax system, all income is taxed once, but only once. Consider, for example, a VAT. The perception that capital is exempt stems from the feature that physical assets are expensed by the purchasing firm. The reason for this feature is that the value-added associated with the purchased asset has already been taxed -- when the producer of the asset sold it to the purchaser. If the purchasing firm were not allowed to expense the purchased asset, this inherent value-added would be taxed twice, resulting in a bias against investment goods, in favor of other goods which are only taxed once.

This becomes more apparent when one considers the case of a vertically integrated firm that produces its own capital assets internally. Such a firm would *not* be allowed to expense its capital assets under a VAT, because the assets would not have been previously subject to the VAT. The rule is that all value-added is taxed once but only once.

Labor compensation is not exempt from the VAT base because, since we don't have a "head tax" in this country, labor value-added has not been subject to a previous layer of tax. The treatment is symmetrical with respect to capital. Only previously taxed capital can be expensed.

The income tax is inherently biased against capital due to multiple layers of taxation. Empirical evidence increasingly establishes that a shift from an income based system to a consumption based one will increase economic efficiency and the rate of capital formation. For instance, a study by Alan Auerbach and Lawrence Kotlikoff concluded that, "[t]he consumption tax base generates significantly more long-run capital formation than either the wage tax or the income tax."[1] Substantial efficiency gains from replacing the corporate income tax with a VAT were also found in an analysis by Ballard, Scholz, and Shoven.[2] Don Fullerton and Diane Lim Rogers also researched VAT/other-tax substitutions and concluded that there were substantial efficiency gains from replacing the income tax with a VAT and even larger ones from using the VAT as a substitute for the corporate income tax.[3]

Fundamental tax reform which replaces the current income-based system with a consumption-based one will, therefore, enhance the international competitiveness of U.S. industry through a removal of the current bias against investment. Of the five reform proposals that are the subject of this hearing, four -- those that define the tax base to be consumption -- pass muster with respect to investment neutrality. Any type of reform which retains an income base will retain the existing bias against capital. Therefore, a broader-based income tax will not enhance competitiveness in this area.

The remaining four reform variants are all consumption taxes. Despite all the attempts at product differentiation and deification of one's own proposal while demonizing all competitors, a flat tax, USA tax, VAT, and a sales tax all essentially achieve the same tax base. They are all consumption-based taxes, and despite different points of taxation, rate structure, and administrative procedures, they are *qualitatively* equivalent. Any one of the four would result in increased investment, economic efficiency, and international competitiveness.

Savings

The United States has one of the lowest savings rates of all OECD countries. If the investment bias were rectified at the business level, but savings remained low, there could be an anomalous result in terms of competitiveness because of the effects of required capital inflows on the value of the dollar.

In a world where capital is mobile, investment can increase without a commensurate change in domestic savings, but only if foreign savers are willing to fund the new investment through capital inflows. In and of itself, there is nothing wrong with foreign savers purchasing U.S. financial assets. There is, however, a secondary effect.

In order to purchase U.S. assets, foreign savers have to transact in U.S. dollars. All else constant, the mirror image of a capital inflow is an appreciation of the dollar, which makes U.S. goods relatively more expensive in world markets. Even if new investment were to make the U.S. economy more efficient, if such investment were financed primarily by foreign savers, there would be at least a partially offsetting effect due to exchange rate changes. Given the vagaries of foreign exchange markets, this countervailing effect should not be overstated, but Lawrence

1 Alan J. Auerbach and Lawrence J. Kotlikoff, *Dynamic Fiscal Modeling*, Cambridge, 1987, at 57.

2 Charles L. Ballard, John Karl Scholz, and John B. Shoven, "The Value-Added Tax: A General Equilibrium Look at its Efficiency and Incidence," *The Effects of Taxation on Capital Accumulation*, Martin Feldstein-ed., University of Chicago Press-1987, at 47.

3 Don Fullerton and Diane Lim Rogers, *Who Bears the Lifetime Tax Burden?*, Brookings-Washington, DC, 1993, at 230.

Summers is correct in this assessment: "The only way in which we can raise both investment and international competitiveness simultaneously is to increase national savings."[4]

In addition, there is strong empirical evidence that international capital is insufficiently mobile to render domestic savings irrelevant. There is a strong correlation between rates of domestic saving and investment in OECD countries. Therefore, rates of investment in productive capacity will be constrained by low rates of saving.

One of the more controversial areas of the tax reform debate is the effect of different tax bases on the aggregate rate of savings. There is virtually no controversy among economists concerning the proposition that an income tax is inherently biased against savings. The following example illustrates this bias. An individual earns income and pays tax. If he or she uses the proceeds for consumption, there are no additional tax consequences; but if the income is saved, the interest is taxed a second time. This well-known double taxation of savings distorts the decision to save or consume.

Whereas most economists accept the notion of the savings/consumption distortion in the income tax, there is considerable controversy regarding the effects on *saving rates* from removing this distortion. There is a well known concept in economics that the response of saving to an increase in the real after-tax rate of return to saving is a function of two countervailing forces. There is a pure substitution effect which increases the savings rate as present consumption becomes relatively more expensive, and an income effect which works in the opposite direction because individuals can save less and still achieve a target level of future consumption. Resolution of the savings response is, therefore, an empirical matter *if we are concerned with an autonomous increase in rates of return.*

In the context of a *revenue-neutral* tax reform, however, there is no income effect. By definition, in the aggregate, the same level of resources is extracted from the private sector. Therefore, the price of future consumption relative to present consumption is altered, producing a savings response, but since in the aggregate, after-tax income remains the same, there is no countervailing income response. In economic parlance, the tax changes are "compensated."

This is not controversial in the economics profession. It is part of Auerbach and Kotlikoff's model: "Since the tax policies considered here are compensated, there is no overall income effect for the private sector... ."[5] It is put succinctly by Feldstein:

> Although offsetting income and substitution effects imply that raising the rate of return has a theoretically ambiguous impact on personal saving, a compensated tax change that increases that rate of return to savers unambiguously raises national saving. Moreover, as Feldstein and Tsiang (1968) noted, the theoretical ambiguity disappears even for an uncompensated change for the vast majority of individuals who initially do no saving. For such individuals, savings would unambiguously be increased by a rise in the real net rate of interest.[6]

Therefore, in the context of revenue neutral tax reform, the subject of this hearing, a replacement of the current tax system with a consumption-base tax should lead to an unambiguous increase in the U.S. savings rate.

There is a growing body of empirical evidence that suggests that tax changes which diminish the anti-saving bias of the tax code do result in increased savings. For instance, recently an article appeared in the prestigious *Journal of Public Economics* entitled, "Do 401(k)

[4] Summers, Lawrence H. 1987. "The Impact of Tax Policy on Savings." In Charles E. Walker and Mark A. Bloomfield, eds., *The Consumption Tax: A Better Alternative?* Cambridge, MA: Ballinger Publishing Company, at 173.

[5] Auerbach and Kotlikoff, at 58.

[6] Martin Feldstein, "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving," *Quarterly Journal of Economics*, May, 1995, at 476.

Contributions Crowd Out Other Personal Saving?"[7] The study considered whether 401(k) plans resulted in new savings or simply supplanted other savings. Poterba *et al* concluded, "most 401(k) contributions represent new saving."[8] This conclusion is nothing new. One of the first researchers to study IRAs, David Wise, produced evidence from individual panel data that IRAs were effective new savings vehicles. In a study of IRA limit increases included in a National Bureau of Economic Research (NBER) volume in 1987 Wise determined:

> The primary focus of this paper, however, has been the effect of limit increases on other saving. How much of the IRA increase would be offset by reduction in non-tax deferred saving? The weight of the evidence suggests that only a small proportion of the increase would be offset by reductions in other financial assets, possibly 20% or less. Our estimates suggest that approximately 45%-55% of the IRA increase would be funded by reduction in consumption and about 35% by reduced taxes.[9]

Other studies, e.g., Feenberg and Skinner (1989)[10] and several papers by Venti and Wise, provide evidence of the net savings effects of IRAs and other tax deferred savings vehicles. In a 1991 study of a survey of 20,000 households, Venti and Wise revisited the issue of the effects of increasing IRA limits on net savings. They concluded:

> About two-thirds of the increase would be financed by reduced consumption and about one-third by reduced taxes. Very little would be financed by reducing other saving or by increasing debt.[11]

A recent paper by Martin Feldstein also confirmed that IRAs and other tax-deferred savings vehicles contribute to national savings; that is, the increase in saving exceeds the resulting loss of tax revenue. The studies previously cited all concluded that national savings has increased as a result of savings vehicles. Feldstein argues that these studies actually *underestimate* the savings effect by not including the effects on corporate tax revenues when new IRA saving is invested in corporate investments that generate income.

> Previous analysis of IRA plans and other savings incentives have miscalculated their effect on tax revenue (and therefore on national saving) by focusing exclusively on personal tax payments. Tax rules that include personal saving also have important positive effects on corporate tax revenue. The revenue loss associated with IRAs and other savings incentives is therefore smaller than generally estimated and may actually be a revenue gain.[12]

It is not only in the United States that evidence linking saving and tax incentives has been found. Burbidge and Davies recently studied the tax-deferred retirement system in Canada and found, "a strong gross correlation between tax incentives for saving and the personal saving rate."[13] This concurs with an earlier study by Carroll and Summers which explained the

[7] James M. Poterba, Steven F. Venti and David Wise, "Do 401(k) Contributions Crowd Out Other Personal Saving?", *Journal of Public Economics*, September, 1995, at 1-32.

[8] Poterba, Venti and Wise, at 2.

[9] David A. Wise, "Individual Retirement Accounts and Saving," *Taxes and Capital Formation*, Martin Feldstein-ed., University of Chicago Press, 1987, at 14.

[10] D. Feenberg and J. Skinner, "Sources of IRA Saving," *Tax Policy and the Economy*, NBER-Chicago, 1989, at 25-26.

[11] Steven F. Venti and David A. Wise, "The Saving Effect of Tax-deferred Retirement Accounts: Evidence from SIPP," *National Saving and Economic Performance*, Bernheim and Shoven-eds., University of Chicago Press, 1991, at 105.

[12] Feldstein, at 476.

[13] John B. Burbidge and James B. Davies, "Government Incentives and Household Saving in Canada," *Public Policies and Household Saving*, James Poterba-ed., University of Chicago Press, 1994, at 55.

divergence in the savings rates in Canada and the United States as resulting from the expansion in tax-deferred retirement plans in Canada.[14]

As was the case with the investment issue, four of the five candidates for tax reform considered in this hearing will increase international competitiveness by removing the anti-savings bias of the present tax code. The USA tax, with an exemption for saving at the personal level while returns to saving are taxed when spent as consumption, is savings neutral. So is the flat tax which taxes all capital returns only once at the business level. Similarly, the VAT and the sales tax are also neutral in their effects on the saving/consumption decision. Any broad-based tax which retains the concept of an income base, however, would continue the artificial distortion of savings choices.

III. Border Tax Adjustments

One of the policy issues where it is claimed that business people and those that study their decisions are most at odds is the effect of border-tax adjustments on competitiveness. The existence of this issue, of course, can be blamed on the GATT (The General Agreement of Tariffs and Trade), which allows a system of border tax adjustments. Such adjustments are allowed on "indirect taxes" (sales taxes, VATs, excise taxes, and the like), but not on "direct" taxes (income taxes, payroll taxes, and other taxes on income flows). Given a choice of adopting the "origin" principle, where taxes are levied on goods in countries where they are produced, or the "destination" principle, where taxes are levied on goods in the country in which they are consumed, the GATT adopted the destination principle. Indirect taxes like the VAT, which are applied *directly* to goods, are levied on imports and rebated on exports while direct taxes like the corporate income tax, which may *indirectly* enter the price of goods, are not applied to imports and not rebated on exports.

There is conventional wisdom that states that border-tax adjustments are irrelevant in the long-run with regard to international trade. Less sophisticated analysis simply argues that any trade effects are eliminated by changes in exchange rates. More sophisticated analysis focuses on the relative prices of traded goods and notes that the *relative* price of imports to exports (both internally and externally) is unaltered *in the long run* under both the origin and destination principles. Therefore, it is argued, border-tax adjustments have no long-run influence over a nation's trading pattern. While this is technically true in the long-run under a set of highly restrictive assumptions,[15] probably the most interesting analysis applies to sectoral changes in the "short run."

The classical theory of trade states that countries trade because they are different. They are endowed with different levels of natural resources, labor of differing qualities and costs, capital, and other factors of production, or there are differences in consumer tastes. Because they are different, countries face different trade-offs in the types and quantities of goods and services they can produce, given their differing resources. In one country a class of goods may be *relatively* less costly than in another country, therefore, "comparative advantages" may exist.

The classical theory holds that by engaging in trade with one another, countries can exploit others' efficiency and better themselves. As they begin to trade, the relative prices of the goods entering trade in each country will change until relative prices are equalized. At this "equilibrium" each country will be economically better off than it was before because there will have been "gains from trade." The faith that is required is that the free market will sort out the best solution. Therefore, countries are best served if prices of goods entering international trade are not distorted by government policies. But not just any prices -- *relative* prices. One of these countries could have higher *absolute* costs for all products entering trade and the other still could benefit from trade. The relative prices that are of importance are expressed as opportunity costs -- what must be given up in terms of one thing to produce another thing.

[14] Chris Carroll and Lawrence Summers, "Why Have Private Savings Rates in the United States and Canada Diverged?," *Journal of Monetary Economics*, September, 1987, at 249-79.

[15] See e.g. Gary Clyde Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments*, Institute for International Economics, Washington, DC, 1996, at 23, 24.

As a general principle, then, policies that artificially distort the *relative* prices of traded goods diminish economic efficiency by lessening the gains from trade. There are both internal and external relative prices to be considered. Economists define the "terms of trade" as the *external* price of exports of a country, divided by the external price of the goods that the country imports. A country is better off when the external price of exports rises relative to imports; that is, when the terms of trade improve; because obviously it can buy more with the same volume of exports -- what it sells in international markets has increased in value.

The terms of trade are not, however, the only relative prices that matter to policy makers. It is well known in the literature, for instance, that there are two countervailing effects of a tariff. There is an efficiency loss from a distortion of the internal prices facing consumers and producers after application of the tariff which disturbs the allocation of resources, and there is an improvement in the terms of trade which benefits the country. For a "small" country, one which has insufficient market share to influence world prices, by definition *no* trade policy can affect the terms of trade. But policies *will* influence internal relative prices and force consumers and producers into decisions they otherwise would not make, thus distorting the allocation of resources and lessening economic efficiency.

The standard methodology used to investigate the effects on relative prices of border-tax adjustments involves a general equilibrium model where all results are reported after the world has fully adapted to a tax change, and no mention is made of what happens during the period of adjustment. It makes a crucial assumption that the country being studied is relatively small; that is, its world market share is sufficiently small that it has no power to affect the world prices of traded goods. By definition, therefore, nothing the country does in terms of policy changes can influence the external terms of trade, but tax changes can affect the internal relative prices of traded goods facing domestic producers and consumers. These relative prices are what are tested, at equilibrium, for the differential effects of border-tax adjustments.

It also assumes that the test country produces three goods. The first good produced by the country is consumed domestically, but also can be exported (exportable). The second domestically produced and consumed good competes with imports from the rest of the world (importables). The final good is produced and consumed domestically and is neither exported nor does it face potential import competition (non-traded).

For equilibrium to occur in these models, three conditions must be satisfied. First, the domestic seller of the exportable good must be receiving the same return, after-tax, in both the home market and the external market. Obviously, if this were not the case, sellers would divert sales to where the after-tax returns were higher, and the positive or negative change in domestic supply in the home market would cause the domestic price to adjust until after-tax prices were equalized in the home and external markets. By definition, the world price is fixed, so that the domestic price of the exportable would be the price that changes to make sellers indifferent between the domestic and external markets. Second, the price of the domestically produced importable good, including tax, cannot be any different than the price of the import, including tax. Otherwise consumers would shift to the cheaper version until demand changes caused the domestic price to adjust to restore equilibrium. Third, domestic supply of the non-traded good must equal demand for there to be equilibrium.

Short-Run Implications

To see how crucial the border-tax adjustment is to the traded goods sector of an economy, consider the following example. Assume initially that a country that is "small" relative to the totality of world trade has no tax system. Because it has little market power, the country's producers are price-takers -- they are constrained to sell at "world" prices. The world price of the country's goods that compete with imports is 10. The world price of the good the country exports is 15. The ratio of the prices of exports to imports (both internally and externally) is 1.5.

The country's government, having listened to economists that have stated that border-adjustments are irrelevant, imposes a 10 percent origin-based tax. Producers of exports would like to charge 16.5 in order to maintain the same after-tax return, as before the imposition of the tax. But they can't. They are constrained to sell at a price, including tax, equal to the world price. In order to remain competitive in world markets, exporters must reduce their return on sales to 13.64 per unit. Note that foreign purchasers are still paying 15 for the exports, so that there is nothing that would pressure exchange rates. The difference is that only 13.64 is going to the private company with the remainder going to the government.

Quite obviously, a reduction in private returns of over 9 percent is going to cause previously competitive companies to lose money. The inevitable result is a contraction in the export producing sector, either through business closures or decreased production. In fact the export sector must contract until the remaining firms find it profitable to sell exports at 13.64.

Similarly, domestic producers that compete with imports would like to charge 11 after the tax is imposed. But they can't either. Imports don't face any tax under the origin principle. If import-sensitive companies want to sell any of their goods, they will have to reduce their private return to 9.09. Again, this will drive companies out of business until sufficient contraction has been achieved that firms find it profitable to compete against imports at a 9.09 pre-tax price, to produce an after-tax price of 10. Note that since the price at the border hasn't changed, there is no pressure for exchange rates to change.

In the sector that produces goods that don't enter international trade, either as exports or as competitors with imports, the story is entirely different. These goods also face a 10 percent tax but they don't face the binding constraint of world prices. Depending on the domestic elasticity of demand, producers will be able to shift some or all of the tax to consumers in the form of higher prices.

These companies, to the extent that they have to bear some of the tax, will also see private returns drop, but not by the full amount of the tax. Trade-sensitive companies, however, will bear the full burden of the tax, due to the tyranny of world price constraints. Thus, the returns available in the traded-goods sector will drop relative to those available in the non-traded goods sector. The result will be a shift of resources out of the trade sector until equality of returns is restored. Once the relative contraction of the trade sector and the corresponding expansion of the purely domestic sector is complete, the economy will be in equilibrium.

At this equilibrium the external price of exports (including the tax) is still 15 and the price of importables to consumers is still 10. The relative price hasn't changed. Similarly, the private return to exports is 13.64, and the private return to importables is 9.09. This relative price is also 1.5.

The country's economists are proven to be right in terms of long-term neutrality. Relative prices are unaltered from the free trade equilibrium, and therefore the tax is entirely neutral with respect to the country's future trade relations. This is small comfort to the traded goods sector, however. This neutrality has only been achieved because their sector has contracted.

Now consider the situation we are in currently. We are considering replacing an origin-based tax with a destination-based system on *a revenue neutral basis*. After such a switch, the tax on non-traded goods would be the same. But since tax is rebated on exports, exporters can increase their private returns to 15, the constraining world price. Once again there is no influence on the exchange rate because the only thing that has changed is that the part of the world price of 15 that was going to the government now goes to the private company. The returns available to exporters have increased *relative* to those in the non-traded goods sector, while in *absolute* terms, the non-traded sector returns have not dropped.

In the import intensive sector, now the tax applies to imports as well as their domestic competitors. Foreign producers require the world price of 10, so the import price including tax rises to 11. Domestic producers can now raise their prices to 11 as well, and their private returns are restored to the free trade level. Here, there may be some countervailing exchange rate pressure.

The higher returns in the traded goods sector leads to an expansion, relative to the non-traded goods sector. Equilibrium occurs when all private returns are equalized. At the new equilibrium all relative prices are the same as under free trade, so the destination-based system is entirely neutral. But this time the long-run neutrality has been achieved only because of a relative expansion of the trade sector.

The "short-run" consequences would appear to be significant indeed. Switching from an origin-based system to a destination principle will result in more exports and/or increased investment in export producing companies during the adjustment period. Similarly, there will be less imports and/or more investment flowing to import-sensitive companies. And since the system will ultimately be trade neutral, it would seem wise for the United States to avail itself of these short-term benefits.

Other Economic Effects

There are other reasons why a destination principle tax is preferred to an origin-based one. Some of the most contentious and frustrating controversies in international taxation concern transfer prices. With an origin-based consumption tax, these controversies remain, indeed may be exacerbated. Companies will have a strong incentive to artificially distort transfer prices.

In a destination-based system, however, all transfer pricing issues are eliminated. There is no incentive to artificially distort transfer prices because if a company understates an import price, it is exactly offset by the lower deduction (or tax credit), taken against the value that is taxed at final sale.

Harry Grubert and Scott Newlon made this point in a *National Tax Journal* article:

> In addition, a destination-principle consumption tax would eliminate income shifting by MNCs [multinational corporations] out of the United States through manipulation of their transfer prices. However, there would continue to be such an incentive under an origin-principle consumption tax.[16]

The transfer pricing issue was also stressed in a follow-up comment to Grubert and Newlon's article:

> Specifically, an origin-based business tax does nothing to resolve the transfer pricing problem, which has been vexing the IRS for many years, and is likely to continue as a major source of difficulty in years to come, despite the adoption of new regulations to deal with the problem.[17]

Another issue has to do with the differential incentives regarding production-facility location (often labeled the "runaway plant" issue) under alternative border-tax adjustments. As stated by Grubert and Newlon:

> In contrast to its effects under the income tax, the exemption of foreign income under a consumption tax, including exemption of receipts of foreign royalties under the destination principle, is not likely to cause a substantial "runaway plant" effect in which multinational corporations (MNCs) shift production abroad. On the contrary, MNCs would likely shift tangible investment, intangible assets and R&D to the United States. . . .
>
> [U]nder the origin principle, but not under the destination principle, some incentive may remain for MNCs to locate in low-tax countries... .[18]

16 Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal*, December, 1995, at 620.

17 Reuvan S. Avi-Tonah, "Comment on Grubert and Newlon, 'The International Implication of Consumption Tax Proposals.'" *National Tax Journal*, June, 1996, at 260.

18 Grubert and Newlon, at 620.

Therefore, if the Congress decides to initiate fundamental tax reform, and shift the base of taxation from income to consumption, it should also choose to shift from an origin principle to a destination principle. This shift will be beneficial to the trade sector, will eliminate transfer-pricing controversies, and will remove distortions that encourage companies to move facilities overseas.

A broad-based income tax is obviously ineligible for a border-tax adjustment under current GATT rules. Similarly, the flat tax would be viewed as a direct tax and therefore ineligible as well. The sales tax, the VAT, and the business portion of the USA tax would all be considered indirect taxes, and therefore could be made adjustable at the border.

IV. The Effects of Base Erosion on International Competitiveness

This testimony has argued that of all the tax reform variants being considered, the form that would most enhance competitiveness is a destination-based consumption tax. Regardless of which system is ultimately chosen, however, affording preferential treatment to certain classes of goods or industries which narrows the tax base could result in a deterioration of international competitiveness. This will be illustrated with reference to consumption taxes.

The economic literature concludes that a consumption tax will have *adverse* trade effects if preferential tax treatment -- such as exemptions, zero-rating, or a lower tax rate -- is afforded to non-traded goods. Since many of the goods in existing consumption-tax systems that receive preferential treatment do not enter international trade, the analysis of preferential treatment must include consideration of the trade effects.

The reasoning is straight-forward. Consider an example where non-tradeables are zero-rated under a VAT, or exempted from a sales tax. If a tax applies to traded goods but not to non-traded goods, the relative prices of exportables to non-tradeables and importables to non-tradeables would increase. Having the tax apply to tradeables but not to non-tradeables introduces a tax wedge between the two sectors. Either the cost to consumers of importables and exportables relative to non-tradeables has increased and/or the returns to businesses of importables/exportables relative to non-tradeables have decreased. In either case the result is a reduction of consumption of tradeables relative to non-tradeables and/or a relative decrease in investment flowing to the tradeable sector. Strictly because of a tax-induced relative price change, the tradeable-goods sector will contract.

This is a serious issue for policy makers when you think of the types of goods that don't enter international trade. Examples include housing, medical care, education, many types of food sold for home consumption, and other goods. The standard proposals to exempt or zero-rate housing, food, medical care, and welfare activities would apply substantially to non-traded goods.

Preferential treatment for some goods and services as a remedy for perceived regressivity has been criticized on a number of grounds. It is generally agreed that exemption, zero-rating, or lower rates are extremely inefficient and costly ways to redress regressivity; and that it is preferable to seek remedies outside the consumption-tax system through income tax credits or transfers. It is also apparent that preferential treatment causes economic inefficiency by distorting consumer and producer choices across industries. Now a third and compelling reason has been added to oppose narrowing of the tax base. The effect will be a *long-term* deterioration of a nation's trading position.

In the current round of tax reform debate, it is clear that policy makers have appreciated the necessity of maintaining a broad tax base and not employing preferential tax rates. All of the major consumption tax proposals -- the Gibbons business tax, the Armey flat tax, the Schaefer-Tauzin sales tax, the Danforth-Boren business tax, and the Nunn-Domenici business tax -- apply one tax rate to all businesses with no exclusions/zero-rating. This is the right result for many reasons including the effects on international competitiveness.

Tax Policy Forum

Value Added Taxes and International Competitiveness

by David G. Raboy

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I. Introduction

It is not uncommon for the views of academic economists and those of business people—whose actions and decisions economists attempt to study—to differ. It is, of course, somewhat of an irony in our academic era, with its models of bounded rationality, rational expectations, and other representations that suggest that business people act in their own self-interest. Yet on some key issues, business people and academic economists can apparently hold radically different views for long periods of time on the effects of policies. One policy issue on which the opinions of these two groups appear to be most at odds is the economic effects of a value added tax (VAT)—or, more precisely, the substitution of a VAT for existing business taxes—on international competitiveness.

The very existence of this issue can be traced to provisions of the General Agreement on Tariffs and Trade (GATT), which includes a system of border tax adjustments.[1] Such adjustments are allowed for *indirect* taxes (sales taxes, VATs, excise taxes, etc.), but not for *direct* taxes (income taxes, payroll taxes, and other taxes on income flows). Given the choice between adopting the "origin" principle—where taxes are levied on goods in countries where they are produced—or the "destination" principle—where taxes are levied on goods in the country in which they are consumed—the GATT adopted the latter. Consequently, indirect taxes like the VAT, which are applied *directly* to goods, are levied on imports and rebated on exports, while direct taxes like the corporate income tax, which may *indirectly* affect the price of goods, are not applied to imports and not rebated on exports.

Since the United States currently relies on origin-based direct taxes with no border adjustments, while the rest of the world is more heavily dependent on indirect taxes with border adjustments, many business people in trade-intensive sectors have argued for transformation of the U.S. tax system, despite the analysis of academic economists. To such proponents of tax changes, Martin Feldstein and Paul Krugman (1990, p. 263), for example, lecture:

> Among many businessmen, however, the case for a VAT is often stated quite differently. They view such a tax as an aid

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[1]The adjustments reflect a "destination-based" system, and are as follows: taxes are forgiven on exports as they cross a country's frontier, and taxes that apply to domestically produced goods can also be levied on imports.

to international competitiveness since VATs are levied on imports but rebated on exports. The case is often stated as follows: an income tax is paid by producers of exports but not by foreign producers of the goods we import, while a VAT is paid on imports but not exports. Surely, say the proponents of this view, this means that countries that have a VAT have an advantage in international competition over countries that rely on income taxation.

In fact, this argument is wrong.

Feldstein and Krugman (1990, p. 264) go so far as to attribute to Charles McLure the view of "the competitive argument for a VAT as evident nonsense."[2]

Mainstream economic theory assumes that economic actors are "rational," that is, that they behave in predictable ways that represent their self-interest, based on available information. Why then would rational, profit-maximizing business people insistently advocate policies that apparently will not achieve their intended goals? Perhaps the information costs are so high that, given bounded rationality, it has been too expensive to educate those with errant opinions. (Presumably, the more lectures that business people receive from academic economists, the lower the transaction costs will be.) Or perhaps this is a principal-agent problem, where managers are promoting policies that do not coincide with the desires of the owners of capital. Or—just maybe—the gulf is not as wide as some economists believe.

This article attempts to reconcile these divergent views on the trade implications of VATs, and to determine what the economic literature actually says about VATs, other taxes, and international competitiveness. A first step must be to cull the plethora of issues and approaches. There is the question of the international effects of a VAT in isolation, or as a substitute for other taxes. The latter possibility raises the question of differences in tax incidence among VATs, the corporate income tax, payroll taxes, or individual income taxes. There is also the issue of the international monetary system and floating exchange rates, not to mention international capital flows.

To begin with, how should "competitiveness" be defined? Much of the popular literature considers the effects of a VAT on the trade balance (the "current account"), while much of the academic literature on trade is more concerned with the effects of tax policy on the relative prices of traded goods or the "terms of trade." The terms of trade, it is claimed, represent a nation's true economic welfare with respect to trade policy. Are the two concepts, the current account and the terms of trade, the same thing? Are they related? Used as alternative measures of the effects of policy change, will they provide the same answers? These are threshold questions. This article argues that if true economic efficiency is what we are after, then the terms of trade, or relative prices, are the best barometer for gauging the effects of policy changes.

If true economic efficiency is what we are after, then the terms of trade, or relative prices, are the best barometer for gauging the effects of policy changes.

Once the proper barometer has been chosen, there are many separate issues that must be analyzed in order to assess the international implications of substituting a VAT for other taxes remitted by businesses. Upon sorting through these various issues, which are discussed below, my reading of the literature indicates that the following conclusions are defensible:

- All else held constant, a switch from an origin- to a destination-based tax system will increase exports somewhat and decrease imports somewhat in the short run. An overhaul of the tax system cannot be justified on this basis alone, but if there is to be a major tax change for other reasons, the destination principle should be employed.
- Although an ideal VAT (broad-based with a single rate) is neutral in its effects on trade, a narrow-based VAT with exemptions and zero-ratings could result in a deterioration of competitiveness.
- The economic efficiency gains associated with a switch from taxes that distort economic decisions to a tax that is less obtrusive will result in additional indirect, positive effects on trade.

The following section defines and provides background on the terms-of-trade concept, as well as on the current account, and explains why the former is preferred to the latter as a gauge for tax policy. The subsequent section temporarily puts aside questions of differential incidence to explore the effects of idealized "origin-based" and "destination-based" VATs on relative prices. We next examine an extremely important point that has not received proper

[2]In fact, McLure did not make this definitive statement. While arguing that a stand-alone VAT was neutral in its trade effects, he states that "it seems reasonable to believe that substituting a VAT for part of the corporate income tax might improve U.S. competitiveness in the short run" (McLure 1987, p. 41).

attention in the popular literature—the effects on trade of a VAT with a narrow base, including exemptions and/or zero-rated goods. Following that, we briefly explore the literature on the effects of substituting a VAT for existing business taxes. We then return to the subject of the current account, and, finally, offer some conclusions.

II. How Should We Judge Competitiveness? Relative Prices and International Trade

The classical theory of trade states that countries trade because they are different (Dixit and Norman 1980, Krugman and Obstfeld 1991). They are endowed with different levels of natural resources, labor of differing qualities and costs, capital, and other factors of production; or there are differences in consumer tastes. Because they are different, countries face different tradeoffs in the types and quantities of goods and services they can produce.

For instance, in one country (country A) it may be possible to choose between producing two cars or 20 televisions with equivalent resources; whereas in another country (country B), the resources employed to build two cars could only produce 10 televisions if shifted to that industry. In the absence of trade, in country A, the *relative price* of televisions to cars is 10—each car is worth 10 televisions. In country B, the relative price is five. We can say that in A, cars are *relatively* more expensive because the production of one entails giving up 10 televisions; while in B, only five televisions are foregone per car. On the other hand, televisions are relatively more expensive in B: One television is worth 20 percent of a car. In A, however, producing a television entails sacrificing only 10 percent of a car.

We can therefore say that A has a *comparative advantage* in the production of televisions, and that B has a comparative advantage in cars. Further, each can benefit from trade. Remember that internally, citizens of A require the equivalent of 10 televisions to buy one car. If, instead, they sent those 10 televisions to B, they could buy two cars. Similarly, B's citizens could internally purchase five televisions with the resources needed for one car. But if they ship that one car to A, they can buy 10 televisions.

For both countries, there are *gains from trade*. As the countries begin to trade, the relative prices in each country will change, due to increased demand for each country's export, until the relative prices are equalized somewhere between the initial levels. At this *equilibrium*, each country will be economically better off than it was before.[3]

> All else held constant, a switch from an origin- to a destination-based tax system will increase exports somewhat and decrease imports somewhat in the short run.

That, in a nutshell, is the classical theory of trade. Each country can exploit the other's efficiency and so better itself. The faith that is required is that the free market will sort out the best solution. Therefore, countries are best served if prices are not distorted by government policies. But not just any prices—*relative* prices. Country A could have higher *absolute* costs for both products, and still country B could benefit from trade. Or as Avinash Dixit and Victor Norman (1980, p. 2) put it, "If two countries engage in trade, each will have incentives to increase production, and reduce consumption, of goods in which it has the lower *relative* marginal cost *prior to trade* than the other." The gains from trade stem from a lack of distortion of *real* prices and costs in the economies of the world. Exchange rates are not relevant in this view.[4] All that matter are the *opportunity costs* — what must be given up in terms of one thing to produce another thing.

This classical theory has been challenged by some rather embarrassing observations. Notably, almost identical countries trade with each other; also, some countries export essentially the same goods to each other (two-way trade). Rather than jettison classical theory, however, new trade theorists have added to it. They developed notions of economies of scale in production (in order to be efficient it might not make sense, given the market, to have 20 countries producing wide-body aircraft or supercomputers); and of imperfect competition.[5] When added to the classical concept of comparative advantage, these concepts do fairly well to explain trade in the modern world.

Whereas some of the new trade theory questions the efficacy of free trade, and most economists would grant that interference is warranted under certain situations, the dominant view of the

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[3] This, of course, is an extremely simple example that ignores, among other things, transportation costs. For detailed discussions of the classical theory of trade, see Dixit and Norman (1980) and Krugman and Obstfeld (1991).

[4] "[T]he exchange rate . . . is immaterial for the validity of the basic gain from trade. The sole purpose of the exchange rate is to translate the comparative advantage into an actual lower cost for consumers in the other country" (Dixit and Norman 1980, p. 3).

[5] *See, e.g.*, Krugman (1980), Lancaster (1980), Harris (1984), and Helpman (1981); for comprehensive volumes, see Krugman (1990) and Grossman (1992).

new trade theorists is that, in general, the additional explanations of trade patterns enhance rather than diminish the potential gains from trade.[6] Therefore, it is still appropriate to judge government policy as to its effects on relative prices.

As a general principle, policies that artificially distort the *relative* prices of traded goods diminish economic efficiency by lessening the gains from trade. They inhibit the decisions of both consumers and producers, and artificially direct both groups into uneconomic activities. There are both internal and external relative prices to be considered. Economists define the "terms of trade" as the *external* price of exports of a country, divided by the external price of the goods that the country imports. Paul Krugman and Maurice Obstfeld (1991, p. 109) call this the "ratio at which countries exchange goods." In the economics profession there is a "presumption that the terms of trade are a relevant measure of the welfare of a trading country—but that is usually taken for granted." (Dixit and Norman 1980, p. 19). As stated by Krugman and Obstfeld (1991, p. 98):

> The general statement, then, is that *a rise in the terms of trade increases a country's welfare, while a decline in the terms of trade reduces it welfare.*

A country is better off when the external price of exports rises relative to imports, that is, when the terms of trade improve, because obviously it can buy more with the same volume of exports—what it sells in international markets has increased in value.

The terms of trade are not, however, the only relative prices that matter to policymakers. It is well known in the literature, for instance, that a tariff produces two countervailing effects. There is an efficiency loss from a distortion of the internal prices facing consumers and producers after application of the tariff which disturbs the allocation of resources, and there is an improvement in the terms of trade which benefits the country.[7] For a "small" country—that is, one that has insufficient market share to influence world prices—by definition *no* trade policy can affect the terms of trade. But policies *will* influence internal relative prices and force consumers and producers into decisions they otherwise would not make, thus distorting the allocation of resources and lessening economic efficiency.

> The relevant question will be whether a VAT, or a VAT which replaces another tax, alters the internal or external relative prices of traded goods from those that would have prevailed under free trade.

Therefore, to gauge the effects of policy, this article looks at how both internal relative prices and the terms of trade differ from those that would prevail under free trade. The relevant question will be whether a VAT, or a VAT which replaces another tax, alters the internal or external relative prices of traded goods from those that would have prevailed under free trade.

III. Why Not Use the Current Account?

The current account, popularly known as the *trade balance*, is one component of a country's international accounts. It is defined as the difference between the value of exports and imports plus income received from foreign investments less income paid to foreigners from investments in the United States, plus adjustments for transfers (such as international relief efforts), and military transactions. The current account is measured in nominal units of a nation's currency.

A second component of a country's international accounts is the *capital account*, which is essentially the net of capital inflows and outflows (both private and public). Capital outflows include government currency reserves and other assets, and private assets such as stocks and bonds issued by foreign companies and governments. Capital inflows are basically official foreign government purchases of home-country assets and private purchases of domestic assets by foreigners. In addition, there is a small component of the capital account for International Monetary Fund Special Drawing Rights.

These two accounts comprise the balance of payments, which is simply an accounting identity that reflects all monetary inflows and outflows. By definition this identity must always be in balance; that is, any deficit in the trade balance must be made up by a capital inflow of equal magnitude. The excess of imports over exports must be paid for by borrowing money from foreign entities in one form or another.

Since the balance of payments must always balance, it also defines the demand for a nation's currency when exchange rates are free to float. Exports plus capital inflows essentially define the external *demand* for a country's currency (because a nation's goods

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[6] *See, e.g.*, the introductory chapter in Krugman (1990).

[7] *See* Dixit and Norman (1980), pp. 23-25; and Krugman and Obstfeld (1991), Chapter 8.

and assets must be purchased in home currency), while imports plus capital outflows define the external *supply* (because home currency must be converted to foreign currency to purchase foreign goods and assets). The supply of a currency will always be equal to demand. Therefore, there cannot be a change in the current account unless there is an offsetting change in the capital account, because both are recorded in nominal terms. If imports rise, the supply of a currency increases because domestic entities need to buy foreign exchange with dollars to purchase the imports. If there is no offset, i.e., foreign entities *demand* more dollars through lending to domestic entities (e.g., purchasing dollar-denominated bonds), then there will be a demand/supply imbalance. When the supply of dollars exceeds demand, the "price" of dollars—just like anything else—will fall. A currency depreciation will occur, returning the nominal current account to its previous position. Obviously, this says nothing about the real economy or economic efficiency.

Politicians focus on the trade balance because to them it relates to jobs. The perception is that exports create jobs and imports eliminate jobs, so a trade surplus is a good thing. Of course a trade surplus also requires capital outflows—any increase in the level of exports relative to imports requires capital, which otherwise would have been invested in the United States, to be invested abroad.[8]

The best way to illustrate that the current account is not a good gauge for policy is to take a noncontroversial issue—say, tariffs—and compare the analysis of that issue with respect to the current account and relative prices.

The world has recently concluded the Uruguay GATT Round, which was designed to reduce tariff and nontariff barriers to trade in a range of sectors including manufacturing, agriculture, and services. More than 100 GATT contracting parties devoted huge amounts of resources to negotiate the reduction of trade barriers, and economic studies published by international bodies predict substantial increases in the world's wealth due to the reduction of the trade barriers accomplished by the new GATT agreement.

Everyone can agree that tariffs distort trade. Tariffs also, economists agree, artificially distort the internal relative prices facing consumers and producers, and therefore change the allocation of resources from what would exist under free trade. Economists also agree that if a country is relatively large, a tariff will change the external terms of trade. Further, there is virtually universal agreement among academic economists that—except in rare situations—tariffs make the world less efficient and less well off; therefore, tariff increases are generally opposed.

> At equilibrium, none of the relative prices facing consumers or producers changes after the imposition of the origin-based VAT. The VAT, therefore, is entirely neutral in its long-run effects on trade.

So in an era of floating exchange rates, *all else held constant*, what happens to the current account if one country increases its tariffs? *Absolutely nothing*:

> In a large class of macroeconomic models with flexible exchange rates the tariff also has no impact on the current account, because an exchange rate appreciation will immediately offset all changes from higher tariffs . . . [I]f a tariff is to reduce a current account deficit it must have the effect of decreasing the country's international borrowing (Engel and Kletzer 1986).

In other words, *nothing can change the trade balance* unless it also changes the capital account.[9]

There is nothing incorrect about this statement. It simply affirms that the current account is an accounting mechanism that measures items in nominal terms, and that there is no necessary correspondence between it and changes in the real economy, the allocation of resources, or economic efficiency. Tariffs are *real* costs, involving the extraction of real resources. The effects of this extraction cannot be masked by changes in strictly nominal phenomena, such as the movement in nominal exchange rates.[10] For this reason,

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[8] *See, e.g.*, Sinn (1990, p. 1) who notes: "The confusion is shared by countries that take pride in being world export champions without realizing that they could equally well regard themselves as capital flight champions."

[9] It may well be that trade barrier reductions will indirectly influence capital flows, but these are second-order effects caused by the first-order changes in the relative prices that determine economic decisionmaking.

[10] It is generally agreed in the literature that exchange rates are immaterial to changes in relative prices. For instance, Dornbusch (1974), considering the effects of tariffs in a model with nontraded goods, states:

> [T]he requisite adjustment is one of relative prices. . . . Indeed there is nothing in this model that will determine nominal prices or an exchange rate and the frequently encountered assumption that in the 'background' monetary and fiscal policy maintain the nominal price of home goods is an unsatisfactory way of concealing what is essentially a non-monetary economy.

the effects of tax and trade policies on real relative prices are the preferred analysis route.

Of course, the trade balance will continue to be a politically charged issue. It is the most publicly accessible image of our trading relationships, and has become politically tied to such issues as the "export of jobs," and some general feelings concerning our standing in the world. Therefore, we will revisit the current account following an analysis of the effects of VAT on relative prices.

IV. Origin-Versus Destination-Based Taxes

Much of the debate on the trade effects of a VAT concerns the prospect of substituting a VAT for other taxes on business, including the corporate income tax and the employer portion of payroll taxes.[11] Such a substitution raises several issues, including potential differences in tax incidence and the effect of switching from an origin- to a destination-based tax. We concentrate on the latter issue here. Using an ideal (broad-based with a single rate) VAT, this section analyzes, in turn, the relative-price effects of an origin-based VAT and a destination-based VAT. It then investigates any effects on the relative prices of traded goods caused by switching from an origin- to a destination-based VAT.

A. The Methodology

Several analyses (e.g., Feldstein and Krugman 1990, Grossman 1980, and Wade 1982) have been written that investigate the effects on relative prices of a VAT. All of these use approximately the same approach, which we will also use here. This standard methodology involves a general equilibrium model in which all results are reported after the world has fully adapted to a tax change, and no mention is made of what happens during a period of adjustment.

The methodology also makes a crucial assumption that the country being studied is relatively small; that is, its world market share is sufficiently small that it has no power to affect the world prices of traded goods. Rather, the country is a *price-taker*; it takes world prices as given. By definition, therefore, nothing the country does in terms of policy changes can influence the external terms of trade, but tax changes can affect the internal relative prices of traded goods facing domestic producers and consumers. These relative prices are what are tested, at equilibrium, for the effects of VAT or other taxes.

The process of moving from the origin-based system to the destination-based one involves some short-run changes in levels of exports and imports.

The standard model assumes that the test country, and the rest of the world, produces three goods. The first good produced by the country is consumed domestically, but also can be exported (exportable). The second is domestically produced and consumed, but competes with imports from the rest of the world (importable). The final good is produced and consumed domestically and is neither exported nor faced with potential import competition (nontradable).

For equilibrium to occur, several conditions must be satisfied. First, the domestic seller of the exportable good must earn the same return, after tax, in both the home market and the external market.[12] Obviously, if this were not the case, sellers would divert sales to where the after-tax returns were higher, and the positive or negative change in domestic supply in the home market would cause the domestic price to adjust until after-tax prices were equalized in the home and external markets. By definition, the world price is fixed, so the domestic price of the exportable must change until sellers are indifferent between producing for the domestic and external markets.

Similarly, the price of the domestically produced importable good, including tax, cannot differ from the price of the import, including tax. Otherwise, consumers would shift to the cheaper version until demand changes caused the domestic price to adjust to restore equilibrium. (Recall that, by assumption, the import price before domestic tax is a world price, and cannot be changed by domestic policies or changes in domestic demand.)

Finally, domestic supply of the nontradable good must equal demand for there to be equilibrium. In this section, where we are considering an ideal VAT with no exemptions or zero-ratings, we can ignore nontraded goods. Nontradable goods will be important when a non-ideal VAT is considered. As discussed in the next section, preferential treatment is often most apparent for goods that do not enter international trade.

This model makes one final assumption. To isolate the relative-price effects of tax changes and allow changes in producer or consumer income to be ignored, it is

[11] The term "taxes on business" is used loosely here to denote the point of taxpayer compliance, not necessarily economic incidence. For instance, business remits VAT, the employer portion of the payroll tax, and the corporate income tax; therefore, these are taxes on business. This does not mean, however, that the owners of business bear the ultimate economic burden.

[12] The implicit assumption is that firms strive to maximize profits. In the real world, firms may price strategically to achieve other goals, such as an expansion of market share.

assumed that all tax revenue is distributed to consumers and/or producers in a nondistorting way that compensates them for any additional tax liability. Thus, relative-price changes, which alter incentives and therefore change economic behavior, are the only subjects of the analysis.

How useful is this model in terms of analyzing the real world? Certainly, the United States, with respect to some products, is not a small country and can influence world prices, but the fact that the model is capable of assessing changes in internal relative prices allows for an understanding of the direction of changes in distorting forces. In addition, it may be possible to adjust the model to allow for a "large country" case.[13] Judging the effects of tax changes on relative prices in a small country is probably a sufficient representation of the general effects for a large country as well. Although the assumed nondistortionary redistribution of tax proceeds is unrealistic,[14] it does allow us to isolate the pure price effects and therefore is useful for *equilibrium* analysis. Such an assumption is not equivalent to the more plausible assumption of revenue neutrality, and the differential intra-equilibrium effects will be examined later in the discussion of the path of adjustment when one moves from an origin-based tax to a destination-based one.

With these thoughts in mind, we can investigate the tax effects of various VATs on the relative prices of traded goods employing Gene Grossman's model (1980). Assume that initially the home (small) country has no tax system. Although it does not matter what system the rest of the world follows—since world prices are given and fixed—let us assume that the rest of the world has destination-based VATs.

In the initial free-trade equilibrium, the world price of imports into the home country is 10; therefore, the price of the domestically produced importable is also 10. The world price of the good that is exported is 15. Therefore, both the internal and external relative price of exports to imports is 1.5.

B. Origin-Based Taxes

This example shows that there is no change, at equilibrium, in any relative prices when a country with no prior tax system imposes an origin-based tax.

The home country imposes an origin-based VAT levied at 10 percent. What does the new equilibrium look like? An origin-based tax applies to exportables consumed domestically, actual exports, and importables produced and consumed domestically, but not to imports.

> The existence of short-run positive trade effects is, in and of itself, no reason to change a tax system, given the uncertainty of the trade effects and the administrative and compliance costs associated with the tax change.

A seller of exportables is constrained in world markets by the world price of 15. Thus, at equilibrium, the seller's return must be reduced to approximately 13.64 so that he can meet the world price after the tax is levied. Of course, the same price applies to exportables consumed domestically so arbitrage will result in an equilibrium where the return to the seller is also 13.64, and consumers pay an after-tax price of 15.

Because there is no tax on imports, they continue to enter the home market at 10. To remain competitive with imports, domestic sellers of importables, at equilibrium, will have to reduce their pre-tax price to about 9.09.

Notice that the small country assumption implies that the origin-based tax is fully borne by domestic producers constrained by world prices. The model finesses this by assuming that the tax proceeds are redistributed to producers in lump-sum fashion, so that the only thing that matters is any change in relative prices.[15]

What did the origin-based VAT do to the relative prices of traded goods facing consumers and sellers? For consumers, exportables still cost 15 and imports and importables still cost 10, so there is no change in the relative price facing consumers. Sellers receive 13.64 for exports and 9.09 for importables, leaving the ratio of returns unchanged. The relative-price ratio of exports (exportables) to importables is still 1.5 for both consumers and producers.

At equilibrium, none of the relative prices facing consumers or producers has changed after the imposition of the origin-based VAT. The VAT, therefore, is entirely neutral in its long-run effects on trade. At equilibrium, the opportunity cost of producing exportables (in terms of foregone im-

[13]In most cases the results of a large-country model will be indeterminant, because the equilibrium result depends on the relative market strengths of the country in exportable and importable markets.

[14]To be nondistorting, a lump-sum distribution exactly equal to the change in tax liability would have to be calculated for every taxpayer for each year that the tax change is in effect. The practical problems in such a calculation are enormous, and it has never been tried. Given political realities, a VAT would likely be used to pay for other tax changes in a revenue-neutral fashion.

[15]Under any assumption that does not distribute tax proceeds to producers in relation to their initial tax liability, the first-order incidence of an origin-based tax will fall on producers.

portables) is exactly the same as before the imposition of the tax, so there is no incentive to alter the pattern of trade.

C. Destination-Based Taxes

What if the country imposes a destination-based tax at the same 10 percent rate? This example shows that, as in the case of an origin-based tax, the imposition of a destination-based tax would cause no change in relative prices, compared to the no-tax scenario.

Looking strictly at the outcome *at equilibrium*, the following would be true. Exporters would charge and receive 15 per unit on the world market because the tax would be rebated. Because sellers must make the same return in the home and external markets, the VAT on exportables would be passed forward so that the after-tax price facing consumers would be 16.5 and sellers would receive 15. The world price of imports is still 10, but now the VAT would apply at the border, so consumers would face an after-tax price of 11. Domestic sellers of importables would also receive 10 so that the after-tax price is 11.

Note that, relative to the no-tax world, the destination VAT is a tax on consumption in the small-country case. Once again, the standard models assume that consumers are fully compensated for the tax via lump-sum transfers.

What are the relative prices of traded goods at equilibrium under the destination-based tax? For consumers, exportables cost 16.5 and imports (importables) 11. The relative price is still 1.5. Of course, since the sellers of exportables and importables are receiving returns equal to world prices, the sellers' relative price also remains at 1.5. Thus, under both the origin- and destination-based VATs, the relative prices of traded goods *at equilibrium* are exactly those that prevail under free trade. Both versions are trade-neutral. This is a standard result readily demonstrated in the literature.

D. The Switch

What happens if a country decides to substitute a theoretically ideal destination-based VAT for an existing ideal origin-based one? This is the central question relevant to the trade-effects debate. Based on the above, moving from one neutral system to another obviously will have no long-run trade effects, *at equilibrium*.[16] Thus, if policymakers decided, for whatever reason, to move to destination-based ideal taxes, they know that they will not create a deteriorating trade situation. But

> The literature concludes that a VAT will have *adverse* trade effects if preferential tax treatment—such as exemptions, zero-rating, or a lower tax rate—is accorded to nontraded goods.

the equilibrium result does not provide the whole picture. There are, for instance, some potentially significant short-run benefits that would accrue to industry sectors that engage in international trade before final equilibrium is reached.

The process of moving from the origin-based system to the destination-based one involves some short-run changes in levels of exports and imports. In order to see this, we must look at the *first-order* changes in relative prices; that is, the prices that prevail immediately after the tax change is implemented—and before sellers have changed their prices. Then we can predict how behavior will change in the interim period before equilibrium is restored.

Under the origin-based tax, producers of exports (exportables) charged 15 on the world market but only received 13.64 in private return. The instant after the destination-based tax goes into effect, exporters will receive rebates for the tax, so the private return will increase to 15. In the first order, exportables consumed domestically are still sold to consumers at 15, but sellers are receiving 13.64 because of the tax. Clearly, there is an incentive for sellers to shift from domestic sales to exports. Also, since returns have gone up for the producers of exports (exportables), investment may flow to that sector.

To the producers of importables, *initially* nothing has changed. By definition, they have not changed their price and the tax is still the same. Therefore, the first-order relative price of exports to importables for sellers has increased to 1.65. This change in relative prices subsequently provokes changes in behavior which restore equilibrium to the relative-price level dictated by world prices over which the country has no influence.

One of these behavioral changes has already been described. Exports will increase due to the higher returns to exports relative to sales of exportables domestically. As the domestic supply of exportables decreases, the price will be bid up by consumers until the pre-tax price equals the world price, and exporters are indifferent between selling domestically or exporting.

Similarly, consumers will find imports more expensive due to the imposition of the border tax that previously only applied to domestically produced importables. Thus, the demand for importables produced domestically will increase relative to imports, and the

[16] A rigorous mathematical proof can be made for this finding.

pre-tax price of importables will rise. This, of course, increases the short-run profits of importable sellers and encourages the commitment of resources to that sector. The pre-tax price will increase to the world price, at which point consumers will be indifferent between imports and importables.

When all the adjustments have been made, the relative price of exports (exportables) to imports (importables) will once again be 1.5 for both sellers and consumers. Trade neutrality will be restored, and there will be no influences on relative prices that deviate from those that would exist under free trade. But along the way, several things will have occurred to a greater or lesser extent:

- profits to exporters and sellers of importables will have increased by some amount;
- new resources will probably have flowed to the trade sector of the economy;
- exports will have increased by some amount;
- imports will have decreased by some amount; and
- exchange rates will have changed.

The magnitude of these effects is uncertain, as is their duration, but from the standpoint of a business person involved in a trade-intensive sector, the results are positive.[17] That is why business people take the positions they do.

The existence of short-run positive trade effects is, in and of itself, no reason to change a tax system, given the uncertainty of the trade effects and the administrative and compliance costs associated with the tax change. But there are many other reasons to overhaul the existing tax system and replace it with a more economically efficient one. If policymakers were to engage in tax reform, they ought to base the new system on a destination principle so that, in addition to the economic benefits that justified the change in the first place, some short-run trade effects would also be enjoyed. Since ultimately both ideal origin- and destination-based systems are trade neutral, the tax change ought to include the switch to a destination system so as to benefit the traded goods sector in the short run.

A compelling reason has been added to oppose narrowing of the VAT base: The effects of such a narrowing will be a *long-term* deterioration of a nation's trading position.

V. Tax Preferences and Long-Run Trade Effects

The preceding section ignores the role of nontraded goods. Feldstein and Krugman (1990) have established that, at equilibrium, both an origin- and destination-based VAT are trade neutral as long as the VAT applies equally to all goods—including nontraded goods. The literature, including Feldstein and Krugman (1990), concludes, however, that a VAT will have *adverse* trade effects if preferential tax treatment—such as exemptions, zero-rating, or a lower tax rate—is accorded to nontraded goods. Since many of the goods in existing VAT systems that receive preferential treatment do not enter international trade, an analysis of preferential treatment, heretofore typically concerned only with regressivity and economic efficiency, must also include consideration of these trade effects.

Consider an example where nontradables are zero-rated. If a VAT applies to traded goods but not to nontraded goods, the relative prices of exportables to nontradables and importables to nontradables would increase. Having the tax apply to tradables but not to nontradables introduces a tax wedge between the different classes of goods. Either the cost to consumers of importables and exportables relative to nontradables will increase and/or the returns to businesses of importables/exportables relative to nontradables will decrease. In either case, the result is a reduction of consumption of tradables relative to nontradables and/or a relative decrease in investment flowing to the tradable sector. The tradable goods sector will contract strictly because of a tax-induced relative-price change.

This is a serious issue for policymakers when one considers the types of goods that do not enter international trade—e.g., housing; medical care; education; various foods, such as fluid milk, some types of fresh produce, eggs, etc., sold for home consumption; and other goods. As Feldstein and Krugman (1990, p. 276) note, "the important point is that the *de facto* and *de jure* exemptions from a VAT are likely to fall primarily on nontraded goods rather than

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[17] Of course, under the small-country assumption, what business gains, consumers lose in the form of higher prices. That the models assume that consumers will be made whole through lump-sum distributions is of little comfort to policymakers. In the real world, where revenue neutrality is a likely scenario, the tax burden on some consumers will be shifted in the first order under the small-country scenario. It is unclear how a large-country scenario would play out. It should also be noted that the switch from an origin- to a destination-based tax could involve a lowering of the tax rate. If a country is running a current-account deficit, as is perennially true for the United States, then the tax base is, by definition, larger under the destination principle than under an origin-based tax. *See* Frenkel, Razin, and Symansky (1991). Accordingly, a lower rate could produce the same amount of revenue.

traded goods and services." The standard proposals to exempt or zero-rate housing, food, medical care, and welfare activities would apply to nontraded goods. Preferential treatment for nontraded goods distorts the relative prices of traded goods (importables and exportables) to nontraded goods for both consumers and producers. Feldstein and Krugman (1990, pp. 276-77) conclude:

> The effect of a selective VAT is, therefore, to increase nontradable consumption and production at the expense of tradable. . . . Clearly the presence of the tax acts as a disincentive to produce traded goods. . . . A selective VAT that falls most heavily on traded goods, then, will tend to hurt the traded goods sectors of an economy—the reverse of the common belief.

John Alexander Wade III (1982) constructs a general equilibrium model—including a balance of payments equation and representation of producer supply and consumer demand—in order to study the effects of a VAT with preferential treatment for nontraded goods. While noting that both importables and exportables faced the same tax, and therefore that, initially, their relative price was undistorted, Wade concludes by predicting secondary effects which would result in a deterioration in the terms of trade at equilibrium: "The conclusion in the case of the nontraded good being zero-rated under a value-added scheme of taxation is that the imposition of the VAT or further increase in the rates of an already existing VAT will likely lead to a deterioration in a nation's terms of trade." (Wade 1982, p. 57)

Bob Hamilton and John Whalley (1986) also consider VATs with narrowed bases. Their line of investigation involves the differences between origin- and destination-based taxes when there are differences in the levels and ways goods are taxed. They provide evidence that origin- and destination-based taxes are *not* equivalent in terms of their effects on a country's terms of trade when narrow tax bases are in evidence. Although the quantitative results of switches from destination- to origin-based taxes under the scenarios investigated by Hamilton and Whalley are not large, they are not to be dismissed. This simply points out that adverse trade results may follow from narrow-based VATs, regardless of border-tax adjustments.

> It is difficult to rationalize that a VAT, with a *qualitatively* similar tax base to the existing hodgepodge of business taxes, would not also have a qualitatively similar incidence.

Preferential treatment for some goods and services as a remedy for perceived regressivity has been criticized on several bases. First, it is generally agreed that exemption, zero-rating, or lower rates are extremely inefficient and costly ways to redress regressivity; and that it is preferable to seek remedies outside the VAT system through income tax credits or transfers. Second, preferential treatment causes economic inefficiency by distorting consumer and producer choices across industries.

Now a third compelling reason has been added to oppose narrowing of the VAT base: The effects of such a narrowing will be a *long-term* deterioration of a nation's trading position. This is especially important in light of the types of taxes that are slated for replacement by a VAT. While it would be nonsensical to claim that these taxes are neutral, nonetheless the payroll tax applies to traded and nontraded sectors, as does the corporate income tax (or the individual income tax in the case of noncorporate businesses). Thus, their replacement by a destination-based VAT with a narrow base could hurt, rather than enhance, U.S. competitiveness.

VI. VATs and Other Business Taxes

So far, this article has reviewed the trade effects of VATs levied under the origin or destination principles with broad or narrow bases. This was a necessary first step in investigating the competitive effects of a substitution of a VAT for existing business taxes. Ultimately, we must return to the question of incidence. The short-term trade effects described earlier that result from shifting from an origin- to a destination-based tax will only occur if the new tax has a similar incidence to the one it is replacing.

A. Incidence

Elsewhere (Raboy 1989b), I have argued that the incidence of existing business taxes must be *qualitatively* similar to that of a VAT. The reasoning underlying this proposition is as follows. At root, a VAT, regardless of its form (credit, subtraction, addition), is a tax on a company's value added. This value added in turn is equal to the sum of payments to the factors of production: wages and benefits to labor; and interest, dividends, and gains to capital. The return to capital that is included in the VAT base may be simply the competitive return to capital or may include quasi-rents associated with innovations, or pure rents associated with less than perfect competition. Paul Conrad (1990, p. 97) has stated that with respect to the VAT, "the incidence on the factors of production (capital, land, and labor) is in proportion to their shares in pretax gross national income."

Business taxes today include the corporate income tax, payroll taxes, and the individual income tax for noncorporate business.[18] Regardless of the interminable debate on the incidence of the corporate income tax, there are theoretical similarities between its base and the capital portion of value added. Most important, the corporate income tax is a tax on the competitive return to equity capital, and therefore is a component of variable cost. As such, the corporate income tax is not dissimilar from ad valorem taxes which also shift a firm's cost curves. As stated by McLure (1987, p. 49):

> A multitude of reasons exist, however, for believing that the corporate income tax can be at least partly shifted either to consumers or to labor, even in the short run. First, corporate income for tax purposes is not made up solely of economic profits; it includes the normal return to equity capital. Thus part of the tax does constitute an element of costs. Second, important portions of the corporate sector of the U.S. economy fit neither the perfect competition nor the pure monopoly mold, and oligopoly behavior is quite consistent with substantial shifting of the corporate tax . . . third, corporate goals other than profit maximization (such as avoidance of antitrust action, constrained sales maximization, or limit pricing based on long-range profit maximization) may lead to shifting of the tax. Finally, if capital is mobile internationally, the corporate tax is more likely to be borne by consumers and by land and labor.

Clearly, payroll taxes are also similar to the labor component of a VAT. Although there are obvious differences—interest is not taxed to corporations but to individuals, nonwage compensation escapes taxation, etc.—the aggregate bases of business taxes today add up to a value-added base with a great deal of preferential treatment. A basic tenet of public finance economics is that the initial point of taxation does not determine a tax's incidence. Economists' general belief is that taxes with identical bases, regardless of the point of taxation, must have the same incidence. Thus, it is difficult to rationalize that a VAT, with a *qualitatively* similar tax base to the existing hodgepodge of business taxes, would not also have a qualitatively similar incidence. As long as the incidence is similar, the short-term trade benefits described earlier will occur.

> Perhaps more important to the determination of exchange rates than actual changes in domestic savings due to tax changes are *perceived* effects in the eyes of foreign exchange traders.

B. Other Relative-Price Effects

There are other aspects of a VAT/business tax substitution that may affect comparative advantage. In classical trade theory, one explanation of comparative advantage that is frequently cited is *relative factor intensity*, which in turn can be traced to relative factor cost. Some economists have argued that replacing the corporate income tax with a VAT would significantly lower the cost of capital in the United States. For example, Gary Hufbauer (1987, p. 189) maintains that: "If the corporate income tax in the Tax Reform Act of 1986 were replaced by the VAT, the cost of capital would drop significantly." This, he concludes, could substantially enhance U.S. competitiveness.

Hufbauer's assertion echoes much of the literature on the cost of capital, which indicates that a VAT is neutral with respect to a firm's decision to use capital and labor, but that the decision is disturbed under the current tax regime due to the capital recovery provisions of the post-1986 corporate tax system. Hufbauer's argument is based on the belief that the current mix of business taxes that fall on capital and labor bases is biased against capital inputs.

VII. The VAT, the Current Account, and Exchange Rates

Throughout this article, I have stressed the importance of economic efficiency for sound tax policy. I have argued that the proper gauge for tax policy as it affects trade should be the relative prices of traded goods, and that the point of comparison should be the relative prices that would obtain under free trade.[19] Further, these relative prices are *real* prices—and the tax effects are *real* as well. Taxes represent extractions of real resources just as surely as energy costs or labor costs. Or, in the words of Hans-Wener Sinn (1990, p. 18): "It is impossible for exchange rate adjustments to compensate for tax-induced changes in relative prices." Purely nominal phenomena, like ex-

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[18]Throughout the article, the term "business tax" is used to denote a tax where the check to the taxing authorities is remitted by the business. This does not mean that the owners of the business bear the ultimate burden of the tax.

[19]This is not to say that incentives affecting saving and investment should be ignored. As noted by Mutti and Grubert (1988), such effects are highly significant to trade. But here, too, it is the intertemporal relative prices, or inter-industry relative prices, that should concern policymakers.

change rates, cannot mask fundamental changes in real costs.

This would seem fairly obvious in the case of other costs facing businesses. What would be the effect if one country discovered a process to manufacture steel that used only half the electricity previously required? That country's steel industry would certainly enjoy an enhancement of its competitive position, because the cost of producing steel relative to other domestic goods would drop, as would the real costs of producing steel domestically relative to foreign-produced steel. All else held constant, the comparative advantage (or disadvantage) of steel production would change. It would be a strange conclusion indeed if this innovation was completely nullified by exchange rate changes resulting from an increase in demand for the country's steel.

Taxes on output are no different from a cost standpoint than per-unit electricity costs. Taxes can only be remitted if steel is sold, and the returns foregone to pay the tax. It is as if a certain level of physical production is transferred to the government. This is not a monetary phenomenon: To argue otherwise is to assume that the entire economy is suffering from money illusion.

A. "All Else Held Constant"

Policymakers will continue to focus on the trade balance where exchange rates do matter. And thus the statement that is currently in vogue—that tax policy cannot affect the current account—must be investigated. My conclusion is that it would be very difficult to predict the effects on the trade balance of instituting a VAT and substituting it for another tax. First, the view that such a change would not affect the trade balance is predicated on the belief or assumption that tax changes do not affect international capital flows. Second, this view is also dependent on the notion that exchange rates are primarily a function of traditional trade and capital flows, whereas the reality is that exchange rates are more influenced by asset trades than by traditional trade flows. This means that the change in the expectations of currency traders after (or in anticipation of) a tax change will influence exchange rates more than currency demand changes associated directly with exports and imports.

What precisely is meant by the statement that tax policy cannot affect the current account? It is based on the balance of payments accounting identity that essentially states:

Exports - Imports =
Capital Outflows -
Capital Inflows

In fact, the perception of fiscal and monetary policy to currency traders may be the dominant force in exchange-rate determination in this regard.

The statement that tax policy (or tariff policy, for that matter) cannot affect the trade balance is predicated on the assumption of *ceteris paribus*—all else held constant. In this case, the "all else" that is being held constant is capital flows.[20] Not surprisingly, if the right side of the equation, net capital flows, is held constant, there can be no change in the left side. Because the balance of payments is set in nominal units of currency, if, for example, a tax change increased the demand for exports, *ceteris paribus*, the dollar must appreciate to restore the left side to the same nominal position as before.

B. Capital Flows

It is conceivable that the "all else held constant" assumption is of less use here for policymakers than with respect to most other economic issues. It may be very difficult to identify the factors and transactions to hold constant because of the complex interactions of taxes and international investment decisions. There is a thriving literature on the effects of tax policy on international capital flows that runs the gamut from "no effects" to "large effects." And the various levels of effects feed through diverse conduits such as deficit reduction or tax-induced changes in savings and investment, all of which would directly affect net capital flows.

For instance, Donald Rousslang and Pieter Van Leeuwen (1990, p. 185) consider the effects of an add-on VAT on trade: "The substantial trade effects found here arise from the effect that eliminating the large federal deficit through tax increases would have on domestic interest rates and net U.S. borrowing from abroad." Similarly, Lawrence Summers (1987, p. 173) notes: "The only way in which we can raise both investment and international competitiveness simultaneously is to increase national savings." Having argued that the Tax Reform Act of 1986 moved toward a savings/investment balance by curtailing investment, Summers (1987, p. 76) suggests:

> The better way of bringing savings and investment into balance is through increases in savings. Here the major necessary step is a reduction in federal deficits. There is also a limited role for tax measures directed at encouraging private sector savings.

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[20]To some this is merely an assumption. To others it is a truism: Tax policy cannot affect capital flows.

Feldstein and Krugman (1990) also stress the role of savings as the way a VAT/income tax substitution would produce short-run trade effects. Hufbauer (1987, p. 196) challenges the all else held constant approach to the balance of payments and tax policy:

> The key assumption in this analysis is that net capital flows are either determined independently of the tax structure, or that improved corporate profitability following the introduction of VAT would attract capital to the United States. . . . The line of reasoning is open to challenge. It contains a basic weakness: the assumption that tax structure makes no difference to long-run domestic savings. In my view, the value-added tax, substituted for the corporate income tax could, in the long run, enlarge domestic savings and thereby ratify an improved trade balance.

The point here is not to argue who is right or who is wrong, but rather to illustrate that there are several paths by which a VAT can affect capital flows, and therefore the exchange rate. But possibly more important to the determination of exchange rates than actual changes in domestic savings due to tax changes are *perceived* effects in the eyes of foreign exchange traders. In fact, the perception of fiscal and monetary policy to currency traders may be the dominant force in exchange rate determination in this regard.

C. Expectations and Exchange Rates

If exchange rates were primarily influenced by changes in the demand for imports and exports, then a VAT change that affected trading patterns would have a predictable effect on exchange rates. But exchange-rate determination is much more complicated, relating primarily to the actions of traders who view foreign exchange as an asset to be traded in its own right. I discuss exchange-rate determination elsewhere (Raboy 1989a and 1990), but it is worth reviewing those arguments here. Foreign exchange trading worldwide grew from $200 billion per day in 1986 to $500 billion in 1989 (Krugman and Obstfeld 1991). The growth from 1983 to 1986 was enormous as well. This growth cannot be explained by differences in merchandise trade or capital flows associated with investment in tangible assets. In fact, these latter transactions may account for only 5 to 10 percent of foreign exchange trading (Dornbusch and Frankel 1987).

What monetary policy might accompany, or be expected to accompany, a major tax reform including the addition of a VAT?

Jeffery Frankel (1989), observing Federal Reserve data, notes that most U.S.-based foreign exchange trading occurs among banks ($50 billion a day in 1986) and among brokers and other financial institutions ($34.4 billion a day in 1986). He also points out that only 11.5 percent of bank trading was with nonbank customers, and that only 4.6 percent was with nonfinancial customers. Similar results were reported for brokers and other financial institutions—both here and for foreign markets. Frankel (1989, p. 51) concludes, "Not only are these totals many times greater than the volume of international trade in goods and services, they are also many times greater than the volume of international trade in long-term capital."

The overwhelming majority of foreign exchange transactions are conducted by investors who view foreign exchange itself as an asset. Ronald McKinnon (1988, p. 86) states:

> The floating exchange rate seems to be dominated by volatile asset preferences rather than adjusting passively to balance current flows of imports and exports. In the face of uncertainty about the future purchasing power of domestic money, liquid foreign exchange assets are more easily substituted for domestic financial assets (money or bonds) than are physical assets such as real estate or stocks of commodities. Foreign bonds or bank accounts are also convenient hedges against possible shifts in domestic, political, or commercial risks. These potential capital flows through the foreign exchanges on a daily basis are huge. Since they are so much greater than the value of commodity trade, they dominate observed movements in exchange rates.

These assets primarily take the form of liquid interest-bearing instruments, and are therefore a component of net capital flows in the balance of payments. As Krugman and Obstfeld (1991) explain, the expected return to a U.S. investor on a foreign currency bond is the rate of return on the foreign bond plus the expected depreciation of the dollar against the foreign currency.[21]

Foreign exchange determination is driven by people who hold foreign exchange as assets, and their transactions are dependent on their expectations. These expectations could easily change in anticipation of a major tax change, but it is difficult to pre-

[21] Or, see Summers (1987, p. 173): "International capital markets should equalize not real rates of return but, rather, real rates adjusted for anticipated changes in exchange rates."

dict the net effect on exchange rates.

Look at all the countervailing items that could affect a trader's perceptions. If the trader perceives that the demand for exports is going to increase and/or the demand for imports is going to drop, he or she may predict a dollar appreciation. But if part of the VAT is used for deficit reduction, he or she may anticipate a dollar depreciation due to decreased U.S. borrowing. Similarly, if he or she anticipates that tax reform is going to lead to greater domestic saving, a dollar depreciation prediction may seem appropriate. But if the expectation is for increased capital inflows due to better investment opportunities, an appreciation may be the better prediction.[22]

The sum of all of the fiscal policy ramifications of the VAT/other-tax substitution will determine the expectations of the traders who buy foreign bonds and have more to do with exchange rates than the buyers and sellers of real goods and services. And we have not even discussed monetary policy! Certainly, expectations concerning the monetary policy that would accompany a VAT—including tax reform—will also be influential in foreign exchange markets.

D. Monetary Policy

It is well known that domestic monetary policy, not just central bank exchange activity, exerts a primary influence on exchange-rate motion.[23] In fact, the *expectation* of monetary changes affects current and forward exchange rates.[24] There is evidence that such expectations cause exchange-rate "overshooting." (Krugman and Obstfeld 1991).

What monetary policy might accompany, or be expected to accompany, a major tax reform including the addition of a VAT? The conventional wisdom is that the Federal Reserve would accommodate the VAT by increasing the money supply, even when a VAT is used to replace other taxes. Thus, against the expectation of an increased demand for exports (and all the possible countervailing effects involving capital flows) there would be an expansion—anticipated or real—of the money supply. This expansion would aim to accommodate a supply-shock in the amount of *the tax rate times the entire domestic economy*, many multiples of any conceivable change in the demand for exports. An anticipated increase in the money supply, of course, exerts downward pressure on the dollar.

> If preferential VAT treatment is afforded classes of goods and services to redress regressivity, the most likely affected goods will be those that do not enter international trade.

All of the potential effects of fiscal and monetary policy will combine to influence the expectations of foreign exchange investors. In all likelihood, these investors are far more important to exchange rate determination than the buyers and sellers of exports and imports, and their expectations more important than the direct effects on exchange rates from increases in domestic saving or from reductions in the federal deficit. Since the expectational effects on exchange rates contain so many offsetting forces, it would probably not be wise to base one's predictions of the effects of a VAT on the current account on an all else held constant assumption.

E. What Is the Answer?

Carl Shoup (1988) notes that the idea that exchange-rate changes would wipe out any tax-induced cost effects is not new. As an example, he refers to the 1953 Tinbergen Report to the European Community of Coal and Steel. This report, produced in an effort to determine whether to adopt a destination- or origin-based sales tax, included an equivalence theorem, which states that tax-induced trade effects would be eliminated by floating exchange rates. Shoup points out that the equivalence theorem was challenged contemporaneously, primarily along the lines noted in this article.[25]

Everything that goes around comes around. So if a policymaker views the current account as the proper measure for judging tax policy, what is he or she to make of the claim that a VAT-based tax reform cannot affect the current account because of exchange-rate adjustments? The last word belongs to Shoup (1988, p. 368):

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[22] To add to the confusion, the magnitude of any real effects is dependent on a host of empirical measures including (1) the domestic elasticity of saving, (2) the substitutability between foreign and domestic assets, (3) factor substitutability, (4) cross-elasticity between domestic and foreign goods, and (5) the initial asset holdings of foreigners (Mutti and Grubert 1988).

[23] *See, e.g.*, Krugman and Obstfeld (1991), Chapter 14; or, for a comprehensive treatment, Baillie and McMahon (1989).

[24] *See, e.g.*, Marston (1987).

[25] Shoup (1988, p. 367) cites Bulassa: "Yet since capital movements, immigrants' remittances, tourist expenditures and other nontrade items also affect exchange rates, changes in tax rates will not lead to proportionate variations in the rate of exchange. In addition, price rises following an increase in tax rates are likely to elicit capital movements responding to differences in price levels . . . thus the presumed long-run readjustment of exchange rates may never take place."

Accordingly, the only tenable position in our present state of knowledge is to assume that the destination and origin principles are neither equivalent nor wholly disequivalent (to coin a word), and that a move from the origin principle to the destination principle will probably increase exports and decrease imports somewhat, but not by as much as the tax rate alone might indicate. . . . This statement may not be of much help in designing tax policy, but it at least avoids the errors inherent in taking either of the extreme positions.

VIII. Conclusions

This article has considered various aspects of the debate concerning the trade effects of a substitution of a VAT for other business taxes in light of both the economic literature and the putative gulf between the beliefs of a wide range of business people and academic economists. I have argued that tax policy should be judged in terms of distortions in the relative prices of traded goods, rather than nominal changes in the trade balance. This argument is based on the view that undistorted relative prices provide the greatest possibility for gains from trade.

Based on my reading of the literature, I believe the following conclusions are warranted:

- At equilibrium, both an origin- and a destination-based VAT are neutral in their effects on the relative prices of traded goods.
- Switching from a pure origin-based VAT to a pure destination-based VAT would cause exports to increase in the short run and imports to decrease. At equilibrium, however, relative prices would return to the neutrality position that existed under free trade.
- If preferential VAT treatment is afforded classes of goods and services to redress regressivity, the most likely affected goods will be those that do not enter international trade. The results of zero-ratings, exemptions, or preferential tax rates for nontraded goods will be a contraction of the traded goods sector, and a worsening of the U.S. terms of trade (an adverse distortion of relative prices).
- Although a VAT is neutral with respect to relative prices, taxes that may be replaced by the VAT may distort the relative prices of traded goods through artificial distortions of factor costs, and intertemporal distortions. Therefore—at least in the short run—a VAT/other-tax substitution may remove some existing distortions in the relative prices of traded goods.
- The effects of the VAT/other-tax substitution on the current account are unpredictable, due to the overwhelming influence on capital flows of foreign exchange traders, whose expectations will be influenced by countervailing aspects of tax policy as well as by monetary policy. The view that exchange-rate appreciations will wipe out any demand influences on exportables (exports) or importables (imports) is based on a narrow assumption unsustainable in real international financial markets. ✦

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Mr. McCRERY [presiding]. Thank you, Dr. Raboy.

I just want to ask a few questions before going to my colleagues. There seems to be, and maybe I misunderstood, but there seems to be some disagreement among the panelists on the efficacy of going from an income tax system to a consumption tax in terms of encouraging foreign business to relocate in the United States.

Mr. Armstrong, I thought you said if we did away with the income tax, went to a consumption tax, you would find that those businesses would simply have to pay their domestic income tax and, in many cases, that would discourage them from coming to the United States, while the other two panelists seem to imply that going from an income tax system to a consumption-based system would encourage foreign investment.

Did I miss something there or is that a correct interpretation?

Mr. ARMSTRONG. From my perspective, we see two types: One, if you are talking about a company that is setting up a plant. Because of the international Tax Code, for example, many British Commonwealth nations do not tax foreign income, so, therefore—however, there is a kicker to it. If it is income earned in a tax-free zone, then it is subject back. They do that for offshore investors, and so forth.

Our concern is if you had a complete zero income tax rate here and even though the company would be subject to a consumption tax in some way or another along the line, that that could be interpreted from a foreign perspective as being a tax-free zone, and I would like to point out that last April, Germany was very interesting in how it is dealing with its budget crisis.

It surrounded all of the offices of Merrill Lynch and several other banks. They attacked it as if it was a drug raid. They cutoff all the phones of Merrill Lynch, all the hand-held cellular phones that the brokers had. They went in, raided all the files, looking for German citizens putting capital offshore.

The net result of those raids effectively sent the Deutsche mark down, the Swiss franc up, and the London Financial Times reported that it was incredible the amount of capital that was suddenly leaving Germany for Switzerland.

That has not resulted in if you are in the financial industry, you are better off working out of London. You cannot do business in Germany.

If I were to go to Germany and answer a question on taxes to be more competitive and my answer can be interpreted as helping someone avoid taxes, that is a 5-year jail term for me personally now in Germany.

So you have to be very careful about the international Tax Code. My lawyers freak out just every time I even have to go to Munich. So I think there is a different side to that.

Now, a consumption tax with zero income tax, from an investment perspective—we are talking about interest income, and so forth, investments in stock markets—absolutely positive, you would have capital flowing in here. This would be like the Cayman Islands of the global economy.

Mr. McCRERY. Is that what you were referring to, Dr. Raboy?

Mr. RABOY. Well, let me see if I can give an example. To me, the distinction is not consumption tax versus the income tax, but origin principal versus destination principal within the consumption tax setup. Where that is relevant is in the discussion of a flat tax versus a USA tax or a VAT.

If I am considering whether or not to locate a facility here, or in the United States, if I am facing an origin-based system, my production is going to be taxed whether it is consumed domestically or exported, and assuming that I am facing a destination principal tax, on the other end, it is going to be taxed again.

Now, on the other hand, if I locate the facility overseas and I import back to the United States, there is no tax under the flat tax or a similar origin-based tax. So I make a calculation.

If the tax savings exceeds the transportation and/or other differential costs of locating overseas, I will locate overseas.

With a destination principal tax, however, that is not going to be the case. If I produce domestically for domestic consumption, I am taxed domestically. If I produce overseas for domestic consumption, and import back, that is going to be taxed at the border. So it is the same tax treatment whether I produce here or produce overseas.

On the other hand, if I export out, the tax is forgiven. So there is no tax-induced incentive to locate in one place or another.

Mr. MCCRERY. Dr. McLennan.

Ms. MCLENNAN. Yes. I would just like to add a few additional comments. If the United States should adopt a new system of taxation, for example, getting rid of the business income tax and substituting either a VAT or a sales tax, there is a school of thought that would state that the United States would then become a tax haven with respect to income tax.

That would presuppose our trading partners would not change their behavior with respect to their own tax systems.

I think when the United States does consider as major a change as you are considering now, you also ought to take into account what the likely effects would be on other countries with respect to their own Tax Codes. I don't expect that the United States would be alone in moving to this kind of change, and that would discount the kind of effects we are discussing here. Obviously, in theory, economists will tell you that, yes, you will go to jail if you do this or that, but in effect, I suspect that the real world isn't going to operate that way.

Mr. MCCRERY. But if we went to a system which basically made the tax consideration of a business unimportant in the calculation of where to locate investment, even if other countries went to a similar system, wouldn't you still have the same results, which is to take the tax consideration out of the equation?

Ms. MCLENNAN. Right. If you can reduce the tax consideration, then the companies that make the best products at the best prices should succeed, and we would hope our companies would be among the world leaders in that. That is what we mean by international competitiveness.

I think all of the panelists you have heard this morning indicate tax is a consideration under the current system, and that is the problem we want to address here.

Mr. McCRERY. That is another question I might get you to elaborate on, but for now I will go to Mr. Houghton. Mr. Houghton, did you have questions for this panel?

Mr. HOUGHTON. Yes. Thank you very much.

I guess the issues that I worry about are fairly simple. They have to do with cash. The United States generates about, I would say on the previous figures—I guess it was 1995—$800 billion in terms of income taxes and about $600 billion in terms of other taxes, FICA taxes, things like that.

So, all of a sudden, you sort of throw that out and you move toward a different tax system. You have got to generate at least $1.4 trillion, and it will probably be up now to $1.5 trillion or $1.6 trillion. How do you do that? That is a really tricky question because somebody sitting here or elsewhere has to make that decision.

We can talk about this thing intellectually, and we can talk about it in terms of competitive reasons, but the question is how do you make that switch. How can you make sure we don't end up with a $500 billion deficit because we have miscalculated this thing? Maybe you would like to make a comment on that, anyone.

Mr. RABOY. Well, that is the $64 trillion question, isn't it? One thing is certain. First, you would want to look at the broadest based tax system possible because the less leakage there is in the system, the more predictable the revenue take of the system is going to be.

Second, you want to reduce the fiscal drag as much as possible on the economy. You want to try to get taxes as much as possible out of the investment and work decisions of Americans. In my view, the one type of tax base that achieves both of those goals is some type of a broad-based consumption tax base. Frankly, the flat tax, the USA tax, and a VAT or national sales tax all get you in that arena.

The developers of all of those proposals were very ingenuous in that they did not allow erosion of the base. They made the base cover everything at a single rate, and I think that gives you the best chance of revenue predictability.

Mr. HOUGHTON. Does anyone else have a comment?

Ms. McLENNAN. I would just like to add to what Dr. Raboy is saying, which is $1.4 trillion represents approximately 17 or 18 percent of the GDP. I believe that the $1.4 trillion also includes the amount we are spending for Social Security tax. So the income tax is really $5 or $6 trillion. That is a huge amount of revenue.

The consumption base is the broadest base we can figure for the base of a tax system, but to go to a pure tax, you know you are going to have very serious transition problems. There will be windfall profits for some individuals and tremendous losses for others. Those who have benefits under the current tax system would lose them when you go to a simple base.

On the other hand, it appears to me, at any rate, based on my experience, that the consumption-based tax is perceived in the countries that have them as fair and equitable across industries.

So I think this Committee is doing the right thing by looking at all of these proposals. You may not get a perfect proposal before you in one shot, but I think the base needs to be shifted from the current income tax base.

Mr. ARMSTRONG. We looked at some of those numbers to perhaps answer that question, and we were looking at taking the BEA numbers.

We found if you instituted a 10-percent sales tax with also a 2-percent sales tax on real estate transactions, that in combination with only a 15-percent flat or fairer type corporation tax was actually vowed revenue-neutral, and it is quite surprising if you really start putting in some of the other aspects which would be more dynamic considerations.

For example, on interest rates and what the Internal Revenue Service says itself it expects that they are close to 17 percent of the economies underground, you are never going to capture any form of an income tax from that side, from the illegal aliens or things of that nature. They will contribute to their local sales taxes, but they will never file an income tax.

So, if you look at the income tax versus a consumption tax from the total GDP perspective, the revenue would actually increase because income tax will never capture that portion the IRS says is 17 percent on underground, and the other problem is—there is a very interesting article on the front page of the New York Times today where 600 are suspected in plots to evade taxes on income. These are 600 government employees.

The income tax is, quite honestly, easier to avoid than the sales tax. It is much easier to do so. If you really look at the numbers objectively, I think you are looking at a potential, at least, of actually collecting more revenue.

Then, if you look at the income tax and its effect on interest rates, we can supply you with a study of interest rates for this country back 200 years. Every time the government raised income tax, interest rates rose basically in direct proportions. Capital invests on a net basis. It doesn't want to say, Well, fine, I will pay you 20 percent, but by the way, I want 95 percent of that back. Capital looks at whatever it is going to have on the table at the end of the day.

So, consequently, my points in my opening statement about the Japanese earning more money from us on investments versus trade is very important to understand because, in effect, we are paying more in interest expenditures on our National debt than maybe are really necessary. We are paying a higher rate to compensate Americans that are paying a very high tax rate, but foreigners are buying them who are paying zero.

Mr. HOUGHTON. But you are not suggesting the foreigners pay a tax on interest.

Mr. ARMSTRONG. No, no. They won't do it.

So what I am suggesting is you perhaps even the playingfield and at least make interest paid on government bonds tax free.

Mr. HOUGHTON. Surely.

Mr. ARMSTRONG. If you could reduce the interest rate itself on the national debt by one-third, you have a surplus, no longer a deficit. You have about a $250 billion surplus.

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

Mr. MCCRERY. Mr. Gibbons.

Mr. GIBBONS. First of all, this is a very interesting discussion.

I think, to generalize, we can all say that no matter what kind of new system we adopt, we ought to have a destination principle as far as taxes are concerned. Is that correct? Does the panel all agree with that? We ought to have a destination principle. This current system we have is just a mess and really distorts everything.

Mr. Raboy, you were kind enough to supply me with a copy of your testimony before you appeared here, and I had an opportunity to read it last night. I am intrigued with your analysis that even if in the long term a consumption tax has no impact upon trade, in a short run, it does. In that short run, how long do you think the short run is in all of that?

Mr. RABOY. I am not sure I could quantify how long it is, but I think it is significant.

When economists talk about the origin and destination principles being equivalent in the long run, there are some assumptions they are making, and when you get a little bit behind them, you see some problems.

The first assumption that is typically made is that the country adopting the tax system has no control over the world prices it is facing. In other words, there are so many companies out there competing that this country's companies can't affect the price of its exports, and similarly, they are price takers in the import market.

Well, if you say the prices you face externally are fixed, then, by definition, those ratios can never change. Therefore, the ratio of the price of exports to the price of imports, the celebrated terms of trade, by definition, can't change.

So what happens? Let's say you didn't have a tax system and you were going to impose a consumption tax and you had listened to your economists who told you that it doesn't matter what you do in terms of border tax adjustments. They say, well, our tradition is an origin system, let us do that.

I want to go out in the export market, and originally, I was charging the world price for my exports, competing with all of the other companies in the world, and I was getting that price.

The day after the tax system goes into effect, I want to maintain the same returns as I did before. So I would like to be able to charge that price, plus the amount of the tax, but I can't. Why? Because world price rules tell—because if I tried to charge the higher price, someone else will undercut me by charging the world price.

What that means is that some way, somehow, I have to reduce my private return until I can get back up to that world price.

The day after the tax goes into effect, there are a whole lot of exporters who are going to be losing money. There is nothing that has happened with exchange rates because world prices are the same.

There has to be an adjustment in the traded goods sector, both on the import side and the export side, and the only way you get to this equilibrium or this neutrality in the long run is by a contraction in the traded goods sector.

At the end of the day, the relative price of exports to imports is the same externally and internally, but only because the traded goods sector has collapsed—or not collapsed, but has been relatively reduced.

Similarly, if you switch from an origin-based system to that of a destination-based system, you ultimately get back to the same equilibrium because world prices are fixed, but the difference is you have a larger export sector. You have importers that have competed more effectively against imports in the short run, and then, ultimately, you are back to the relative price equalization. There might be some exchanges rule changes, too.

Mr. GIBBONS. Mr. Armstrong, you have more experience in exchange rates than I do. Let me pump your mind for a while.

What really controls the exchange rates? In the long, long run, probably international trade has something to do with it, but in the short run, is it more financial considerations than it is trade considerations?

Mr. ARMSTRONG. Yes. Quite frankly, trade is minimal.

Mr. GIBBONS. That is my impression.

Mr. ARMSTRONG. If you look at the United States-Japanese trade deficit, it has not changed dramatically in 2 years. Yet, the Japanese yen went up 40 percent, down 40 percent.

If you look at, for example, Nippon Life, the largest insurance company in Japan, they have a portfolio of about $1.2 trillion. If they decided to move 10 percent of their portfolio to U.S. stock markets, that is more than 2 years' worth of trade numbers.

The trade is more of a psychological impact, but in my opinion, the currency markets have been reduced to the fact of almost an international polling.

Mr. GIBBONS. An international what?

Mr. ARMSTRONG. An international poll where the markets and capital vote on the confidence of countries on a daily basis.

So, consequently, you will find with the elections with Boris Yeltsin, the dollar restrengthening because of concerns that, well, maybe if Yeltsin lost, then you are going to have problems in Europe.

So you have capital movements that are taking place for a variety of reasons, geopolitical security, financial security, rules of law. Trade is also part of it, and the other part of it is taxes and how that impacts investment, and that is the point I was trying to make about the national debt.

You really have foreigners paying no tax and penalizing Americans. Then, you look at our American corporations, we tax them in worldwide income. Nobody else does.

It seems like when you look at the broad scope of everything, Americans are the number one prejudiced people in the entire world. Nobody else is as punitive on their citizens as the United States, and it seems ironic that we are supposed to be the leader of the free world, but when it comes to the Tax Code, we seem to be absolutely backward.

Mr. GIBBONS. I apologize for taking this extra time.

I am amazed that America has done so well when I look at our system and the penalties we put on our people for jobs, taxes, and for everything else. That really concerns me. We have a very expensive system to administer.

I don't know how expensive, but it is horribly expensive, probably the most expensive system in the world to administer. I worry about America's future when I see us dragging along as economic baggage, useless baggage, our horribly expensive tax system, and then not doing perhaps as much as we should as far as education is concerned. I think the future of our country depends upon how well we educate our minds and how efficiently we operate our economy.

I am very pessimistic that we seem to be headed in the wrong direction.

Mr. ARMSTRONG. I agree. I am always impressed by some of my European friends whose little children may be 5 or 6 years old and they are speaking four different languages.

Mr. GIBBONS. Yes.

Mr. ARMSTRONG. It is quite impressive to see, quite honestly, but I totally agree with you.

Mr. GIBBONS. Thank you.

Mr. MCCRERY. Before I call on Mr. Portman, Mr. Armstrong, do you happen to know the current percentage of public debt that is held by foreigners? You said in your testimony that we have had up to 40 percent of it.

Mr. ARMSTRONG. I would have to check the 1995 numbers. The highest number I have seen that fluctuate up to is about 42 percent.

Mr. MCCRERY. Was that recently?

Mr. ARMSTRONG. Pardon me?

Mr. MCCRERY. Was that recently?

Mr. ARMSTRONG. Yes, within the last several years. It has been coming down largely because of concerns about the dollar. It has caused a lot of foreigners to sell government bonds, particularly in the United States, also Canada. One of the largest institutions in Japan lost so much money on the foreign exchange on our bond markets here that they actually announced they are no longer going to buy government bonds from anybody in the world again.

Mr. MCCRERY. But it is still a significant portion. Is that your appreciation?

Mr. ARMSTRONG. I would only be taking a guess. I think it might be down to maybe the 25- to 30- percent area at this point.

Mr. MCCRERY. OK, thank you.

Mr. Portman.

Mr. PORTMAN. I thank the Chairman. I have really enjoyed the testimony. I have many questions, and I will try to keep it to three, one for each panelist, but feel free to chime in as I ask them.

Dr. McLennan, first, your testimony regarding border adjustability was very interesting, and I would like the two of us to have a dialog on the impact.

In essence, what you are saying is it doesn't really matter because the exchange rates will adjust, and if we have a flat tax or if we choose to have an indirect tax which we can border adjust, such as the Europeans do, that in the end we will have, in essence, the same outcome. I think Dr. Raboy is saying the quantity of trade will be adjusted, although at the end the cost will be the same because of the adjustment. How do you square that?

Ms. MCLENNAN. I don't think we are in disagreement at all. Border tax adjustability to me is just a mechanical means by which you enforce a value-added tax. We could go that way. That is a destination principle, European-style, value-added tax.

We could have a national sales tax, which would not be border adjustable. Sales taxes normally aren't, and you would have the impact on the exchange rate.

Mr. PORTMAN. Excuse me. Is that because they are considered by the GATT to be direct taxes?

Ms. MCLENNAN. No. A sales tax is also an indirect tax, but normally exporters are forgiven the sales tax. If you buy anything, for example, in the United States, if you get something from the L.L. Bean catalog, citizens of Maine add 6 percent sales tax. Nobody else pays the sales tax. There isn't a system by which you pay the sales tax and have it rebated afterward.

Mr. PORTMAN. It is not that international rules would preclude that. You indicate any indirect tax we could apply.

Ms. MCLENNAN. It is not clear that international trade agreements would make it difficult to have a border-adjusted sales tax. I have never heard of a sales tax that had border adjustability connected to it. It is just a different way of taxing the same income.

I want to add to the comments the two panelists had on the last question. I believe currency markets do adjust very quickly to changes in tax systems. If the United States were to adopt something like a value-added tax, all the other countries of the world would have sufficient notice to know that this would happen, and banks would know about it. I believe it won't be very long by the time the dollar adjusts to its new value in international trade.

Mr. PORTMAN. You went beyond that and earlier had indicated that not only would the exchange markets change, but it is likely that tax systems would change over time.

Ms. MCLENNAN. Well, that could happen, too. It may be a period of really major adjustments on the parts of lots of trading countries to a new tax system.

The other thing to remember is when the United States does something, many countries will look to the United States in a sense as a model, and there is a lot of copying in terms of policies of this nature. So you may not see that much turmoil as the theorists would have you believe at the outset. To get back to your question, border tax adjustability in itself may not have any impact, but if border tax adjustability is connected to a tax policy which encourages savings and investment, where your basic economic activities are encouraged, that in itself will have an effect on our competitiveness, and it should be a positive impact on U.S. trade and investment.

Mr. PORTMAN. If you can try to quantify that, just to play devil's advocate for 1 moment, you would say, then, based on your earlier testimony that it is much more important to move to a system that is not penalizing savings and investment——

Ms. MCLENNAN. Right.

Mr. PORTMAN [continuing]. So people can make economic decisions and not tax-related decisions. So a flat tax as an example which would be direct and not border adjustable would be a much more important factor than whether it is border adjustable or not, the fact that it is a different system.

Ms. MCLENNAN. Exactly. I think it is the overall impact.

If you do away with double and triple taxation and the complexity of compliance, all of those factors are very important and shouldn't be forgotten as a goal for the tax system.

Mr. PORTMAN. But you all differ in your degree of importance you would attach to indirect versus direct, destination versus origin?

Mr. RABOY. I am not sure. I would agree that the primary consideration should be the tax base. If we could get a flat tax or a VAT or a national sales tax or a USA tax, any of those would be terrific.

Mr. PORTMAN. Compared to the current system?

Mr. RABOY. Yes, compared to the current system.

The bias against capital and saving is probably the most——

Mr. PORTMAN. But you see a marginal, even greater improvement if you can go to something that is destination based——

Mr. RABOY. That is border adjustable, yes.

Mr. PORTMAN [continuing]. And border adjustable.

Mr. RABOY. Absolutely. Again, the reasons are because there will be short-run trade benefits, real benefits to the trade sector. You eliminate transfer pricing controversies and other locational types of disincentives.

Mr. PORTMAN. I wish I had more time, Mr. Armstrong, but maybe someone else can go into this further. This fascinates me, this notion of tax-free bonds because it would put us in a level playingfield with foreign investors and government bonds.

You mentioned the figure of $250 billion. Where do you come up with that? Our interest on the debt is, what, about $200 billion a year?

Mr. ARMSTRONG. We now, I believe, are collecting close to $100 billion more than we are spending on actual programs, which is being absorbed by interest.

Mr. PORTMAN. OK. So what would be the net effect of your proposal in terms of the government revenues' impact on the budget?

Mr. ARMSTRONG. It would really depend on how much of the national debt you could shift over.

I can tell you in the financial community, there is something else that has happened here, and that is that in 1993, the Treasury began trying to take advantage of the steep yield curve in this country, and they started shifting the national debt short term. I will be glad to provide the commission with a chart on that. We are now 70 percent.

Mr. PORTMAN. This was in 1992 or 1993?

Mr. ARMSTRONG. In 1993.

Mr. PORTMAN. OK.

Mr. ARMSTRONG. Yes.

We are now funded 70 percent, 5 years or less. One-third of the entire national debt is funded 1 year or less. All right. This is why short-term interest rates have doubled in the last 2 years, and we now have a yield curve that is practically flat.

Initially, the Treasury was doing that, trying to save on interest expenditures to bring the deficit down.

Mr. PORTMAN. Right.

Mr. ARMSTRONG. It is now backfiring, but it had a very serious impact in the financial pension fund community. What happened was that pension funds had gone out and bought mortgage-backed securities. Well, mortgage-backed securities can be recalled, and that is what happened. So many people went out and began refinancing their mortgages.

The pension funds lost that long-term maturity and ended up being thrusted into the short term, at the same time the Treasury cut the 30-year bond auction down.

Well, at this point, you ended up with companies, for example, Coca-Cola and Disney, who were suddenly able to issue 100-year bonds, and the marketplace bought them immediately because the pension funds, their liabilities and their investments are not matched.

I believe, and I have talked to a number of people in the industry about this, if the Treasury were to take advantage of this particular point in time and perhaps issue zero coupon bonds that were tax free, you could effectively reduce your interest expenditures dramatically in the short term, which would give you more than enough time to help change the total outlook of this country, but you have to follow through. You can't use those savings and spend them, but you could save a substantial amount of money doing that right now, and there is a marketplace for them because the pension funds need the long-term maturities right now.

It is kind of a casualty thing or Keystone Cop maneuver. I don't know how this—you know, I have never seen this happen before in the 20 years that I—or 25 years that I have been doing it.

Mr. PORTMAN. I appreciate that.

I think we need a new hearing, Mr. Chairman, just on this topic.

Thank you for your testimony.

Mr. HOUGHTON [presiding]. Thank you very much.

Ladies and gentlemen, thanks very much for being with us. We certainly appreciate it.

Now, the third panel is Messrs. Boyle, Rogers, Cox, Barone, Christian, and Kostenbauder. We are delighted to have you, and if you would take your place at the table, we would appreciate it.

All right, gentlemen. Thanks very much for being with us. If you would like to give your testimony, starting with Mr. Boyle, I certainly would appreciate it.

Thanks very much.

STATEMENT OF MICHAEL P. BOYLE, CHIEF TAX COUNSEL AND GENERAL AUDITOR, MICROSOFT CORP., REDMOND, WASHINGTON; ON BEHALF OF SOFTWARE PUBLISHERS ASSOCIATION

Mr. BOYLE. Good afternoon. I am Mike Boyle, chief tax counsel and general auditor for Microsoft Corp. Thank you for the opportunity to present testimony today on behalf of the Software Publishers Association.

The SPA has 1,200-plus member companies of all sizes, large and small. These companies develop, market, and produce a wide variety of software.

Fair taxation of software revenue is a fundamental concern of our members. The efficient development and distribution of software technology products, which are key American exports, must not be unduly burdened by U.S. tax policy.

My testimony today will stress the following points: First, international double taxation of software income must be avoided; second, current tax treaty protections against excessive foreign taxes must continue; and third, incentives for creating intellectual property and intangibles within the United States should be retained.

The software industry has grown rapidly in recent years. In 1995, the top 100 personal computer software companies had combined worldwide revenues of $16 billion. The industry employs approximately 500,000 people in the United States, and there are approximately 2 million workers in software programming jobs in this country. Exports make up a significant part of the overall revenues of the industry.

The typical software company spends a high proportion of its total revenues on research and development. The chief assets of software companies are their work force and intellectual property. A major expense is employee compensation.

A key to maintaining international competitiveness is the avoidance of international double taxation. Currently, double taxation is reduced through the foreign tax credit mechanism and reduction in foreign taxes under U.S. tax treaties. Other provisions of current law having a direct impact on competitiveness include the deductibility of employee compensation, the R&D credit, and export incentives like the foreign sales corporation provisions which, as you may know, are currently a source of controversy because of an overly narrow IRS interpretation that would deny certain software exports from receiving fringe benefits. But the goals of these provisions remain important to the software industry, and they should not be abandoned as we explore fundamental tax reform.

The tax reform proposals now under consideration would dramatically change. For example, all of the proposals would eliminate the foreign tax credit and avoid taxation by a territorial system under which foreign-source income would not be taxed. A territorial system would put tremendous pressure on the U.S. rules for determining whether income is U.S. or foreign source. If the United States taxes income as U.S. source, there will be no relief from double taxation if a foreign country taxes the same income.

The U.S. tax treaty network would be affected by the elimination of an income tax. Sales taxes and value-added taxes are not covered by income tax treaties. Loss of treaty protection would cause very serious hardship to software companies because the level of withholding taxes imposed by foreign countries would no longer be limited by treaty.

In the absence of treaties, prohibitively higher rates of withholding taxes, in some countries 40 percent or higher, would be imposed on software royalties. These rates are imposed on gross payments, not on net income, further increasing the tax burden.

Moving on to wages, the flat tax proposal would not permit a deduction for fringe benefits. The USA tax would deny any deduction for all employee compensation.

Both of these proposals cause SPA members serious concern. The software industry is heavily labor-intensive and employee compensation is often the single biggest expense of a software company.

Loss of a deduction for this expense would create an incentive to export development and production jobs outside the United States. Under all of the reform proposals, the R&D credit would be eliminated. Any tax reform proposal should include measures that would continue the beneficial effect of this incentive provision.

Export incentives are intended to maintain a level playingfield with our trading partners. The national sales tax and the USA tax would exempt export income altogether from U.S. tax and are, therefore, preferable in this respect to the flat tax.

In conclusion, our members feel that if we are to maintain a worldwide competitive advantage, tax reform must ensure that international double taxation will be avoided, current tax protections against excessive foreign taxes must continue, and incentives for creating intellectual property and intangibles within the United States must be retained.

The U.S. software companies currently enjoy a commanding competitive advantage over that of every other country. Any reform to the U.S. tax system must not impair that advantage and should preserve American jobs.

I look forward to the opportunity to provide any assistance we can to this Committee as it explores the alternatives.

Thank you very much.

[The prepared statement follows:]

STATEMENT ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX

before the
HOUSE COMMITTEE ON WAYS AND MEANS
July 18, 1996

on behalf of
THE SOFTWARE PUBLISHERS ASSOCIATION

by
Michael P. Boyle
Chief Tax Counsel and General Auditor
Microsoft Corporation

I. Introduction

I am Michael P. Boyle, Chief Tax Counsel and General Auditor for Microsoft Corporation. I appreciate the opportunity to present testimony on behalf of the Software Publishers Association on the impact of various tax reform proposals on international competitiveness.

The Software Publishers Association is the leading trade association for the personal computer software industry. Its 1200-plus member companies are businesses of all sizes, large and small, that develop and market software for business, consumer, and educational applications. Perhaps more than any other industry, software manufacturers derive their revenues from the creation and transfer of products resulting from the development of intellectual property and other intangible assets -- copyrights, patents, and software programs.

In the international context, this means that the taxation of income earned from the creation of valuable software programs, as well as their transfer and use overseas, is a fundamental concern of our members. U.S. tax policy must not unfairly burden the efficient development and distribution of software technology and products, which are key American exports to the world markets. U.S. software currently enjoys a commanding competitive edge over that of every other country. Any reform of the U.S. tax system must not impair that advantage.

This testimony will first describe the scope and importance of the U.S. software industry. We will explain how the software business operates, and how its products are created and marketed. The current income tax provisions applicable to the industry will be summarized. We will then give a short summary of the provisions of current tax reform proposals that would have an impact on the international operations of software companies, and analyze potential issues that would arise under each of the proposals. Overall, the testimony is primarily intended to underscore the importance of considering the effect of any tax reform proposal on international transfers of intellectual property, software, and other valuable intangibles.

II. The Software Industry

A. *Overview*

The software industry has grown during the past several years into one of the most dynamic and rapidly expanding sectors of the U.S. economy. In the early days of computers, hardware and software were typically bundled together, and software was not available for separate purchase. With the advent of the personal computer, however, it became possible to establish independent companies that specialize in the development of software alone. These companies do not deal in hardware, but simply sell software separately to purchasers of computers and other customers. The business includes other areas as well, such as designing custom software for larger computers and mainframes.

The American software industry today is large and getting larger. In 1995, the top 100 personal computer software companies had combined worldwide revenues in excess of $16 billion. Employment in the software industry increased at a double-digit rate throughout the 1980's, and is still increasing today. The industry employs approximately 500,000 people in the U.S., and there are approximately 2 million workers in software programming jobs in this country.

Exports make up a significant part of the overall revenues of the industry. In 1995, for example, 39 percent of the software revenues of the top 100 companies was derived from exports. Several of those companies made more than half their earnings from exports.

Software is an area in which the United States currently dominates world markets. A recent survey of the global software industry by *The Economist* magazine observed: "If everything is going software, most of the world is in trouble and America is laughing." The U.S. software industry makes an estimated three-quarters of the packaged software used around the world today. The nearest rivals, Germany and the United Kingdom, together share about 10% of the market.

B. *The typical software company*

The typical software company spends a high proportion of its total revenues on researching and developing new products. Relatively little of its capital is invested in hard assets and equipment. Its chief assets are its workforce (which tends to be both highly skilled and highly compensated), its intellectual property, and its other intangible assets. Its major expense is the compensation of its employees, whose skills and creativity contribute most of the value to the products and services from which the company's revenues are derived. For many companies, exports account for a significant portion of revenues.

Most American software companies do the majority of their software development work in the United States. However, other countries are currently competing actively -- through highly lucrative tax and business incentives -- for this development work and the employment that goes with it, including Australia, India, Ireland, Israel, Singapore, and Switzerland.

C. *Creation of a software product*

A software product is initially conceived in outline form. The functions and features of the product are identified, and its technical architecture is determined. The details of the product are then designed, followed by coding and extensive testing. The product may then be "ported" -- that is, modified to be compatible with several different hardware configurations. Products destined for international markets must be translated and localized to satisfy the language and cultural requirements of various foreign countries. Software engineers employed by the software companies, as well as outside contractors, do all of this work.

When the product is ready for use, a master tape or disk of the software is created. Duplicate copies of the software product are manufactured from this master. Documentation to accompany the product is also developed; this documentation is a vital part of the final product package, because it allows the user to install and run the programs.

D. *Marketing of a software product*

Software companies market their products through several channels in order to achieve the broadest possible market coverage. Typically, marketing will be done in some or all of the following ways:

- Directly to end users through the company's own sales force;
- Through dealers;
- Through third party distributors;
- Through original equipment manufacturers that bundle the software product with their own hardware and sell the combined product; and
- Through value-added resellers that combine the product with their own software and sell the combined package.

These techniques do not vary significantly in the overseas markets. Some companies have foreign subsidiaries through which they market their products. Others rely more on third party distributors. In order to distribute the products efficiently, an intermediary may be licensed the right to reproduce and perhaps modify the software package.

III. Current Tax Provisions Applicable to International Transfers of Software

United States corporations are taxed on their worldwide income. Because foreign countries also tax the operations of companies operating within their borders, international double taxation is a constant problem. Current U.S. law seeks to relieve the potential double taxation that arises in this situation by allowing a credit against U.S. income taxes for foreign income taxes paid, subject to a number of limitations. Foreign countries also typically impose withholding taxes on income arising within their borders and paid to foreign companies, including taxes on dividends, interest, and royalties. U.S. foreign tax credits are also available for these withholding taxes. In both of these cases, however, the foreign tax credit is applicable only against U.S. tax attributable to foreign source income as defined under U.S. law. The Internal Revenue Code prescribes detailed rules for determining the source of many different categories of income. Often, the foreign corporate tax plus the withholding tax are high enough that the U.S. foreign tax credit is limited, which may put U.S. companies at a disadvantage.

Where a U.S. corporation operates in a foreign country through a subsidiary corporation, U.S. tax on income derived from the subsidiary's active business is deferred under the "controlled foreign corporation" provisions of the Code. Such income is taxed when it is repatriated to the U.S. parent in the form of a dividend. An indirect tax credit for foreign taxes paid by the subsidiary on the active income is available to the U.S. parent when the dividend is paid. Most other income earned by controlled foreign subsidiaries is taxed currently to their U.S. shareholders.

Relief from foreign income taxes is also available under the provisions of the many bilateral tax treaties to which the U.S. is a party. Tax treaties are in place with virtually all of America's major trading partners, and limit the taxes that the foreign countries can impose on various categories of income. (The United States grants reciprocal benefits to treaty-partner residents deriving income in this country.) These treaties are by their terms limited to taxes on income and on capital, and are a significant part of the worldwide network of safeguards that gives U.S. companies a level of certainty necessary to operate across borders.

Transfer pricing rules apply to transactions between related parties. The IRS has the authority to reallocate gross income, deductions, and other tax items between related entities in order to align the terms of their transactions with those that unrelated parties, dealing at arm's length, would have agreed to. Software companies, whose products and services are almost always unique, have faced special difficulties under these rules because the absence of "comparable" transactions between unrelated parties gives rise to great uncertainty with respect to the appropriate "arm's length" terms. Also of concern to our members is the so-called "super-royalty" provision, added to the Code in 1986. Under this provision, income derived from a transferred intangible must be commensurate with the income that the intangible subsequently generates; for example, the transfer price for a software license, if characterized as a transfer of intangible property subject to the super-royalty rule, can be retroactively adjusted in future years to accord with the annual revenue derived from the software product. These adjustments can lead to unexpected results not fully consistent with the arm's length standard, will often result in double taxation, and are an additional source of significant uncertainty.

The Foreign Sales Corporation, or FSC, regime is one of the most important U.S. tax incentives for exports from the United States. These provisions were enacted to offset competitive disadvantages faced by U.S. exporters because many of our trading partners have more favorable systems for taxing exports. Under the FSC provisions, an exemption from tax is available on roughly 15%-30% of the income earned from export transactions if certain requirements are met. The purpose of the FSC rules is to encourage the development and manufacture of products in the United States and the subsequent transfer of those products overseas.

There is currently some controversy over the applicability of the FSC rules to software. The Treasury Department's temporary and proposed FSC regulations contain language that arguably is broad enough to allow computer software manufacturers to export computer software, with or without the right to reproduce, and receive FSC benefits. However, the IRS interpretation of these regulations has been to deny FSC benefits for exports of software accompanied by the right to reproduce. This interpretation discriminates against the software industry by denying this benefit, which is available to all other U.S. exporters. Our members believe that Treasury should modify its interpretation of the regulations to make it clear that these benefits are available to this important export sector of the U.S. economy. Its refusal to do so would require the enactment of remedial legislation.

A temporary tax credit for research and experimentation expenses carried out in the United States has been available for several years. Software companies devote a considerable portion of their budgets to R&D, and the credit enables them to continue the research needed to maintain their products' leadership role in the world marketplace by lowering the net cost of research. For several years, however, there has been great uncertainty over the continued extension of the credit. (For example, the Senate version of the Small Business Job Protection Act would allow the credit to lapse for one year.) This uncertainty affects the budgeting of the amount and location of research expenditures, which typically must be done some years in advance. Much of the potential benefit of the credit is lost because companies are unable to compute long-term research budgets with the certainty that the credit will be available in future years. A permanent credit would enhance competitiveness still further and encourage companies to continue to expand their development operations in the U.S., creating additional jobs and exports.

IV. The Principal Tax Reform Proposals

A. *Overview*

Here is a brief description of the aspects of each of the major tax reform proposals that would affect the international competitiveness of the software industry.

B. *The Flat Tax*

The Flat Tax (as contained in H.R. 2060) would impose tax at a single rate on income from the sale or exchange of property or services in the U.S. and on income from the export of property or services overseas. The bill itself does not address the treatment of foreign source income, but statements made by Majority Leader Armey indicate that the Flat Tax would be a territorial system of taxation, perhaps similar to the "exemption" system used by some countries (for example, Austria and Switzerland). Income earned outside the United States would not be subject to U.S. tax. No foreign tax credits would be allowed under this system.

C. *The National Sales Tax*

The National Sales Tax would be imposed on the gross amount of payments for the use, consumption, or enjoyment in the United States of any taxable property or service. Taxable property would not include intangibles. An exemption from the tax would be provided for property purchased for export, but imports would be subject to it.

D. *The Value Added Tax (including the USA Tax)*

The Committee requested comments on two types of value added taxes, or VATs. The first is the credit-invoice method VAT, used in many countries, which would be applied to the sales price of goods or services and shown on the invoice for those goods or services. The tax would not be imposed on purchases for goods and services used in the seller's business. The VAT would also not be imposed on exports, although it would apply to imports. The rate of VAT may vary (sometimes down to zero) depending on the nature of the goods or services transferred. The treatment of royalty income derived from the foreign use of intellectual property and certain other intangibles, including software copyrights and patents, varies from country to country; our members believe that such income is comparable to income from the export of goods and should not be subject to the VAT.

The other kind of VAT is a subtraction method VAT, of which the USA Tax is an example. This VAT would be imposed on the gross profits (defined as the excess of gross receipts over business purchases) of businesses that sell or lease goods or services in the United States. Gross receipts would not include amounts derived from exports of goods and services; if "exports" are properly defined, foreign source royalties for the use of intellectual property and certain other intangibles should be excluded from the U.S. tax base. Under the USA Tax, wages and other compensation costs would not be business purchases and would not be deductible from gross receipts. (A payroll tax credit, up to the amount of the annual FICA tax liability, would be available.)

V. Issues Arising Under Each of the Reform Proposals

A. *Overview*

This section of the testimony identifies issues of importance to our members that would arise under each of the fundamental tax reform proposals described above. The intent of this section is not to advocate particular solutions to these issues, but to ensure that they are properly and fully addressed in the course of the tax reform process.

B. *Sourcing rules*

As discussed above, a significant amount of the revenues of software companies arises from operations in foreign markets. These operations typically entail the payment of foreign taxes to the countries in which those companies operate.

All of the proposals would eliminate the foreign tax credit mechanism and instead avoid double taxation by a so-called "territorial" system. In principle, such a system might be expected to be at least neutral with respect to our member companies' international competitiveness; indeed, the territorial system might improve competitiveness in cases where limitations in current law prevent a full foreign tax credit.

However, in order to achieve this result, the rules for sourcing of income need to be carefully examined. The U.S. rules are not the subject of international agreement, and it is possible for a foreign country to tax income that is considered to be from U.S. sources under U.S. rules, and therefore subject to U.S. tax. In the absence of a foreign tax credit, there would be no way to avoid double taxation in these cases. Similarly, rules for sourcing deductions would become critical, because a deduction allocated to foreign sources would be a deduction of no use for U.S. tax purposes.

Sourcing rules applicable to specific categories of income are of special concern to our members. Under current law, for example, royalties derived from the active licensing of software patents and copyrights for use overseas are foreign source income. If this rule were changed, the withholding taxes that many foreign countries impose on royalties would give rise to double taxation. The imposition of double taxation on cross-border royalties is inconsistent with international tax policy and must be avoided in drafting any tax reform proposal.

For these reasons, the successful implementation of a territorial tax system would require a careful and detailed review of the sourcing rules. In particular, it would be desirable to examine how the U.S. rules and the rules used by foreign countries (which are generally much less detailed) will interact.

C. *Problems under tax treaties*

The United States' international tax treaty network would be substantially affected by the elimination of an income tax. Sales taxes and value added taxes are not covered by treaties, and it is uncertain whether our treaty partners could be persuaded that some of the proposed replacements for the current income tax system are the equivalent of income taxes and therefore covered by the treaties. The United States might be faced with terminations of many of its treaties if treaty partners feel that the concessions they have made in reducing the tax burden of U.S. taxpayers operating in their countries are no longer balanced by reciprocal concessions by the U.S.

Loss of treaty protection would cause very serious hardship to our members because the level of withholding taxes imposed by foreign countries would no longer be limited. In the absence of treaties, prohibitively high rates of withholding taxes – in some countries, 40% or higher -- can be imposed on license payments for software copyrights and patents. These rates are imposed on gross payments, not on net income, further increasing the tax burden from operating in many jurisdictions. In addition, the expanded opportunities for foreign taxation would likely increase the administrative and compliance burdens that foreign withholding taxes generate.

The interaction between treaty problems and the move to a territorial tax system is complex and beyond the scope of this testimony. The territorial system might serve to alleviate some of the difficulties that might otherwise arise, but the problem of high foreign tax rates on foreign source royalty income would remain. In addition, the loss of the treaty system would seriously impair the ability of the U.S. government to exchange taxpayer information, negotiate solutions to bilateral tax disputes (including transfer pricing disputes), and deal with foreign tax authorities on matters of tax administration.

The Flat Tax might be considered more favorably under our income tax treaties if foreign source royalty income would be exempt from U.S. tax and the Flat Tax remains an income tax of the type covered by treaties. Because of the significant structural differences between the Flat Tax and the current tax system, however, the Flat Tax would at the very least upset the compromise solutions to double taxation problems that most treaties embody. Even this proposal, therefore, would require a detailed scrutiny of the existing tax treaty network.

D. *Exports*

Export benefits under current tax law are concentrated in the FSC regime described above. This regime, which provides tax incentives for some export income, would disappear under all of the fundamental tax reform proposals. To the extent that the National Sales Tax and VAT proposals such as the USA Tax would exempt export income altogether from U.S. tax, of course, they would in fact be a great improvement over the FSC regime. The Flat Tax, on the other hand, neither exempts exports from tax nor includes FSC rules. For an industry like ours, which exports so much of its products, FSC benefits or more substantial export exemptions are needed in order to maintain a level playing field with our trading partners.

E. *Transfer pricing*

The current U.S. transfer pricing regime under section 482 of the Code has received a great deal of attention and adjustment over the past several years. A substantial amount of work -- including multilateral negotiations at the OECD -- has been devoted to arriving at a system of transfer pricing principles that are fair, workable, and subject to broad international agreement. Any tax reform proposal should be careful to preserve the consensus view that has been painstakingly developed in this area. The exemption of foreign source income from U.S. tax has the potential to save both taxpayers and the government millions of dollars in compliance and controversy costs, but only if the source rules are clearly enunciated. Transfer pricing controversies would be further alleviated by those proposals that exempt exports from U.S. tax.

F. *Employee compensation*

The Flat Tax proposal would permit a deduction for wages but not for fringe benefits. The USA Tax would deny any deduction for employee compensation. Both of these proposals cause our members serious concern. The software industry is heavily labor-intensive, and employee compensation is often the biggest single expense of a software company. Loss of part or all of a deduction for this expense would increase U.S. tax liability and increase the after-tax cost of labor, and might therefore create an incentive to export development and production jobs outside the U.S. The payroll tax credit under the USA Tax proposal would not eliminate the problem, because most software engineers earn incomes above the annual FICA limitation. Similarly, the overall lower rates would not fully compensate for the loss of the deduction and would effectively result in discrimination against labor-intensive industries.

G. *Research & experimentation credit*

Under all of the reform proposals, the research and experimentation tax credit would be eliminated. This credit is designed to preserve or increase the level of research and experimentation in the U.S. economy and the concomitant number of U.S. jobs created thereby. Our members believe that any fundamental tax reform proposals should include measures that would continue the beneficial effect of the existing incentive provisions.

H. *Scope of a sales tax*

The National Sales Tax, like many comparable state sales taxes, would not be imposed on "intangible property." However, at the state level, our members have encountered some controversy with taxing authorities over how sales apply to software products and their eligibility for the exemption. If a sales tax is adopted at the federal level, it should clarify that income derived from many types of software transactions is specifically exempt in order to avoid these disputes.

I. *Transition issues*

No tax reform proposal should be adopted without carefully considering transition issues. Many existing business structures and contractual arrangements have been developed on the assumption that the current income tax system would continue in place. A fairly extensive transition period would likely be needed if fundamental tax reform is adopted, in order to avoid upsetting the legitimate expectations of taxpayers and thereby reducing their ability to compete in the international markets.

VI. Conclusion

The impact of the fundamental tax reform proposals on the competitiveness of the American software industry will depend to a considerable extent on the resolution of the issues discussed above. If we are to maintain our worldwide competitive advantage, our members must be assured that international double taxation will be avoided; that the transfer of intellectual property and other intangibles overseas will receive tax treatment at least as favorable as that accorded to other types of exports; and that care is taken not to increase the after-tax cost of the compensation being paid to their U.S. employees, thereby preserving American jobs. Software is an important industry in which the United States is currently the world leader. Tax reform should preserve this pre-eminent position.

Mr. HOUGHTON. Thank you, Mr. Boyle.
Mr. Rogers.

STATEMENT OF JOHN E. ROGERS, DIRECTOR OF TAXES AND ASSISTANT TREASURER, FMC CORP., CHICAGO, ILLINOIS; ON BEHALF OF COALITION ON ROYALTIES TAXATION; ACCOMPANIED BY JOHN W. COX, TAX DIRECTOR, BMC SOFTWARE, INC., HOUSTON, TEXAS

Mr. ROGERS. Good afternoon, Mr. Chairman. I am John Rogers, director of Taxes and assistant treasurer for FMC Corp. FMC is headquartered in Chicago and is one of the world's leading producers of chemicals and machinery for industry, government, and agriculture. Approximately one-half of our sales, which are approaching $5 billion, are outside the United States.

I am accompanied today by John W. Cox, who is director of tax for BMC Software. BMC is headquartered in Houston and is a worldwide software developer and vendor of software solutions for automating application and data management across host-based and open-based environments. More than 40 percent of BMC's $430 million in current revenues are from exports.

FMC and BMC are members of the Coalition on Royalties Taxation, which includes in its membership U.S.-based multinational companies in a broad array of industries, a total spectrum of U.S. industry.

My testimony today will emphasize four points. First, any reform proposal must tax cross-border licensing in a way that keeps research and development activities in the United States. Second, cross-border transfers in intangibles are necessary for U.S. companies to do business in foreign markets. Third, foreign-source royalty income from these transfers should be treated in the same way as other foreign-source income. Finally, double taxation of foreign-source royalty income must be prevented and current income tax treaty benefits must be preserved.

In order to compete in foreign markets, U.S. corporations must be able to efficiently create and disseminate intangible property throughout the world. Technology development in the United States means jobs. In most businesses, these research jobs pay high salaries and provide meaningful and challenging employment opportunities. Any gaps left by U.S. companies will be filled by our foreign competitors.

In conducting their business activity worldwide, U.S. corporations routinely license intangibles to their related foreign subsidiaries and joint ventures as the most efficient way of operating in foreign markets. These licenses create foreign-source royalty income. The U.S. tax treatment of such income is crucial to preserving the U.S. development of the intangibles and the economic benefits to the United States that this investment creates.

Under current U.S. law, a company is taxed on its worldwide income. A tax credit for tax that is paid to foreign countries including withholding taxes on royalties is intended to avoid double taxation of that income.

Current tax provisions that specifically affect the competitiveness of U.S. exporters include the foreign sales corporation, or FSC rules, which are intended to encourage U.S. exports. A temporary research credit is also available.

The current tax reform proposals provide for a territorial system of taxation under which foreign-source business income is not subject to U.S. tax. Foreign tax credit is eliminated because it is assumed that the territoriality will prevent double taxation. If a territorial tax system is adopted, it is extremely important that appropriate sourcing rules be adopted to prevent taxation in the United States of business income that is already subject to tax in a foreign jurisdiction.

Consistent with a territorial system, royalties and license fees earned in foreign countries should be exempt from U.S. taxes because they represent foreign-source business income which is already provided for by U.S. law. Otherwise, double taxation would make many typical business transactions unprofitable.

A key area that remains unresolved, though, is the impact of the tax reform proposals on the current system of U.S. income tax treaties. If these treaties no longer apply, U.S. companies doing business overseas may be severely harmed. Withholding taxes imposed on royalty income by our treaty partners will increase, but treaty protection is removed. The Coalition urges the preservation of the treaty system that is currently in place.

In conclusion, proposals for tax reform should exclude foreign-source royalties from the U.S. tax base because these royalties are already subject to tax in the countries they pay, or U.S. tax would constitute double taxation in the absence of foreign tax credits, and this would be burdensome and hamper continued development, which is important for competitiveness.

[The prepared statement follows:]

Statement
on
The Impact on International Competitiveness
of Replacing the Federal Income Tax
before the
House Committee on Ways and Means
on
July 18, 1996
on behalf of
The Coalition on Royalties Taxation
by
John E. Rogers
Director of Taxes and Assistant Treasurer
FMC Corporation

I am John E. Rogers, Director of Taxes and Assistant Treasurer for FMC Corporation. FMC, headquartered in Chicago, is one of the world's leading producers of chemicals and machinery for industry, government and agriculture. Approximately one-half of FMC's $4.5 billion 1995 revenues were from international sales. I am accompanied today by John W. Cox, Tax Director for BMC Software, Inc. BMC, headquartered in Houston, is a worldwide developer and vendor of software solutions for automating application and data management across host-based and open system environments. More than 40% of BMC's $430 million in revenues are from exports.

FMC and BMC are members of the Coalition on Royalties Taxation ("the Coalition"), which includes in its membership U.S. based multinational companies doing business in a broad array of industries, including consumer products, software, industrial manufacturing, entertainment and fast food. These companies represent America's leading exporters in their industries. They create valuable intellectual property and other intangible assets in the United States and utilize these intangibles in international commerce. (For simplicity we will refer to these assets as "intangible assets.") In order to competitively market products in foreign jurisdictions, these corporations must be able to efficiently create and disseminate intangible property throughout the world. For that reason, the members of the Coalition share a concern with how the income derived from the use of intangible assets overseas (generally represented through royalties) would be taxed under a reformed U.S. tax system.

I. The Importance of U.S.-Developed Intangibles to U.S. International Competitiveness

U.S. corporations lead the international marketplace in their respective industries in developing new technologies used to create new products, manufacturing expertise, and marketing strategies. This technology is the product of U.S. based research and development which produces market leading patents, copyrights, trademarks and business know-how. The ability to efficiently utilize these intangible assets throughout the world is a key component in the international operations of a U.S. corporation. U.S. policy should not impede the cross border dissemination of these important business assets. The National Commission on Economic Growth and Tax Reform (Kemp Commission) highlighted the need to be concerned with the tax treatment of foreign source royalties in designing a new tax system in stating that "attention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."[1]

The following testimony will focus on the manner in which intangible assets are used by U.S. multinational corporations in foreign jurisdictions and the U.S. tax ramifications of these transactions. It will also review the treatment of the development and dissemination of intangible assets under the various alternative tax proposals. The Coalition does not endorse any particular alternative taxing system; rather, our purpose is to focus attention on the importance to the U.S. economy of the efficient international dissemination of U.S.-developed intangible assets as an important issue that must be considered as a part of the tax reform process.

A. How U.S. Multinationals Utilize Intangibles Overseas

The ability of a U.S. corporation to conduct business outside the United States often requires that its foreign affiliates obtain the right to utilize intangible assets that are developed by the U.S. parent. Furthermore, in some cases, U.S. corporations may directly license the right to use intangibles to their foreign customers. As reflected by the broad membership of this Coalition,

[1] *Report of the National Commission on Economic Growth and Tax Reform*, Washington, D.C., p.18.

intangible assets are utilized in international commerce by companies doing business in a broad array of industries. U.S. corporations often license the use of intangibles to their related foreign subsidiaries for their use in manufacturing and marketing their products overseas. This license creates foreign source royalty income.

In the case of a manufacturing concern, licensing intangibles to a foreign affiliate allows a U.S. based manufacturer to compete in foreign markets. If a U.S. corporation sells U.S. manufactured products in foreign markets through foreign distribution subsidiaries, the U.S. corporation generally must license marketing intangibles to the foreign distribution subsidiary that sells the U.S. manufactured products in the local markets. In the case of a foreign subsidiary of a U.S. corporation that both manufactures and sells products in its local markets, the U.S. corporation generally must license both marketing and manufacturing intangibles to the foreign subsidiary in order to operate in the local market.

Some businesses depend on the efficient distribution of technology-based products through licensing. In the electronics and software industries, the value of the product is largely driven by the technology and other creative content contained in the product. This technology is often protected by a copyright or patent, and product distribution takes the commercial form of a license. Furthermore, the obsolescence rate of intangible assets in these industries is so high that the technology base must be continually replenished in order to retain market share. In these businesses, the primary value of the product is the intellectual property that is contained in the product. The U.S. tax treatment of income derived from the use of intellectual property is a significant economic component in determining the ability of a U.S. company to conduct profitable operations in foreign jurisdictions. Similar issues would affect publishing, music, films, television and other creative industries in the United States.

Franchising U.S. businesses in foreign markets is another industry that is dependent on the efficient dissemination of intangible assets. The "Americanization" of the global economy has allowed many businesses to expand globally through the use of franchise agreements. Under these agreements, many U.S. companies license the use of trademarks, trade names, operational plans, and store designs to a local franchisee. The local franchisee invests capital in the local business and the U.S. franchisor receives a fee for the use of intangible assets and for services performed on behalf of the franchisee.

In addition, many U.S. companies are entering new markets by forming joint ventures with a non-U.S. partner that is engaged in a compatible business in a foreign market. U.S. corporations are often required to make their intangible assets available in a local jurisdiction as part of the joint venture transaction. These transactions often result in a license of intangible assets by the U.S. corporation to a joint venture entity. It is often necessary to license intangible property to the joint venture in order to execute the business objectives of the venture.

B. Technology Investment Promotes Capital Formation and Economic Growth

Capital formation is essential to long-term economic growth, whether through investment in plant and equipment (tangible capital) or through investment in product, process, or market development (intangible capital). By enhancing production and expanding markets, capital formation increases worker productivity, reduces costs and prices, and increases international competitiveness. In order to promote long-term economic growth, tax policy should not impede the license of intangible property so as to promote both tangible and intangible capital formation.

Research and development activity is a vital element in the production of both tangible and intangible capital. The leading position of U.S. companies in their respective industries is often a function of U.S. research. These research activities focus on creating new products and improving the manufacturing process of existing products, the result of which is higher productivity and an increase in capital formation in the United States. With technology and intangible assets playing a larger role in the development of new products, it is imperative that these research activities be maintained in the United States.

Many indirect benefits are also derived from the development of intangibles that are not directly apparent in the commercial operations of a particular company. For example, when a company invests in a piece of machinery, it alone derives the benefits of using that machinery. When a company invests in new technology (or other types of "headquarters services[2]"), however, the benefits provided are not limited to the firm paying for the investment. Some of

[2] For this purpose, we consider headquarter services to include technology, know-how, patents, copyrights, trademarks, and tradenames.

the benefits spill over to competitors, to other industries, as well as into the community where the investment is located. For example, employees moving from one firm to another may share technological know-how of their former employer with their new employer. Or, as another example, a breakthrough in the development of manufacturing processes for computer components could also provide benefits for the manufacture of other machinery. When a firm does a cost-benefit analysis of undertaking investment in intangible capital, it does not factor in spillover benefits that are important to the overall economy. Thus, it is widely asserted by economists that private firms' investment in intangibles is less than optimal from the standpoint of expanding the overall economy. Tax policy should recognize the importance of the domestic development of intangible assets and the ability of a U.S. corporation to use those intangibles in foreign affiliates. *Even more than in the case of investment in tangible capital,* investment in intangible capital should not be unduly burdened by the tax system.

C. Creation of High-Skill, High Wage Employment in the United States

When the U.S. exports intangibles, it increases demand for U.S. expertise in science, engineering, management, and marketing. These occupations generally pay high salaries and provide meaningful and challenging employment opportunities. In order for economies of scale to be fully exploited, U.S. investment in intangible assets should have worldwide markets. Any impediment to the worldwide utilization of intangible assets will reduce future investment and employment in high-technology sectors. Excess taxation of royalties reduces the return to investment in intangibles and along with this taxation there will be a reduction in high paying, high-skilled employment in the United States. Any gaps left in the marketplace by U.S. companies will be filled by investment in intangibles by foreign competitors.

The increasing availability of trained scientists and engineers abroad is causing U.S. companies that once conducted all research in the United States to seriously look beyond U.S. borders. For example, the *Wall Street Journal* has reported, "U.S. professionals are starting to see job opportunities vanish as employers look for engineers and programmers in Ireland, Russia, Malaysia, India and Singapore, where there are plentiful surpluses of well educated professionals."[3] Caution must be taken in developing alternative tax systems to promote the increase of human capital in our economy and stem the movement of technology development offshore.

II. <u>Discussion of the Current Income Tax</u>

Under current law a U.S. corporation is taxed on its worldwide income. A foreign tax credit system is provided to avoid double taxation of income that is considered under U.S. tax rules to be earned outside the United States, referred to herein as "foreign source income." Royalty income earned by a U.S. multinational from the use of intangibles outside the United States is foreign source income. This income, when derived in the context of an active trade or business, is taxed in a manner similar to income derived from the sale of a manufactured product. For example, in applying the foreign tax credit rules, foreign source royalty income derived from a controlled foreign affiliate that is actively engaged in business outside the United States is treated as active trade or business income. Similarly, under current subpart F rules, royalty income derived from active development or licensing of intangibles is excluded from the definition of foreign personal holding company income. Thus, the active licensing income, if earned by a controlled foreign corporation, is treated as active income and is not subjected to the subpart F, PFIC or section 956A anti-deferral regime. The royalties received for the use of these intangibles are often subject to foreign withholding taxes and foreign value-added taxes in the payor's jurisdiction. Current law allows the foreign withholding tax to be credited against U.S. income tax that would be owed on these royalties.

U.S. tax law has provided a temporary research and experimentation tax credit, designed to provide an incentive for developing technology in the United States. Under current legislative proposals, there would be a 12 month period during which the research credit lapses.[4] This suspension causes U.S. companies to question the ongoing viability of the credit in making their plans for future investments in U.S. research. A permanent research credit would provide a strong incentive for U.S. corporations to expand their research activities in the United States.

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[3] *Wall Street Journal*, "Age of Angst: Workplace Revolution Lifts Output But Job Security Is Getting Harder to Come By," pg. A8, March 10, 1993. See follow up article, *Wall Street Journal*, "Like Factory Workers, Professionals Face Loss of Jobs to Foreigners," pg. A1, March 17, 1993. See also, *New York Times*, "Skilled Workers Watch Their Jobs Migrate Overseas, A Blow to Middle Class," pg. A1, August 28, 1995.
[4] See Senate version of Small Business Job Protection Act, §1203 of H.R. 3448.

Current law also provides an incentive for exporting from the United States—the foreign sales corporation (FSC) rules. The FSC rules provide an exemption from U.S. tax for approximately 15% of income derived from export sales of most U.S. products. The benefit was designed to encourage U.S. companies to manufacture or develop their product in the United States for sale or lease overseas. IRS interpretations of the application of the FSC rules to export of software could negate the incentive to develop software in the United States.[5] These rules inappropriately discriminate against software products when compared with similar products.

The title-passage rule under section 863(b) generates foreign source income from the export of U.S. manufactured products, thereby allowing U.S. corporations to more efficiently utilize foreign tax credits. Under the title passage rule, income from goods manufactured in the United States and sold overseas generally is considered to be earned half in the United States and half outside the United States. By allocating 50% of this income to foreign sources, the title passage rule allows greater utilization of foreign tax credits, thereby reducing the risk of double taxation and the cost of producing goods in the United States for export markets. Again, this foreign source income treatment promotes exports.

A. Alternative Tax Proposals:

The following is a brief description of the three alternative tax proposals under consideration followed by a discussion of the impact of these proposals on the taxation of income from intangibles.

1. Flat Tax (H.R. 2060)[6]

With respect to business income, the Flat Tax is imposed on the sale or exchange of property or services in the United States and the export of property or services. H.R. 2060 does not specify whether the proposal would subject income earned outside the United States to U.S. tax and whether foreign tax credits would be allowed to prevent double taxation of this income. It is our understanding that the proposal is expected to provide a territorial system of taxation, under which income earned outside the United States would not be subject to U.S. tax. However, export income would be subject to U.S. tax. Because income earned outside the United States would not be subject to U.S. tax, a foreign tax credit system is not included to prevent double taxation.

The Coalition believes that royalty income from the exploitation of intangibles outside the United States should be characterized as foreign source income under the Flat Tax and, thereby, not subject to U.S. tax. Because foreign source royalty income is subject to foreign withholding taxes in the jurisdiction of origin, double taxation will occur if this income is taxed again under the Flat Tax regime.

2. National Sales Tax[7]

Under a National Sales Tax, a tax would be imposed on the gross payments for the use, consumption or enjoyment in the United States[8] of any taxable property or service, whether produced or rendered in the United States. Taxable property includes any property (including leaseholds) other than intangible property. Exemptions from the tax are provided for property that is purchased for resale, used to produce other taxable property or services, or exported from the United States for use, consumption or enjoyment outside the United States. Under the National Sales Tax, the exemption of intangibles, if properly defined, will exclude royalty income from taxation.

3. Value-Added Taxes

a. Credit - invoice method VAT

Under a credit-invoice method VAT, a tax is applied to the sales price of goods or services, which is generally disclosed on the invoice. A business credit is provided for the VAT on purchases of goods and services that are used in the seller's business. VAT systems generally

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[5] See Treas. Reg. §1.927(A) -1T(f)(3); TAM 9344002 (May 27, 1993).

[6] For purposes of this testimony, we are basing our analysis on H.R. 2060, introduced by Rep. Dick Armey (R-TX) on July 19, 1995. H.R. 2060 does not provide many details as to how its flat tax system would apply to income earned by U.S. multinationals. Our discussion of specific aspects of the Flat Tax that are not included in H.R. 2060 is based on public comments made by Rep. Armey or his staff.

[7] For purposes of this testimony, we base our analysis on H.R. 3039, introduced earlier this year by Reps. Schaefer (R-CO), Tauzin (R-LA), and Chrysler (R-MI).

[8] The term "United States" includes any commonwealth, territory or possession of the United States.

exempt exports from tax and impose tax on imports. Thus, foreign source royalties would not be subject to the VAT. In addition, a VAT system may exclude certain goods, services, or classes of taxpayers by providing a "zero rating" or an exemption.

b. Subtraction method VAT9/USA Tax.

The business tax under the USA Tax is a subtraction method value-added tax and is imposed on the gross profits of firms that sell or lease property or services in the United States. Gross profits are defined as the excess of gross business receipts over business purchases. Gross business receipts do not include amounts received for property or services exported from the United States for use or consumption outside the United States. If exports are properly defined, foreign source royalties should be excluded from the U.S. tax base. Under the USA Tax, wages and other compensation costs are not considered to be business purchases, although a payroll tax credit is provided up to the amount of the FICA tax liability.

B. Discussion of Impact of Various Tax Reform Plans on Intangibles Developed in the United States and Used Overseas

1. Territorial Tax System

All of the tax reform plans discussed above provide for a territorial system of taxation. Under a territorial system, foreign source business income is not subject to U.S. tax. Territorial tax systems do not include a foreign tax credit mechanism because it is assumed that the U.S. jurisdiction of taxation is appropriately defined to avoid double taxation of foreign source business income. If a territorial tax system is adopted under fundamental tax reform, it is extremely important that appropriate sourcing rules be adopted to prevent taxation in the United States of business income that is already subject to tax in a foreign jurisdiction. Consistent with a territorial system, royalties and license fees described above should be exempt from U.S. tax because they represent business income. The treatment of these fees as foreign source business income is consistent with their treatment under current law. It is critical to preserve a tax system that avoids double taxation. If a cross border transaction is subject to taxation in both the foreign jurisdiction and in the United States, then, depending on the circumstances, it is possible that the transaction will no longer be economically viable.

2. Treatment of Exports

Both the National Retail Sales Tax and the VAT (whether credit invoice method or subtraction method) are destination-based territorial tax systems. Under the destination principle, goods and services are taxed in the jurisdiction in which the products are sold rather than the jurisdiction in which the products are produced. All major consumption taxes in force throughout the world exempt exports, including exports of intangibles, from tax.[10]

As stated previously, exempting exports from U.S. tax will help level the playing field for these products to compete in foreign markets. Foreign source royalties paid to U.S. corporations are payments for the export of intangible assets created by the corporation and, as such, these royalties should be exempt from tax under a destination principle consumption tax, like the National Sales Tax[11] or a VAT. This taxing regime is consistent with similar taxes imposed by our leading trading partners. Furthermore, the export of intangibles improves the U.S. balance of trade in the same manner as an increase in exports of tangible property. This is reflected in official government statistics published by the U.S. Commerce Department which include royalty payments from abroad as exports. According to two Treasury Department economists, exemption of foreign income under a consumption tax, including exemption of receipts of foreign royalties under the destination principle, would likely cause multinational corporations to shift tangible investment, intangible assets, and R&D to the United States.[12]

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[9] Because the business portion of Unlimited Savings Allowance (USA) Tax is a subtraction method value-added tax, we have based our analysis on the provisions of that tax, as set forth in S. 722, introduced by Senators Domenici (R-NM) and Nunn (D-GA).

[10] Under the consumption taxes imposed by Canada, Japan, Germany, the United Kingdom, France, Italy and most other industrial countries, royalties received from abroad for technology developed within their borders are not subject to tax.

[11] Even if the National Sales Tax did not follow a destination principle, it is assumed that exports of intangibles would not be subject to tax because the proposal does not subject any intangible property to tax.

[12] Grubert and Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal*, Vol. XLVIII No. 4, December 1995, p. 620.

Many economists recognize that avoiding double taxation on export transactions and utilizing tax policy to promote export activities is necessary to maintain a level playing field for domestic producers trying to compete in foreign markets, thus promoting growth and free trade. Our current income tax system recognizes this need through the foreign sales corporation (FSC) rules, which exempt approximately 15% of export sales income from U.S. tax. Clearly, a system that exempts 100% of export sales income from U.S. tax will play a far greater role in assisting U.S. exports to compete with products made by foreign trading partners that have more beneficial systems for taxing exports. Economists state that a destination principle consumption tax will minimize price distortions facing producers.[13] They stress that it is important to minimize these distortions so that producers do not relocate their production.

One of the proposed purposes of reforming our current tax system is the elimination of the complexity that plagues the current income tax. Our current international tax structure, with its complicated rules for determining the amount of foreign tax credits that may be utilized, is one of the most complicated parts of the current system. One particular aspect of this complication that would be eliminated with a destination-based system is the establishment of an "arm's-length price." Of all transfer pricing issues, nothing is more difficult than establishing the price for the transfer of intangible assets. In recent years, some of the largest and most complex cases involving taxes have involved setting the correct royalty rate for transactions between related parties. Currently, taxpayers must devote significant resources to establishing arm's-length royalties charged to related parties for the right to use intangibles. This complexity would continue under any tax that continued to tax royalties from abroad. Under the destination based system, the exclusion of royalties from abroad would eliminate dozens of pages of tax regulations and tens of millions of dollars in compliance costs incurred by the private sector as well as the government.

3. <u>Treaties</u>

Another area that remains unresolved is the impact of the three tax reform proposals on the current system of U.S. income tax treaties. Because these taxes may be characterized as consumption taxes, there is an issue as to whether or not the existing income tax treaties will remain in effect if these proposals are enacted. If these treaties no longer apply, U.S. companies doing business overseas may be severely harmed. The Coalition urges Treasury to use all efforts to preserve the treaty system that is currently in place.

4. <u>Other Issues Affecting Development of Intangibles in the United States for Use Overseas</u>

As stated previously, the exemption of foreign source royalties from U.S. tax could cause multinationals to shift development of R&D and other intangibles to the United States. However, limiting the deduction for employee compensation, as would be the case under the USA Tax, would create a conflicting disincentive to locate development activities in the United States. Activities involved in the development of these intangibles are very labor intensive and higher levels of wages are generally associated with these activities. Because wages above the FICA limit are generally provided for many of these functions, the net effect of denying a deduction for these labor costs will be to encourage firms to perform these activities outside the United States.

None of the tax reform plans provide for an R&D credit. As stated previously, the R&D credit has provided an incentive to perform research activities in the United States. If the credit is eliminated under fundamental tax reform, it is important to assure that other aspects of the new tax system encourage the development of technology in the United States, rather than overseas. Maintaining our base of innovation and technology is vital in maintaining our position as a world economic leader in the 21st century.

Conclusion

Proposals for tax reform should exclude foreign source royalties from the U.S. tax base. Because these royalties are already subject to tax in the country of the payor, U.S. tax would constitute double taxation in the absence of foreign tax credits. Burdensome taxation of foreign source royalties would hamper U.S. economic growth and competitiveness; in particular, the expansion of employment in high wage industries would suffer and these jobs could be moved overseas. Including foreign royalties in the U.S. tax base would retain much of the complexity under current law. Finally, if tax reform proposals are considered consumption taxes, international norms clearly dictate exemption of foreign source royalties from tax.

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[13] Hufbauer and Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*. Institute for International Economics (1996), pg. 24.

Mr. HOUGHTON. Thank you very much, Mr. Rogers.

Mr. Cox, do you have any testimony?

Mr. COX. No, Mr. Chairman, I do not.

Mr. HOUGHTON. OK.

Ernie.

Mr. CHRISTIAN. I am with Mr. Barone. Mr. Barone is next.

Mr. HOUGHTON. All right, good.

Mr. Barone.

STATEMENT OF SALVATORE V. BARONE, PRESIDENT, HARPER SURFACE FINISHING SYSTEMS, INC., MERIDEN, CONNECTICUT; AND CHAIRMAN, INTERNATIONAL TRADE COMMITTEE, ASSOCIATION FOR MANUFACTURING TECHNOLOGY; ACCOMPANIED BY ERNEST S. CHRISTIAN, ESQ., OUTSIDE TAX COUNSEL, ASSOCIATION FOR MANUFACTURING TECHNOLOGY

Mr. BARONE. Thank you, Mr. Chairman. I am Salvatore V. Barone. AMT, the Association for Manufacturing Technology, is a trade association of over 350 machine tool building firms throughout the United States. Most are small businesses like mine. I am accompanied by Ernie Christian who is the special outside tax counsel to AMT and is available to the Committee in helping me answer detailed tax questions.

America urgently needs the tax system rebuilt from the ground up, around a new set of design principles to compete and win in world markets.

AMT believes that America can and must compete and win in world trade. About 35 percent of the output of my industry is exported. We have 13 percent of the world market, but should have more, and 50 percent of the machine tools used in the United States are of foreign origin. How much greater would our market share be if America's tax system were not tilted against us? That is hard to say, but we and our industry's 53,000 employees would like the chance to find out.

We have evaluated three leading alternative tax systems under an International Competitiveness Index based, in part, on the following factors: Number one, expensing of business capital investment in the United States; number two, a territorial rule whereby the tax only applies in the United States, thereby allowing U.S. companies to directly compete in foreign markets on a level tax playingfield with their local competitors abroad; number three, complementary export and import adjustments; and number four, tax simplicity. The complete index and its results appear in our written testimony.

The business level portion of the USA tax by Senators Domenici and Nunn scores 100 percent on the index. It resembles a simplified version of the present corporate income tax, with expensing of capital equipment and appropriate international adjustments engrafted into it.

Because exports to foreign markets of American-made goods are not taxed, there is no tax advantage in manufacturing abroad for sale abroad. The reason for direct investment abroad is primarily to penetrate foreign markets and to establish a beachhead for exports.

A study by the Institute for International Economics provides strong statistical evidence that direct participation by U.S. companies in foreign markets enhances U.S. exports and U.S. jobs.

On the other hand, because the USA tax taxes imports, there is no U.S. tax advantage for a company to manufacturer abroad for the purpose of selling back into the U.S. market. There will be no runaway plants.

This simple business tax framework assures that foreign companies who compete in U.S. markets pay their appropriate fair share of the tax burden in this country. It is also consistent with international treaty agreements. Border tax adjustments for exports and imports are not the exclusive province of a VAT. According to a new study by Dr. Gary Hufbauer, border tax adjustments can also be included within other tax structures, such as the USA tax, which are more reflective of the American experience.

The business level portion of the flat tax scores very low on the International Competitive Index largely because it taxes exports of American-made products, while imposing no tax on foreign-made products.

The third alternative we have evaluated is the general concept of replacing the Federal income tax with a retail sales tax. Leaving aside all other considerations which may bear upon this alternative, a retail sales tax would rank very high, close to 100 percent, from an international competitiveness perspective. Even if the economic incidence or burden of the retail sales tax is in significant part borne by business, and ultimately by their employees and owners, a retail sales tax is implicitly border adjusted for exports and imports and is implicitly territorial.

In conclusion, Mr. Chairman, we at AMT strongly urge this Committee and Congress to make enactment of an internationally competitive tax system a matter of the highest national priority.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF SALVATORE V. BARONE, PRESIDENT HARPER SURFACE FINISHING SYSTEMS, INC. ASSOCIATION FOR MANUFACTURING TECHNOLOGY ACCOMPANIED BY ERNEST S. CHRISTIAN, ESQ. OUTSIDE TAX COUNSEL ASSOCIATION FOR MANUFACTURING TECHNOLOGY

Re: The Impact on International Competitiveness of Replacing the Federal Income Tax

I. Introduction

I am Salvatore V. Barone, President of Harper Surface Finishing Systems, Inc., Meriden, Connecticut, and I am testifying today on behalf of AMT -- The Association For Manufacturing Technology, whose International Trade Committee I am honored to chair. AMT is a trade association whose membership includes over 350 machine tool building firms with locations throughout the United States. America's machine tool industry builds and provides to a wide range of industries the tools of manufacturing technology including cutting, grinding, forming and assembly machines, as well as inspection and measuring machines, and automated manufacturing systems. The majority of the association's members are small businesses.

Today's topic -- international competitiveness -- embodies the essence of your Committee's continuing series of hearings on fundamental tax restructuring: the need to concentrate on creating a new tax system that will serve the long-term national interest in a global economy.

America urgently needs a tax system rebuilt from the ground up around a new set of design principles to compete and win in world markets. That is fact one. Fact two is also obvious: the present federal income tax in the Internal Revenue Code of 1986 is almost exactly the opposite of what is needed to serve the best interests of the United States. Had one set out by design to create a tax system that works against us (and, therefore, in favor of our foreign competitors), it is hard to imagine a more successful job than the present federal income tax. It discourages saving and productive capital investment in the United States; it favors imports over exports; it makes it hard for U.S. companies to directly compete in foreign markets; and, if they do, it discourages them from bringing the money home for reinvestment in the United States.

At the very time that successful competition in world trade has become increasingly important to national well-being, we are plagued by persistent trade deficits. We have become a debtor nation, dependent on borrowing from abroad. Productivity has lagged; real wage growth has been slow; annual economic growth rates have been less than satisfactory; and federal budget deficits have continued to mount. Given the seemingly intractable nature of these failings, some people have characterized the 1990s and beyond as an "age of diminished expectations" for America. From an international perspective, some pessimists may mistakenly view world trade as exporting more U.S. jobs than American-made products.

We at the AMT do not share this pessimistic view about the future. We believe that American industry can compete and win and that successful competition in world trade is the key to the kind of enhanced economic growth on which a more secure and prosperous America depends. We say this from the perspective of the industry which produces the machinery and new manufacturing technologies used by other businesses to produce products sold here and around the world. We are at the heart of the productive process -- putting more and better factory-floor technology in the hands of American workers. We are also substantial exporters ourselves. About 35% of the output of our industry is exported. In total, we employ 53,300 people and most of these jobs are good paying manufacturing jobs using the best and newest technologies. My own company is one of the smaller members of the industry, but we employ approximately 50 people and, to date, more than 68,000 of our modern surface finishing systems have been installed worldwide. In recent years, 15 to 20% of our sales have been exports. Thus, we are strong believers in export trade and in the benefits to America that derive from an ever-increasing flow of "American-made" goods into global markets.

We also believe that American businesses and their employees should be able to compete on a level playing field; most particularly that the tax system of the United States should not be biased against our own best interests in the global marketplace. American-made machine tools comprise only 13% of the world supply. Worse, about 50% of the machine tools used in the United States are of foreign origin. How much greater would our share of domestic and foreign markets be if the American tax system were not biased against us? It is hard to say. The same is true of American industry in general. Taxes are not the only factor as we all attempt to compete at home and abroad against foreign competitors. But we and our employees would like to have the opportunity to compete on a level tax playing field and we believe it is a matter of urgent national policy that we and they be given the chance.

It would be one thing if the anti-investment, anti-export biases in the Internal Revenue Code of 1986 were necessary -- if there were no alternative. But that is not the case. There are alternative tax systems which are not only far more congenial to successful international competition but also more fair, efficient and consistent with the best interests of the United States and the American people. We hear much about "tax fairness", but there is certainly nothing fair about a tax system, such as the present federal income tax, which impedes economic growth, costs jobs and lowers living standards.

For the most part, the pro-job, pro-growth alternative tax systems are well-known and well-developed in substantial detail. The principal ones are identified in the notice of your Committee's hearings. We applaud the Chairman and the Committee for putting the international focus on the leading alternative tax systems and we welcome the opportunity to comment on them. This Committee, this Congress, and the next, have an historic opportunity to fundamentally restructure the American tax system for the better. Just as it is vital that we not lose that opportunity, it is equally vital that we not lose sight of the world trade aspects amidst the many other concerns that bear upon taking such a monumental step.

Focusing on international trade necessarily puts a heavy emphasis on taxes paid by businesses, but, in doing so, we do not mean to diminish the importance of the way individuals are taxed under any new alternative tax system. Successful international competition depends on a higher level of personal saving and investment in the United States. Therefore, from every perspective, fundamental tax reform must begin with removing the present strong bias against saving. Individuals should either be allowed to deduct the amount they save (and later pay tax when they withdraw their deferred income from the national savings pool) or, if they are allowed no deduction, the earnings on their savings should be excluded from tax. So long as the present bias against personal saving exists, no matter how good the new international tax rules may be, the U.S. economy will not be able to compete at its full potential in the global market. Similarly, to the extent that corporations and other businesses are taxed separately from individuals, businesses should be allowed to expense capital equipment purchases. Fortunately, the present law penalty on personal saving and business capital investment is so indefensible that its elimination is now almost synonymous with fundamental tax restructuring. In one way or another, elimination of the bias against saving and investment is embodied in all the leading alternative tax proposals we have evaluated. In that respect, AMT endorses them all.

Before going on to evaluate and compare the strictly international tax rules of the leading alternatives --- most notably as related to exports, imports and taxation of foreign-source income -- AMT would like also to share with the Committee a few overall perspectives which we believe are highly relevant to choosing between the various alternatives. First, any new tax system should be considered as a whole -- the individual portion and the business portion must be considered together. In short, it must truly be a tax "system" that is internally consistent and that actually works. Indiscriminate cherry-picking of particular aspects of different proposals -- no matter how appealing they may seem in isolation -- could produce a monstrosity similar to present law. Second, the new tax system for America's future must be enactable as a whole. Not only must it be fair, it must be perceived as fair by the American people.

Further, we believe that the new tax system should truly be an "American" tax system. International comparisons are often relevant, particularly when illustrating the relative disadvantages presently imposed by the Internal Revenue Code of 1986, but the basic elements of the new tax system should be chosen on their own merits, without regard to what other countries may or may not do. For example, there is an independent rationale, well-grounded in tax policy and economics, for allowing a deduction for personal saving and business capital investment. Cross-border adjustments for exports and imports in combination with a territorial rule that excludes foreign-source income provide a logical and meritorious framework that stands on its own. The presence or absence of similar rules, in varying degrees, in other countries' tax systems is not the reason for their adoption here. Similarly, the fact that a new American tax system may have some elements in common with a foreign tax system does not mean that we are adopting that foreign tax system per se. Quite to the contrary. For example, appropriate border tax adjustments for exports and imports are not the exclusive province of the European "VAT". They can directly or indirectly be incorporated into some tax structures which are more consistent with our American experience.[1]

There is no reason why the United States should be limited by the tax experiences of other countries. There is no reason why we should not have a better tax system than anyone else -- one that is fairer, simpler, more efficient and, above all, in the long-term best interests of the United States in a global economy. You on this Committee have an historic opportunity and you should take advantage of it.

II. International Competitiveness Index

AMT has evaluated three leading alternative tax systems against a common set of criteria directly and indirectly related to international competitiveness. The criteria include all of those specified by the Chairman of this Committee in a public announcement in 1995, as well as several others. We fully endorse the Chairman's list of criteria for fundamental tax reform and agree with its emphasis on simplification and on international competitiveness. The alternative tax systems we have evaluated are: the business-level USA Tax (the Unlimited Savings Allowance System in S. 722 by Senators Pete V. Domenici and Sam Nunn); the business-level Flat Tax (in general, H.R. 2060 by House Majority Leader Armey); and the general idea of a retail sales tax.

In the cases of the USA Tax and the Flat Tax, the results of AMT's Competitiveness Index evaluations are set forth below in comparison to the present corporate income tax. Because the retail sales tax does not fit readily in this index format without further explanation, the retail sales tax is evaluated separately in connection with a later general discussion of that subject.

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[1] See Gary C. Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments* (Washington, D.C.: Institute For International Economics, 1996).

INTERNATIONAL COMPETITIVENESS INDEX

	USA Tax	Flat Tax	Present Corporate Income Tax
Expenses Capital Equipment Cost in U.S.	Yes (+1)	Yes (+1)	No (-1)
Excludes from Tax All Exports of American-Made Products	Yes (+1)	No (-1)	No (-1)
Taxes Imports of Foreign-Made Products	Yes (+1)	No (-1)	No (-1)
Is Territorial (i.e., applies only in U.S.)	Yes (+1)	Yes (+1)	No (-1)
Foreign Royalty Income Is Excluded Export Receipt	Yes (+1)	No (-1)	No (-1)
Is Neutral as Between Labor and Capital	Yes (+1)	No (-1)[2]	No (-1)
Allows Credit for Employer-Paid Payroll Tax	Yes (+1)	No (-1)	No (-1)
Solves Transfer-Pricing Problem	Yes (+1)	No (-1)	No (-1)
Is Revenue-Neutral (No overall increase/decrease in business taxes)	Yes (+1)	No (-1)	Yes (+1)
Is Simple and Efficient	Yes (+1)	Yes (+1)	No (-1)
NET SCORE (Max. 10)	**+10**	**-4**	**-8**

A. Discussion of Competitiveness Criteria in the Context of the USA Tax

Because it satisfies all the criteria within a simple and understandable framework, the USA business-level tax provides an excellent illustration of how a low-rate business tax which allows expensing of capital equipment in the U.S. can be combined with border-tax adjustments and "territoriality" to produce an essentially ideal result: a neutral, evenhanded tax that treats all businesses alike (whether corporate or noncorporate, capital intensive or labor intensive, financed by equity or by debt, large or small) and which is neither tilted for or against us when we compete in foreign markets nor for or against foreign companies when they compete in our markets.

The USA business tax is ultimate simplicity. To calculate its tax for the year, a business (1) adds up the amount of its revenues for the year from sales of products and services in the United States, (2) subtracts the amount of its deductible input costs for the year, (3) multiplies the resulting "gross profit" by the 11% tax rate, and (4) takes a credit for the 7.65% employer-paid FICA tax imposed by present law on its payroll. The payroll tax credit is a unique feature of the USA Tax and is in lieu of any deduction for wages paid to employees. Like the Treasury's Comprehensive Business Income Tax proposal in 1992, and like other proposals designed to

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[2] At the business level, it is not neutral, but tends to be neutral when combined with the individual tax, except for the absence of a payroll tax credit. In this latter respect, returns to labor are taxed more heavily than returns to capital.

eliminate the bias against equity financing, no deduction is allowed for interest.

From a world trade perspective, the highly salutary and complementary relationships between border tax adjustments and territoriality can best be illustrated by applying the USA Tax in a series of fairly typical situations.

(1) TexCorp wishes to compete in the widget market in foreign Country A either by manufacturing widgets in Country A for sale in Country A or by manufacturing widgets in the U.S. and exporting them to Country A. Because the USA Tax is "territorial", it does not apply to TexCorp's direct manufacturing and sales operations outside the U.S. Therefore, like the local widget manufacturers in Country A, TexCorp only pays the Country A tax and can compete with these foreign companies on a level tax playing field. Similarly, because exports are excluded from U.S. tax, TexCorp would only pay the Country A tax if it manufactured widgets in the U.S. and exported them into the Country A market. The U.S. tax effect is the same in both cases. What actually happens, as is fairly typical, is that TexCorp starts off by manufacturing directly in Country A in order to penetrate the market and then follows up with exports of American-made components and related product lines. In other cases, also not unusual, TexCorp might start off with exports to Country A and then follow up with some additional direct investments and operations in Country A in order to expand its export sales of American-made products in Country A. Thus, there is a complementary relationship between the export rule *and* the territorial rule. (If the tax were territorial, but exports were not excluded from tax, TexCorp would be tax-advantaged by manufacturing abroad to sell abroad.) It is also important to note that because the tax is territorial, TexCorp can bring home its profits from Country A and reinvest them in the U.S. tax-free; the same as it can reinvest its export profits in the U.S. tax-free.

(2) TexCorp also has a new technology related to widgets which, after developing a foreign market for widgets, it wishes to license to others for use in Countries B and C. In other words, TexCorp wants to export the fruits of some American ingenuity which is also a valuable product. Because of the export rule, the foreign royalty income under the license agreement is correctly excluded from tax.

(3) NewCorp wishes to sell widgets in the U.S. market. It can either manufacture the widgets abroad in Country X and ship them back into the U.S. or it can build a new plant in New England near its headquarters and manufacture the widgets there. Because of the 11% import tax under the USA Tax, there is no tax advantage for NewCorp if it manufactures abroad instead of in New England. If NewCorp manufactures a \$100 widget abroad and sells it back into the U.S., an \$11 import tax is paid. This is the same rate of tax NewCorp would pay it if manufactured the widget in New England. (Under a territorial rule *without* a complementary import tax, there might be "runaway" plants, but with the import tax there will be none. Thus, the synergistic combination of territoriality, an export exclusion, and an import tax provides the U.S. with all the advantages of territoriality without the disadvantages.)

(4) ForCorp, a foreign corporation headquartered in Country Y, wishes to sell widgets in the U.S. market. It could remain offshore, manufacture the widgets in Country Y and distribute them in the U.S. through a sales subsidiary or it could build a plant in Kentucky and both manufacture and sell in the U.S. Because of the 11% import tax, there is no tax advantage to ForCorp in remaining offshore.

(5) In a variation of Situation (4), ForCorp wishes to sell widgets all around the world; not just in the U.S. market. Because the USA Tax rate is only 11% and because U.S. production costs such as capital investment in the U.S. for new plants are deductible, and because of the export exclusion, the U.S. would be a very attractive place for ForCorp to locate its plant.

Not only does the combination of territoriality, an export exclusion, and an import tax produce consistent procedural or mechanical results in the tax calculation, the combination also produces important results as a matter of economic substance: income and job creation.

A good example is the combination of territoriality and the export exclusion. A recent study by Edward Graham at the Institute for International Economics will soon be published by the Oxford University Press.[3] It shows an extraordinarily high degree of statistical correlation between the amount of direct investment by U.S. companies in a foreign country (as in Situation (1) above) and the amount of U.S. exports to that foreign country. In other words, the more U.S. companies penetrate foreign markets and gain market share by direct "on-the-ground" operations in a foreign country, the greater the amount of exports of American-made products to that country. Thus, U.S. foreign direct investment abroad is good for U.S. exports and good for U.S. jobs. The combination of territoriality, an export exclusion, and an import tax facilitates this synergistic result.

B. The Flat Tax and the Competitiveness Index

The business portion of the classic Flat Tax (H.R. 2060) does allow expensing and is territorial, and both of these characteristics are positives. But, overall, the Flat Tax does not score well under AMT's International Competitiveness Index. There are many reasons for this deficiency, as indicated in the brief presentation of the Index itself, but the most significant reasons appear to be the absence of an import tax and the absence of an export exclusion.

Without belaboring the point, a few examples may suffice. In prior Situation (1) where TexCorp had the choice to manufacture in the U.S. for export abroad or to manufacture abroad for sale abroad, under the Flat Tax it would be to TexCorp's advantage to manufacture abroad insofar as U.S. taxes are concerned. This is because the Flat Tax taxes U.S. exports. Similarly, in prior Situation (2), because the Flat Tax taxes U.S. exports, foreign royalties from licensing U.S. know-how and technology would be taxed. TexCorp might be better advised to develop the technology abroad instead of developing it here and licensing the use abroad. In Situations (3), (4) and (5), because the Flat Tax does not tax foreign imports, it would have been to the advantage of NewCorp or ForCorp to manufacture abroad for sale into the U.S.

C. General Discussion of Sales Tax Option

Setting aside all other considerations and assuming that a retail sales tax replaced the federal income tax, the resulting tax system would score very high on AMT's International Competitiveness Index -- in the area of 90 to 100%.

A retail sales tax is *implicitly* border adjustable for imports and exports and is *implicitly* territorial. These implicit or indirect characteristics arise because a tax is paid only to the extent that a retail sale occurs in the United States.

Even if, as some economic analysis suggests, the economic burden of the retail sales tax is in significant part borne by businesses (and, ultimately, their owners and employees), there is an implicit export exclusion because no tax is ever paid with respect to a sale to a non-U.S. purchaser and no tax ever enters the system potentially to be passed back to the seller. Similarly, if a U.S. company is operating and selling abroad, there is never any U.S. retail sale and no U.S. tax ever enters the chain of price-tax-volume relationships between seller and purchaser. Thus, a retail sales tax is implicitly territorial.

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[3] Edward M. Graham, *On the Relationships Among Direct Investment and International Trade in the Manufacturing Sector: Empirical Results for the United States and Japan.* Institute for International Economics, 1996. To appear in Dennis Encarnation, editor, Does Ownership Matter: Japanese Multinationals in East Asia (London: Oxford University Press, forthcoming).

On the import side, if either a U.S. company or a foreign company manufactures a product abroad which directly or indirectly finally shows up as a retail sale in the U.S., a tax liability arises. Thus, in this indirect sense, there is an implicit import tax, i.e., the retail sales tax is the same whether the product sold in the U.S. is of domestic or foreign origin.

III. Conclusion and Recommendations

AMT believes that any new tax system for America's future should be territorial, should include complementary export and import adjustments, and should relieve the bias against personal saving and business capital investment. The new tax system should also be simple.

Based on our analysis using the International Competitiveness Index, it appears that there are two fundamentally different ways of doing this. One is the USA Tax (which resembles a very simplified version of a corporate income tax with expensing and appropriate international adjustments engrafted on to it). The other is the general idea of replacing the entire federal income tax with a retail sales tax.

While the USA Tax and the retail sales tax are far apart and greatly different in many other respects, either one would have a beneficial impact on international competitiveness.

Mr. HOUGHTON. Thank you very much, sir.
Mr. Kostenbauder.

STATEMENT OF DAN KOSTENBAUDER, GENERAL TAX COUNSEL, HEWLETT-PACKARD CO., PALO ALTO, CALIFORNIA; ON BEHALF OF HIGH-TECHNOLOGY TAX RESTRUCTURING GROUP

Mr. KOSTENBAUDER. Thank you. My name is Dan Kostenbauder. I am general tax counsel for the Hewlett-Packard Co. in Palo Alto, and I am appearing and appreciate the opportunity to testify today on behalf of the High-Technology Tax Restructuring Group. This is an ad hoc group of companies that have a leadership position in the development of cutting-edge American technologies. Characteristic of the group is a very large and high level of investment in research and development.

We are not taking an overall position on any of the bills that are being considered by the Committee and Congress, but the purpose of our testimony today is to really highlight the fact that a couple of the major proposals could actually have the impact of putting a greater burden on research and development activities and the utilization of technology, and we want to stress this point and make sure it is given due consideration as these various proposals are developed.

Just as a way of background, the U.S. investment in technology has been growing fairly sharply in recent years. In 1980, total public and private R&D by the U.S. companies and government was $63 billion, and that increased to $173 billion in 1994. The preponderance of that growth was due to investment in the private sector, and the importance of R&D is it increases U.S. productivity and leads to better jobs and higher levels of economic activity.

It also is very critical in our success in global marketplaces. If we are competing just on the level of low wages, we are going to be in bad shape.

Mr. HOUGHTON. Could I interrupt you 1 minute?

Mr. KOSTENBAUDER. Sure.

Mr. HOUGHTON. What portion of that is our——

Mr. KOSTENBAUDER. Research—I quite honestly can't tell you.

Mr. HOUGHTON. All right. Thank you very much, sir.

Mr. KOSTENBAUDER. I can certainly try to find that.

So, in any event, there is a clear link between the investment and the expenditure in research and development activity and the competitiveness of U.S. companies and also our standard of living here in the United States.

A couple of general points about the tax treatment of R&D, it is important and our society tends to underinvest in research and development without further incentives. The reason for this is the benefits to society of things like the development of a polio vaccine or better communication systems. It is really a benefit that in time permeates the whole economy, the whole society, and the inventors and the developers of those technologies have certain patent protection for a certain number of years and have a certain ability to garner for themselves a reward for their efforts. They will be compensated, but society achieves a greater benefit than the individuals performing the activity of research and development and so forth.

So it is very critical that to enhance the overall welfare of society that incentives be available for research and research-type activity.

Another thing that needs to be considered in the broader context is that a number of other countries certainly believe this, and they have established and have as part of their Tax Codes efforts to incentive research and development types of activities.

I would like to highlight just a couple of the major factors that are aspects of our current system, as well as the main proposed systems, and the impacts of those provisions on the aftertax cost of conducting research and development.

Certainly, under current law in the United States, although it is subject to the expiring provision status, we have had in the Code for a number of years a research and development tax credit. Clearly, that supports R&D. We have also had the section 174 expensing for research and development, which is also favorable, and beyond that, we have coupled with the way that our foreign tax credit mechanism works and the U.S. tax treaty that have been negotiated with foreign countries a generally low rate of foreign tax on royalties and other results of the income that derives from activity conducted in the United States in terms of developing intellectual property. So that tends to reduce the level of foreign tax on those types of activities.

Under both the USA tax or the flat tax, however, there is no R&D credit, and they definitely have less favorable treatment of labor cost, where there is no deduction for compensation under the USA tax and then there is no deduction at all for fringe benefits for payroll taxes under the Armey flat tax.

Also, the treatment of export income changes under both of these provisions. The USA tax would not tax exports of goods and services and would treat foreign-source royalty income as an export for that purpose. So that would be favorable.

The understanding that we have of the Armey flat tax, however, is that foreign royalties would be taxable in the United States. Again, the example we have attached to the testimony works through with some reasonable levels of assumptions, and for most companies under either system, the fundamental conclusion is that the aftertax cost of conducting R&D in the United States, as we understand those provisions today, would be higher than they are under the current tax system. So that is a very important concept, and we want to again go back and emphasize the importance of this. It translates into potentially lower levels of research and development.

Professor Brownwyn Hall has done recent research that indicates the amount of R&D undertaken is sensitive to the aftertax cost of R&D, and a consequence of the adoption of those proposals under the USA tax, it could reduce private sector R&D by up to 6 percent, and the flat tax could reduce private sector R&D by something in the range of 4 to 12 percent.

I will stop here. I see my time is up, but I think we have stressed the point.

[The prepared statement and attachment follow:]

STATEMENT OF DAN KOSTENBAUDER
GENERAL TAX COUNSEL
HEWLETT-PACKARD CO.
ON BEHALF OF HIGH-TECHNOLOGY RESTRUCTURING GROUP

Introduction

The High-Technology Tax Restructuring Group appreciates the opportunity to testify at today's hearing on international issues arising from proposals to replace the federal income tax system.

The High-Technology Tax Restructuring Group is comprised of companies that have taken a leadership position in developing cutting-edge American technologies. Member companies include Eastman Kodak, Hewlett-Packard Co., IBM, Intel Corp., Intergraph Corp., Microsoft, 3M, Motorola, Oracle, Sybase, Inc., Texas Instruments, and Xerox. While we operate in different industries, we have in common high levels of investment in U.S. research and development activities that help America compete in worldwide markets. Price Waterhouse LLP serves as technical adviser to our group.

In our testimony, we review the relationship between R&D and economic growth, the case for increasing the level of private sector R&D expenditures above what would occur under a neutral tax system, and the potential effects of tax restructuring proposals on domestic R&E activities. Our testimony does not take a position in support of or in opposition to any of the specific tax restructuring proposals that have been advanced to date. Rather, our purpose is to highlight that these tax restructuring proposals, as currently drafted, may increase the tax burden on the development and utilization of technology by U.S. companies.

R&D and Technology are Vitally Important to the U.S. Economy

U.S. investment in technology has grown sharply in recent years. Total spending on R&D in the United States has increased from $63 billion in 1980 to $173 billion in 1994.[1] R&D spending in 1994 accounted for about 2.6 percent of the nation's gross domestic product (GDP).

The private sector has been the main engine behind this growth. In 1980, private industry and the federal government each contributed about $30 billion in spending on R&D.[2] By 1994, the private sector's R&D spending had risen to more than $102 billion, far surpassing the federal government's $62 billion. Private industry's share of national R&D investment has increased from about 40 percent in 1970 to about 60 percent in 1994. Because the private sector is the main source of R&D funding in the United States, the tax treatment of income and expenditures significantly affects national levels of research.

Investment in R&D by the private sector translates into higher U.S. productivity and higher U.S. living standards. Technology allows us to produce "more with less," which is the essence of increasing productivity in the economy. A recent report by the Office of Technology Assessment that accounts for the effects of technology throughout the economy attributes at least half of all economic growth in the United States to advances in technology.[3] Thus, it is unlikely that one of the main goals of tax restructuring advocates -- to increase the national rate of economic growth -- can be achieved if the effect of tax reform

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[1]See "National Patterns of R&D Resources: 1994," National Science Foundation, at 56.

[2]See National Science Foundation, *supra*, at 56.

[3]See "The Effectiveness of Research and Experimentation Tax Credits," Office of Technology Assessment, 1995 at 2.

is to increase the tax burden on technology and thus reduce private sector R&D spending in the United States.

R&D is likely to be an even more important factor in future economic growth. Non-defense R&D expenditures as a percentage of GDP have grown steadily since 1980 for the United States and also for most our major trading partners.[4]

High-quality U.S. jobs also hinge on R&D and technological advances. Companies that invest heavily in R&D tend to have high employment growth rates, and to employ high-skilled workers at high wage rates. Technological advances also translate into higher-paying jobs in other sectors of the economy.

Technology is also a key to U.S. trade competitiveness. Investment in R&D also play a greater role in determining who will succeed in global markets. The United States is now the world's largest exporter in technology trade, measured royalty and license fees flowing into the United States for use of intellectual property. In 1994, the United States earned $22.4 billion on inflows of royalties and license fees from abroad.[5] The United States exports four times the amount it imports in technology trade, and is the only major country to have a large positive balance. Japan and Germany barely break even in technology trade.[6]

The Marketplace Does Not Fully Reward Private R&D Activities

In a market economy, companies tend to under-invest in R&D activities because they generally are not able to retain all the benefits of these activities. Patents and other intellectual property rights allow companies to capture only a portion of the benefits accruing from their R&D activities. Other companies subsequently are able to produce more efficiently by applying advances made by the technological research of other firms. For example, a broad range of manufacturing industries have used advances in computer hardware and software to help streamline production processes. The general public also benefits as higher-quality products become available at lower prices.

Because of these "spillover" effects, the total return for a particular R&D activity (taking into account benefits accruing to other companies and the general public) often is higher than for the company that initially undertakes the research. The total rate of return on R&D investment to society has been estimated at about 50 percent by the Office of Technology Assessment, while the average private rate of return is much lower -- about 20 to 30 percent.[7]

A key issue for the U.S. government is how to address the failure of a market economy to generate a socially optimal level of R&D investment. One option is to fund R&D through direct federal spending programs. A consensus has emerged, however, that private business generally does a better job of finding opportunities for technological advances than

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[4]See National Science Foundation, *supra*, at 77.

[5]See Dept. of Commerce, Survey of Current Business, June 1995, at 85.

[6]See "Multinationals and the Technology Base," Office of Technology Assessment, Sept. 1994, at 91.

[7]See Office of Technology Assessment, *Supra Note 3*, at 3-4.

government agencies. While the typical return to corporate R&D may range from 20 percent to 30 percent, the return from direct federal R&D spending is often as low as 5 percent.[8]

Alternatively, the government can seek to promote technological advances through the tax system. This generally involves far lower administrative and overhead costs for the federal government than direct spending programs.

The Current U.S. Tax System Recognizes the Importance of Encouraging R&D and Technology

The U.S. income tax since 1981 has provided an explicit incentive to boost the level of R&D above what otherwise would occur in the marketplace. Prior to its expiration July 1, 1995, the research and experimentation (R&E) tax credit under section 41 provided a 20-percent credit for the amount by which a taxpayer's qualified research expenditures -- generally comprised of wages and supplies -- for a taxable year exceeded a base amount.[9] The legislative history to the 1981 Act states that the credit was intended to stimulate R&D investment, and Congress has acknowledged its continuing importance by extending the credit six times since its inception.

Qualified R&E expenditures eligible for the section 41 credit generally may be deducted under section 174.[10] Section 174 was enacted in 1954 as a means of encouraging investment in research and reducing uncertainty over whether research expenses should be deducted currently or capitalized.

The tax systems of our leading trading partners also recognize the importance of encouraging R&D activities. Canada, France, Japan, and other countries provide an R&D tax credit. Canada's tax credit is one of the most favorable, with a 20-percent rate on all -- not just incremental -- qualified expenditures. Our trading partners also allow immediate deductions for general research expenses, and many provide for accelerated depreciation schedules for certain capital expenditures related to R&D activities.

A tax system's impact on R&D is not limited to its treatment of costs relating to the *development* of new technologies. The treatment of the *utilization* of those technologies also plays a major role in taxpayer decisions relating to R&D activities. For many high-technology companies, a key issue is how U.S. international tax rules treat income derived from exploiting the use of an intangible overseas.

In this regard, the U.S. tax system begins with the general rule that tax is imposed on a "worldwide" basis --i.e., U.S. businesses are taxed on all of their income, both U.S. and

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[8] See Office of Technology Assessment, *Supra Note 3*, at 3-4.

[9] The section 41 research tax credit expired after June 30, 1995. The High Technology Tax Restructuring Study Group supports current proposals to reinstate the research credit and allow an elective "alternative incremental research credit."

[10] Deductions allowed under section 174 are reduced by an amount equal to 100 percent of the taxpayer's research credit. In lieu of reducing section 174 deductions, taxpayers may elect to claim a reduced credit.

foreign source. Thus, income received from the sale or license of intangible assets is taxable whether from domestic of foreign sources.

Royalties received for the use of intangible assets outside of the United States generally are considered territorially to be foreign source income for purposes of the foreign tax credit. Under the so-called "look-thru" rules, foreign royalties generally are treated as "active" income with the result that low-tax foreign royalties and high-tax foreign dividends may be averaged for purposes of determining the foreign tax credit limitation. This allows increased utilization of foreign tax credits.

Withholding tax often is imposed by foreign governments on the gross amount of royalty payments. The current U.S. income tax treaty network generally serves to reduce withholding taxes on royalties to the extent possible. Withholding taxes generally are creditable for U.S. tax purposes.

Also of importance for many high-technology companies are the current-law rules requiring apportionment of domestic research expenses between U.S. and foreign source income. Domestic research expenses that are apportioned to foreign source income reduce the limitations applicable to utilization of foreign source credits. As a result, for every $100 of domestic research allocated to foreign-source income, foreign tax credits may be reduced by as much as $35 at the current 35-percent U.S. corporate tax rate. This loss in foreign tax credit is tantamount to treating the foreign-allocated portion of U.S. research expenses as nondeductible. Final section 861 R&E allocation regulations issued in December 1995 take a step toward mitigating this problem.

While the current U.S. tax system is far from perfect, some aspects of the corporate income tax, such as the recently expired research tax credit, recognize the importance of R&D and the development of U.S. technologies. U.S. international tax-law provisions contain both pro- and anti-competitive features.

Leading Tax Restructuring Proposals Would Change the Landscape

Leading proposals to restructure the U.S. tax system could have a significant impact on decisions relating to the development and utilization technologies. The "USA Tax" (S. 722) introduced by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM) and the "Flat Tax" (H.R. 2060) introduced by House Majority Leader Dick Armey (R-TX) have in common the replacement of the federal corporate income tax with a new business tax. These new business taxes in many respects would make a radical break with current law:

- **No incentive for R&D**: Neither the USA Tax nor the Flat Tax would retain the R&E tax credit. There is no explicit incentive for performing R&D activities in either bill.

  In drafting their USA Tax proposal, Senators Nunn and Domenici initially explored the question whether their proposed business tax could accommodate an R&E tax credit or some other type of incentive for research activities.[11] It is unclear why the drafters of the USA Tax decided not to include a research credit in their bill. It is possible that the drafters were concerned that inclusion of a research credit could jeopardize the legality of border tax adjustments under the General Agreement on Tariffs and Trade (GATT). Unlike the USA Tax, however, the Armey Flat Tax does not have border adjustments; consequently, GATT considerations would not preclude inclusion of a research tax credit in a Flat Tax system.

- **Less favorable treatment for labor costs**: Both the USA Tax and the Flat Tax would provide less favorable treatment of labor expenses than the current-law income tax. In this regard, both proposals would tend to increase the cost of R&D activities.

  Under the USA Tax, businesses would not be allowed to deduct compensation of research scientists, engineers, and other employees, including salary and wage expense, pension contributions, and health and other fringe benefits. Moreover, businesses would not be allowed to deduct payroll taxes. However, employers would receive a tax credit for their share of payroll taxes.[12]

  The Flat Tax would allow a deduction for wages, salaries, and employer pension contributions, generally as under the present-law income tax. However, as under the USA Tax, there would be no deductions for payroll taxes or for health insurance and other fringe benefits provided to research scientists, engineers, and other employees.

- **Expensing for certain costs now capitalized**: Some aspects of tax restructuring proposals as they relate to R&D activities would be more favorable than current law. Both the USA Tax and the Flat Tax would allow current deductions for all business purchases. Thus, for example, amounts paid for laboratory facilities, equipment, and certain intangible assets in conjunction with R&D activities could be deducted currently rather than depreciated or amortized over a period of years.

- **Treatment of "exports"**: As described above, the USA Tax would not tax exports of goods and services. The USA Tax would treat foreign-source royalty income as an export for this purpose. Thus, a U.S. company that licensed a technology for use overseas would not include royalty income from the licensing arrangement in its taxable gross receipts.

  The Flat Tax would appear to provide less favorable treatment for foreign-source royalty income. While the statutory language of the Armey bill (H.R.

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[11] In a 10/21/94 letter to then-Treasury Secretary Lloyd Bentsen, Nunn and Domenici ask, "Would a business cash-flow tax as described which also includes an R&D tax credit similar to current code Section 41's research and development credit for wages paid for qualified research services qualify for border adjustment under GATT?"

[12] It is unclear whether the USA business tax's payroll tax credit is GATT-legal. See G. Hufbauer, Border Tax Adjustments and Fundamental Tax Reform, Institute for International Economics (1996), for a discussion of this issue.

2060) does not specifically address the treatment of royalties and license fees received from abroad, it is clear that export income as a general rule would be subject to tax. Like the current-law income tax, the Flat Tax would tax goods and services produced in the United States whether consumed domestically or abroad. Foreign withholding taxes levied on royalties and other income would not be deductible or creditable under the Flat Tax. Thus, U.S.-based R&D would be taxed at a higher level under the Flat Tax than today.

- **Impact on withholding taxes:** It is unclear whether the existing U.S. income tax treaty network would continue under the USA Tax or Flat Tax, both of which would repeal the corporate and individual income taxes. U.S. tax treaties in many cases currently serve to reduce withholding tax rates on cross-border payments for intangibles. It is possible that existing treaties -- and withholding rates -- might be jeopardized if the United States unilaterally were to eliminate its income tax system. This would raise the possibility of increasing foreign taxes by billions of dollars on the foreign operations of U.S. companies.

- **No allocation of R&E expenses**: Both the USA Tax and Flat Tax are territorial taxes. Under these systems, there would be no foreign tax credit and no allocation of R&E expenses between U.S. source and foreign source.

The Flat Tax and the USA Tax are not the only proposed models for a new tax system. The **"National Retail Sales Tax Act"** (H.R. 3039), introduced by Representatives Dan Schaefer (R-CO) and Billy Tauzin (R-LA) would replace the corporate and individual income taxes, as well as certain other federal taxes, with a retail sales tax similar to levies currently imposed in 45 States and the District of Columbia.[13] By contrast to the current income tax system, the Schaefer-Tauzin proposal contains no provisions designed to encourage R&D.

On the Whole, These Changes Could Increase the Cost of U.S.-Based R&D

The potential effects of the USA Tax and the Flat Tax can be illustrated by means of a simple example *(See Appendix)*. The example posits a U.S. multinational that spends $100 million on research in the United States, of which $42 million is qualified research expenses for purposes of the research credit.[14] Of the $100 million in total research expenses, $26 million is wages and salaries, $3.9 million is employee benefits, $2 million is payroll tax, $20 million is depreciation, and $48.11 million is for other expenses.[15]

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[13]Unlike State retail sales taxes, the Schaefer-Tauzin proposal would apply to services as well as goods.

[14]R&D reported on SEC Form 10-K by public corporations included in the COMPUSTAT database amounted to $102 billion for fiscal years ending in 1992. The IRS reports corporate taxpayers claimed $43.3 billion of qualified research expense (QRE) for tax years ending July 1, 1992, through June 30, 1993. The ratio of QRE to R&D, therefore, is estimated as 42 percent.

[15]The Office of Technology Assessment estimates that 62 percent of qualified research expense is allocable to compensation. See Office of Technology Assessment, *Supra Note 3*, at 19-20.

In 1992, the research tax credit amounted to 3.6 percent of qualified research expenses, so the hypothetical taxpayer in this example is assumed to be able to claim a research credit of $1.51 million (presuming that the research credit is extended).[16]

The taxpayer's R&D activities result in patents and other valuable intangible assets that produce U.S. income and foreign income. For purposes of this example, it is assumed that half of the income from the intangible assets is earned in the United States and the other half is attributable to foreign royalties. The taxpayer's foreign royalties are subject to an average withholding tax rate of 5 percent.[17] U.S. multinationals are required to allocate domestic research expense between U.S. and foreign sources for purposes of computing the foreign tax credit. For purposes of this example, the taxpayer allocates 25 percent of U.S. research expense to foreign sources.[18]

For simplicity, the example only includes items of income and expense directly related to R&D, and the taxpayer is assumed not to be subject to the alternative minimum tax.

Under present law, assuming extension of the expired R&D tax credit, the hypothetical taxpayer would need to earn $90.96 million to break even on $100 million of R&D if the taxpayer were in an excess foreign tax credit position, and would need to earn $98.49 million if in a deficit foreign tax credit position. The break-even return is less than the $100 million cost of R&D due to the research credit ($1.51 million) and, in the case of the excess foreign tax credit taxpayer, the utilization of foreign tax credits (in excess of the 5-percent withholding tax on the royalty). The income tax system therefore provides an incentive for private sector R&D by reducing the after-tax cost of $100 million of R&D to $90.96 million or $98.49 million, respectively, for a representative taxpayer with and without excess foreign tax credits.

The impact of the USA and Flat taxes on the cost of performing R&D in the United States can be measured by calculating the change in return required to break even on $100 million of R&D for the taxpayer in the preceding example. The 11-percent USA Tax is intended to be revenue-neutral. By contrast, the 17-percent Flat Tax introduced by Rep. Armey would raise less revenue than present law.[19] For the sake of comparability, the Flat Tax also is analyzed at a 21-percent rate, which has been determined by the Treasury Department as necessary to achieve revenue neutrality.[20]

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[16]Data provided by the IRS Statistics of Income Division based on Forms 6765 filed for tax years ending July 1, 1992 through June 30, 1993.

[17]The United States seeks to obtain a zero withholding tax rate on royalties in its bilateral income tax treaties, but many treaties provide for a 5 percent or higher rate such as the U.S. treaties with Australia, Canada, China, France, India, Italy, Japan, and Spain. See Price Waterhouse LLP, *Doing Business in the United States*.

[18]Under regulations (Treas. reg. 1.861-8), taxpayers generally may allocate 50 percent of U.S. research expense to U.S. source income and apportion the remaining 50 percent on the basis of U.S. and foreign sales.

[19]The Armey Flat Tax would initially be imposed at a 20-percent rate but would drop to a 17-percent rate after two years.

[20]See U.S. Department of the Treasury, Office of Tax Analysis," New Armey-Shelby Flat Tax Would Still Lose Money, Treasury Finds," Reprinted in *Tax Notes* (Jan. 22, 1996), at 451-61.

Under the Nunn-Domenici USA Tax, the break-even return on $100 million of R&D would be $98.06 million under the facts of the example. Thus, for the taxpayer in this example, the USA Tax would reduce the after-tax cost of R&D by 0.4 percent, or increase it by nearly 8 percent, depending on whether or not the taxpayer currently is in an excess foreign tax credit position. The potential rise in the after-tax cost of R&D primarily is attributable to the loss of the research credit and the inability to deduct compensation and payroll taxes.

Impact of USA and Flat Taxes on R&D
[See Appendix for details]

	Percent increase in "break even" rate of return of domestic R&D over present law*	
Tax Regime	***Excess foreign tax credits***	***Excess foreign tax credit limitation***
USA Tax	7.80%	-0.40%
Armey Flat Tax (17%)	14.10%	5.40%
Revenue-neutral Flat Tax (21%)	14.50%	5.70%

*Assumes extension of expired research tax credit.

Source: Price Waterhouse LLP

Under the Armey Flat Tax, the break-even return on $100 million of R&D would be $103.76 million at a 17-percent rate and $104.12 million at a 21-percent rate. Thus, for the taxpayer in this example, the 21-percent Flat Tax would increase the after-tax cost of R&D by 5-15 percent compared to present law, depending on whether or not the taxpayer is in an excess foreign tax credit position. The rise in the after-tax cost of R&D primarily is attributable to the loss of the R&D credit, the taxation of foreign royalties with no credit or deduction for foreign withholding taxes, and the inability to deduct payroll taxes and employee benefits.

Recent research by Prof. Brownwyn Hall (University of California-Berkeley and National Bureau of Economic Research) indicates that the amount of R&D undertaken by companies is sensitive to the after-tax cost of R&D. Based on an econometric analysis of R&D expenditures by U.S. companies over the last decade, Prof. Hall finds that a 1-percent increase in the after-tax cost of R&D results in a decline in private sector R&D of between 0.8 and 2.0 percent.[21] Using the lowest end of the range of results reported in this research, the USA Tax conservatively would be expected to reduce private sector R&D by 0-6 percent for a representative taxpayer, while a 21-percent Flat Tax would be expected to reduce private sector R&D by 4-12 percent.

While the effects of the USA and Flat taxes will depend on the particular circumstances of individual taxpayers, the preceding example shows that a U.S. multinational with typical facts can expect an increase in the after-tax cost of R&D, compared to present law, under the Flat Tax, and can expect either a smaller increase or no change under the USA Tax.

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[21]See Brownwyn Hall, "R&D Tax Policy During the Eighties: Success or Failure?" *Tax Policy and the Economy*, vol. 7 (1993) pp. 1-36.

The Impact of Tax Restructuring on R&D and Technology Should Not be Overlooked

We commend the Ways and Means Committee for holding these hearings on tax restructuring. We agree with the overall goals of tax reform proposals -- to promote economic growth, increase savings and investment, and simplify tax administration. At the same time, we believe it is important not to overlook the potential adverse impact on the development and utilization of American technologies.

We are not the first to raise these concerns. The January 1996 report by the Kemp Commission, a 13-member panel charged with studying the current tax system and outlining recommended changes, zeros in on these concerns in its discussion of the need to simplify U.S. taxation of international activities. The report states, "attention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."[22]

The stakes are high. Any tax changes that would increase the tax burden on the development and utilization of American technology will have negative consequences for U.S. economic growth, productivity, U.S. jobs, U.S. exports, and the leadership position of U.S. companies in the technology-driven global marketplace.

We stand ready to work with the committee as the coming debate over tax reform unfolds. A common goal should be to create a tax system that encourages American businesses to pursue R&D activities in the United States and avoids tax barriers to utilizing home-grown technologies overseas.

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[22]See "Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century," The National Commission on Economic Growth and Tax Reform, January 1996.

APPENDIX

Effects of Tax Restructuring Proposals on the Tax Treatment of R&D: Example

ASSUMPTIONS			
Foreign share of return	50%		
Foreign withholding tax	5%		
	Total	Qualified	Nonqual.
R&D expenses (sec. 174)	100.00	42.00	58.00
Wages and salaries	26.00	26.00	0
Payroll tax	1.99	na	1.99
Employee benefits	3.90	na	3.90
Fixed cost (depreciation)	20.00	na	20.00
Other	48.11	16.00	32.11
U.S. apportioned R&D	75%		

Item	Present law /1/		Flat tax		USA tax
	Excess FTC	Deficit FTC	Armey-Shelby	Revenue neutral	(Nunn-Domenci)
Tax status					
Tax rate	35%	35%	17%	21%	11%
Effective rate of R&D credit	3.6%	3.6%	na	na	na
Foreign tax credit position	Excess	Deficit	na	na	na
AMT	no	no	na	na	na
Gross income	90.96	98.49	103.76	104.12	98.06
U.S. source	45.48	49.25	51.88	52.06	49.03
Foreign royalty, gross of withholding tax	45.48	49.25	51.88	52.06	49.03
Withholding tax	2.27	2.46	2.59	2.60	2.45
Research expense (sec. 174)	100.00	100.00	100.00	100.00	100.00
U.S. source	75.00	75.00	100.00	100.00	100.00
Foreign source	25.00	25.00	0.00	0.00	0.00
Components of research expense					
Wages	26.00	26.00	26.00	26.00	26.00
Payroll tax	1.99	1.99	1.99	1.99	1.99
Benefits	3.90	3.90	3.90	3.90	3.90
Fixed cost /2/	20.00	20.00	22.79	22.79	22.79
Other /3/	48.11	48.11	48.11	48.11	48.11
Qualified research expense	42.00	42.00	na	na	na
Taxable income	-7.53	0.00	6.86	7.22	-21.87
U.S. tax before credits	-2.63	0.00	1.17	1.52	-2.41
Credits	8.68	3.97	0.00	0.00	1.99
Research credit	1.51	1.51			
Foreign tax credit	7.17	2.46			
Payroll tax credit					1.99
U.S. tax after credits	-11.31	-3.97	1.17	1.52	-4.40
U.S. and Foreign tax	-9.04	-1.51	3.76	4.12	-1.94
Research expense after U.S. and foreign tax	90.96	98.49	103.76	104.12	98.06

1/ Assumes extension of expired research credit.
2/ Fixed costs generally are depreciated over 5 years under present law and would be expensed under a consumption-based tax. Steady-state ratio of depreciation to gross investment assume to be 87.7%.
3/ Amount deductible assumed not to change under USA and Flat taxes.

Mr. HOUGHTON. All right. Thank you very much.

Mr. Gibbons, do you have any questions?

Mr. GIBBONS. Well, first of all, I appreciate all of you coming and contributing to this. Since I am leaving here at the end of this term, let me give you the benefit of a little of my experience of having sat here 26 to 27 years.

I think this Committee, generally speaking, is way ahead of you. I think this Committee has generally given up on ever being able to do anything that is reasonable or sensible or economically sound with the income tax system. I think we are ready to go to a consumption tax system, and as I listen to each one of you, you are all still hanging on to that old income tax system, and I can understand why you are reluctant as business people to get out and lead the charge for a consumption tax system. But frankly, it needs to be done because I believe this Committee is ready to move in that direction if we can just get some kind of reasonable signal from the American public that they are ready to go in that direction.

I hear you talk about the United States being considered a tax haven if we get rid of our income tax system. I understand what that may mean, but are there any of you out there that believe if we get rid of our entire income tax system, even if we have to lose some of the advantages we have with our tax treaties now, that you as a company would be worse off without any income tax than you would if you have to preserve your rights under a tax treaty?

If you don't have any income tax in the United States, if we go completely to a consumption tax system, do any of you believe that even though you may lose some benefits under the current tax treaties, you would be worse off than you are if we get rid of the income tax?

Mr. CHRISTIAN. Mr. Gibbons, I have a hard time imagining that under any of the leading proposals that anyone would be worse off. The American economy, the American future, the American employees would all be better off in all respects under any of the kinds of systems that are being talked about.

If I might, since I have been privileged for many years to talk about matters with you——

Mr. GIBBONS. Yes.

Mr. CHRISTIAN [continuing]. And others of this nature, if you will take a look at the index in the AMT testimony of Mr. Barone, I think it is quite revealing. It only undertakes to evaluate the USA tax at the business level, present law, and the flat tax by the House Majority Leader.

You, of course, are aware that the USA tax at the business level and your proposal for a business or subtractive VAT are, in fact, identical. It just depends on how one wishes to look at those two proposals.

Either can be considered to be a consumption tax in the way economists define consumption tax. Under such definition, it is, in fact, income that is being taxed, the output of labor and the output of capital, but economists call such a tax a consumption tax because it does not double tax investment or saving.

So, in fact, your proposal is included within AMT's index and would rank 100 percent at the business level.

Mr. GIBBONS. Well, I want to thank you for that explanation, and I want to thank you, Mr. Christian, for allowing me to learn at your feet here.

Mr. CHRISTIAN. I didn't mean that, Mr. Gibbons.

Mr. GIBBONS. No, I do. I remember when we used to meet in executive session here and we had our tables squared out there where you are now sitting. I used to be privileged to sit next to you there while you were on the administration explaining these things to us.

So I want to apologize to all of you for the mess we have made out of the Tax Code over those years, but it wasn't because you didn't try or because you didn't give us good advice.

Mr. CHRISTIAN. I think I helped you mess it up, Mr. Gibbons. I am trying to fix it now, as you are.

Mr. GIBBONS. Well, me, too. Me, too. I think I have learned enough about it to be one of those persons that is sworn off completely of what we have been doing all of these years. I am ready to start something new. I am ready to go dry.

Thank you very much.

Mr. KOSTENBAUDER. Mr. Gibbons, if I can just address your question.

Mr. GIBBONS. All right.

Mr. KOSTENBAUDER. In the context of the points I was making about R&D and technology development activity in the United States, there is one sense in which—and again, we have systems. We are very familiar with many of the details in the current system.

Mr. GIBBONS. Yes.

Mr. KOSTENBAUDER. So there are at least a number of uncertainties about these other systems. So, acknowledging that, one of the ways in which the USA type of system which does have expensing for capital equipment and other business inputs——

Mr. GIBBONS. Yes.

Mr. KOSTENBAUDER [continuing]. But because it does not permit the deductibility of compensation, wages, fringe benefits, and other things, it can have to some degree a detrimental effect on those companies that really do have a lot of research and development because the main characteristic of research and development expenses are that they are really the good, high-paying jobs that we have for all of our bright engineers and other people who are engaged in the R&D activity.

So it is a case where under current law because those expenses are all deductible currently versus at least in the consumption tax systems, because the compensation-type expenses are not currently deductible, and they are such a big part of R&D, there very well could be a real attention as to which is more favorable. Then, when you couple it with some of these considerations about the results of R&D and the intellectual property generated outside the United States, actually bearing a higher burden because foreign governments may result to a U.S. activity by increasing the withholding rates on the royalty-type payments which generally flow back to the United States as a consequence of our abilities to generate research and development and technology that others around the world want access to, in those kinds of contexts, it could very well be the current system might be somewhat more favorable.

Mr. GIBBONS. Well, I would say that is true if we do it as an add-on, but I propose that we do it as a replacement, that we replace the current income tax, which would really impact upon your high-paid people, and we replace the corporate income tax, not add a consumption tax to it.

Consumption tax, I think, would be a disaster if we just added on. I want to replace the income tax and the payroll taxes and the corporate income taxes, and I think when you do all of that, you have really energized your R&D development process.

I realize payroll is a very big part of R&D, but we are not taxing your payroll anymore, either as a FICA tax or as an income tax, and that should really energize your R&D here in the United States.

Mr. BOYLE. Congressmen, if I might amplify on Mr. Kostenbauder's comments on consumption taxes, many of the details of the various reform proposals are not fully fleshed out, and there is a potential which is somewhat frightening in terms of the possibility of double taxation——

Mr. GIBBONS. Yes.

Mr. BOYLE [continuing]. As well as withholding of potentially up to 40 percent, and we would be very concerned that the loss of tax treaty coverage would be a very big detriment, in particular, to the software industry.

Mr. GIBBONS. I understand where you are coming from on the tax treaties. I am familiar with them and how they impinge upon you, but it seems to me that even if we did get rid of our income tax, you would still be a lot better off than you would under the tax treaty. That is my guess, but I would be happy to explore that further with you.

Mr. Christian.

Mr. CHRISTIAN. If I might, Mr. Chairman, comment on both of the last two points. Picking up where Mr. Gibbons just amplified on what he was saying, I think Mr. Gibbons made the point that under his proposal, there is no payroll tax. Under present law, the payroll tax obviously under present law functions the same as disallowing a portion of wages.

Under the USA tax, which is very like Mr. Gibbons at the business level and to some extent was patterned after it, there is a credit for the employer payroll tax.

I would further point out in talking about R&D or software or all intellectual property that upon the export, which is the subject of today's hearings, into the world market of the fruits of United States know-how, thought, or ingenuity, there is no tax. There is no tax on the labor element. There is no tax on the capital element.

Under the USA tax, for example, which uses the credit mechanism to relieve the existing employer payroll tax, given the fact that the USA business rate is only 11 percent, the credit is the equivalent of allowing about a 76-percent deduction for wages.

I would further point out, under Mr. Gibbons' approach and the variation which is reflected in the USA approach, that no foreign royalties are taxed. No exports of any intellectual property are taxed. All deductions associated with R&D in the very broadest sense, even exported R&D, the income from which is excluded, all of those costs are deductible in the United States. In other words, there is no longer any of this 861 allocation, even though the income is export income and not taxed. The costs are deductible in the United States against other U.S. income.

I would not dispute anything with my good friend, Dan Kostenbauder, to my right here, but I find it very hard to believe, as you do, Mr. Gibbons. At the end of the day, I find it very hard to believe that everyone in every respect is not better off under your proposal or the USA tax.

Mr. GIBBONS. Thank you.

Mr. HOUGHTON. OK. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Barone, your testimony criticizes the current Federal income tax system and its impact on international trade. Could you elaborate on what you were talking about as far as specifics and specific of the group that you are representing today?

Mr. BARONE. In terms of the tax that we pay on exports?

Mr. CHRISTENSEN. Yes.

Mr. BARONE. We find we have a difficult time even competing onshore, let alone offshore, because of the Tax Code we currently have.

Our U.S. machine tool market is just short of $7 billion, about $6.8 billion, and we lose one-half of that market to offshore competition. We find it hard to believe they can come here and compete with us at a 50-percent level, and we have a tough time getting to 30 percent in our exports. We think this is largely due to our Tax Code.

Mr. CHRISTENSEN. Mr. Kostenbauder, you made a comment talking about using the R&D credit and it should be enhancing the overall benefit of society. Hewlett-Packard probably uses the R&D credit for a number of areas. What is the main area that they use it for?

Mr. KOSTENBAUDER. Well, Hewlett-Packard's experience right now is not very favorable with the current structure of the R&D credit, quite honestly, but speaking for the broader group and for the high-tech folks, in general, our research and experimentation, technically the research and experimentation credit, applies to a broad range of activities, and certainly the range of activities that accompany Hewlett-Packard or other software companies or hardware companies, semiconductor manufacturers, pharmaceuticals, it is really the entire development process of the technology and the intellectual property, the know-how and the patents and so forth that are part of the real sort of core value of these technology companies. It is the ability to develop that. So that is the category.

I am not sure I am totally responsive to your question, but it is that fundamental portion of our activity, and for a number of these companies, the percentage of total revenue that would be spent on research and development, although I haven't seen the specific numbers for this group, I am sure would range from probably a very minimum of 5 percent to 15, 20, or 25 percent. So there is a tremendous level of research that goes into especially the activities of your more high-tech companies in the U.S. economy, and I think the total expenditure in the U.S. economy is around 2 percent, give or take, or maybe a little below that, but somewhere around 2 percent is the total for the entire economy. So, clearly, these are more research-intensive companies.

Mr. CHRISTENSEN. If we were to move to a totally restructured tax system, would you elaborate a little bit more on your position concerning the tax treaties and how that would impact the software industry and the high-tech industry?

Mr. KOSTENBAUDER. Right. Well, the key consideration today is that the U.S. Government and Treasury Department negotiate treaties with other countries in terms of the income tax rules and typically between two countries that have income taxes.

There are a number of different things that are addressed in those treaties, a wide range of issues. One important one generally, but certainly for our industry, relates to a definition almost of doing business, so that you would not be taxed or you would have some protection against being treated as a permanent establishment, which would be treated as doing business in a foreign country. So we like to have those rules as broad as possible, so as to not have incidental activities in a foreign country generate a full tax liability there.

The other thing that is very peculiar to our industry relates typically to the treatment of royalty income. The U.S. Government has negotiated, particularly with some of our major trading partners, the Japanese and Germans and others, where there is a lot of trade relating to high-tech products and where a lot of U.S. companies will actually license the technology that we develop here and receive a royalty flow-back into the United States, the policy of the U.S. Government is to have those withholding tax rates that the foreign governments would impose as low as possible. In many cases, they are zero or 5 percent on a negotiated basis.

The statutory rules of many foreign countries can be as high as 40 percent. The U.S. rate is 30 percent on similar flows outside of the United States unless they are reduced.

One of the big factors that is beneficial for us, but also beneficial for the U.S. Treasury, is that to the extent that those foreign taxes imposed are very low on that foreign-source income from the royalty that is being used outside the—or the technology that is being used outside the United States that generates the royalty flow, that income is then fully taxed by the U.S. foreign sales corporation and it does not have a large foreign tax associated with it that would otherwise be, in a sense, fully creditable against the U.S. tax.

So, if there is a dollar of U.S. tax, instead of having a dollar of foreign tax that gets credited against that, it might only be a nickel of foreign tax, and the U.S. Treasury, of course, can get the differential.

So, in the context of one of these systems that might be developed that would in any way impair the integrity of this treaty network that has been negotiated and renegotiated for decades, it could put us in the position of having the foreign governments seeing the United States change its tax system, having the treaties no longer be really valid because we don't have anything that is denominated or considered an income tax system. They would go ahead and raise their withholding tax rates on that technology, and therefore, the U.S. foreign sales corporaion would be, in a sense, maybe not disadvantaged by that, but all of the companies receiving those royalties would find they have now sustained a much higher increase in their foreign taxes imposed by foreign governments.

Mr. CHRISTENSEN. Thank you for your testimony, and I thank the panel for their time and testimony today.

Thank you, Mr. Chairman.

Mr. HOUGHTON. Thank you, Mr. Christensen.

I am not going to raise any questions because it is late and we certainly appreciate the fact you have been here.

I would just like to make two statements. My question really is, If you separate this into three parts, whether we do anything, what we do, and how we sell it. We have been talking about what we do, but the question for this Committee and for this Congress is whether we do anything at all, whether we have got the guts to do something, and then the last part is, of course, how do we sell this thing. The question then, the overriding issue, is how do we get some emotion into this thing, how can we tie it down to human beings so they feel politically this is the right way to go, and that, of course, is the big question, I think, you can help us with.

The second thing I would like to say is that the person I am going to miss most on this Committee is this man right over here. He has been a wonderful stimulator and a great leader in this whole area, and I just hope, Sam, that you are going to be able to hang around and lead us as you feel Ernie had led the intellectual discussions here.

So thank you very much, everybody. We appreciate it.

[Whereupon, at 1:13 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF THE
CHEMICAL MANUFACTURERS ASSOCIATION
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
ON
THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF
REPLACING THE FEDERAL INCOME TAX

The Chemical Manufacturers Association ("CMA") appreciates this opportunity to present its views on the impact on U.S. international competitiveness of replacing the Federal income tax. CMA commends Chairman Archer and the Committee on Ways and Means for holding hearings on this subject. In many respects this is the most important single issue that the Committee and the Congress must responsibly address and answer before adopting any alternative tax system.

CMA is a nonprofit trade association whose member companies represent more than 90 percent of America's productive capacity for basic industrial chemicals. Since 1991, the chemical industry has been the nation's leading exporter. The chemical industry also ranks first among all U.S. manufacturing sectors in research and development spending with an estimated $18.1 billion in 1995. Most importantly, the chemical industry provides over one million high-tech, high-wage jobs for American workers.

The importance of maintaining the international competitiveness of U.S. manufacturers and the American jobs they provide can not be over-stressed. Yet, in the more than 50 years that Congress has addressed Federal income tax reform, the importance of the Federal income tax on U.S. competitiveness has only recently been recognized. To a considerable extent the prior tax reform efforts of the Committee on Ways and Means and the Congress reflect the conditions and times in which they were developed.

When Congress addressed the bill that ultimately became the Internal Revenue Code of 1954, the United States was the world's dominant industrial nation with a virtually unlimited market for its products and exports. Although international competition had increased greatly by the late 1960's, the impact of tax reform on U.S. international competitiveness did not receive major attention in the Tax Reform Act of 1969. On the other hand, by increasing the tax burden on corporations (and disproportionately on capital-intensive manufacturing industries like the chemical industry), the Tax Reform Act of 1986 accelerated our problems in competing with foreign manufacturers and producers. Thus, we are most encouraged that the Committee on Ways and Means is now focusing on what we regard as the most critical issue presented under any tax system.

The chemical industry is an excellent example of how closely the economic health of U.S.-based manufacturing is linked to strong, competitive, and expanding foreign trade. The world-wide chemical industry is a fiercely competitive, global industry with large, well-financed foreign competitors. World-scale plants and efficient product flow are essential for any chemical company to compete in both domestic and international markets.

Of necessity, U.S. chemical companies must build foreign plants to serve growing foreign markets. These new plants become markets for U.S. products. In time, these foreign plants will produce goods that will in turn be sold in world markets, including the United States. However, the net result of our foreign trade is a larger market for U.S. products and greater job security for American workers.

Over time, the U.S. chemical industry has grown from producing primarily basic commodity chemicals to producing commodity and specialty chemicals. Although our industry has grown and changed dramatically, it continues to provide over one million quality jobs for American workers. Today a substantial portion of those jobs is directly dependent on the expanded market that growing U.S. chemical exports provide.

With this in mind, the important topics for the chemical industry in assessing an alternative tax system are:

- Cost of Capital
- Research Incentive
- Taxation of Ex-U.S. Income
- Export Incentives
- Energy and Environmental Costs

CMA's views on these topics are summarized below:

Cost of Capital

It is generally recognized that the cost of capital for U.S. corporations exceeds that for its foreign-based competitors. While the cost of capital is a widely-used term, there is a significant difference of opinion on what factors impact the cost of capital. CMA believes that tax policy has a direct and significant impact on the cost of capital. Moreover, tax policy is a factor within the direct control of Congress and the President. Taxes can affect the cost of capital through tax rates, depreciation methods and capital cost recovery systems, investment incentives, taxation of foreign income, the alternative minimum tax, taxation of dividends, and the taxation of capital gains. If Congress wishes to make the U.S. more competitive, each of these critical elements must be addressed favorably and in concert.

Although the Tax Reform Act of 1986 reduced marginal corporate tax rates, it adversely affected the chemical industry by increasing U.S. cost of capital. It is important that in adopting an alternative tax system Congress should not increase the cost of U.S. capital, but, if possible, should reduce that cost.

Research Incentives

In today's competitive global environment it is simply not enough to be the low-cost producer. To be successful, U.S. companies must be first to market products that offer superior value to the customer. Research and development ("R&D") is important to the chemical industry because it can lead to increased productivity that can overcome disadvantages in capital and labor costs and also to the discovery of new products. To develop a steady stream of high-value products, a company must have the resources to invest substantial sums in R&D. Because of this, CMA strongly supports a permanent, improved R&D tax credit and favorable rules governing the allocation of R&D expenses between U.S. and foreign income under Section 861. In this respect we emphasize that temporary measures do not provide the predictability needed for the long-range planning required for modern research projects.

Taxation of Ex-U.S. Income

In today's global environment, U.S.-based multinationals must compete in world markets. There are at least five components of international competition problems:

- The ability to compete in U.S. markets against imported products.
- The ability to compete in U.S. markets against products manufactured in U.S. plants owned by foreign-based companies.
- The ability of U.S. exports to compete in the home market of foreign-based competitors.
- The ability to compete in foreign markets where both the U.S. and foreign-based competitors have local manufacturing operations.
- The ability to compete in foreign markets where neither U.S. nor the foreign-based company has local manufacturing operations.

As these fact patterns illustrate, the ability to compete internationally is a complex problem. Policy makers need to understand and to consider each of these situations to ensure that we effectively maintain our international competitiveness. For many years, U.S. tax policy has discouraged U.S.-based firms from making investments abroad. This policy disregards the fact that it is impossible to compete in many countries without first investing in local manufacturing operations. Those foreign plants translate immediately into expanded U.S. exports and the American jobs those increased exports support.

In this respect, CMA has strongly opposed efforts to tax U.S. corporations currently on the income of their foreign subsidiaries, such as the bill recently introduced by Senator Dorgan (D-ND), S-1597, "the American Jobs Act of 1996." This is substantially the same bill that Senator (then Congressman) Dorgan introduced in 1991 as H.R. 2889. CMA's statement on H.R. 2889 to this Committee noted that in 1990 U.S. chemical exports were $39 billion--then equal to the nation's total agricultural exports and significantly larger than U.S. aircraft exports of $30.1 billion in that same year. In 1990, we also enjoyed a healthy net U.S. trade surplus in chemicals of $16.8 billion. In contrast to Senator Dorgan's 1990 analysis, U.S. chemical exports accounted for $60.8 billion five years later with a net U.S. chemical trade surplus of $20.4 billion in 1995. Despite the substantial increase in both exports and imports over 1990 levels, the U.S. chemical industry maintains a net U.S. trade surplus in chemicals that is 21.4 percent greater than the 1990 level. More importantly, the U.S. chemical industry today continues to provide over one million high-quality, high-paying jobs, while implementing major technological innovations and efficiencies.

Incentives for Exports

CMA is a strong supporter of the Foreign Sales Corporation ("FSC") incentive and believes that it has been a positive force in expanded chemical industry exports over the past decade. Congress should strengthen the overall incentive that the tax system provides for exports.

One important U.S. tax disadvantage arises from the fact the U.S. does not tax consumption, but relies primarily on income taxes for the bulk of its tax collections. Many of our world trading partners, however, rely upon a specific consumption tax-- the invoice-credit method value added tax ("VAT")-- to pay a substantial portion of their total costs of government.

As initially adopted by the 1947 General Agreement on Tariffs and Trade ("GATT") and subsequently incorporated in the 1994 WTO Agreements, a nation may make valid border adjustments of VAT taxes by imposing the VAT on imports and by rebating the tax on exports. However, a nation may not legally make border adjustments for income taxes. With border adjustments the VAT is trade-neutral and does not impair the competitiveness of a nation's manufactured products in domestic or foreign markets. This key advantage of the VAT over income taxes merits strong consideration by this Committee.

Energy and Environmental Costs

We recognize the Committee is holding a separate hearing on the impact of an alternative tax system on energy-related issues. However, we must emphasize that energy and environmental costs are key factors in determining the international competitiveness of the U.S. chemical industry. To the extent that an alternative tax system raises the costs of U.S.-based production relative to foreign-based production, U.S. manufactures will be less competitive in both domestic and world markets. This is especially true for the energy costs of the chemical industry, which uses energy both as fuel and as raw material for its production processes.

CMA is committed to a safe and clean environment. This requires very large capital expenditures for new equipment to meet environmental standards. Under the income tax system, the tax costs of these expenditures are substantial. For example, expenditures for pollution control equipment must be depreciated over the full applicable life for new investment, even though the expenditure relates to assets that have been in use for many years. There may be additional tax liability because of the alternative minimum tax and the allocation of interest to foreign source income. Any new tax system should avoid imposing added costs on these essential investments.

Conclusion

We again commend Chairman Archer and the Committee on Ways and Means for addressing in this hearing the impact on international competitiveness of replacing the Federal income tax with alternative tax systems. The impact on international competitiveness is the single most important issue for the U.S. chemical industry in assessing alternative tax systems.

CMA has confined this statement to general principles and chosen not to address specific tax proposals now before the Congress. Although several of these proposals are obviously the product of much serious, thoughtful study and hard work, they still do not contain all the specific detail required for large corporations to assess their specific impact. This is especially true with respect to the tax treatment of international operations of U.S. corporations.

Because of the very high stakes for our nation's economy, we believe the Committee should consider modifying its usual procedure in this instance. After these hearings and consultation with the Committee, the Chairman could direct the Committee staff to develop a detailed draft "mark" bill and then provide an extended period for public comment. This would enable major taxpayers to assess the actual impact of the draft proposal on their operations. In our view, the additional time for public review would in the end produce a better bill and enhance its prospects for enactment.

Comments on the
Impact of the Proposed Replacement Tax Systems on the
International Competitiveness of American Workers and Businesses

Submitted by
The Tax Reform Study Group
within the Council on Tax & Fiscal Policy
An Initiative of Joint Venture: Silicon Valley Network

These comments are submitted pursuant to the House Ways & Means announcement of June 26, 1996. They are submitted for inclusion in the printed record of the hearing held on July 18, 1996 on the impact of the proposed replacement tax systems on the international competitiveness of American workers and businesses. The Tax Reform Study Group previously submitted comments for the written record of the May 1996 hearing on the impact of tax reform on state and local governments.[1] The Tax Reform Study Group is also working on a more comprehensive comment letter to submit to the tax writing committees at a later date.

Background on the Tax Reform Study Group

The Tax Reform Study Group was formed in October 1995 and consists of individuals from business, state and local government, and academia who are interested in studying the proposals for reform of the federal and state tax systems and tax reform in general and the impact to Silicon Valley. The Group provides objective forums for people in Silicon Valley to learn about tax reform and how it affects them and their employers. The Group maintains a Web page where interested people can obtain objective information on tax reform:

http://www.svi.org/jointventure/tax/tax_fed.html

Joint Venture: Silicon Valley Network is a dynamic model of regional rejuvenation with a vision to build a community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to act on regional issues affecting economic vitality and quality of life. One of its initiatives is the Council on Tax & Fiscal Policy.

Drafting: The views expressed in the comment letter represent the collective views of the Tax Reform Study Group within the Council on Tax & Fiscal Policy of Joint Venture: Silicon Valley Network, and not necessarily the views of any individual members of the Study Group, the Council or of Joint Venture. The primary draftsperson of these comments was Annette Nellen, Professor, San Jose State University; substantive contributions and review were provided by William C. Barrett, Director: Tax, Export & Customs, Applied Materials, Inc.; Dan Kostenbauder, General Tax Counsel, Hewlett-Packard Company; Larry R. Langdon, Vice President - Tax, Licensing & Customs, Hewlett-Packard Company; David W. Mitchell, Hoge, Fenton, Jones & Appel, Inc.; Jerry Nightingale, Financial Advisor, Royal Alliance; Donald J. Scott, Director: Tax Compliance, Oracle Corporation; Dean Smith, Ireland, San Filippo & Company; John Webb, Vice President - Taxes, National Semiconductor Corporation.

Global Facts Must Be Considered In Reforming the Federal Income Tax System

In reforming the federal income tax code, it must be kept in mind that it was created and, despite regular modifications, works best for an era that no longer exists. The Internal Revenue Code (IRC) is based on the industrial age where tangible goods - easy to track and measure - were the key commodities. We are now living in the information age which requires a different perspective and set of rules than the industrial age.

Today, businesses and workers must deal with a global economy. While we still hear the term "international business", such a term is outdated because all business today is involved in or influenced by the global economy in some fashion. A new business formed in the U.S. may engage in international transactions in its early years, rather than later when they get "big enough." Per the OECD, the "period between start-up and internationalization is becoming shorter - often three or four years compared to five to ten years a decade ago." The OECD also reports that about 1% of small and medium sized manufacturing businesses (about 40,000 firms) are "truly global." Such firms produce about 26% of OECD exports and about 35% of Asian exports.[2]

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[1] These comments can also be found at http://www.svi.org/jointventure/tax/tax_fed.html, or 96 STN 142-36 (July 23, 1996), or State Tax Notes, Vol. 11, No. 4, July 22, 1996, pg. 253.

[2] "Helping Small Firms Adapt to the Globalised Economy," *OECD Letter*, Vol. 5/4, May 1996; http://www.oecdwash.org.

The current global environment that must be the model in the minds of tax code reformers is shaped by many realities, including the following:

- *Increasing Importance of Foreign Markets.* The level of both U.S. exports and imports continues to grow.[3] In 1980, exports represented 8.5% of the U.S. economy and 12% in 1994.[4] DRI/McGraw-Hill has predicted that the current growth in exports will lead to $1 trillion by 1998.[5] Foreign markets are growing and many U.S. companies are ready to provide goods and services to them. The Computer Systems Policy Project (CSPP) predicts that by the year 2000, about 70% of the demand for information technology will come from foreign markets.[6] The importance of the global economy to the computer industry was summarized by the CSPP as follows.

  > The ability to sell products and access technology worldwide is essential to the continued competitiveness of the U.S. computer industry and its success around the world. The industry must grow globally or die!
  >
  > ...
  >
  > Continued success of the U.S. computer industry around the world depends on its ability to bring competitive products to market quickly. To do that, it's essential that companies be able to source technology globally - wherever it can be found - to maintain the industry's competitiveness and productivity. No country can have a monopoly on technology - its flow across international boundaries is a business reality.[7]

- *Global Competition For Technology Jobs and Tax Dollars.* Many foreign countries actively compete for U.S. businesses to locate operations in their countries, particularly those bringing technology based jobs. Incentives include tax holidays, low tax rates, direct funding from the government, and duty rate reductions. This reality must be considered in efforts to improve the international competitiveness of U.S. companies and workers. The OECD has undertaken efforts to deal with international business and tax competition to prevent competition that may be harmful to governments and businesses. A June 1996 economic communiqué of the G7 leaders noted that business and tax competition can distort trade and investment and "lead to the erosion of national tax bases."[8]

- *The Services Sector Is Growing While the Manufacturing Sector Is Declining.* The Department of Commerce reports that by the 21st century, telecommunications and information-based industries will represent about 20 percent of the U.S. economy.[9] In 1995, the "Fortune 500" was changed to include both industrial and service firms. The reasons for this change include the fact that a "new economy" has emerged with the line between manufacturing and service activities more blurred; "the digital revolution has made the distinction between manufacturing and services increasingly theoretical."[10] The services sector of the economy showed job growth from 1989 to 1991 (almost 3 million jobs added), while the manufacturing and construction sectors showed job decline (about 1.5 million jobs).[11] In 1950, services represented about 31% of GNP, while tangible goods represented about 55% of GNP. In 1990, these percentages had changed to 52% and 40%, respectively.[12]

  The growth in the services sector is not a U.S. phenomenon. In France, job growth in financing, insurance, real estate and business services grew at double the rate of overall

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3 Department of Commerce, *U.S. Foreign Trade Update*, http://www.ita.doc.gov/industry/otea/usftu/usftu.html.

4 See Aley, "New Lift For the U.S. Export Boom," *Fortune*, Nov. 13, 1995, pg. 73.

5 *Id.*

6 CSPP, "Public Policy and the U.S. Computer Industry - Freedom To Grow - Leadership Into The 21st Century," January 1995, http://www.cspp.org/reports/. The Department of Commerce reports that for advanced technology products (ATP) a trade surplus exists of $7 billion for January to April 1996. ATP represents about 500 products where the technology is from a "recognized high technology field (e.g., biotechnology)", and which represent leading edge technology in that field. See http://www.census.gov/ftp/pub/foreign-trade/Press-Release/.

7 CSPP, *supra.*

8 As reported in Massey, "G7 Leaders Spur OECD's International Tax Reform Efforts, 96 TNT 132-2, July 8, 1996.

9 Undated memorandum from the National Telecommunications and Information Administration (NTIA) within the U.S. Department of Commerce (possible date is July 1995).

10 Stewart, "A New 500 For The New Economy," *Fortune*, May 15, 1995, pgs. 166, 174.

11 U.S. Bureau of the Census, "Net Job Growth/Decline in the United States by Industry Division, http://www.census.gov/ftp/pub/epcd/ssel_tabs/images/jobchan.gif. From 1980 to 1992, the number of jobs in the manufacturing industry declined by 14.2% (about 3 million jobs), while jobs in services industries grew 78.4% (about 13.5 million jobs). U.S. Bureau of the Census, Statistical Abstract of the United States 1995, 115th Ed., Table No. 858.

12 Snell, ed., *Financing State Government in The 1990s*, National Conference of State Legislatures (NCSL), December 1993, pg. 21.

employment. At the same time, manufacturing jobs fell from 36% to 29% and agricultural jobs fell by about half. Similar patterns have occurred in the OECD countries.[13]

- *Intangible Assets - Information, Intellectual Property and Human Capital, Are Key Assets.* With the decline in the manufacturing sector and the increase in the services sector, tangible assets have somewhat declined in importance relative to intangible assets and knowledge. However, financial and economic reporting is still driven by tangible capital. U.S. Department of Commerce data reports capital expenditures by industry, but not investment in workers and intangible assets.[14] Certainly, tangible assets are much easier to measure than intangible assets, but without a focus on intangible investment in intellectual property and human capital, economic perspectives will be distorted. A tax reform focus on a system to increase capital investment (in tangible/measurable items), is not by itself appropriate. Instead, consideration must also be given to what tax and fiscal policies are appropriate to a business environment where developing human capital and protecting intellectual property is key to survival and improved growth.[15]

  Intangible assets are often difficult to fit into the taxing schemes of the current tax laws. Again, this difficulty stems from the fact that our tax rules are structured to address the industrial age, not the information age. For example, the tax law does not provide a simple answer as to whether a software developer who only transfers its software over the Internet has to deal with inventory rules, or whether software duplication and packaging is considered manufacturing. Also, the current tax law cannot clearly label a software transaction as being a sale of goods, a rental, or royalties. This failure leads to difficulties applying domestic and foreign tax rules and leads to much cost and confusion.[16]

What is Meant by "International Competitiveness?"

The term international competitiveness has different meanings to different people. To some, it may mean a focus only on exports (trade competitiveness), and not on investment outside the U.S. (multinational competitiveness). To some, it may mean solely looking at how tax rules may encourage or discourage certain activities. However, in debating how international competitiveness is impacted by major federal tax reform, a broad perspective should be taken. This perspective should also consider how domestic policies, with respect to savings incentives and fiscal problems (such as the U.S. debt and budget deficits) impact global investment and competitiveness. It should also consider the costs that businesses face in terms of a complex tax system and uncertain tax rules and how they can hinder a firm's ability to effectively compete in the global economy. (The debate should also consider the factors described in the next section of this letter.)

A 1991 Joint Committee on Taxation report includes a detailed discussion on the competitiveness of the U.S. economy. The report looks at this concept in terms of trade competitiveness, standard-of-living competitiveness and multinational competitiveness. It also discusses different measures of competitiveness and various policies, such as government regulations, technology and investment, that can impact competitiveness.[17]

Many Factors Impact International Competitiveness and Trade

While a nation's tax rules and tax infrastructure impact a company's cost of doing business and many of its decisions, many other factors are also important. These factors, many of which are briefly explained below, must be considered along with the tax rules in any reform designed to improve the international competitiveness position of U.S. companies and workers. For example, a tax rule designed to encourage exports will not help a technology company facing out-dated export controls. Similarly, the rapid technological pace at which products advance requires a legal infrastructure that can deal with this pace so that companies are not left behind in marketing their

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[13] Miller and Wurzburg, "Investing in Human Capital," *The OECD Observer*, No. 193, April/May 1995, pg. 16.

[14] For example, International Trade Administrative Data; http://www.ita.doc.gov/industry/otea/usio/.

[15] For more information on this topic, see "Investing in Human Capital," *supra*.

[16] For example, see Erickson, "Royalty Income From Software: Is It Rental or Sales Income?," *High Tech Industry*, July-August 1996, pg. 46. Also see letters submitted to the Treasury Department over the past five years by Baker & McKenzie on behalf of the Software Coalition: Tax Notes Today, 95 TNT 185-61 (Sep. 21, 1995), Tax Notes Today, 92 TNT 199-75 (Oct. 1, 1992) and October 24, 1991, Tax Notes Today, 91 TNT 237-51 (Nov. 20, 1991). For an alternative perspective on revenue characterization of software transfers, see Covington & Burling letter of December 11, 1992 to the IRS on behalf of IBM; Tax Notes Today, 92 TNT 256-20 (Dec. 24, 1992). Also see September 4, 1992 letter from Compuware Corporation to the IRS supporting the IBM's comments; Tax Notes Today, 92 TNT 189-38 (Sep. 17, 1992). Also see the Covington & Burling letter to the IRS dated June 12, 1992, Tax Notes Today, 92 TNT 165-38 (Aug. 13, 1992).

[17] Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, (JCS-6-91), May 30, 1991, pgs. 3 to 14 [hereinafter, JCS-6-91]

products worldwide because competitors are not subject to out-dated trade restrictions and other legal obstacles.

Briefly described below are some of the factors that must be considered in the entire debate on improving the international competitiveness position of American workers and businesses. The tax reform process should consider these factors in order to develop a cohesive set of policies that don't conflict with each other and thus defeat the overall goals of improving international competitiveness.

- *Education and worker training.* With the increased importance of intellectual and human capital of many businesses, relative to the importance of machinery, workers must be adequately prepared. The CSPP reported that in 1993, 74% of computer companies' revenues were derived from products that were not even in existence two years earlier.[18] Clearly, workers in such environments must be prepared for life-long learning and adaptability and have a solid technological foundation from which to grow. Development of these skills should begin in primary and secondary education; not just in college or trade schools.

- *Cross-border worker mobility.* We are accustomed to workers moving from state to state to find better jobs or to move when their employer expands. Such moves are relatively simple - visas and other paperwork are not required. In a global economy, attention should be given to making worker moves from one country to another a simpler proposition as well. The U.S. should work with other countries to stream-line worker transfers because such mobility is part of doing business in the global economy.

- *Intellectual property protections.* Clearly, protection of intellectual property of U.S. companies is an important part of being able to compete effectively in the global economy. While this is true for all types of companies with patents, copyrights, trade secrets and trademarks, it is particularly important in the software industry. Without international respect for intellectual property rights, a software company's ability to compete is greatly diminished. Software piracy must be controlled in order for U.S. software companies to be able to compete globally. Because software is one of the fastest growing industries,[19] attention needs to be given to this difficult problem.

- *Savings and investment.* The U.S., its businesses and its workers could be slowed down due to impediments to savings and investment, such as:

  - a high national dissavings in the form of our $5 trillion national debt and continual annual budget deficits;
  - double taxation of corporate earnings;
  - tax depreciation rates that are slower than those of other countries and the actual obsolescence rates of some high technology equipment;
  - high tax rates on capital investment, and lacking or distorted savings incentives (current savings incentives tend to favor home ownership relative to other types of investments);
  - reduced R&D incentives[20] and government investment in private R&D relative to other countries; and
  - anti-deferral tax provisions, such as IRC §956A and the PFIC rule's overlap with controlled foreign corporation rules, which encourage U.S. multinational firms to invest offshore.

- *Export controls.* While much debate[21] has occurred on export controls, solutions are often slow in coming. While these are difficult issues, often involving issues of national defense and security, they must be resolved in the same rapidly changing environment in which exporting businesses are trying to compete. The CSPP places the estimated cost of current export

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[18] CSPP, "Public Policy and the U.S. Computer Industry - Freedom To Grow - Leadership Into The 21st Century," January 1995, http://www.cspp.org/reports/.

[19] The Business Software Alliance (BSA) describes the computer software industry as one of the fastest growing industries and one that contributed over $36 billion to the U.S. economy in 1992. BSA, "The Computer Software Industry," January 1994.

[20] For example, the U.S. does not have a permanent research tax credit which hinders U.S. investment in R&D. Various studies have shown that an incentive and subsidy is warranted, Congress and the Administration favor a credit, yet, it is allowed to continually expire. See Cox, "Research and Experimentation Tax Credits: Who Got How Much? Evaluating Possible Changes," Congressional Research Service, June 4, 1996, for references to studies justifying some level of public support for private R&D.

[21] For background on the encryption technology debate, see S. 1726, the Commerce Promotion Act of 1996 and S. 1587, the Encrypted Communications Privacy Act of 1996; 104th Cong., 2d Sess. Also see "U.S. Offers 'Relief' From Curbs on Exports of Encryption Products," *International Trade Reporter*, BNA, Vol. 13, No. 24, pg. 973, June 12, 1996.

controls on cryptography at $60 billion and 200,000 potential jobs through the year 2000.[22] U.S. multinational firms should not have to suffer the consequences of politicized trade issues.

- *Antitrust policies*. Current antitrust policies should be reviewed and consideration given to what constitutes effective policies for U.S. companies competing in a *global* environment. While a company's actions are typically viewed in the context of how they affect U.S. competition, such actions should also be viewed as to how antitrust policy may impede the U.S. company from competing internationally. Again, difficult issues are involved, but they must be considered in the context of the topic of international competitiveness of American workers and businesses.

- *A global information infrastructure (GII)*. Issues that have arisen in the U.S. regarding the national information infrastructure (NII), such as protection of intellectual property, content control and security, will also exist on the GII. The U.S. government should work with U.S. businesses and other governments to help ensure that the potential of the GII (including its business potential) is not hindered.[23]

- *A global legal infrastructure*. U.S. businesses have been burdened by a complex domestic infrastructure involving differing regulations and rules among the 50 states and often within each state as well. As the global economy grows and the above issues are addressed, consideration should be given to standardization of some processes such as registration of intellectual property, business registration, payment procedures, settlement of tax disputes, and export and import procedures.

Recognize How Other Countries Tax and Spend

The U.S. is only one of two OECD countries that does not employ a federal VAT. Thus, our tax system is "out-of-sync" with most countries. Current proposals for major reform call for replacement of the federal income tax with a consumption tax. Such a step would also keep the U.S. tax system out-of-sync with other OECD countries because they employ an income tax along with consumption taxes.[24] Before taking a drastic step to completely eliminate the U.S. income tax system, careful analysis should be made as to, 1) why other countries have both income and consumption tax systems, 2) how government spending in other countries differs from the U.S. (for example, many European countries have higher social spending on unemployment benefits, education and health care) and how that impacts their taxing decisions, 3) the ability to use the income tax system to reduce the regressivity of a consumption tax, and 4) the impact to state and local governments of replacing the federal income tax with a consumption tax.[25] In addition, tax differences between the U.S. income tax system and those of other countries, such as territorial versus worldwide tax systems, sourcing rules and foreign tax credit rules, should be considered in terms of how such differences may impede the competitiveness position of U.S. firms.

Importance of Identifying Policy Goals For the New Tax Rules

Arguably, some of the complexity of today's tax laws stems from the failure to ask the following question prior to making changes to the IRC: "Does the change support the underlying revenue and competitiveness policies of the U.S. tax laws?"

For example, international tax rules do not necessarily have similar policy objectives underlying them. This can lead to distorted incentives, such as where one rule encourages domestic investment, while other rules favor foreign investment (for example, current IRC §956A which actually encourages foreign investment in offshore plants versus the research tax credit which

22 "Foreign Encryption Products Threaten U.S. Market, Industry Warns Lawmakers," *International Trade Reporter*, BNA, Vol. 13, No. 25, pg. 1019, June 19, 1996.

23 See OECD, "Common Vision Needed for Global Information Society," *OECD Letter*, Vol. 5/6, July 1996, and "Global Information Infrastructure and Global Information Society (GII-GIS)," OCDE/GD(96)93, for information on OECD activities in this area. See CSPP, "Perspectives on the Global Information Infrastructure," February 1995, for suggestions from several computer companies on the role of industry and government in effective development of the GII. Also see National Telecommunications and Information Administration (NTIA), "The Global Information Infrastructure: Agenda for Cooperation," 60 FR 10359, February 24, 1995.

24 OECD figures show that for 1992, OECD countries as a group relied on the following sources for tax receipts: personal income taxes 29.7%, corporate income taxes 6.8%, social security 25.0%, property taxes 5.5%, general consumption taxes, 17.1% and specific goods taxes 11.5%. Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems*, (JCS-1-96), March 14, 1996, pg. 84.

25 See previous submission by the Joint Venture Tax Reform Study Group on the impact of tax reform on state and local government; http://www.svi.org/jointventure/tax/tax_fed.html, or 96 STN 142-36 (July 23, 1996), or State Tax Notes, Vol. 11, No. 4, July 22, 1996, pg. 253.

encourages domestic investment in R&D activities). Similarly, U.S. tax rules have not necessarily focused on the tax rules businesses face in foreign countries and how the U.S. tax rules on sourcing of expenditures, foreign tax credits, transfer pricing and labeling of transactions (such as sale of goods versus royalties) can lead to double taxation, costly controversies and non-neutrality of the tax rules (because tax implications can influence a business's investment decisions).

In reforming the tax system, time must be given to discussing what the appropriate policies should be to support the tax rules with respect to international business transactions. For example, should the rules encourage exports? be neutral as to where production occurs? follow a standard established by an international group, such as the OECD? or something else?[26] Without first having this discussion, any replacement tax rules will lead to the same complexities and distortions that currently exist in the federal income tax rules. Similarly, any efforts made to reform our current income tax rules in the international tax area (prior to major federal tax reform) should follow these same principles of first identifying, 1) what is the policy goal of the international tax rules, 2) whether the particular proposal will be within that policy goal, and 3) whether the proposal is the simplest and most effective method of reaching that goal.[27]

Finally, more efficient tax policies could stem from a better dialogue between government and industry. Government needs to listen to the experiences that companies are having in dealing with tax issues in their worldwide activities. Many of these issues can only be solved by actions on the part of Congress and the Administration to clarify or correct the U.S. tax laws, or in dealing with issues businesses face in applying both U.S. and some other country's tax laws to the same transaction.

Businesses have brought various tax rules that are not in the best interests of the U.S. economy, to the attention of Congress and the Administration. Two recent examples are, 1) the failure to clarify the IRC or regulations to enable software companies to obtain foreign sales corporation (FSC) benefits similar to that obtained by other industries, and 2) the failure to hear U.S. companies' appeal that the passive asset rule of IRC §956A and the PFIC rule's overlap with controlled foreign corporation rules actually encourage, rather than discourage, offshore plant investment. Given the rapid technological changes companies deal with today and the various complexities of doing business globally, a more efficient system must be developed for government and business to work together to maintain a set of tax rules that best serves the interests of the U.S. fisc and does not adversely impact U.S. companies and their workers. Multi-year delays in fixing problem areas in the tax law is not acceptable in the rapid technological and business development pace of today's global economy. Reform efforts should include creation of a system for quick resolution of costly tax issues and uncertainties as to how the law applies.

Problem Areas With Current Proposals and Tax Reform In General

- *Determine whether GATT-compatibility is important.* Consensus does not exist as to how important it is for a tax to be GATT-compatible. Some commentators view it as unimportant under the theory that a border adjustable tax is not an effective tool in reducing the trade deficit. In a 1992 report, the Congressional Budget Office stated that border adjustments do not improve the balance of trade because of resulting changes in exchange rates.[28] However, others, including Congressman Archer, view GATT-compatibility as an important goal for tax reform.[29] The importance of GATT-compatibility, must be further analyzed and openly

[26] For a more detailed discussion of tax policies underlying certain foreign tax provisions of the IRC, see JCS-6-91, *supra*, pgs. 232 to 264.

[27] For example, these steps should be taken with respect to recent legislative proposals: S. 1597, 104th Cong., 2d Sess. (Dorgan) and S. 1928, 104th Cong., 2d Sess. (Levin). For an alternative perspective on this type of legislation, see Merrill and Dunahoo, "'Runaway Plant' Legislation: Rhetoric and Reality," 96 TNT 131-18 (July 5, 1996).

[28] CBO, *Effects of Adopting a Value-Added Tax*, February 1992, pg. 63. Also see Esenwein, Congressional Research Service, "Consumption Taxes and the Trade Balance: The Role of Border Tax Adjustments," 95-893E, Aug. 14, 1995. This report notes that the balance of trade is affected by international capital flows, not by the flow of traded goods and services and border tax adjustments. "[A]ny changes in the product prices of traded goods and services brought about by border tax adjustments would be immediately offset by exchange rate adjustments. ... That is not to say that changes in the tax structure could not influence trade patterns. Tax policy can and does affect the composition of trade. In addition, changes in tax policy which might affect the underlying macroeconomic variables that govern capital flows (for instance, by increasing either public or private savings which in turn would lower interest rates) could affect the balance of trade. But, by themselves, border tax adjustments will not change a nation's balance of trade."

[29] Congressman Archer, "Goals of Fundamental Tax Reform," in *Frontiers of Tax Reform*, The Hoover Institute, 1996, pg. 5. Also, per Congressman Gibbons, a "border-adjustable tax system would promote the competitiveness of American companies and invigorate American exports." Gibbons, "A Revenue System for America's Future," outline to his subtraction method VAT proposal, March 27, 1996, pg. 3.

debated prior to instituting a tax that is not GATT-compatible, such as the Armey flat tax, or making an effort to ensure that a new tax is GATT-compatible if it makes no difference. This debate should consider, 1) the effect of GATT-compatibility under various trade balance scenarios, 2) the effect in the long-term versus the short-term, 3) the impact of transitioning to a GATT-compatible tax, 4) possible differences of impacts among industries, and 5) trading partner acceptance of the taxing system as GATT-compatible.

- *Determine whether a subtraction VAT is GATT-compatible.* If it is determined that GATT-compatibility is important, careful attention must be paid to the new tax to be enacted to be sure that it is truly GATT-compatible. Most of the world using a VAT uses the credit invoice VAT which is more obviously an indirect tax, relative to the subtraction VAT. As noted by former Treasury Assistant Secretary, Les Samuels, "Whether a subtraction method VAT would survive a GATT challenge is an untested issue."[30] Also, per a 1991 Joint Committee on Taxation report: "there is considerable uncertainty as to whether a subtraction-method VAT would be legal under GATT. The distinction may be made that a subtraction-method VAT, unlike a credit-invoice VAT, is not imposed on particular transactions but directly on a business, where the tax base is equal to the business's value added. In this technical respect, a subtraction-method VAT may more closely resemble a corporate income tax than a sales tax."[31] On the other hand, others believe that a subtraction VAT is likely to be GATT compatible.[32]

  In the GATT-compatibility debate, it is important to note that the current proposals call for a *variation* on a subtraction VAT. While a pure subtraction VAT might be shown to be GATT compatible, the USA subtraction VAT is not a pure subtraction VAT because of its NOL carryforward and FICA credit provisions. These provisions may indicate that it is not an indirect tax. However, if this is true, these are fixable aspects of the proposal; the key will be to fix such problems prior to enactment, rather than upon a later GATT challenge.

- *Expand the VAT debate to include the credit invoice VAT.* Almost all countries that use a VAT use the credit invoice method VAT. However, current major tax reform proposals in the U.S. all call for some form of the subtraction method VAT. Reasons for favoring a subtraction method VAT over the credit invoice VAT include:

  - The subtraction method VAT is viewed as not tolerating any special rates or exemptions, thus it will not suffer from the same problems that the income tax has (such as having over 100 special preferences).
  - In terms of computation, the subtraction method VAT looks more like the income tax and thus, will be better accepted in the U.S.

  Both of the above reasons for favoring a subtraction method VAT have serious underlying problems. First, it is not politically reasonable to assume that preferences and special rates cannot be added to a subtraction VAT - someone will surely figure out a way! In fact, it has already been shown that a subtraction method VAT can tolerate exemptions as evidenced by the Danforth-Boren business activities tax (BAT), a form of subtraction VAT introduced in 1985, which calls for an exemption for businesses with gross receipts under $100,000.[33]

  The fact that a subtraction VAT has similarities to our current income tax is both a plus and a minus. The plus is that it will rely on records businesses already have in place for state income tax and financial reporting purposes. The minus is the fact that it leads to confusion as to what is actually being taxed; it also leads to potential GATT-compatibility problems. For example, one of the common complaints voiced about a subtraction method VAT proposal, such as the USA tax, is that it is an unfair tax on labor because no deduction is allowed for labor. Such a comment likely comes about because when the tax looks so much like our income tax, we expect it to include "typical deductions," such as those for labor. However, a consumption-type VAT taxes "value-added" to goods and services acquired from another business as the goods and services move through the production and distribution chain. The key element of that "value-added" is the labor that a business applies to the goods and services as they move through the production and distribution chain (thus, there is no "deduction" for wages because it is *supposed* to be taxed under a value-added taxing scheme).

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[30] From June 7, 1995 record testimony (pg. 28) before the House Committee on Ways and Means by then Assistant Treasury Secretary (Tax Policy), Les Samuels.

[31] JCS-6-91, *supra*, pg. 304.

[32] For example, see Hufbauer and Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments*, Institute For International Economics, 1996, pgs. 67 to 70. Hufbauer posits that the subtraction VAT can be attributed to individual products unlike the corporate income tax which is dependent on the business cycle and other factors. Hufbauer also suggests that the associated legislation should be drafted to indicate that the liability for the tax attaches when the goods or services are sold. The Hufbauer text contains an excellent and very complete discussion of border adjustments. Also, the sponsors of the USA proposal appear to have taken the position that it is a GATT-compatible tax.

[33] S. 2160, 103d Cong, 2d Sess.

Under the credit invoice form of a consumption type VAT, it is more clear what (and who) is being taxed and the complaint that it is an unfair tax on labor is not typically raised. Yet, where there are no exemptions or special rates, both forms of VAT raise the same amount of revenue.

A subtraction VAT may lead to GATT-compatibility problems because it is proposed to look so much like a non-GATT compatible income tax (direct tax). For example, under the USA proposal, if a business has purchases greater than revenues, a net operating loss (NOL) is generated which can be carried forward for 15 years[34] (very much like our income tax system). Under a VAT, a refund would be more appropriate when a business's purchases from other businesses exceed its sales for the year. Also, under the USA proposal, a business could transfer its NOL carryforward along with a transfer of its assets.[35] These two features make the USA business tax look more like something imposed on the business (a direct tax) rather than on the consumer (an indirect tax). Under a credit invoice VAT, these issues do not arise. A credit invoice VAT makes it clear that the ultimate consumer is paying the VAT and if purchases exceed sales for a business, the business receives a VAT refund. Also, the credit invoice VAT is known to be GATT-compatible, while the forms of subtraction VAT proposed in the current debate have not been tested under GATT (see earlier discussion).

For the reasons noted above, as well as the fact that a debate as significant as replacing the federal income tax requires an honest look at all possible options, all appropriate proposals should be on the table, including the credit invoice VAT.[36] This will lead to a more effective debate, allow for consideration of how most of the rest of the world taxes and perhaps allow for a more honest perspective of what a consumption-type VAT is and how it does indeed differ from our current income tax.

- *Renegotiation of tax treaties.* Current tax treaties deal with income taxes, not consumption taxes. Thus, the treaties will need to be renegotiated if the income tax is replaced. The time frame needed for this task, as well whether other countries would be willing and interested in renegotiating treaties with the U.S., must be considered in the tax reform debate.

- *Industry neutrality with respect to a destination-based tax.* For a variety of reasons, certain financial factors differ among industries. For example, U.S. Department of Commerce figures for 1994 show the following for two different industries:[37]

	Motor vehicles and Car bodies (SIC 3711)	Computers and Peripherals (SIC 3571, 3572, 3575, 3577)
Production workers	198,000 (est.)	67,000 (est.)
Average hourly earnings	$24.57	$13.01
Total employment	237,000 (est.)	191,000 (est.)
Capital expenditures	$2,774 million (1992)	$2,123 million (1992)
Value of shipments	$185,111 million (est.)	$70,500 million (est.)
Value of exports	$22,038 million	$30,393 million
Value of imports	$72,596 million	$46,833 million

This information indicates that these two industries vary in the amount of shipments that are exported and the amount of total workers who are production versus non-production workers. In addition, the capital expenditures for the two industries are close in amount although total shipments in the motor vehicle industry are over twice those for the computer industry. Differing exports, capital expenditures and wage bases will exist among companies within each industry as well. These differences should be given some consideration in the design of a neutral tax system so that businesses are not unfairly and unjustifiably favored or penalized under the tax system.

For example, the current design of the USA tax for businesses imposes a separate tax on the value of imports (but at the same tax rate as imposed on domestic operations). The USA tax allows businesses to reduce their tax liability by a credit equal to the FICA taxes paid. However, this credit may not be used to reduce the import tax. A capital intensive business, such as a chip manufacturer, may have zero tax liability under the business tax due to the expensing of capital equipment and the FICA credit. Such a company may likely generate NOL and FICA credit carryovers as well. At the same time, the company will owe an import tax. Thus, the tax system for such a company becomes one of zero domestic tax (with NOL and

[34] S. 722, 104th Cong., 1st Sess., §207(b).

[35] S. 722, 104th Cong., 1st Sess., §207(d)(2).

[36] Much analysis has been performed on the credit invoice VAT by two tax practitioner groups: AICPA, *Design Issues in a Credit Method Value-Added Tax for the United States*, May 1990, and ABA Section of Taxation, *Value Added Tax - A Model Statute and Commentary*, 1989.

[37] Bureau of the Census, International Trade Administration, http://www.ita.doc.gov/industry/otea.usio/95s1481.txt (95s1494.txt).

credit carryovers which may never be needed), with tax only paid in the form of an import tax. On the other hand, a company that does not rely on imports to the same degree and/or is not capital intensive, will be able to claim benefit of its FICA credit because it does have domestic business tax base. Thus, two companies could have equal domestic wage bases yet be subject to quite different tax bills. A remedy to allow for a more neutral tax would be to allow for the FICA credit to be used against any tax liability.

- *Destination-based versus origin-based tax system.* A common preference touted for a destination based tax is that it will improve the balance of trade. However, many commentators state that this is not true (see GATT discussion above). This issue is closely tied into GATT compatibility (discussed above) and should be debated with that similar issue. Included in that debate should be other factors, such as transfer pricing issues and rules, that may tend to justify one tax system over the other. For example, while transfer pricing issues would be reduced from a U.S. government perspective under a destination-based tax, transfer pricing remains an issue under an origin-based tax system. However, under a destination-based tax system, U.S. businesses may likely face heightened transfer pricing scrutiny from other countries because the pricing of U.S. exports receives no scrutiny under the U.S. tax laws, potentially making such values entering foreign countries more "suspect." State tax coordination with a federal consumption tax should also be included in this origin versus destination-based debate.[38]

- *More attention needs to be given to intangibles in taxing schemes.* Transfers of intangible assets, such as information and software, are more difficult to tax relative to the transfer of visible tangible assets. Also, while tangible assets can be seen by customs agents when the goods cross borders, the same is not true of information, software and telecommunications. With the increasing amount of revenues generated from transfers of intangibles, realistic tax schemes must be found. Such schemes should be coordinated with the rules of other countries to avoid double taxation, and unnecessary compliance burdens. For example, under the Armey flat tax, if the licensing of U.S. technology to a foreign entity is viewed as a taxable export and the foreign country also taxes the royalty income, the U.S. taxpayer will be subject to double taxation because the Armey flat tax does not allow for a foreign tax credit. As noted by the National Commission on Economic Growth and Tax Reform ("Kemp Commission"), attention must be paid to the "proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."[39]

  The current reform proposals and the tax reform debate have ignored the tax treatment of intangible assets for the most part. For example, the USA proposal includes rules on sourcing goods and services for purposes of determining if income and expenses are considered non-taxable export income, or a taxable import. However, it does not discuss how to source royalty income and royalty payments related to intangible assets, or whether such payments are considered to be for services.

  The Armey flat tax does not include sourcing rules at all. Guidance would be needed, for example, on how to determine whether licensing of an intangible asset to a foreign licensee should be viewed as a taxable export, non-taxable investment income, or non-taxable foreign income. Also, where development of an intangible occurs both inside and outside the U.S. and/or it is licensed both inside and outside the U.S., guidance will be needed as to how the costs and revenues from the intangible factor into the taxpayer's U.S. tax liability.

- *Potential problems if the U.S. becomes a tax haven.* In *The Flat Tax*, authors Hall and Rabuska note that with a 19% tax rate and expensing of investment, "foreign investment should pour into the United States."[40] While this may sound great for the U.S. economy, consideration must be given to whether such an assumption is realistic (investment in the U.S. is not solely dependent on tax considerations). Should this assumption be a possibility however, the U.S. must then factor in what possible "retaliatory" actions other countries may take to try to keep investment within their borders. Such competition for business and tax dollars might not be a beneficial outcome for both businesses and governments.[41]

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[38] For a thorough discussion on the topic of origin based versus destination based taxes and related international tax issues presented by major federal tax reform, see Grubert and Newlon, "The International Implications of Consumption Tax Proposals," *National Tax Journal*, December 1995, pg. 619; Avi-Yonah, "Comment on Grubert and Newlon, "The International Implications of Consumption Tax Proposals,"" *National Tax Journal*, June 1996, pg. 259; Grubert and Newlon, "Reply to Avi-Yonah," *National Tax Journal*, June 1996, pg. 267; Avi-Yonah, "The International Implications of Tax Reform," 95 TNT 223-63, (Nov. 13, 1995); and Horowitz, "Evaluating Fundamental Tax Reform: The U.S. Multinational Perspective," 96 TNT 27-61 (Feb. 7, 1996).

[39] Report of the National Commission on Economic Growth and Tax Reform, January 1996, pg. 18.

[40] Hall and Rabushka, *The Flat Tax*, Hoover Institution Press, 1995, pg. 121.

[41] For a perspectives on this, see Slemrod, "Some Implications for American Tax Policy of Global Competition," *Tax Notes International*, 3 TNI 1039, September 1991; and Holland and Owens, "Tax, Transition and Investment, *The OECD Observer*, No. 193, April/May 1995, pg. 29.

Conclusion

With respect to consideration of the impact of major federal tax reform on international competitiveness, we encourage Congress to:

- *Recognize a changed business environment and the need for quick action to solve problems.* Identify what the global economy of today and the tomorrow looks like and how it differs from the world that shaped our existing tax laws and policies. Businesses should not be held back by unclear rules and the slowness of the government bureaucracy to fix roadblocks that hinder a business's ability to effectively compete in the global economy. If the debate is focused on what currently exists in the IRC and why rules were written the way they were years ago, it will be a useless debate.

- *Think globally, not domestically.* A key statistic cited in discussing international competitiveness is the level of U.S. exports and imports. This perspective by itself is outdated and limiting because it is easy for many high technology companies to operate almost anywhere in the world, yet still provide benefits to the U.S. economy. Perhaps the focus should be on worldwide operations and whether a U.S. business is facing any legal obstacles that are impeding its worldwide growth and how the U.S. can assist in reducing such obstacles.

  A focus on exports and imports (the trade imbalance) may also lead to "domestic tunnel vision" which similarly might lead to policies that impede the worldwide growth of a U.S. business. A decision by a U.S. firm to locate operations outside of the U.S. should first be viewed as a reasoned economic one which likely still provides some benefits to the U.S. economy.[42] Today, application of "domestic tunnel vision" is likely to apply and lead to legislation to prevent or penalize such business decisions. Such actions should be considered in terms of whether they make sense in terms of the global economy in which businesses operate today.

- *Work with businesses to better identify the appropriate policies that should underlie international tax rules.* For example, should exports be encouraged? Should investment in foreign business activities be discouraged? Should taxes be a neutral factor in these decisions? Consideration must also be given to how other countries tax international transactions and how countries can work together in the global economy and collect tax revenues in an effective and cost-efficient manner.

- *More than just tax rules need to be considered.* Approach the task of improving international competitiveness as the broad proposition that it is. That is, consider education and worker training of today's workers who must deal with rapid technological advancement and competition from skilled workers in other countries. Also consider how to protect intellectual property of U.S. businesses in the global economy, how U.S. savings and investment actions and policies impact the ability of U.S. businesses to compete globally, as well as the impact of export controls, antitrust policies, and how the global infrastructure in which businesses must operate might be streamlined through coordinated efforts of governments working together.

- *Work to preserve and further encourage this country's entrepreneurship and technological expertise.* Given the rapid changes in technology and the continuing growth potential for high technology products, U.S. policies should focus on ensuring that students are provided the skills to enable them to work in and further advance high technology industries.

- *Various tax impediments to competition exist.* Consider the broad realm of tax impediments to competition. This includes, complexity and its related compliance costs and costs of actions not taken due to tax uncertainty, lack of government commitment to R&D incentives, depreciation rates that serve revenue needs rather than business realities, double taxation of corporate income, hindrances to capital formation such as rules that prefer debt over equity, and income tax differences between U.S. rules and those of its major trading partners.

- *Start now.* Realize that the international aspects of tax reform are likely the most difficult ones and the above tasks should begin now.

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[42] For example, as noted in a 1991 Joint Committee on Taxation report, outbound investment may free up U.S. debt capital and labor for new investment opportunities in the U.S. JCS-6-91, *supra*, pg. 235.

STATEMENT ON THE IMPACT OF FUNDAMENTAL TAX REFORM ON THE INTERNATIONAL COMPETITIVENESS OF U.S. BUSINESS AND WORKERS

BY THE
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

JULY 18, 1996

Introduction

The National Association of Manufacturers wishes to express its great appreciation to the Committee's Chairman, Mr. Archer, for inviting us to present our views on the impact of fundamental tax reform to the international competitiveness of U.S. businesses and workers, including the effect of fundamental tax reform on imports and exports. NAM represents almost 14,000 member companies and subsidiaries.

As you know, the international tax area of our current income tax system includes a myriad of complexities. NAM has consistently supported various foreign tax simplification proposals that have been introduced in Congress over the last few years. A number of Congressmen and Senators, as well as officials of the Clinton Administration, have suggested that the current Internal Revenue Code ("Code") can be repaired, or at least improved to an acceptable level with some modifications (both major and minor). Others, like yourself Mr. Chairman, have argued that our current tax system must be pulled out by its roots and replaced with an entirely new system, such as one that taxes the consumption of goods and services.

Upon initial reflection, it appears that the leading tax proposals would greatly simplify the international area for most taxpayers. These proposals move away from the current system that taxes "worldwide" income, to approaches that are "territorial" in nature, meaning they exempt most types of foreign income (passive investment income being a major exception). These proposals would also promote the competitiveness of U.S. multinationals versus foreign based competitors by their exemption of foreign source dividends and branch income. This would help ensure that foreign subsidiaries of U.S. companies do not pay more tax on their corporate income than their foreign competitors do in foreign markets. These proposals are also uniform in reducing the tax rates for corporations, which again should help U.S. companies compete against their foreign competitors. The USA and flat tax proposals would be beneficial to manufacturers by providing for immediate expensing of capital investments.

However, it must be kept in mind that all of these proposals will require extensive efforts in the area of transition rules and will have a tremendous impact on businesses. Some experts advocate more of a "cold turkey" approach in which there will be a minimal transition period, while others advocate a more comprehensive and long-lasting approach. In any event, without special transition rules, the replacement of the income tax with a consumption tax would haphazardly subject many individuals and businesses to large tax penalties. In addition, without adequate transition relief, tax reform proposals could have a large and significant impact on the financial statements of many firms. Finally, business taxes under any new system should be compatible with the border adjustable systems of our trading partners so that, for example, American exports are not double taxed by the U.S. and the destination country.

Whether or not any of the tax reform proposals eventually become law, NAM believes that the current tax system as it impacts the international area has much room for improvement. Therefore, to assist you in deciding whether to retain the current tax system with modifications or to implement fundamental tax reform, we have provided a sampling below of the many inequities that currently exist in our tax system regarding the international area:

Provide Look-Through Rules for So-called "10/50 Companies"

Current law (resulting from changes provided by The 1986 Tax Reform Act ("TRA")) requires U.S. companies involved in foreign joint venture corporations (as opposed to foreign partnerships) to calculate separate foreign tax credit ("FTC") limitations for income earned from each such joint venture corporation in which U.S. owners own less than a majority interest (at least 10 percent but not more than 50 percent, i.e., so-called "10/50 Companies"). Thus, a U.S. corporation owning many 10/50 Companies must create a very large number of separate baskets. Not only does this result in substantial complexity and higher costs, it also results in a very detrimental tax situation versus controlling (i.e., more than 50 percent) owners of foreign joint ventures. That is because owners who receive dividends, interest, rents or royalties from controlled foreign corporations ("CFCs") can "look-through" such income to the nature or character of the payor corporation's underlying income, and include it in these general limitation basket categories instead of into separate limitation baskets.

U.S. owners of foreign joint ventures often are unable (through no fault of their own) to acquire controlling interests, especially in cases where the foreign joint venture partner is a foreign government or the activity involved is a government regulated industry. It is patently unfair to penalize such non-controlling joint venture owners. Instead, current law should be changed to equalize the treatment for both types of joint venture owners, by allowing look-through treatment for income (dividends, interest, rents, and royalties) earned from all foreign joint ventures owned at least 10 percent by U.S. owners.

On a related matter, current Treasury Regulations (§ 1.904-5(h)(1)) require that payments of interest, rents, and royalties from partnerships to partners not acting in that capacity must also treated as separate basket passive income unless U.S. partners own more than 50 percent of the partnership. Again, this result is not good tax policy. However, by extending look-through treatment to 10/50 companies as proposed above, this problem involving partnerships will be corrected.

Repeal Section 956A

Code Section 956A, implemented with the 1993 Tax Act, was intended to eliminate so-called "deferral" of U.S. income tax for U.S. shareholders of CFCs to the extent that the CFC's earnings are invested in excess passive assets rather than in active business assets. However, this section has instead had the effect of adding an additional layer of complexity to the already existing anti-deferral regime of the Code, while providing taxpayers an incentive to engage in costly, non-economical transactions in order to avoid its application. Contrary to earlier estimates, this provision has not created a positive impact on cash flows from foreign companies to U.S. parents, or resulted in more U.S. manufacturing jobs. Rather, it has created incentives for investing in assets outside the United States and should be repealed immediately.

Exclude CFCs from the PFIC Rules

The Subpart F rules of the Code currently provide exceptions to the general rule of so-called deferral for tax haven and foreign personal holding company ("FPHC") type income (i.e., passive income) from CFCs. The 1986 TRA added certain provisions called the Passive Foreign Investment Company ("PFIC") rules that effectively tax all income currently from foreign subsidiaries that have more than a designated amount of passive income or assets, even though the balance of the income is from active manufacturing operations. In other words, all income can be effectively tainted even though only a portion of it is from passive type activities that would have been currently taxed under Subpart F rules. Although the PFIC rules were intended to eliminate certain identified abuses relating to U.S. investors in overseas mutual funds, they were inadvertently drafted in a manner to also cover CFCs (even though CFCs were already sufficiently regulated by the Subpart F rules). To correct this error, the PFIC provisions should be amended so that companies subject to Subpart F (i.e., CFCs) are exempt from their application.

Amend Definition of PFICs

The PFIC provisions currently apply where 75 percent or more of a foreign corporation's gross income is passive, or where at least 50 percent of the foreign corporation's assets produce passive income. By using a gross income test, a foreign corporation will become a PFIC even though 99 percent of its gross receipts are from the active conduct of a trade or business, so long as its cost of goods sold exceeded its gross receipts that year and it had a dollar of passive income (like working capital interest income). This result is illogical. The PFIC provisions should be amended so that they only apply where the predominant character of the business is passive or the majority of assets is passive. This can be accomplished by changing the test to look to gross receipts rather than gross income, for example, by defining foreign corporations as PFICs if at least 75 percent of their gross receipts are passive.

Retain Current Sourcing Rules under Section 863(b)

Current law allows taxpayers who manufacture goods in the U.S. and sell the goods outside the U.S. to treat 50 percent of the income arising from the sale as foreign sourced income. The intent of this provision is to enhance the competitiveness of U.S. businesses in the global market place and generate additional jobs in the U.S. Proposals have been made in recent years to significantly curtail or eliminate this provision as a way to raise revenues for other programs. It is this sort of "rob Peter to pay Paul" approach, without regard to a coherent tax policy, that has brought us to the point where we are today.

Repeal the 90 Percent Limit on FTCs under the Alternative Minimum Tax ("AMT")

Current law limits the ability of taxpayers to offset their corporate AMT liability by allowing FTCs to offset only up to 90 percent of such AMT. This has the likely result of taxing certain U.S. multinationals more heavily on their foreign income than their foreign competitors, or domestic companies having no foreign operations. Repealing this limitation would merely permit foreign taxes actually paid to be offset up to the amount of AMT liability on foreign source income, without affecting any U.S. source tax liability. As a result, the likelihood of double and sometimes triple taxation of foreign source income would be lessened, making U.S. multinationals more competitive internationally.

Alternatively, taxpayers could be given an election to use as their AMT FTC limitation fraction the ratio of foreign source regular taxable income to entire AMT income. This would eliminate the need to separately calculate AMT foreign source taxable income.

Amend the AMT Cost Recovery Rules

The AMT is a significant factor in reducing the competitiveness of U.S. companies. Approximately one-half of AMT revenues are generated from manufacturing and resource-based industries. These industries are cyclical in nature and compete in markets where prices are determined by global competition. This increased tax burden cannot be passed on in the form of price increases since no other country in the world imposes such a draconian system of taxation. All of our major competitor countries provide better cost recovery for investments than does the U.S. under the AMT depreciation rules. At a minimum, the AMT cost recovery rules, regarding both depreciable lives and methods, should be conformed to those provided by the regular corporate income tax depreciation rules.

Extend FTC Carryforward and Carryback Periods

Currently, FTCs not used against U.S. tax in the current year may be carried back 2 years and carried forward 5 years. In contrast, the rules for net operating losses ("NOLs") provide a 3 year carryback and 15 year carryforward period. The shorter time periods have caused FTCs to expire unused, subjecting foreign source income to double taxation and frustrating the purpose of the credit. The current rules are especially harsh for taxpayers in cyclical industries which experience substantial operating losses. Thus, the FTC carryback and carryforward periods should be amended to conform with the time periods for NOLs, i.e., 3 year carryback period and 15 year carryforward period.

Amend Domestic Loss Recapture Rule

Currently, when a taxpayer has taxable income from U.S. sources but an overall loss from foreign sources, the foreign source loss reduces the U.S. source taxable income and U.S. tax liability by decreasing the taxpayer's worldwide taxable income on which the U.S. tax is based. When the taxpayer subsequently earns foreign source income, a potential double tax benefit (i.e., deduction for the loss but no payment of U.S. tax on subsequent foreign source income because of FTCs) is avoided under a rule requiring a recapturing of the prior tax benefit upon subsequently derived foreign source income. It does this by treating a portion of that foreign income as domestic source for FTC purposes (which reduces the allowable FTCs for the year). Current law also provides that an overall U.S. loss reduces a taxpayer's foreign source income. The U.S. loss reduces the taxpayer's U.S. tax liability and, through application of the loss against foreign income, the FTC limitation is correspondingly reduced. However, taxpayers are not allowed to recapture the prior U.S. loss by recharacterizing subsequent U.S. source income as foreign source. To prevent this inequity (and achieve tax symmetry), the law should be amended to recharacterize such subsequent domestic income as foreign source to the extent of the prior domestic loss, in order to recognize the FTC that was disallowed because of the domestic loss.

Increase Allocation of R & E to U.S. Source Expense

Taxpayers that perform research and experimentation ("R & E") in the U.S. but also generate foreign source income must allocate part of their U.S. incurred R & E against their foreign source income. The allocation ratio has changed several times over the last 20 years. For example, from 1987 through 1988, taxpayers were allowed to apply 50 percent of their U.S. incurred R & E costs against U.S. source income with the remaining allocated between U.S. and foreign source income based on gross sales or gross income; from 1989 through 1992, taxpayers could apply 64 percent of U.S. incurred R & E against U.S. source income with the remaining 36 percent allocated between U.S. and foreign; from 1993 forward, taxpayers again may only apply 50 percent of U.S. sourced R & D against U.S. source income, with the remainder allocated between U.S. and foreign source.

A permanent and more liberal solution to the R & E allocation is required. Research programs require long-term planning and foreign jurisdictions are not likely to recognize research expenses incurred in the U.S. as proper deductions for foreign local tax purposes (in fact, the net effect may encourage taxpayers to perform research outside the U.S. in order to secure full local tax deductions). Therefore, the law should be amended to permanently provide that 64 percent of U.S. incurred R & E is to be allocated against U.S. source income, with the remainder allocated based on gross sales or gross income.

Make Permanent the R & E Credit

Innovation is the key to the international competitiveness of U.S. companies, and tax policies encouraging investment in research such as the R&E tax credit are important elements to encourage such innovation. This is particularly the case because most of the trading partners of the U.S. companies provide various forms of R&D incentives in their country. It is also very important that these tax policies are stable, reflecting the long term nature of the research process. Thus, we strongly recommend that Congress make permanent the R&E tax credit.

Modify Rules for Allocating Interest to Foreign Source Income

Taxpayers are required to allocate domestic interest expense to both foreign and domestic business activities. This is based on the theory that money is fungible and there is flexibility in obtaining and utilizing funds. However, interest expense incurred by foreign affiliates is not taken into consideration in allocating interest expense to foreign source income. To ignore foreign affiliate interest expense is inequitable and places U.S. multinational companies at a competitive disadvantage. In this regard, interest expense incurred by a U.S. subsidiary of a foreign company is allocable entirely to U.S.-source income (assuming the subsidiary's operations are conducted only in the U.S.); however, a U.S.-based multinational company that is a direct competitor in the U.S. market must allocate a portion of its interest expense to foreign-source income to the extent it has foreign assets or shareholdings. Thus, the U.S. income of the U.S. based company is overstated and overtaxed compared to the foreign-owned U.S. subsidiary. To correct this problem, the interest expense of all controlled companies (more than 50% owned) within an affiliated group, including foreign corporations, should be factored into the allocation. This would allow interest expense incurred by foreign affiliates to reduce the interest expense of the group that would otherwise be allocated to foreign-source income.

Use E & P Depreciation for Asset Bases when Allocating Expenses

Taxpayers may elect to allocate interest between foreign and U.S. sourced income on the basis of tax book value. Since U.S.-sited assets typically reflect accelerated depreciation while foreign-sited assets utilize slower depreciation methods, U.S.-sited assets will typically have lower tax bases than similarly placed in service foreign-sited assets. This results in a disproportionately higher amount of interest being allocated against foreign-sourced income. To correct this problem, the law should be amended for purposes of allocating expenses to permit taxpayers to determine basis for both U.S. and foreign-sited assets by using the same depreciable methods and lives as used for E & P purposes.

Exempt Foreign Entities from the Uniform Capitalization Rules

The uniform capitalization rules ("UNICAP") under Code Section 263A require certain costs to be capitalized to inventory and certain interest to be capitalized as a production cost. Although the legislative history to this section does not compel its application to foreign corporations not doing business in the U.S., the Treasury Regulations specifically apply such rules to foreign corporations with U.S. shareholders. However, U.S. multinationals already incur significant costs at both the head office and affiliate level to bring foreign E & P into conformity with U.S. tax principles for purposes of computing FTCs. Requiring the determination of UNICAP adjustments to such earnings merely adds additional compliance costs that are not borne by foreign based multinationals. Since UNICAP really has no relevance to foreign corporations not conducting business in the U.S., and since the revenue generated by applying these rules to foreign entities is small in relation to the administrative burden they cause. Code Section 263A should be amended to exempt foreign entities not doing business in the U.S.

Additional Provisions

This is by no means an exhaustive list of all the problems currently existing in the international area of the U.S. income tax system. Both Congressmen Amo Houghton and Sander Levin, through H.R. 1690, and Senator Larry Pressler, in his recently introduced International Tax Simplification for American Competitiveness Act of 1996, have proposed many additional provisions that would help to eliminate some of the complexities which plague the foreign tax area. Some of those provisions would:

- Allow shareholders of PFICs to make mark-to-market elections, provided that the PFIC stock is traded on a national securities exchange or otherwise treated as "marketable" under Treasury Regulations.
- Clarify the definition of passive income for PFICs, so that the same-country exceptions from the definition of FPHC income under Code Section 945(d) do not apply in determining passive income for purposes of the PFIC definition, and make it clear that passive income does not include Foreign Sales Corporation ("FSC") income.
- Allow intangible assets for PFIC purposes to be valued at fair market value (if value can be readily obtained).

Treaty Issues

The impact of tax reform on our existing tax treaty network must not be overlooked. Of course, the most recognized function of tax treaties and the principal reason they are negotiated is to eliminate double taxation of the same income, which occurs when two jurisdictions attempt to tax the same income or assets due to overlapping exercise of authority. However, most of the tax systems being proposed to replace the current U.S. income tax would be territorial in nature and exclude foreign source income from taxation (e.g., a "flat" tax or a "goods and services" tax). Thus, the issue of double taxation would be reduced considerably under such regimes. Nevertheless, many other benefits resulting from our tax treaty network would be jeopardized no matter what alternative tax system is chosen to replace the current one.

For example, one significant benefit of tax treaties is to facilitate business transactions between countries that might otherwise be inhibited by overly intrusive national taxation. Beyond the actual tax cost, the mere exposure to another country's tax system may impose significant transactional complexities on a company venturing outside its own national borders, e.g., protracted dealings with various tax authorities. To alleviate some of these problems, treaties include a notion of "permanent establishment" ("PE") as a threshold to taxation. Under this concept, the business profits of an enterprise of one country will not be deemed to be subject to taxation by the other country unless it does business there through such a PE, i.e., unless there is a sufficient connection between the enterprise and the taxing country in terms of having a fixed place of business there, dependent agents, etc. Moreover, most of the recent treaties negotiated by the U.S. have limited the imposition of tax to the business profits attributable to the PE, as opposed to items unrelated to the PE itself (such as passive investment income and capital gains). In addition, tax treaties sometimes exempt residents of one country who visit the other for a limited period of time. This eliminates the need to prorate small amounts of income and file foreign tax returns (often more irritating than paying taxes), and encourages interaction of visitors between countries.

The tax systems of most countries impose withholding taxes (at often high rates) on payments to foreigners of items such as dividends, interest, rents, and royalties. Lowering of these withholding taxes is another important function of tax treaties. If U.S. companies operating abroad cannot receive reduced withholding tax rates offered by tax treaties, they often suffer excessive levels of foreign tax. This puts such U.S. companies at a competitive disadvantage relative to companies headquartered in other countries that do provide such treaty benefits. Thus, it is clear that tax treaties measurably reduce the barriers to U.S. participation in international commerce.

Almost all treaties forbid discrimination against the nationals of a treaty partner. One general effect of this is to prohibit U.S. tax on residents of treaty countries that is more burdensome than the tax imposed on similarly situated U.S. persons. Likewise, U.S. persons operating in treaty countries would also be protected under such a non-discrimination type clause. A nondiscrimination clause would generally permit differences in the treatment of domestic and foreign taxpayers only if justified by significant differences in the circumstances of those taxpayers.

Another function of tax treaties is to ensure that equity is served and tax is imposed at least once, i.e., by targeting tax avoidance schemes such as the use of tax havens. Most U.S. tax treaties contain explicit provisions called "anti-treaty shopping". These provisions identify the group of taxpayers entitled to benefit from the treaty relief while, at the same time, also preventing other taxpayers (generally from countries not party to the treaty) from enjoying such treaty benefits. To help support enforcement, income tax treaties generally provide for exchanges of information between the tax authorities of the treaty countries. In addition, most provide a mechanism known as "competent authority", which permits a taxpayer of one country to seek the assistance of that country's tax authorities for support against adverse interpretations of the treaty by the other country's taxing authorities. Even if the U.S. moves to a territorial system of taxation, such needs may not be muted since our treaty partners may still require such information exchanges.

Conclusion

We thank you for this opportunity to provide our comments and trust that this has given you a better understanding of the many problems that currently exist in the tax law as it applies to the international area. We sincerely hope that this will help you in your decision whether to revise the current system or move toward a completely new tax framework.

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.
PRESENTED TO THE
HOUSE WAYS AND MEANS COMMITTEE
BY FRED F. MURRAY, VICE PRESIDENT FOR TAX POLICY
JULY 18, 1996

ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS
OF REPLACING THE FEDERAL INCOME TAX

Mr. Chairman, and Members of the Committee:

The National Foreign Trade Council, Inc. (the "NFTC" or the "Council") is pleased to present its views on the impact on international competitiveness of replacing the federal income tax.

The NFTC is an association of businesses with some 550 members, founded in 1914 under the auspices and support of President Woodrow Wilson and 341 business leaders from across the U.S. Its membership now consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies and most of the 50 largest U.S. banks are Council members. Council members account for at least 70% of all U.S. non-agricultural exports and 70% of U.S. private foreign investment. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad.

The founding of the Council was in recognition of the growing importance of foreign trade to the health of the national economy. Since that time, expanding U.S. foreign trade and incorporating the United States into an increasingly integrated world economy has become an even more vital concern of our nation's leaders. The value of U.S. international trade (imports plus exports) as a percentage of GDP has more than doubled in recent decades: from 7 percent in the 1960's to 17 percent in the 1990's. The share of U.S. corporate earnings attributable to foreign operations among many of our largest corporations now exceeds 50 percent of their total earnings. Direct foreign investment by U.S. companies in foreign jurisdictions continues to exceed foreign direct investment in the United States (in spite of the net debtor status of the U.S.) by some $180 billion in 1994. In 1995, U.S. exports of goods and services totaled $805 billion -- 11.1 percent of GDP.[1] In 1993, 58 percent of the $465 billion of merchandise exports from the U.S. were associated with U.S. multinational corporations: $110 billion of the exports went to foreign affiliates of the U.S. companies, and another $139 billion of the exports were shipped directly to unrelated foreign buyers.[2]

Given the importance of the international economy to the United States, the Council would like to compliment the Committee on giving international issues a prominent place in this series of hearings. The NFTC would like to make its points in four principal areas of concern: (1) observations concerning the existing system of income taxation, and some suggestions concerning possible reform of the existing system, if that course of action is ultimately chosen by the Committee after careful study of the alternatives; (2) observations concerning the requisites for any new system that replaces the existing income tax system as the primary tax system of the federal government of the United States; (3) observations concerning the transition from one system to another; and (4), very importantly, observations concerning the membership of the United States in the international community of nations and the importance of maintaining its tax and trade agreements and relationships in that community.

Existing Law

United States policy in regard to trade matters has been broadly expansionist for many years, but its tax policy has not followed suit. The provisions of Subchapter N of the Internal Revenue Code of 1986 (Title 26 of the United States Code is hereafter referred to as the "Code") impose rules on the operations of American business operating in the international context that are much different in important respects than those imposed by many nations upon their companies. Some of these differences may make American business interests less competitive in foreign markets when compared to those from our most significant trading partners:[3]

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[1]U.S. Department of Commerce, "Survey of Current Business," April 1996.

[2]U.S. Department of Commerce, "U.S. Multinational Companies: Operations in 1993," June 1995, at 39.

[3]See, Financial Executives Research Foundation, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues*, 1996, Ch. 9.

- The United States taxes worldwide income of its citizens and corporations who do business and derive income outside the territorial limits of the United States. Although other important trading countries also tax the worldwide income of their nationals and companies doing business outside their territories, such systems generally are less complex and subject to more significant limitations under their tax statutes or treaties than their U.S. counterparts.

- The United States has more complex rules for the limitation of "deferral" (although the United States taxes the worldwide income of its companies, it permits deferral of the tax on unrepatriated foreign earnings of controlled foreign corporations, except where one of six complex series of "anti-deferral" provisions of the Code apply) than any other major industrialized country. In addition, the anti-deferral provisions of most countries do not tax active business foreign income of their companies, while those of the U.S. impose current U.S. tax on several types of active business foreign income as well as on passive foreign income.

- The current U.S. Alternative Minimum Tax (AMT) system imposes numerous rules on U.S. taxpayers that seriously impede the competitiveness of U.S. based companies. For example, the U.S. AMT provides a cost recovery system that is inferior to that enjoyed by companies investing in our major competitor countries; additionally, the current AMT 90-percent limitation on foreign tax credit utilization imposes an unfair double tax on profits earned by U.S. multinational companies -- in some cases resulting in a U.S. tax on income that has been taxed in a foreign jurisdiction at a higher rate than the U.S. tax.

- The United States has more complex rules for the determination of U.S. and foreign source net income than any other major industrialized country. In particular, this is true with respect to the detailed rules for the allocation and apportionment of deductions and expenses. In some cases, these rules are in conflict with those of other countries, and where this conflict occurs, there is significant risk of double taxation.

- The U.S. foreign tax credit system is very complex, particularly in the computation of limitations under the provisions of section 904 of the Code. These provisions require the segregation of various types of income into "baskets," and then require the application of complex separately-computed limitations to these baskets. While the theoretic purity of the computations may be debatable, the significant administrative costs of applying and enforcing the rules by taxpayers and the government is not. Systems imposed by other countries are in all cases less complex. United States policies in regard to the credit make U.S. business interests less competitive in other respects as well (e.g., see the discussion below of "tax sparing" adopted by other countries).

As merely noted above, the United States system for the taxation of the foreign business of its citizens and companies is more complex than that of any of our trading partners, and perhaps more complex than that of any other country. While that result derived from good intentions, today's global marketplace places pressures on U.S. business that were not present when our system was contrived, even during the significant changes in the 1960's when American business interests were still clearly predominant in many foreign markets.

The United States has long believed in the rule of law and the self-assessment of taxes, and some of the complexity of its income tax results from efforts to more clearly define the law in order for its citizens and companies to apply it. Other countries may rely to a greater degree on government assessment and negotiation between taxpayer and government -- traits which may lead to more government intervention in the affairs of its citizens, less even and fair application of the law among all affected citizens and companies, and less certainty and predictability of results in a given transaction. In some other cases, the complexity of the U.S. system is simply ahead of development along similar lines in other countries -- many other countries have adopted an income tax similar to that of the United States, and a number of these systems have eventually adopted one or more of the significant features of the U.S. system of taxing transnational transactions: taxation of foreign income, anti-deferral regimes, foreign tax credits, and so on. However, while difficult to predict the ultimate evolution, none of these other country systems seems prone to the same level of complexity that affects the United States system, and U.S. businesses can no longer afford the burdens of the current U.S. tax system as it applies to foreign operations.

Further, in a system that has required very significant compliance costs of both taxpayers and the Internal Revenue Service, the costs of compliance burdens associated with the international provisions of the Code are disproportionately higher relative to U.S. taxation of domestic income and to the taxation of foreign income by other countries. For example, a recent survey found that nearly 40 percent of total federal tax compliance costs were attributable to foreign-source income. The disparity may be significant given the findings that only 21.1 percent of assets, 24.1 percent of sales, and 17.7 percent of employment were related to the same income.[4]

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[4]See Marsha Blumenthal and Joel B. Slemrod, "The Compliance Cost of Taxing Foreign-Source (continued...)

Many foreign companies do not appear to face the same level of costs in their operations. The European Community Ruding Committee survey of 965 European firms found no evidence that compliance costs were higher for foreign source income than for domestic source income.[5] Lower compliance costs and simpler systems that often produce a more favorable result in a given situation are competitive advantages afforded these foreign firms relative to their American counterparts.

Short of fundamental reform -- a reform in which the United States federal income tax system is eliminated in favor of a consumption-based tax system or some other sort of system -- there are many aspects of the current system that could be reformed and improved. These reforms could also lower the cost of capital, the cost of administration, and therefore the cost of doing business for American firms.

For example, the NFTC applauds the work of Mr. Houghton (R-NY) and Mr. Levin (D-MI) of this Committee to construct a vehicle for the further consideration and ultimate passage of a number of these potential reforms: The International Tax Simplification and Reform Act of 1995, H.R. 1690 (104th Cong., 1st Sess.) A similar bill is currently being prepared in the Senate. These bills would address serious problems: the overlap between the anti-deferral regimes of the passive foreign investment company ("PFIC") rules and the rules relating to controlled foreign corporations ("CFC"); other reforms of the PFIC rules; other reforms to the CFC rules; extension of the indirect foreign tax credit of section 902 of the Code to lower tier subsidiaries; reforms related to the computation of the foreign tax credit and translation of amounts of foreign taxes, simplified foreign tax credit computations in calculation of the AMT; elimination of the section 1491 excise tax and reforms in the corresponding regimes of section 367; exemption of additional active business income from the anti-deferral rules to level the field for other business interests not now permitted deferral; extension of the carryback and carryforward periods for utilization of unused foreign tax credits, simplification of the rules applicable to joint ventures conducted through so-called "10 / 50" companies; recognition of the European Union as a single country for purposes of the anti-deferral rules, creating symmetry between previous rules designed to recapture overall foreign losses and new proposed rules applicable to overall domestic losses; and various other provisions to reduce reporting thresholds, simplify computations and calculations, expand *de minimis* rules, and reduce the amount of information required to be accumulated, processed, and stored.

Other more major, more general reforms have in the past been suggested and studied elsewhere. For example, one of those often cited and credited with potential benefits to the current income tax system is the concept of integration of the corporate and individual income tax systems of the United States. This concept was the subject of a 1992 U.S. Treasury study and also of a study under the auspices of the American Law Institute ("ALI").[6] Integration of the individual and corporate income taxes refers to various means of eliminating the separate, additional burden of the corporate income tax, in favor of a system in which investor and corporate taxes are interrelated so as to produce a more uniform levy on capital income. This conceptual model (or series of models), in addition to addressing possibly undesirable effects of the current system on corporate financial practices (relating to the differences between debt and equity financing), may also be important because most of the other developed countries have in recent decades adopted various forms of integration. As the American economy itself becomes more "integrated" into the world economy, and therefore becomes more inseparable from other national economies, it becomes more important to understand the potential advantages and disadvantages of this concept, and other types of concepts or features of foreign tax systems, for the United States and for U.S. business.

In fact, a recurring theme of this testimony is the importance of considering the United States as a member of the world community of nations, and the importance to United States business interests of providing harmony between the tax system of the United States and that of other nations where United States companies must conduct their business. The same is true as well for foreign investors who invest capital in the United States. Major dislocations may ensue in the wake of major reforms that fail to address this important, though sometimes forgotten, point.

Like the concept of integration, another possible major reform (though less sweeping than repealing the income tax) is the possible conversion of the U.S. worldwide system of taxation into one based upon "territorial" principles. In contrast to the worldwide system, which generally defers tax on earnings until

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[4](...continued)
Income: Its Magnitude, Determinants, and Policy Implications," in *National Tax Policy in an International Economy: Summary of Conference Papers*, (International Tax Policy Forum: Washington, D.C., 1994).

[5]*Id.*

[6]The ALI integration proposals would convert the separate U.S. corporate income tax into a withholding tax with respect to income ultimately distributed to shareholders. See, Alvin C. Warren, Jr., Reporter, *The American Law Institute, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration*, The American Law Institute (1993).

they are repatriated, the territorial system generally exempts foreign earnings -- usually active business income of the multinational corporation. The net effect is that a multinational would pay tax on business income only in the jurisdiction where that business income is earned. The desired treatment may be provided by statute or by treaty. A territorial system is to an extent used in more than a dozen industrialized countries, including the Netherlands, France, Germany, and Canada and most of Latin America. (Certain aspects of the U.S. system are currently territorial: the exclusion under section 911 of the Code for foreign earned income of expatriate employees is a territorial feature.)

Use of a territorial system to exempt foreign source income may ensure that U.S. businesses do not pay more in taxes on their foreign income in a particular market than their foreign competitors. But, such a system is not necessarily simple: passive investment income might still be taxed. That result would require maintenance of look-through and anti-deferral rules, and would also necessitate a foreign tax credit mechanism. Further, a territorial system places unique stresses upon income and expense sourcing rules, particularly where active business income is differentiated from passive investment income. Transfer pricing rules would also be at least as important as they are today.

Another widely-adopted practice in world commerce is that of "tax sparing." The practice arises most commonly in the context of developing countries who offer various types of tax incentives or tax holidays to induce foreign companies to make significant investments in the local economy. The concept is that a developed country, for example, may nevertheless allow a foreign tax credit for the taxes foregone by the developing country (as compared to those that would have been paid to the developing country but for the incentive or holiday). The result is a financial gain to the foreign company, and perhaps also to the developing country. Despite its interest in fostering economic growth in the developing countries, the United States has uniquely long opposed adoption of rules permitting this practice in its internal statutes and income tax treaties. Other developed countries have chosen the opposite policy -- and many developing countries have therefore continued to press for this treatment. For example, Japan significantly strengthens the competitive position of its companies in world markets outside Japan by its acceptance of tax sparing. As a result, American companies suffer a competitive disadvantage in world markets, and suffer further harm because tax treaty negotiations with these countries often fail over this provision -- a completed treaty would benefit both nations and taxpayers in many other ways as well. While the NFTC does not now encourage a change of policy on this important issue, the Council does believe it is time to carefully reconsider U.S. policy, a policy that was last debated when American interests dominated many world markets. It is well to remember the anti-competitive effects of it -- and the resulting costs to American business interests.

Before leaving these observations on the current system, it would also seem appropriate to be reminded of several important provisions of current law that serve to foster exports and the growth and prosperity of American economic interests abroad.

The leading proposals currently being considered by the Committee could have a significant impact on the economics of the development and use of technology. For example, in all three of the proposals for the USA Tax[7], the Flat Tax[8], and the National Retail Sales Tax[9], there is a significant break from the current law treatment of R&D expenditures performed in the United States. None of these three proposals would retain the R&D tax credit of section 41, and none of them would provide other direct incentives for performing R&D activities in the United States. Research and development activity is a significant component in the production of both tangible and intangible capital. The leading position of many U.S. companies in their respective industries is often a function of U.S.-based research. In fact, the ability of a U.S. corporation to conduct business outside the United States is often tied to its ability to utilize intangible assets developed by the U.S. parent. Also, in many cases, U.S. companies may directly license the right to use intangibles to their foreign customers. Whether or not these activities are competitive may often relate to the taxation of the various transactions -- the incentives to undertake the R&D in the United States in the first place and the treaty-based reductions in withholding tax rates applicable to remittance of foreign sourced royalties. As stated in the report of the National Commission on Economic Growth and Tax Reform ("Kemp Commission"), in designing a new tax system:

> "[a]ttention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States."[10]

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[7]The Unlimited Savings Allowance (USA) Tax (S. 722), as proposed by Senator Nunn (D-GA) and Senator Domenici (R-NM).

[8]H.R. 2060, as proposed by Mr. Armey (R-TEX).

[9]H.R. 3039, as proposed by Mr. Schaefer (R-CO) and Mr. Tauzin (R-LA).

[10]*Report of the National Commission on Economic Growth and Tax Reform*, Washington, D.C. (1995), at 18.

Any new tax system should contain provisions which assure that the after-tax return on R&D performed in the U.S. is not undermined. For example, if a territorial tax system were to be adopted that is coupled with a repeal of the foreign tax credit, the tax reform system should contain a destination-based approach to the taxation of intangibles that would exempt foreign royalties and license fees from the U.S. tax.

For many years, regulations issued by the U.S. Treasury under section 863(b) of the Code have allowed goods that are manufactured in the U.S. and sold abroad to generate a combination of manufacturing and sales income to the same taxpayer. Such taxpayers are permitted to apply an apportionment formula, which generally treats half of the combined income as manufacturing income attributable to U.S. sources and the other half as sales income attributable to foreign sources. The amount of foreign source income generated for export transactions is crucial because foreign source income is eligible for the foreign tax credit. The source rule operates as a significant incentive for U.S. multinationals that are considering new investment -- savings attributable to the rule are often considered in the cost analysis when making a decision to locate new manufacturing facilities in the United States.

The Foreign Sales Corporation ("FSC") provisions of sections 921 through 927 of the Code are one of the most important U.S. tax incentives for exports from the United States. These provisions were adopted to offset disadvantages to U.S. exporters in relation to more favorable tax schemes allowed their foreign competitors in the tax systems of our trading partners. These provisions encourage the development and manufacture of products in the United States and their export to foreign markets.

As noted above, these incentives are important to U.S. taxpayers and to the domestic U.S. economy, and any replacement system must effectively address the same concerns.

Looking Forward Into A New System

In addition to the USA Tax, the Flat Tax, and the National Retail Sales Tax proposals noted above, other significant reform proposals have been "informally" before the Committee, or have been articulated elsewhere. In particular, much attention has been given to the invoice-method and subtraction-method Value Added Tax ("VAT").[11]

All of the major proposals currently before the Committee would completely eliminate the present federal income tax and would replace that system with a new consumption-based tax system. The first three proposals would tax only U.S. operations, and apparently would repeal most U.S. withholding taxes on income paid to foreign investors. U.S. businesses operating abroad would not be taxed on their foreign source income, and dividends paid by foreign subsidiaries to their U.S. parent companies would not be subject to U.S. tax. The foreign tax credit rules would presumably no longer be necessary under such a regime, nor would the anti-deferral rules of subpart F of the Code.

Each of the proposals would therefore address aspects of the current system noted above that cause serious cost and administrative concerns to American businesses operating abroad. But, in spite of the fact that major simplifications would occur relative to certain aspects of the present system, other complexities may be created or maintained. Under some of the systems, the tax cost of certain operations is actually increased in the new system. And, as with any major reform there will be dislocations -- there will be "winners" and "losers." Serious examination of the proposals will be required.

The proposals noted here differ in the way in which they treat export and import operations. They are either "destination-based" or "origin-based" in their approach. Under the destination principle, imports are generally taxed and exports are exempt. The consumption of goods and services within the United States is taxed under a destination-based approach. By contrast, under the origin principle, exports are generally taxed and imports are not. An origin-based tax would include within its base domestic consumption plus net exports. For example, the USA Tax and the National Retail Sales Tax are both destination-based taxes, and the Flat Tax is an origin-based tax.

Economists do not generally believe that destination-based taxes offer a long-term incentive to exports.[12]

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[11]Mr. Gibbons (D-FL), former Chairman and now Ranking Minority Member of the Committee, has proposed a subtraction-method VAT.

[12]See, Harry Grubert and T. Scott Newlon, "The International Implications of Consumption Tax Proposals," 48 *National Tax Journal* No. 4, December 1995, at 619; and Reuven Avi-Yonah, "Comment on Grubert and Newlon," 49 *National Tax Journal* No. 2, June 1996, at 259, 262; Gene Grossman, "Border Tax Adjustments: Do They Distort Trade?" 10 *Journal of International Economics*, February 1980, at 117-128; Martin Feldstein and Paul Krugman, "International Effects of Value-Added Taxation," *Taxation in the Global Economy*, ed. by Assaf Razin and Joel Slemrod, Chicago: University of Chicago Press, 1990, 263-278.

(continued...)

On the other hand, it may be easier ultimately to harmonize destination-based taxes (e.g., a VAT) than those that are origin-based (e.g., the Flat Tax or the income tax). That would appear to be the experience of the European Union in its efforts to date. (Of course, the Ruding Commission is not faced with an "either/ or" choice in its efforts.)

The NFTC has not yet adopted a position on the respective proposals now before the Committee. Even the more well developed proposals still require much study and further development. As the Committee moves forward in its deliberations, however, the Council would enjoy the opportunity to provide additional information to the Committee.

Transition Into A New System

Much of the public discussion that has to date surrounded the current effort to examine a total restructuring of the United States tax system has adopted an assumption of total repeal of the existing income tax -- a total repeal that some have advocated with no provision for transition from the old system to the new. The old system would simply "die" on one day, and the new replacement system would simply be started and be fully operational on the next. These assumptions are apparently based upon political concerns, and upon the further assumption that if any vestige of the current system were allowed to continue after the beginning of the new system, the unwanted old system would survive and continue in a parallel track. Despite the possible merits of the political and practical concerns that form the basis of these assumptions, there are countervailing considerations that cannot responsibly be ignored.

First, it is important to attempt to grasp the magnitude of the contemplated changes. It is not realistic to assume that the real impacts of the system can be forecasted with a high level of certainty of result. Unlike previous reforms of the income tax system[13], which only changed portions of the income tax system, the proposed changes would entirely replace the system with a new one. Some of the replacement systems are theoretic models and as yet untried. Although not free from controversy, it is at least plausibly argued that previous "major" reform efforts have produced significant and undesirable results in addition to the desirable results that drove the efforts. For example, the effects of the Tax Reform Act of 1986 on the real estate industry may have worsened the savings and loan debacle of the 1980's. It seems reasonable to assume that the effects of changes of this magnitude will have far more significant effects than those experienced before, many of which may be unanticipated in nature much less degree.

One of the concerns raised by any new system is the uncertainty caused by unanticipated issues. The present system has resulted in much litigation -- hundreds of thousands of court cases over eighty-three years of the life of the current system. It is important to note that a system of statutes which covers thousands of paragraphs of statutory language has still left so much open to argument over interpretation and application. A new system, even a simpler one, would still engender much of this same activity until, like the present system, guidance and interpretations needed by the government and the taxpayers were worked out in regulations, in the courts and in the Congress. Nevertheless, a new simpler system should attempt to lessen the amount of interpretive activity that will inevitably ensue -- and should be constructed in a way that makes resort to the regulations, the courts, and the Congress so important in the present system.

A principal issue that requires much of this interpretative activity is the definition of the base of the tax. Examples in the current income tax system that have produced much controversy are the definition of a capital gain or loss, and the classification of an individual as an employee or an independent contractor. And, among the many subissues that may arise in the context of defining the tax base, a most important area of controversy in the international context is the sourcing rules. These rules, defining the origin and destination of goods and services and other principles necessary to apply any of the proposals presently before the Committee, will be stressed by both the government and the taxpayers in their respective compliance efforts. Just as the present system has taken many years to settle, time will be required to resolve these matters in any new system.

As noted above, perhaps the most important aspects of transition will concern changes in economic behavior and vested interests of taxpayers. American companies currently have many hundreds of

[12](...continued)

Of course, as another famous economist pointed out, "[i]n the long term, we are all dead." The short-term consequences of shifting to a border-adjustable tax may be significant.

[13]Until the 1939 Code was effective, Congress enacted an annual revenue bill, but major principles of the law remained remarkably consistent. The first major codification and revision of the law came with the 1939 Code. A second major recodification and reform of the law came with the 1954 Code. Since the 1954 Code, Congress has enacted 32 bills making changes in primary sections of the Code, perhaps the most significant of which was the Tax Reform Act of 1986.

billions of dollars of prepaid tax assets and deferred tax liabilities on their balance sheets. Many of these companies have hundreds of millions of dollars of foreign tax credit carryovers, net operating loss carryovers, and other tax attributes that have considerable financial value. While the stated goal of a change to a consumption-based tax is to increase personal savings and investment in the United States, the short-term effects of transition will be important -- not only in terms of existing tax attributes and stock values, but also in terms of changes in markets, product lines, and consumption patterns.

Before leaving a brief consideration of the process of transition to a new system, it would also be appropriate to consider another important aspect of the process. While much of the change has been well-intentioned, change in the tax law has become an important part of daily political life. Such changes are often part of the political agendas of both of the major political parties in the United States. As the second half of this century has progressed, the process of change to the tax system of the United States has accelerated. In the 40 years since the Internal Revenue Code of 1954 was enacted, there have been more than 30 significant federal tax enactments. This amounts to substantial amendment of the system on the average of every 1.3 years.[14] In an economic environment where manufacturing plants and market penetration may require many years and hundreds of millions of dollars of capital investment, it is becoming more and more difficult to make the economic projections that planners need to make these significant decisions. Instability in the tax laws of the United States (and other nations as well) creates economic uncertainty among taxpayers, and in turn generates economic costs of lost opportunities and higher transaction costs. Uncertainty in existing law (or about pending legislation) interrupts, distorts, or stifles economic activity, adds to complexity, and forces private industry to expend additional resources on tax research and planning, compliance, and litigation. It has been estimated, for example, that uncertainty with regard to the federal taxation of wage and investment income costs the U.S. economy 0.4 percent of national income per year, and that the cost, in these terms, of taxpayer uncertainty that accompanied the tax changes embodied in the Revenue Reconciliation Act of 1993 alone cost the U.S. economy an estimated $20.5 billion.[15] Any further changes in our present tax system should have stability as a fundamental objective.

Effects on the International Agreements of the United States

The United States is an important member of the international community of nations. As important as the effects of transition from the income tax to some other form of tax system may be to U.S. taxpayers, the construction of such a system and the transition to it will have important impacts upon the relations of the United States with its trading partners and other members of the international community.

In the years since the United States adopted its income tax, many other countries have adopted an income tax, and a number of these systems tax corporate income of resident companies on a world-wide basis.[16] As the income tax is not the only tax levied by the United States government, so it is that many of these other countries also have other taxes as part of their national tax systems, and have adopted various forms of consumption taxes, principal among these being the Value Added Tax.[17] As the world economy approaches greater and greater integration, trading blocs have been formed. Two significant examples of these are the European Union and the North American Free Trade Agreement. Efforts to integrate have in turn put pressure on national governments to fit their national policies within negotiated norms; and, in the European Union, for example, great effort has been and is being made to reach a "harmonization" of tax regimes including a balancing of impacts of income and consumption based taxes in and among the member nations.[18] A shift of this magnitude in a country as important as the United States will produce ramifications in other nations, and may produce significant dislocations unless the transition is carefully planned and implemented.

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[14]See Arthur P. Hall, "The Cost of Unstable Tax Laws," *Tax Notes* (November 7, 1994), at 759.

[15]*Id.*, at 760.

[16]See, e.g., *Corporate Taxes: A Worldwide Summary*, Price Waterhouse (1995).

[17]*Id.*

[18]The focus of this hearing is that of international effects of the shift to an alternative primary tax system in the United States. It bears noting, however, that significant levels of consumption and other taxes are also imposed in the United States -- by the individual States themselves. Moving the federal government to a tax system primarily focused on a consumption based tax and away from an income tax may also produce dislocations in State government revenues, and generate some of the same concerns that exist in and with major trading blocs like the European Union.

See, e.g., Holtz-Eakin, "Consumption-Based Tax Reform and the State-Local Sector," Draft (1/14/96), The American Tax Policy Institute.

A more direct impact upon both the taxpayers of the United States and the relations of the United States with its trading partners and other members of the international community would be the impact of such reforms on the treaty obligations of the United States.

An initial concern of several of the proposals would be the permissibility of border tax adjustments of a consumption-based tax under the General Agreement on Tariffs and Trade ("GATT").[19]

The United States has in force some forty-eight[20] Conventions for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income ("income tax treaties") with various jurisdictions, not including other agreements affecting income taxes and tax administration (*e.g.*, Exchange of Tax Information Agreements or Treaties of Friendship and Navigation that may include provisions that deal with tax matters). It has taken more than sixty years to negotiate, sign, and approve the treaties that form the current network.[21] A number of new agreements are being negotiated by the Treasury Department.[22] Nevertheless, the U.S. treaty network has never been as extensive as the treaty networks of our principal competitors. The U.S. treaty network covers only about 22 percent of the developing world, compared to coverage of 40 to 46 percent by the networks of Japan and leading European nations. This discrepancy has persisted for many years, even though the United States relies on the developing world to buy a far larger share of its exports than does Europe.

The typical income tax treaty provides for the elimination or at least mitigation of double taxation in a number of ways: modification or at least clarification of sourcing rules, rules affecting computation of foreign tax credits, specification of certain taxes that are or are not considered to be income taxes for the purposes of the foreign tax credit, rules allocating income to permanent establishments or establishing transfer prices, rules establishing the competent authority mechanism, and other rules in which jurisdiction to tax is relinquished. The most important form of this last relinquishment is the reciprocal reduction of withholding taxes imposed by the respective contracting states on dividends, interest, royalties, and certain other types of cross-border flows. The treaties also provide a number of "administrative" mechanisms for resolution of disputes as to state of residence, exchange of tax information between tax authorities of the two contracting states, nondiscrimination against nationals or other parties of one contracting state by the other contracting state, and the like.

The principal function of an income tax treaty is to facilitate international trade, investment, and commerce by removing or preventing tax barriers to the free flow or exchange of goods and services and the free movement of capital and persons. In making such an agreement, a contracting state acts in two capacities.

First, as a country of residence, the contracting state imposes tax on the income derived by resident individuals and legal entities (and, in countries like the United States that tax their citizens on a world-wide basis, its non-resident citizens and those legal entities organized under its laws or otherwise subject to its jurisdiction). In this capacity, the contracting state seeks to minimize the source-based taxes imposed on these taxpayers by the other contracting state, its treaty partner. If, like the United States, its system of world-wide taxation is relieved by a foreign tax credit mechanism, it will have a revenue interest in this outcome, but even in other circumstances, it will have an interest in the reduction of source-based taxes as a means of assuring fair treatment of its taxpayers and promoting their foreign trade and commerce.

Second, as a country of source, the contracting state imposes a tax on income derived by individuals and entities resident in its treaty partner. In this role, the contracting state has multiple and not always congruent interests. The source country is interested in protecting its revenues from unwarranted erosion. However, it is concerned with providing a hospitable environment for desirable inbound foreign investment, and fostering the general climate of international trade and investment. Lastly, since these

[19]See Victoria Summers, "The Border Adjustability of Consumption Taxes, Existing and Proposed," in *Tax Notes International*, June 3, 1996, at 1793, 1800.

[20]The count is somewhat imprecise -- e.g., the effects of the treaty with the former Union of Soviet Socialist Republics and its effects on the former members of that Union are not considered. Some treaties have been terminated in part, and there are a number under active negotiation or renegotiation, or that have been signed but not ratified.

[21]The current international consensus favoring income tax treaties is derived from sixty years of evolution, starting with the model income tax treaty drafted by the League of Nations in 1927, culminating in its "London Model" treaty in 1946, and carried on later by the United Nations, and the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development ("OECD"). The U.S. first signed a bilateral tax treaty in 1932 with France, which treaty never went into force. The first effective treaty, also with France, was signed July 25, 1939, and came into force on January 1, 1945.

[22]A hearing intended to be held in early September of this year is expected to deal with four treaties, and the termination of an existing one.

bilateral treaties are reciprocal agreements, a country must be willing to make concessions with respect to its source-based taxes in order to gain similar reciprocal concessions from its treaty partner. The concessions generally lead to a relaxation of domestic rules of source-based taxation of non-resident individuals and entities (e.g., a reduction of withholding tax rates).

The loss of revenue from withholding taxes, or other reductions of source-based taxation has now, after these six decades, become generally accepted as the price for obtaining for its taxpayers the benefits of neutral tax treatment with respect to their international trade, investment, and commerce. In fact , there has developed a remarkably broad, general consensus among national governments, even those who agree on few other principles, that it is in their interest to enter into income tax treaties, and almost as broad consensus as to the form of the mechanisms adopted.

Income tax treaties enable U.S. firms to compete in foreign countries, and foreign firms to establish plants in the United States and invest in American securities. Without the tax treaty network and complementary national legislation, double taxation would create an enormous barrier to the international movement of capital and technology. Likewise, the crippling of our treaty network could cause world trade to shrink because so much of it depends upon cross-border investment and open channels for movement of capital and technology. A recent study, based upon earlier data, and conducted under the auspices of the NFTC, illustrates the possible consequences of abandoning all existing U.S. tax treaties, and, in selective ways, changing U.S. tax laws to extract more revenue from inward foreign investment:

- Broadly speaking, the average foreign tax burden on income flowing to the United States, which is predominantly from direct investment and therefore subject to foreign corporate tax as well as withholding taxes, would rise from about 16.0 percent (with a treaty network) to about 23.4 percent (without a treaty network). The average U.S. tax burden on income flowing to foreign investors would similarly rise from about 9.1 percent to about 14.1 percent.

- In relative terms, the tax burdens on U.S. investment abroad and foreign investment in the United States would thus escalate by about the same amount. However, the absolute tax level is lower on foreign investments in the United States because that investment is concentrated in bank deposits and portfolio securities, which are not immediately subject to the U.S. corporate income tax.

- As a consequence of higher tax rates, international investment would implode. Using a conservative estimating procedure, it was calculated that the stocks of U.S. investment abroad and foreign investment in the United States would each shrink by about $340 billion annually, without a treaty network.

- Reduced foreign investment in the United States would curb competition in the U.S. marketplace and raise U.S. interest rates. U.S. consumers would have to pay higher prices for a smaller variety of goods, investment would be squeezed and, ultimately, growth rates would be lower. In addition, the smaller role of multinational firms would curtail U.S. exports by some $21 billion annually, which would reduce the domestic employment of those firms and their suppliers by an estimated 340,000 jobs.

- In order for the U.S. Treasury to realize any revenue gain from the non-treaty world, the Congress would need to impose a new withholding tax on interest paid to foreign investors on their U.S. bank deposits and Treasury securities. At a rate of 5 percent, the new tax would raise significant revenue, about $6.4 billion annually. However, the larger tax revenues would be more than offset by the inevitable rise in U.S. Treasury interest payments (net of associated tax reflows) on Treasury debt held by the public in this country and abroad. Higher interest payments to the public (net of tax reflows) were estimated by the model at $7.1 billion.

- If the level of international investment imploded by twice as much as the conservative estimating procedure might suggest, the U.S. Treasury would lose $0.8 billion on U.S. income payment to foreigners, and $3.2 billion on U.S. income receipts from foreign sources. In other words, the Treasury could lose up to $4.0 billion from a policy that abandoned the U.S. tax treaty network.

- In any event, U.S. multinational enterprises would be substantially worse off. Their income flows before foreign tax would contract from $279 billion to $240 billion. Their combined tax burden, counting payments both to foreign governments and the U.S. Treasury (after allowing for the U.S. foreign tax credit), would rise by $9.4 billion. The loss of income coupled with a rising tax burden would significantly impair the competitive strength of U.S. multinational enterprises relative to rival firms based in Japan and Europe.

  -- G. Hufbauer, "Tax Treaties and American Interests -- A Report to the National Foreign Trade Council, Inc." (1988).

While the preceding analysis dealt with the presence and absence of the tax treaty network in a world where the United States maintained its present income tax system, its conclusions are illustrative of likely consequences that would result in a world in which other nations nevertheless maintained their income and withholding taxes, despite changes in the U.S. system, and in which U.S. multinational enterprises must compete. Absent a "level playing field" environment, taxes of all types on the income and capital flows on the U.S. multinational enterprise can easily escalate in proportion to the economic activity involved, and particularly where more than two jurisdictions are involved, can exceed one hundred percent.

In Conclusion

Again, the Council applauds the Chairman and the Members of the Committee for giving international issues prominence in the consideration of fundamental tax reform. The NFTC is appreciative of the opportunity to work with the Committee and the Congress in going forward into this process of consideration of various alternatives, and the Council would hope to make a contribution to this important business of the Committee.

WRITTEN STATEMENT OF J. THOMAS PEARSON, SENIOR VICE PRESIDENT, TAXATION, RJR NABISCO SUBMITTED TO THE HOUSE COMITTEE ON WAYS AND MEANS FOR THE RECORD OF THE HEARING HELD ON JULY 18, 1996, ON THE IMPACT ON INTERNATIONAL COMPETITIVENESS OF REPLACING THE FEDERAL INCOME TAX

THE TREATMENT OF OVERALL DOMESTIC OR FOREIGN LOSSES UNDER A REFORMED FEDERAL INCOME TAX

Introduction

As part of the hearings on replacing the Federal income tax. the Committee on Ways and Means has examined proposed replacement systems that include an income tax with one or more rates and an income tax with unlimited savings deductions. The retention of an income tax system, in any form, would continue the need for U.S. tax rules that limit the incidence of international double taxation. Thus, presumably, a foreign tax credit ("FTC") would continue to be available to U.S.-based multinational corporations that make income tax payments to foreign governments. A reformed Federal income tax system that includes FTCs might similarly retain the current law rules for calculating the amount of foreign-source income that enters into the calculation of FTCs.[1] This statement focuses on the disparate treatment of overall domestic and foreign losses in calculating foreign-source income under current law, an area that warrants simplification in any event.

The Problem With Current Law

Section 904(f)(1) of the Internal Revenue Code (the "Code") provides that an overall *foreign* loss that reduces U.S. tax on U.S.-source income must be "recaptured," by re-characterizing subsequent foreign-source income as domestic-source income. Because there is no similar rule for an overall *domestic* loss that reduces foreign-source income, taxpayers who have made foreign tax payments with respect to such income lose the benefit of FTCs. As a result, international double taxation occurs over time, and thereby increases the cost of doing business abroad. Obviously, increasing the cost of doing business contravenes the goal of advancing U.S. competitiveness.

Previous Proposals To Provide Symmetry

The often cited solution to the problem under current law is to provide symmetry in the treatment of overall domestic and foreign losses, beginning with the "Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, introduced by former Chairman Rostenkowski and Mr. Gradison of the Ways and Means Committee – and as recently as the introduction of the "International Tax Simplification and Reform Act of 1995, cosponsored by Ways and Means Committee members, Houghton and Levin. Both of the noted proposals would achieve symmetry by increasing the complexity of the income tax system: Provision would be made for the re-characterization of domestic-source income as foreign, where an overall domestic loss has reduced foreign-source income and thereby reduced a taxpayer's FTC.

An Alternative Proposal To Achieve Symmetry <u>With</u> Simplification

As first proposed by the Treasury Department in testimony before the Ways and Means Committee in 1992, "the goal of simplification would be better served by repealing [the rule for overall foreign losses] rather than by enacting re-characterization

[1] The relative amounts of foreign- and domestic-source income are relevant because Section 904(f) limits the allowable FTC to the U.S. tax on foreign-source income, calculated by multiplying the ratio of foreign-source income to worldwide income by the pre-FTC U.S. tax.

rules for overall domestic losses." Significantly, Treasury's 1992 testimony dismisses concerns about whether repeal of the rule for overall foreign losses would erode U.S. taxing jurisdiction, and questions whether this is a realistic concern in view of safeguards such as the "branch loss recapture" rule of section 367(a)(3)(C) of the Code.

The theoretical concern identified by Treasury's 1992 testimony is whether the repeal of the rule for overall foreign losses would increase incentives to use foreign losses against U.S.-source income, while claiming FTCs to limit U.S. tax on foreign-source income. The ploy identified by Treasury involves operating foreign loss-generating businesses through foreign branches, while earning foreign source income through foreign subsidiaries eligible for deferral." As also noted by Treasury, however, there are other safeguards that weigh against this theoretical stratagem:

1. *Branch Loss Recapture Rule.*— The "branch loss recapture rule" in section 367 of the Code is specifically aimed at recapturing pre-incorporation losses of a foreign branch, where a taxpayer might otherwise incorporate a foreign branch to avoid tax on subsequent profits. This provision triggers gain recognition on the incorporation, quite apart from the possible application of current law section 904(f)(1) of the Code.

2. *Reduced Utility of FTCs Since 1986.*— The Tax Reform Act of 1986 and subsequent legislation have greatly reduced the efficacy of managing foreign losses via the scheme envisioned by Treasury, with many new provisions that weigh against the loss-branch/profitable subsidiary strategy in particular, and FTC planning in general: For example, under section 904(f)(5) of the Code, separate basket losses are allocated *pro rata* first to separate foreign basket income, before any allocation is made to U.S.-source income. As another example, the manner in which the apportionment base under the interest allocation rules takes account of stock in a foreign subsidiary results in an increased -- and unfavorable –allocation of interest expense to foreign-source income, greatly increasing the potential for double taxation. In this regard, note also that an overall foreign loss can result from the allocation of domestic expenses to income derived from a foreign subsidiary operation.

3. *Proliferation of Anti-Deferral Rules.*—In addition to the recapture rule in section 367 of the Code and the reduced utility of FTCs, one might point to the 1993 enactment of the Section 956A tax on the holding of excess passive assets by a controlled foreign corporation ("CFC"). Note also that there are five other anti-deferral regimes that could apply to a U.S.-owned foreign corporation – *e.g.*, the passive foreign investment company rules. Section 956A, in particular, operates to impose a current U.S. tax even in the case of active business income derived through a CFC.

Conclusion

If an income tax system is retained, including a FTC regime, it will be important to conform the treatment of overall foreign and overall domestic losses. In this case, symmetry can be achieved with simplification by simply repealing the rule for overall foreign losses.

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION
BEFORE THE COMMITTEE ON WAYS AND MEANS OF
THE HOUSE OF REPRESENTATIVES
SUBMITTED FOR THE RECORD
OF THE HEARING ON
THE IMPACT ON INTERNATIONAL COMPETITIVENESS
OF REPLACING THE FEDERAL INCOME TAX
JULY 17, 1996

I. INTRODUCTION.

The Securities Industry Association (the "SIA") is pleased to make this statement for the record on the impact of fundamental tax reform on the competitiveness of U.S. businesses.[1] The SIA welcomes the opportunity to comment on the tax reform proposals that Congress will be considering, and supports the efforts of the Committee on Ways and Means (the "Committee") to review the effect on international competitiveness of the various alternatives that have been proposed to replace the existing federal income tax system. From the perspective of the SIA, tax reform in the international area is essential in order to maintain the competitiveness of U.S.-based securities firms in an increasingly global economy.

Many economists have described the increasing globalization of the world economy. As we describe below, this process of globalization has been particularly rapid in the financial services industry. As U.S.-based securities firms have expanded into the global capital markets, they have transformed the securities industry into a worldwide integrated business in which U.S. firms have a leading international presence.

The international provisions of the Internal Revenue Code (the "Code"), enacted in the 1960s and last substantially debated and revised in 1986, have not kept pace with the changes in the world economy, and the place of U.S.-based companies in that economy. From the perspective both of the securities industry and of the U.S. economy as a whole, the growth of truly global operations requires a fundamental change in the assumptions upon which our tax laws are premised, particularly assumptions about the structure of the financial markets and the activities of market participants.

The SIA believes that the long-term financial viability of the U.S. financial services industry, and in particular the ability of U.S.-domiciled financial institutions to compete in the international arena, requires an environment in which all similarly-situated competitors -- U.S. and non-U.S. alike -- are subject to comparable regulatory burdens, including the burdens imposed by systems of taxation. In the absence of fundamental revision to the international tax rules of the United States, however, the growing dichotomy between contemporary commercial realities and the Code will impair the ability of U.S.-based companies to compete in the global economy, because foreign competitors generally are subject to more economically neutral rules.

For example, as a result of the subpart F and foreign tax credit anomalies described below, the effective tax burden on the U.K. subsidiary of a U.S.-based securities firm may well be significantly higher than the amount of tax actually paid by that subsidiary to the United Kingdom. Because most continental European universal banks or securities firms operate under an exemption regime that does not tax income earned abroad (or operate under a foreign tax credit regime that does not have the elaborate rules of the Code), the effective tax

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1 The SIA is the securities industry's trade association representing the business interests of about 750 securities firms in North America, which collectively account for approximately 90 percent of securities industry revenue in the United States. SIA members—including investment banks, broker-dealers, specialists and mutual fund companies—are active in all securities markets and in all phases of corporate and public finance, serving individual and institutional investors, corporations and government entities.

burden on income from a U.K. subsidiary of such a continental European competitor is likely to be simply the amount of U.K. tax paid. This difference in home country tax regimes means that the Code imposes a significant constraint on the ability of the members of the SIA to compete in London against their continental European competitors.

To date, the members of the SIA have relied on their head starts in financial technology and in financial product expertise to develop their foreign operations. As these gaps narrow, however, the high after-tax cost of deploying capital internationally will make SIA members less globally competitive than would be the case if they operated under international tax rules comparable to those enjoyed by their global competitors.

For tax reform to be effective, that reform must be based on a thorough understanding of how different global industries operate. In addition, any new system for taxing business income of U.S.-based companies earned abroad must be simpler than the tortuously complex and arcane international tax rules of the Code. Finally, effective reform must remove the existing structural biases of the Code against international business operations.

The remainder of this statement accordingly contains three sections. Part II describes the globalization of the securities industry over the last decade, and the non-tax constraints that affect the manner in which a U.S.-domiciled securities firm is structured and operates abroad. Part III very briefly describes the principal structural defects of the Code's rules applicable to the international operations of U.S.-domiciled securities companies. Finally, Part IV turns to the various consumption-tax-based reform proposals that the Committee is considering, and discusses their potential impact on U.S.-based securities firms.

Because most current tax-reform proposals provide little guidance as to their application to financial intermediaries, Part IV suggests two structural imperatives that the SIA believes must be part of any fundamental tax reform package in order to tax the U.S.-based securities industry fairly. First, all expenses (including interest expense) related to carrying on an active securities business should be deductible by firms conducting such a business. Second, the difficulties in imposing a territorial tax system on an industry whose transactions are as multi-jurisdictional as the security industry's must be addressed. Only fundamental tax reform that incorporates these imperatives can truly promote the securities industry's competitiveness in the global securities markets.

II. THE SECURITIES INDUSTRY.

A. Globalization of the Securities Industry.

The recent and rapid globalization of the securities industry can be seen from two different perspectives. From one perspective, the industry has become global in the sense that the major firms in the industry now compete for customers outside of each firm's home jurisdiction; in fact, international expansion has been a crucial engine of growth for many securities firms domiciled within and without the United States. Another way in which to view the globalization of the securities industry is from the perspective of the transactions entered into by these firms with customers. Increasingly, such transactions are comprised of the efforts of personnel and systems located all over the world; it is now very common for a single transaction to have personnel employed by several affiliated companies in different jurisdictions participating in, and adding value to, the deal. These two global trends are discussed immediately below.

1. Competition for Customers and Business Worldwide. Historically, companies needing capital to expand their businesses looked principally to their local capital market and to the local financial institutions that could provide them with access to that market. In the past, therefore, the U.S. capital market was the principal locus of business for U.S.-domiciled securities firms, and their principal competitors were other U.S. financial institutions. The U.S. federal income tax rules applicable to U.S. financial institutions reflect this traditional domestic focus.

In recent years, however, the world's financial markets have become highly integrated and interdependent. Advances in communications and information technologies, innovations in financial products, and changes in the relevant regulatory schemes have made it possible for the world's financial institutions to conduct their business activities around the globe, twenty-four hours a day. As a result, multinational securities firms now enter into transactions and services with customers worldwide. These activities include sales and trading of securities in all of the major capital markets, and providing corporate finance and investment banking services in both developed and developing countries. This increased cross-border financial activity is both the result of, and the impetus for, the establishment of foreign operations by multinational financial institutions.[2] As part of this global transformation, U.S.-based securities firms have invested billions of dollars to establish operations in London, Tokyo, and other important financial centers in order to compete actively with other financial institutions to do business with customers based in those jurisdictions. Similarly, foreign financial institutions have expanded into markets outside their home countries, including the U.S. domestic securities market.

As a result of carrying out that active competition for customers in those important non-U.S. financial centers, members of the SIA now employ thousands of employees outside the United States. These international operations in turn contribute a substantial portion of the revenues of the worldwide group of companies to which they belong. For instance, in 1985 few, if any, members of the SIA earned as much as 10 percent of their income overseas, while in 1995 many of the larger members of the SIA derived a very significant share of their revenues from foreign operations, in some cases exceeding 50 percent of such firms' aggregate revenues.

As a consequence of these changes, U.S.- and foreign-domiciled multinational securities firms now compete directly with one another for financial services business in financial centers throughout the globe. That competition extends not only to competitive incursions into another institution's domestic markets (e.g., Swiss banks doing business in the United States, or U.S. securities firms competing in Frankfurt for German domestic securities business), but also, and more meaningfully, to third-country international financial services centers (e.g., U.S., Swiss and German institutions all competing in London).

As this trend toward globalization has progressed, U.S.-based securities firms have become recognized leaders in the global securities industry; in fact, U.S.-based securities firms are responsible in large part for the recent surge in technological and financial innovation that has resulted in globalization of the industry. Due to their expertise and technological advantages, U.S.-based securities firms have become part of the small group of multinational securities firms that dominate the global capital markets.[3] Maintaining this position of leadership is important not only for those firms and their international customers, but also for their U.S. employees and for their U.S. customers, which benefit from the innovative products and services offered by U.S.-based securities firms.[4]

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2 Evidence of the increasingly cross-border nature of the securities markets is plentiful. For instance, the share of the aggregate capitalization of the global equity market represented by U.S. companies has gone from 52.9 percent in 1980 to 38.6 in 1995; in the global bond market, that share has also decreased, from 52.6 percent in 1985 to 43.4 in 1995. See 1996 Securities Industry Fact Book (published by the SIA). In short, the global securities market pie has grown larger, and other nations are seeking capital in increasing amounts relative to the United States. Thus, the future pre-eminence of the U.S.-based securities industry will be determined by how it can compete in a world in which the demand for capital is increasingly located outside the United States.

3 In fact, "league tables" (i.e., rankings in the securities industry) for 1995 list 12 members of the SIA among the 15 highest ranking firms in terms of worldwide equity and debt offerings. See Investment Dealers Digest, Jan. 8, 1996, at 37.

4 The contribution that members of the SIA make to the U.S. economy is substantial. SIA members collectively employ about 350,000 individuals. Moreover, they manage

(continued...)

2. Cross-Border Transactions. The globalization of the securities industry extends not only to the location of the industry's customers but to the very nature of the transactions and trading activities that take place every day among market participants. As technology helps to create a more efficient global market, an increasing number of interested and informed issuers, investors and traders come together to lower costs, collapse earnings differentials, hedge risks, impound new information quickly into prices, and efficiently allocate capital. The transactions that comprise global trading activities often involve the participation of personnel in several jurisdictions in order to complete a single transaction.

To take one simple example, a U.K. institutional investor wishing to purchase shares in a Mexican company may go to a London-based salesperson employed by a U.K. subsidiary of one of the members of the SIA to effect the transaction. In order to get those shares for the customer, the U.K. subsidiary typically would purchase them from or through its U.S. broker-dealer affiliate, where its Latin American equity traders are located. Research analysts covering that Mexican issuer (whose research reports formed the basis of the U.K. customer's decision to invest) in turn might be located in a Mexico City office. The U.K. subsidiary might take credit risk with respect to its customer's obligation to settle the trade, while the U.S. affiliate takes market risk in respect of trading in the security in question. Finally, the "back office" trade support and clearing functions might be located in a fourth affiliate in a different location. All of these affiliates would be joined by sophisticated electronic communications networks, so that from the perspective of the customer the trade is executed seamlessly.

B. Structure of International Securities Businesses.

Unlike the conduct of most multinational businesses, the conduct of a financial services business generally is regulated. As a result, U.S.-domiciled securities firms operate under important and substantive non-tax constraints—particularly regulatory capital and inventory funding requirements—on their operations and funding in the major financial services centers within and without the United States.

Because the treatment of interest expense is critical to financial services institutions, and because Congress has in the past viewed the allocation of interest expense by multinational companies as a potential source of abuse, it is important to appreciate that the non-tax substantive regulation of financial services companies substantially reduces the ability of U.S.-domiciled financial institutions to capitalize or operate their foreign subsidiaries to minimize their U.S. tax liabilities. The discussion immediately below demonstrates the significance of the treatment of interest expense to financial services companies and the regulatory and practical constraints circumscribing, in particular, the capitalization of foreign securities affiliates by U.S.-domiciled securities firms.

1. Regulatory Capital Requirements. U.S. industrial corporations doing business outside the United States generally are subject only to modest legal requirements as to the amount and form of capital required to be held by the entities through which that non-U.S. business is conducted. By contrast, a foreign subsidiary of a U.S.-based securities firm generally is subject to a stringent regulatory regime in the foreign jurisdiction in which that subsidiary operates.[5]

As with U.S. securities regulation, the principal purpose of foreign regulation is generally to protect the customers of a foreign securities subsidiary by ensuring that the

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(...continued)

the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans.

5 As a practical matter, the interaction of U.S. and foreign securities regulations ordinarily impels U.S. multinational securities firms to conduct their international operation largely through subsidiaries, rather than branches.

subsidiary can fulfill its obligations to customers on a stand-alone basis. To that end, most foreign regulatory regimes will, among other matters, (i) impose net capital requirements and require the subsidiary to maintain a minimum level of capitalization at all times and (ii) in the European Community, in particular, limit the amount of credit that can be extended to other affiliated companies (so-called "large exposure" limitations). One consequence of these requirements is to restrict significantly the ability of a foreign securities subsidiary, as compared to a foreign subsidiary of a U.S. industrial company, to shift funds to related entities, whether through dividends or through other mechanisms.

2. Inventory Funding Requirements. A securities dealer finances its day-to-day operations with a much higher level of leverage than does a non-financial business (e.g., a 20:1 or 30:1 debt-equity ratio rather than a 1:1 or 2:1 debt-equity ratio). Much of this leverage is attributable, on the one hand, to a securities dealer's commercial need to carry an enormous volume of securities in inventory, and, on the other, to the dealer's ability to finance that inventory at attractive rates, typically through secured financing arrangements. A high level of leverage thus is an essential component of a securities firm's ordinary business operations. Because the amount of funding that such a firm needs is driven by its day-to-day business operations, funding requirements also vary on a day-to-day basis, and the firm therefore must constantly adjust its funding levels to reflect varying securities positions.

A foreign securities subsidiary, like a domestic U.S. firm, requires regular access to short-term funding to finance its inventory of liquid securities positions. The best source of such funding frequently is in the local market in which the subsidiary operates, because much of the subsidiary's borrowings will be collateralized by securities inventory that trades in the local market, and that market generally provides the lowest-cost funding available for such collateralized borrowings. Foreign securities subsidiaries therefore regularly operate with high levels of short-term funding from local capital markets, which funding in turn usually is secured by the collateral (e.g., inventory) being funded.

As the discussion below suggests, the current international tax rules of the Code do not fairly deal with interest expense. In light of the critical importance of interest expense to the securities industry, it is crucial that any fundamental tax reform correct these flaws.

III. FLAWS IN THE EXISTING INTERNATIONAL TAX REGIME.

To date, the success of U.S.-based securities firms has come in spite, not because, of the outdated, complex and anti-competitive international U.S. tax rules. This Part III briefly reviews some of the most important deficiencies of current law, in the hope that any fundamental tax reform recommended by the Committee will not repeat these errors.

Subpart F of the Code imposes special anti-deferral regimes on foreign investment earnings (e.g., interest and dividends) of U.S. taxpayers. The first fundamental tax hurdle faced by U.S.-based securities firms is that stocks, bonds and other securities, which give rise to investment income in the hands of most taxpayers, are simply inventory to such firms. The Code has failed to recognize this distinction, and in many cases treats U.S.-based multinational securities dealers as if they were investors, rather than bona fide active businesses, thereby subjecting significant revenues earned by such firms in the active conduct of their businesses to the anti-deferral regimes intended to discourage offshore incorporated investment vehicles. Similarly, the "investment in U.S. property" rules contained in subpart F simply do not work when applied to ordinary course-of-business activities of multinational securities groups. No industry outside the financial services sector is subject to the anti-deferral rules of subpart F in respect of its core business activities.

A second hurdle that the Code currently presents to U.S.-based securities firms is that the foreign tax credit rules of the Code—whose purpose is to prevent double taxation of the same earnings by both a foreign jurisdiction and the United States—do not operate as they were intended. For instance, the special foreign tax credit rules relating to the treatment of interest expense for multinational firms date back to 1986, and have the effect of treating U.S.-based securities firms as if they pay more foreign tax on less foreign income than is really the case, with the result that some foreign income of these firms that is subject to foreign tax is taxed a second time by the United States. While these rules apply to all U.S.

firms, they produce particularly harsh results when applied to securities firms, because such firms necessarily have high leverage and operate within a unique regulatory and market environment that restricts how and where they borrow. These rules also stand in contrast to the tax regimes applicable to foreign securities firms, which generally are not subject to any special limitations on the deduction of interest expense at all.

The SIA has developed and proposed specific amendments to the Code designed to deal with these (and other) hurdles with which the Code confronts the U.S.-based securities industry. The SIA's proposals, however, are not the focus of this statement;[6] rather, this brief discussion on the shortcomings of current U.S. tax law puts into context the discussion that follows regarding the proposals for fundamental tax reform that the Committee is considering.

IV. TAX REFORM PROPOSALS.

A. General Concerns.

The SIA believes that the foregoing discussion makes a compelling argument for revising the U.S. tax rules applicable to the international operations of U.S.-based securities firms, but leaves open to question the ideal form of such change. The alternatives under consideration by the Committee generally fall into two categories: consumption-based tax proposals of various kinds, and a modified income tax. Each of the consumption tax proposals would involve a drastic shift in U.S. tax policy as it applies to business income earned abroad, from a system that taxes the worldwide income of a U.S. taxpayer to a system that by its nature is territorial.

Each system would tax a business enterprise on its gross receipts from sales or exchanges of property or services used (in the case of destination-based systems) or produced (in the case of origin-based systems) in the United States. Excluded from income under these proposals would be gross receipts and purchases of foreign branches or affiliates, as well as dividends from foreign subsidiaries. As a result, each of the consumption tax proposals exempts from federal tax income that is earned outside the United States, regardless of whether derived from the conduct of a business or from investment, and regardless of whether earned by U.S.- or foreign-based companies. Because each of these systems excludes income earned from foreign operations from the U.S. tax base, these proposals presumably would make obsolete the Code's foreign tax credit rules and the Code's complex set of anti-abuse rules relating to unrepatriated income of U.S. controlled foreign corporations.

This radical simplification of the international tax regime is welcome in principle. That simplification may prove to be illusory however, unless certain critical issues are addressed in more detail. While most of the consumption tax proposals envision special rules for financial intermediaries, those rules are not fully developed. For example, in view of the treatment of interest expense as non-deductible for non-financial intermediaries in many of the tax reform proposals, the distinction between financial intermediaries and other taxpayers, or financial intermediation and other businesses carried out by the same taxpayer, will be essential to assessing the impact of any proposal upon the U.S. financial services industry. Similarly, and as discussed below, Congress will need to devote considerable energy to developing rules for determining where financial products or services will be treated as

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6 Attached as an exhibit is a technical memorandum dated April 3, 1996, which was written by an ad-hoc group of SIA members. The memorandum discusses in more detail the SIA's concerns about the operation of the existing international tax regime, sets out its specific suggestions for reforming the international tax provisions of the Code and attaches an appendix with a comparative analysis of how different jurisdictions tax the international financial services activities of their financial services companies. A series of examples illustrating the application of current law to common fact patterns involving the international operations of U.S.-domiciled securities firms is attached as a second exhibit. The technical memorandum has previously been submitted to the staff of the Joint Committee on Taxation.

produced or used, particularly when value is added to a single trade by affiliates in several jurisdictions.

Finally, aside from the concern over the specifics of each of these proposals, the adoption of any one of these proposed systems of taxation would raise many additional concerns of interest to U.S. financial institutions, including (i) the potential capture by foreign countries of the business tax base foregone by the United States and (ii) the risk of undermining the current income tax treaty system, and in particular the reduced rates of foreign withholding tax provided by those treaties.

In light of the above concerns, it is impossible for the SIA to support outright any one of the packages for fundamental tax reform being considered by the Committee; each proposal being considered, in respect of how it would tax the securities industry, leaves too many questions unanswered or leaves them to be answered by future regulations. Without clear rules, any claimed gains in simplicity and competitiveness would be illusory, lost in the costs of compliance with a complex tax system with which the securities industry has no experience in dealing.

Rather than support any one of the tax reform proposals being considered, the SIA offers instead two structural imperatives that it believes must be part of any tax reform proposal that wants to promote the competitiveness of the U.S.-based securities industry. First, all expenses related to (i) carrying and trading securities and (ii) writing financial contracts, should be considered deductible by those carrying on an active securities business. Second, the difficulties attendant on any territorial tax system as applied to securities transactions (i.e., the problems associated with determining either the origin or destination or jurisdiction of use of income from such transactions) need to be addressed; without clear rules as to when income from multi-jurisdictional, multi-input transactions will be taxed, a territorial system offers no particular advantage over the current U.S. tax regime. These two imperatives are discussed below.

B. Structural Imperatives For Fundamental Tax Reform.

1. Expenses. As demonstrated above, the securities industry carries out active businesses with customers as financial advisors and as dealers in securities and financial contracts. The securities industry is similar in some respects to other industries in that a securities firm must maintain substantial positions in inventory, both in the traditional sense of securities held for resale to customers, and in the sense of contractual positions (e.g., swaps) entered into with customers that are carried on the books of swap dealer affiliates. To do so requires both substantial financing costs and extensive hedging of positions to minimize, for example, the risk of loss while holding such securities (even for a few moments) before these securities can be sold to customers.

Under most of the proposals being considered by the Committee, interest expense would be deductible by financial intermediaries, a group which includes securities firms. The proposals are silent, however, regarding the deductibility of non-interest-expense-related costs (such as option premiums on unexercised options and other costs of hedging inventory risk) incurred by U.S.-based securities firms in the ordinary course of business. These costs and expenses are not ancillary issues to securities firms, but rather go to the heart of their business operations; as a result, it is critical that all such items remain fully deductible in calculating a securities firm's tax base.

2. Origin/Use/Destination. Each of the proposals under consideration by the committee would tax a U.S.-based securities firm on its gross receipts from sales of property and services used (i.e., destination-based) or produced (i.e., origin-based) in the United States. While such rules might be straightforward to apply to industries that produce and sell tangible products, the globalization of the securities industry has resulted in an industry whose products and services cannot easily be contained within an origin- or destination-based construct.

Securities transactions in the modern global economy have many parts. Marketers, traders and "back-office" personnel all provide essential input into each transaction. Increasingly, these inputs are located in different jurisdictions, making it difficult (if not impossible) to designate one jurisdiction as the one which has produced the product or service. In addition, the capital put at risk by a worldwide securities group in effecting a cross-border transaction might be provided several affiliates: one affiliate might take the customer credit risk, for example, while another assumes the market and hedging risk associated with a customer position. The significance of capital as a key factor in the production of income by a securities firm thus further complicates the above analysis.

It is equally difficult to assess in which jurisdiction the end result of a securities transaction is put to use (i.e., the destination of the transaction). For instance, a Swiss industrial firm wishing to hedge the U.S. dollar/Swiss franc risk related to the stock it holds in its U.S. subsidiary might enter into a currency swap with the U.K. affiliate of a U.S.-based securities firm. The jurisdiction that is the "destination" of that hedge transaction could be Switzerland or the United States, or even the United Kingdom, depending on whether the transaction is viewed on its own or by its purpose as a hedge, and if a hedge, where the risk being hedged is treated as located.

Neither the Code nor the fundamental proposals under consideration by the Committee were devised to account for these sorts of multi-jurisdictional transactions in which value is added to every trade by affiliates all over the world; instead, the focus of those rules is the physical location of a particular trade or product, which is no longer readily identifiable in a world of electronic trading of securities that are not themselves even embodied in physical certificates. Establishing the geographical source of global securities, therefore, is increasingly difficult. Even physical marketplaces (e.g., trading floors and clearing houses), in many cases, are being overtaken by virtual marketplaces (e.g., networks of computers and users) as the situs of transactions. In a world of global integrated markets and simultaneous electronic trading in many jurisdictions, the concept of a geographic source or destination of a transaction or product thus provides a weak nexus for classifying global trading activities.

An analogy for the problems presented by attempting to tax multi-jurisdictional securities transactions in a territorial tax regime are the issues presented by electronic commerce on the Internet. Like securities transactions in the global marketplace, it is impossible to tax transactions that occur on the Internet without taking into account the realities of the instantaneous global electronic marketplace. Internet transactions also involve inputs from consumers and producers all over the world, and determining which jurisdictions have a taxable nexus to such transactions is difficult. The Treasury Department and others are currently mounting efforts to provide tax rules that take into account the increasing amount of electronic commerce—commerce that is being conducted in a very different way than in the past—and make it easier to determine the situs and tax the income from such transactions.[7]

While electronic transactions on the Internet and other computer-based markets present similar problems in respect of taxation as do securities transactions in the global marketplace, one key difference between the two is that the concerns of the securities industry over the taxation of multi-jurisdictional securities transactions have been present for more than a decade, and have grown in intensity concomitant with the global growth in the securities industry. These concerns, as they relate to electronic commerce over the Internet, are still in their infancy. As applied to the securities industry, by contrast, these problems are serious concerns today, and will become even more important in any territorial-based tax system.

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7 For instance, at an ABA Tax Section meeting on May 10, 1996, Bruce Cohen of the Treasury Department's office of International Tax Counsel stated that an issues paper is being prepared that will highlight the major tax issues in the Internet and electronic communications areas, and asked for practitioner input. 71 Tax Notes 1009, May 20, 1996. Similarly, the Federation of Tax Administrators recently held a conference to discuss nexus issues regarding, in part, taxation of transactions on the Internet. Tax Notes Today, May 14, 1996. Such concerns also are being addressed at the state level. See States Seek to Tax Internet Sales and Services, Tax Notes Today, June 18, 1996.

A proposal for tax reform that lacks clear rules for determining when (and how) income from the multi-jurisdictional, multi-input transactions that are characteristic of the global securities industry will be taxed cannot possibly treat fairly the firms in that industry. While all of the proposals under consideration by the Committee are commendable for their efforts to simply the international U.S. tax rules, none contains clear rules as to how to source the income of U.S.-based securities firms.

V. CONCLUSION.

The SIA believes that the existing international tax rules of the United States have a strong structural bias against the international operations of U.S.-domiciled securities companies. That bias is apparent when the Code's rules applicable to multinational securities firms are compared with the tax regimes under which *non-U.S. competitors* operate. That bias also is visible when the Code's treatment of the international operations of U.S. securities firms is compared to its treatment of analogous international activities of *U.S. industrial* firms. The international successes achieved to date by members of the SIA thus have come in spite, not because, of the tax environment in which those firms operate.

The SIA has tried to demonstrate in this statement that the adoption of any one of the consumption-tax-based proposals currently under consideration would, at best, not harm the U.S.-based securities industry and, at worst, would worsen the competitive position of that industry. While the current system admittedly requires significant amendments, the SIA cannot unqualifiedly support radical reform unless that reform clearly addresses how the new system would tax the international business of the U.S.-based securities industry.

Accordingly, the SIA encourages the Committee to continue its efforts to reform U.S. tax law, but hopes that the Committee will work to add much-needed clarity to what are today only sketches of possible alternative systems. If nothing else, the SIA hopes that this submission demonstrates that a tax regime modeled on the manufacture and sale of tangible property cannot simplistically be extended to the multi-jurisdictional trading of intangible financial products.

[Technical Memorandum is being retained in Committee Files.]

IMPACT OF REPLACING THE FEDERAL INCOME TAX ON MANUFACTURING AND ENERGY AND NATURAL RESOURCES

WEDNESDAY, JULY 31, 1996

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

The Committee met, pursuant to notice, at 10:15 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
July 18, 1996
No. FC-19

CONTACT: (202) 225-1721

Archer Announces Hearing on the Impact of Replacing the Federal Income Tax on Manufacturing and Energy and Natural Resources

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing to examine the impact of the proposed replacement tax systems on manufacturing and energy and natural resources. **The hearing will take place on Wednesday, July 31, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

BACKGROUND:

As part of its hearings on replacing the Federal income tax, the Committee on Ways and Means has begun to examine how the proposed replacement systems would affect specific segments of society and the economy. Witnesses will be asked to focus on the advantages and disadvantages of some of the proposed replacement tax systems using the following guidelines:

1. The basic alternatives are: an income tax (with one or more rates); a flat tax (such as the one introduced by House Majority Leader Dick Armey); a national sales tax (such as the one introduced by Reps. Schaefer and Tauzin); a value added tax (either subtraction method as proposed by Rep. Gibbons or an invoice-credit method); and an income tax system with an unlimited savings deduction (such as the USA tax system introduced by Senators Domenici and Nunn).

2. The alternatives, whenever possible, should be considered in their pure, conceptual form (i.e., witnesses are discouraged from focusing exclusively on all the permutations of a so-called "flat tax" or on which items should (or should not) be exempted from a tax).

3. Any new tax system would replace the individual income tax, the corporate income tax, and estate and gift taxes. Witnesses could also consider replacement of payroll taxes and excise taxes, as long as they consistently considered such replacement for all proposed tax systems.

4. Replacement must be deficit-neutral, both in the short-term and the long-term.

Following this hearing, the Committee will continue to examine the impact of the proposed alternatives, including the effects on: individuals and families; employee benefits and retirement and personal savings incentives; home ownership and real estate generally; agriculture; retail sales; financial services; service industries; and health care. Dates for hearings on these topics will be announced in one or more future press releases.

FOCUS:

The focus of this hearing will be limited to the impact of fundamental tax reform on domestic manufacturing and on energy and natural resources.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business Wednesday, July 24, 1996. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff at (202) 225-1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Committee office, 1102 Longworth House Office Building, no later than 10:00 a.m. on Monday, July 29, 1996.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Wednesday, August 14, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

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

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

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

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

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

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

Note: All Committee advisories and news releases are now available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS_MEANS/' or over the Internet at

Chairman ARCHER. The Committee will come to order.

The Chair apologizes for the delay in starting the hearing this morning, but we never know when there is going to be a vote. I think most people here understand when those two lights come on and the two buzzers sound, we have got to get over there and vote. So with apologies to all of you, we will now begin.

The distinguished Member of the Committee, the gentleman from Missouri, Mr. Hancock, will introduce our first witness this morning.

Mr. HANCOCK. Mr. Chairman, I want to thank the Chairman, and I regret other Members are not here for the testimony that will be forthcoming. Maybe they will show up shortly. But I appreciate the opportunity to talk to you about one of the most outstanding individuals I have ever known.

On April 21, 1991, in the Springfield, Missouri, News and Leader, in my hometown of Springfield, Missouri, I read this article. It says, "15-Year Battle With IRS Brings Bittersweet Victory."

Even though I had known Mr. Johnson for 49 years, this was the first time I had ever heard of the difficulties with the Internal Revenue Service. I called Mr. Johnson and had lunch with him the next day, and he told me the story about what had happened to him and his dealings with the Internal Revenue Service.

Again, I would like to point out that Mr. Johnson never contacted me, nor did he ever ask me to take any action whatsoever on his part as a Member of the U.S. Congress. But after hearing his story, if I had not known Mr. Johnson prior to this time and completely trusted his honesty and integrity, I would not have believed in a free society this could happen to anyone.

Let me go into a little detail on my 49-year association with Mr. Johnson and his wife, Jean, whom I have also known for 49 years.

Johnny Johnson was president of the fraternity I pledged in 1947 when I entered college at Southwest Missouri State College. He was 7 years older than I, had flown B–17s for 29 missions over Germany, while our colleague, Sam Gibbons, who isn't here, was fighting the battle on the ground. Quite frankly, for an 18-year-old freshman who had never been over a thousand miles away from home, Mr. Johnson was a hero. We certainly would be better off today if freshman students had people like Mr. Johnson to consider their heroes.

He was going to school on the GI bill and carrying a paper route morning and night to pay his way. I am sure his influence on me caused me to join the U.S. Air Force as my choice of services in 1951 during the Korean war.

I have now known Mr. Johnson for 49 years. I know very few people—I know no one I respect more.

Mr. Chairman, Members of the Committee, I want to ask you for the next few minutes to put yourself in Mr. Johnson's shoes. Think about how you would have reacted if the same thing had happened to you. Listen to his story closely.

Mr. Johnson is a convicted felon. Neither Mr. Johnson nor his wife, Jean, knowingly or willfully intended to violate the income tax law. On the other hand, two Federal courts have determined the Internal Revenue agents did willfully violate the law, and they have never been prosecuted. In fact, the Justice Department is continuing to defend the agents by appealing another decision that was handed down on May 16, 1996.

Let me close by pointing out what the U.S. district judge said in his decision: "Because of the unmitigated arrogance and unprofessional conduct of the U.S. attorney from the Department of Justice, there is a word to be said about obedience to the integrity of the adversarial process." He went on ahead to say, "The U.S. attorney is a representative not of an ordinary party to a controversy, but of a sovereignty whose obligation to govern impartially is as compelling as its obligation to govern at all and whose interest, therefore, is not that it shall win but that justice shall be done." *Burger* v. *United States*. I don't know the date. I don't know the citation.

Mr. Chairman, the judge concluded, "let the process end here," 20 years after it began.

One final note, a footnote to his decision says, "Reforestation to replace the trees for paper in this case will cost more than was collected in taxes from the Johnsons in 1981."

Thank you again, Mr. Chairman. Again, I wish there were more Members of this Committee to hear the story, which is a story that supports your position completely about what needs to be done as far as our income tax law is concerned.

If anyone has any questions of me before Mr. Johnson talks, I will be more than happy to try to answer them.

Thank you.

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

INTRODUCTION OF JOHNNY JOHNSON
BY REP. MEL HANCOCK
BEFORE THE WAYS & MEANS COMMITTEE
JULY 31, 1996

I want to thank the Chairman and the Members of the Ways & Means Committee for holding this hearing and allowing me to introduce one of the most outstanding individuals I have ever known.

On April 21, 1991 in the Springfield News-Leader in my home town of Springfield, Missouri, I read this article. Even though I had known Mr. Johnson for 44 years, this was the first time I had ever heard of his difficulties with the Internal Revenue Service.

I called Mr. Johnson and had lunch with him the next day and he told me the story about what had happened to him in his dealings with the Internal Revenue Service. Again, I would like to point out that Mr. Johnson never contacted me nor did he ever ask me to take any action whatsoever on his part as a member of the United States Congress. But after hearing his story, if I had not known Mr. Johnson prior to this time and completely trusted his honesty and integrity, I would not have believed that in a free society, this could happen to anyone.

Let me go into a little detail of my 49 year association with Mr. Johnson and his wife Jean, who I have also known for 49 years.

Johnny Johnson was President of the fraternity I pledged in 1947 when I entered college at Southwest Missouri State College. He was seven years older than me, and had flown B-17's for 29 missions over Germany (while our colleague Sam Gibbons was fighting the battle on the ground with the paratroopers). Quite frankly, for an eighteen year old freshman who had never been over 1,000 miles away from home, Mr. Johnson was a hero. We certainly would be better off today if freshmen students had people like Mr. Johnson to consider their heroes. He was going to school on the GI bill and carrying a paper route morning and night to pay his way. I'm sure his influence caused me to join the United States Air Force as my choice of services in 1951 during the Korean War.

I have now known Mr. Johnson for 49 years. I know very few people who I respect more.

Mr. Chairman, and Members of the Committee, I ask you for the next few minutes to put yourself in Mr. Johnson's shoes. Think about how you would have reacted if the same thing had happened to you.

Listen to his story closely.

Mr. Johnson is a convicted felon. Neither Mr. Johnson nor his wife Jean knowingly or wilfully intended to violate the income tax law.

On the other hand, two Federal courts have determined that the Internal Revenue agents did willfully violate the law, and they have never been prosecuted. In fact, the Justice Department is continuing to defend the agents by appealing another decision handed down on May 16, 1996.

Let me close by pointing out what United States District Judge Kenneth M. Hoyt said in his decision:

> "Reforestation to replace trees used for paper in this case will cost more than was collected in taxes from the Johnsons in 1981."

Thank again to the Committee. If anyone has any questions of me before Mr Johnson is recognized, I will be glad to respond.

STATEMENT OF REP. JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON REPLACING THE FEDERAL INCOME TAX
July 31, 1996

Mr. Chairman, thank you for holding this important hearing on how replacing the federal income tax might impact America's manufacturing sector and our energy and natural resources.

Clearly, we need a tax system which is simpler and fairer for all Americans. We need a system which raises the standard of living for families, encourages Americans to save, increases capital investment and boosts our international competitiveness.

And like many Americans who are concerned both about the health of our economy and the health of our environment, I know our legacy must be that we leave a strong economy and a sound environment to our children and their children. It is absolutely critical for us to do both.

I am looking forward to hearing the input from our distinguished panelists today. I am also glad we are hearing from Mr. Johnny Johnson today, who will help us have some grasp of the intrusiveness and abuses of power that have grown out of our current tax system.

Thank you, Mr. Chairman.

Chairman ARCHER. Well, Mr. Hancock, you make an excellent beginning witness for the Committee in your articulation.

Before we hear from Mr. Johnson, I just want to say briefly to the Committee that today we continue our hearings on fundamental structural tax reform, and we will continue to examine the impact of replacing the Federal income tax as it will affect manufacturing, energy and natural resources. These sectors of our economy are extremely capital intensive. Both industries employ many Americans, but they require a tremendous amount of investment in order to keep people employed. Both are also integral to the economic future of the Nation. We really can't have long-term economic growth without a strong manufacturing and energy base. Understanding the impact of the tax system on these industries is critical to fundamental tax reform.

But before turning to the subject of that hearing, we will detour briefly to hear Mr. Johnson, whom you have beautifully introduced, so that he can tell us about his experiences—perhaps a euphemism to say untoward and unfortunate—with the IRS.

Our colleague, Mel Hancock, first brought Mr. Johnson's case to my attention and requested he be given the opportunity to appear before the Committee to tell us about his experiences. And because those provide a particularly compelling example of the breach of privacy rights that can occur when the IRS is overzealous in its enforcement of the income tax, I agreed with Mel Hancock that the Ways and Means Committee should hear Mr. Johnson's story this morning.

Given the limited number of days remaining in this session of Congress and the fact that we are going to have, I believe, a very hectic schedule legislatively in September, Mr. Johnson is scheduled to appear today since this will likely be the only opportunity we will have this year to receive his testimony.

Mr. Johnson's experiences should reinforce our resolve to change our tax system to one that eliminates the need for the aggressive methods of enforcement and intrusiveness which is part and parcel of the income tax. And, Mr. Hancock, as you mentioned, it is my goal in the years that I will continue to serve in the Congress to tear the income tax out by its roots and to get the IRS completely and totally out of the lives of every individual American. Mr. Johnson's case is emblematic of why we need to do that, why we need to be concerned about the individual freedom and privacy that we treasure so much in this country.

I will say again that Thomas Jefferson in his memoirs said one of his most notable achievements while in public office was to remove the Federal tax collector from any direct contact with the American citizen. I hope we can do that in this century.

Mr. Johnson, we are pleased to hear from you. If you have a written statement, without objection, it will be inserted in its entirety in the record, and we will be pleased to hear your oral comments and testimony. And welcome, we are delighted to have you with us. I regret the experience you have been through, but today you will have an opportunity to tell the entire country about that experience. You may proceed.

STATEMENT OF E.E. "JOHNNY" JOHNSON, SPRINGFIELD, MISSOURI

Mr. JOHNSON. First of all, I would like to thank you, Chairman Archer, and all Members of the Committee for allowing me the time here today to speak briefly about my ongoing 20-year confrontation with the Internal Revenue Service.

Now, the first thing I would hope to establish is that this is not——

Chairman ARCHER. Mr. Johnson, could you perhaps move the microphone a little bit closer to you. Because we are having a little difficulty up here being able to hear you.

Mr. JOHNSON. Yes, sir. Is this better?

Chairman ARCHER. Yes.

Mr. JOHNSON. First of all, I would like to establish that it is not my purpose today to indict the entire Internal Revenue system because I know full well here are thousands of fine, dedicated, loyal employees there. But in an organization of this size, I also believe it is quite possible to have some involved who do not measure up to the standards we would prefer.

In my particular case, I think I had the misfortune of falling into the clutches of a few people who can best be described by saying that their ignorance was overshadowed only by their arrogance. However, in trying to explain what has happened, I would say the group was not at all interested in justice—only publicity.

As this has progressed over 20 years, it seems to me that the purpose has not been to see justice done but, rather, to make an example of me for their own purposes of public relations. As a matter of fact, one agent told me in my office in Galveston, Texas, that he was not interested in right and wrong so much as he was interested in publicity for the Service.

As I said earlier, it is difficult to summarize 20 years in 5 minutes, but I will try to do that as well as I possibly can.

After this had been going on for about 1 year, I became very concerned about the direction the investigation was taking, and so I went to the president of the company I worked for, and with whom I served on the board of directors. I explained to him in detail all that was happening and what I feared was happening. He suggested that I in turn speak to two senior members of the executive committee of the board of directors of the company and bring them up to date as well.

Every contact I had with the Internal Revenue Service from then on, which covered a little more than 3 years, I reported in detail to these three gentlemen. Each time they assured me that they had total faith in what I was doing and that I had done nothing significanctly wrong and to put it behind me as quickly as I could in any way that I could. Above all, try to keep it quiet so that I could protect my job, my name, and my family.

After this had gone on for some 4 years, at the urging of these three men, my attorney, Robert White in Houston, negotiated a plea bargain with the assistant U.S. attorney in Houston to allow me to put this thing behind me, to protect my job which I had worked at for 33 years, to protect my wife, and also save a considerable amount of legal expenses for both me and the government.

The central point of this plea bargain was that it would be done quietly and with no publicity.

Three days after the plea bargain was negotiated, the first of two news releases were released by the Internal Revenue Service, both of which contained not only confidential but also false information about me. When questioned about this breach of the plea bargain at the first trial, one of the agents passed it off by saying—now, this is not a direct, word-for-word quote, but, in essence, it is what was said. She said, Well, we realized everything might not have been done just exactly correctly, but in this voluntary tax system we have, in order for it to be made to work, we must occasionally crucify a well-known taxpayer.

Fighting a battle like this for over 20 years has been trying, to say the least. My family and I have come to believe that it is almost impossible to see justice done. We have won twice before Federal judges and a jury. We won twice before the Fifth Circuit, and the first decision was overturned in the third appeal to the Fifth Circuit by the IRS on purely a jurisdictional point.

Still, the IRS continues to fight on, as Mr. Hancock said. They have appealed the second decision that I won.

Now, they insist what was done is proper, in spite of the fact that two judges and a jury have in loud and emphatic terms said "hogwash." I realize full well I probably will not live long enough—I am sorry—to clear my name. If I can prevent what has happened to me from happening to someone else, I will have been compensated.

This country has been good to me. I have had opportunities no kid from southeast Missouri could ever expect to have. And I am grateful for that. It has given me a chance to start over again. I hope I haven't appeared to be bitter because I am not. But I want this type of thing to stop.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF E.E. "JOHNNY" JOHNSON
SPRINGFILED, MISSOURI

TESTIMONY PRESENTED TO WAYS AND MEANS
JULY 31, 1996

First, I would like to thank Chairman Archer and other members of the Committee for offering me this opportunity to appear here today in the hope that I can help bring into focus practices of the Internal Revenue Service where the agency is being overly aggressive in the pursuit of its missions. Be assured it is not my intent to indict the Internal Revenue Service as a whole. They have an enormous responsibility to perform, but all organizations and individuals should have limitations. In my case, reasonable limits were clearly exceeded.

Mel Hancock and I have been close friends for some 50 years. However, I never talked with him about my problems with the Internal Revenue Service until 1991, when he called me after reading an article in the Springfield, Missouri, newspaper about the United States District Court in Houston awarding me a judgment against the United States for wrongful disclosures from my confidential IRS files. That judgement is now gone, and I am still fighting my case in litigation 15 years after the IRS destroyed my career just for its own publicity.

I think perhaps I should start my testimony by describing my personal history and then explaining what happened to me that forced me to file my case against the IRS and its agents. In order for you to understand what happened, I have to tell the story chronologically.

MY PERSONAL BACKGROUND AND EXPERIENCE

I was delayed in going to college because of World War II. I joined the Army Air Force and in due course became a B17 pilot serving in the European theatre. I guess if it had not been for World War II, I never would have gone to college, because the G.I. Bill provided veterans like me with funds to attend college.

After college I went to work for my older brother, who was a general agent in Springfield, Missouri, for the American National Insurance Company of Galveston, Texas. During 10 of the next 14 years I was the most successful salesman in American National's sales force. After those first 14 years with American National, my brother died of a heart attack, and I became the general agent. In my first year as general agent, our agency finished second in sales for American National and in the next six years we were the most productive and profitable of all the agencies in American National. By 1972, which was my twenty-first year in the insurance business, I was asked by the American National home office to move to Galveston, Texas to become the Executive Vice President in charge of worldwide insurance sales. Because of the prestige in this move and the potential for further growth, I took a 60% pay cut and moved my family from Springfield, Missouri, to Galveston, Texas.

Apart from the huge pay cut, I had a great deal of trepidation about my move to Galveston because I had no experience in a corporate headquarters and I wondered if I could exist in that atmosphere. I knew the insurance sales business and I knew that I could always return to Springfield and sell insurance. The move to Galveston required me to surrender my agency; nevertheless, I moved my family to Galveston. My first assignment out of the home office was to visit and revisit the 175 field offices of American National to instill some of the techniques that I had used in Springfield. In an effort to improve production at all these offices as rapidly as possible, I traveled five days a week for the first three years in Galveston.

With my heavy travel schedule, I was generally gone from Galveston from Sunday night to late Friday night. My goal was to meet and to get to know all the company's field personnel. I taught the sales techniques that I had used and encouraged the field force to use them. From 1972 to 1981, sales improved roughly 700% and profits rose from about $14 million to $105 million. During this time I spent a lot of the company's money on travel and entertainment and I spent a lot of my own money for this same purpose. I wanted to lay a foundation to be able to join one of these 175 agencies or perhaps acquire one or more of the agencies if I decided that I couldn't take it at corporate headquarters.

At the time of my brother's death, it became quite clear that his wife knew nothing about his personal financial affairs, and I decided that when something happened to me, my wife would not be left floundering as my brother's wife had been. So, I began to involve my wife in my business affairs. Her only employment had been shortly after we were married in 1949, as a volunteer grammar school teacher. She became the family's bookkeeper. She kept track of all my expenses, which were paid for by check, credit card or cash, and categorized them just as all bookkeepers do. In essence, when I got home from each trip, I would give my wife what I had and reconstruct it as best I could. At the end of each year, the bookkeeping workpapers that she compiled were turned over to our CPA who prepared and filed our annual income tax returns. I accept total responsibility for what later occurred; I should never have thrust so much responsibility on someone so ill-prepared for it.

When I was making my visits to the 175 field offices of American National, even though I had an unlimited expense account with the company, I spent $15,000 to $20,000 per year out of my own pocket on travel and entertainment matters. About $7,500 per year was spent in cash. I had receipts for some of the cash disbursements which I turned over to my wife for bookkeeping purposes and the other cash disbursements I identified in general terms for my wife. For example, I would tell her that I spent $190 in cash on a trip to Boston, Providence and New Haven. Unknown to me, my wife was overwhelmed by the bookkeeping process and confused by the lack of receipts for some of the disbursements. She discovered these receipts only when the monthly credit card bills came. As a consequence, my wife normally delayed keeping the books for a given month until the American Express and MasterCard bills were received for the following month. This delay made the bookkeeping process substantially more difficult for her.

During this time, I was home only on Sundays because on Saturdays I worked at the home office doing my administrative work. We never talked about the bookkeeping problems she was having and I didn't discover the magnitude of these problems until four or five years later when a routine IRS audit turned into a criminal case with me being the target of that case.

By 1981, through the tremendous efforts of many of us at American National, we had built the eighth largest life insurance company in the United States in permanent life insurance in force. I was in the enviable position of Senior Executive Vice President and served on the boards of directors of our company and numerous subsidiaries. I had over five thousand full time agents in the field worldwide, with responsibility for many thousands more employees. My salary had multiplied several times, and the fringe benefits were terrific. I reported only to the board of directors, not even to the president of the corporation. I believe I was in line to become the next CEO and Chairman of the Board of American National. In short, I felt I had about the greatest job that one could have in the insurance industry, and I loved my work.

THE IRS AUDIT AND INVESTIGATION

Early in 1976, American National was notified by the Internal Revenue Service that it would be audited. I was advised that the IRS wanted to audit several of the top officers of the company. I volunteered to be one of those audited, and several days later an agent came to my office and requested copies of my returns for 1972 and 1973. Since I had just filed my 1975 return, I asked him if he would mind auditing 1974 and 1975 also so that I would be brought up to date. This procedure had been suggested to me by a friend and executive with American National.

The initial contact I had with the Internal Revenue agent involved his requests for a lot of documents which I readily supplied. After a period of time, the auditor brought another agent with him and these agents began asking me and my wife to identify every disbursement we had made by check, by credit card and by cash, whether or not the items were deducted. After a while, still another agent was brought into the picture. He was a Criminal Investigation Division agent.

I had no concept of what these agents were looking for. When they wanted to talk to me, I talked to them and answered any and every question they asked. After some months of this, I asked the Criminal Investigation agent, "If you folks think I have done something wrong, why don't you tell me what it is and let me see if I can explain it. If I can't explain it, if I owe you taxes. I'll pay you and we'll get on with our business." The Criminal Investigation agent's reply was: "Mr. Johnson, the only good advertising the Internal Revenue Service gets is when it brings a big one down and your name is a household word to thousands of people." I said, "Do you mean to tell me that you think you can take me to a court of law and get a conviction on me with what you have from my records?" He said, "Probably not, but I can get your name in the newspaper and that will have accomplished my purpose." I said, "Right and wrong doesn't enter into the question?" He said, "Not at all."

I became deeply concerned with what was going on, so I consulted with the company's lawyer who was involved with the audit of American National's tax returns by the IRS. He recommended that I immediately retain outside counsel,I and I retained Robert I. White of the law firm of Chamberlain, Hrdlicka, White, Williams & Johnson in Houston. At the same time I consulted with the corporation's president and told him what had been going on. It was agreed that I would report all significant development in the investigation to the company's president and to two key members of the corporation's executive committee. Thus, I would keep informed three key individuals who served with me as members of the corporation's board of directors. Over the five-year course of the investigation, I did just that.

The Criminal Investigation agents who worked on my case seemed obsessed with finding the answers they wanted rather than securing the truth. A typical example concerns interviews that were conducted at restaurants where I entertained company visitors. We regularly met and ate at one of four or five restaurants in Galveston. I had charge accounts at all of these restaurants and turned the bills in to the company for payment. I remember being told by two or three of the restaurant owners that they had received visits from the Criminal Investigation agent who was trying to develop the theory that I was entertaining personal friends and family members at the restaurant and was passing along the bills for such personal matters to the company. These owners told me that the agent said to them, "Maybe if we audited you it would improve your memory about who Johnson was really entertaining at your restaurant." Another time, a company general agent in Missouri called to advise that the Criminal Investigation agent had visited him and tried to get him to lie about the nature of certain expenditures that I had made when I had visited that general agent's office. The general agent had surreptitiously tape recorded his conversation with the Criminal Investigation agent, so we knew exactly what had occurred.

On another occasion the Criminal Investigation agent interviewed an American National home office officer about a trip that he had made with me to Honolulu. The officer permitted the Criminal Investigation agent to reduce his statement to writing and then immediately signed the statement and surrendered it to the agent, retaining a photocopy. The officer showed the photocopy to me, and I pointed out a couple of mistakes in the statement about who was at certain meetings and the purpose of the meetings. The officer readily agreed that these corrections should be made so that the statement would be correct. When he called the Criminal Investigation agent to have the corrections made, the Criminal Investigation agent said, "These changes will change the entire statement you gave--and you can't make corrections at this late time." The company officer made the pen and ink corrections to a photocopy and mailed the photocopy, by certified mail, with a transmittal letter to the Criminal Investigation agent.

Another time, my mother-in-law, who was more than seventy years old at the time, called me at the office. She was hysterical. When she finally composed herself, she stated that she had been interviewed for two hours by the most abusive man she had ever met. It turned out to be the Criminal Investigation agent.

My youngest daughter, who was in Austin attending the University of Texas, was contacted by the Criminal Investigation agent who interviewed her wanting to know what she was doing with the money that my wife and I were sending monthly for school expenses. I never did understand why such inquiry had to be made of a seventeen year old girl when none of the items were deducted in our tax returns.

Probably forty insurance business associates were interviewed by the Criminal Investigation agent. Most of these people called me to report what was said and the attitude exhibited by the agent. The agent's constant statement was, "All we want to do is put Johnson in jail." I remember one time the Criminal Investigation agent stated to me, "I believe I could get you two years in the slammer for that statement."

NEGOTIATIONS WITH THE IRS AND DEPARTMENT OF JUSTICE

After the IRS finished its protracted and abusive investigation, it recommended that I be prosecuted for tax evasion for the years 1974 and 1975. I had no concept about the basis for such a recommendation. Working through my attorney and the CPA he engaged, it turned out that my wife, in her efforts to be a perfect bookkeeper, on several occasions in each of those two years tried to account for currency disbursements I had made on business trips for which there were no receipts by modifying the total of a disbursement on an American Express receipt. For example, my wife altered a $75 receipt to read $175. In this way she was trying to document my expenditure of $100 in cash in that city on that date. It was readily apparent from the monthly statement that came from American Express that the charge was not $175 but rather $75. In addition, my wife had listed among business disbursements checks for purely personal items such as purchasing a lawnmower for the house. She did this to supply a piece of paper to explain a currency disbursement of similar amount that had been spent in another town on a business trip . In total, these currency disbursements amounted to about $7,500 a year. Currency had actually been spent for business purposes, but through my wife's naivete she had accounted for these cash disbursements by modifying American Express receipts and by listing disbursements by check that had nothing to do with business. This was what the IRS' criminal case against me was all about.

My attorney and I were able to review each and every one of the altered American Express tickets and the checks written for personal purposes that had been classified by my wife as a business deduction. My attorney told me that if these amounts had been listed correctly as currency expended on the business trips, they would have not been questioned. However, he said, it appeared as though I was claiming as business expenses items that had not been expended or that had been expended for purely personal purposes.

In my initial review of these documents with my lawyer, I told him that I knew nothing about the modifications of the American Express tickets or the claiming of personal checks as business expenses. He asked me to take a polygraph tests about my lack of knowledge. I took the polygraph test and the examiner confirmed that I was truthful when I said that I had no knowledge of these items. My lawyer made me take a second polygraph test which I did with the same results. My lawyer and the CPA also analyzed the checks that I had cashed incident to making business trips. They were easily able to demonstrate availability of currency for purposes of paying the amounts that my wife had documented in the bookkeeping process through the altered American Express tickets and the misclassified checks for personal items.

In talking about strategy in the case, my lawyer advised me that the likelihood was that the government was going to go forward with the prosecution unless we presented the bookkeeper, my wife, who would take responsibility for the alterations and misclassifications. My lawyer said that since my wife was the person who did this, the likelihood was that she would be placed into the net with me, even though the amounts of tax involved were less than $5,000 per year for each of the years 1974 and 1975. So the strategy evolved, and the case proceeded as follows:

1. We told the IRS and the Department of Justice lawyers that the altered documents and misclassified checks were misclassified by my bookkeeper to reflect actual disbursements of currency. Then we showed that there were more than sufficient checks to cash to supply the currency spent on these trips. The dollars involved

were relatively small, slightly less than $200 a week for forty weeks a year. That's all we were talking about. Of course, taxis to and from the airports and tips accounted for most of that.

2. The Government was told that I knew nothing about these modified documents and misclassified personal checks. The polygraph tests were offered, and my attorney told the IRS and the Department of Justice lawyers that I would be willing to submit to polygraph examinations by the FBI or anybody else that the government selected.

3. We compiled and presented statements from nearly 100 insurance agents who stated that I always paid bills in cash in our after hours get togethers.

4. Despite the foregoing, the Department of Justice wrote advising that there would be a criminal prosecution for tax evasion filed against me in the United States courts in Galveston.

After further consultation with my lawyer and my wife, we decided to take a desperate gamble by disclosing to the Department of Justice that my wife was the bookkeeper who had altered the documents and misclassified the personal checks. This was done in a deposition taken in the United States Attorney's Office in Houston.

Months after the deposition was taken, we received a letter from the Department of Justice stating that, as my lawyer had predicted, both my wife and I would be indicted for tax evasion.

All the way through this process, I held weekly or twice monthly meetings with the company's president and the two members of the Executive Committee of the Board of Directors keeping them apprised of every development in the case, including the fact that there was a threat that my wife and I would be indicted for tax evasion for about $5,000 a year for 1974 and 1975.

My lawyer, Mr. White, began negotiations with the Department of Justice in an effort to make a plea bargain. The Department of Justice wrote my lawyer and advised that the Department of Justice would abandon the case against my wife, would proceed by criminal information against me for one year only, and would recommend that the case be disposed of with probation if I would plead nolo contendere (if the judge would accept it) or guilty (if the judge would not accept a nolo contendere plea).

I met with the company's president and advised him of the plea bargain offer. He advised that if the matter could be disposed of discreetly, with no adverse publicity, the plea of guilty or nolo contendere would not affect my job.

After consultation, my lawyer negotiated the following fine points of my plea bargain:

1. In order to prevent news reporters from spotting the papers filed in the court clerk's office, the U. S. Attorney agreed that I would be prosecuted under my legal name, which is a name that I have never used in my life - Elvis Eugene Johnson. My address would be reflected as 1100 Milam Street in Houston, which was the address of my lawyer's office. My Galveston address would not be mentioned, and I would not otherwise be identified in the court papers.

2. My lawyer worked with the judge and the court personnel (with agreement by the U. S. Attorney) to permit the investigation of my character, reputation and background to be conducted <u>before</u> the criminal case started. The recommendation of how to dispose of the case thus would be received by the judge before he even had a case before him.

3. Before the criminal case was filed, my lawyer and the government lawyer would meet with the judge to be certain that my case was going to be concluded with probation rather than any actual imprisonment.

4. The criminal information against me would be filed late on a Friday afternoon and would be disposed of immediately in court.

5. The U. S. Attorney agreed not to issue a news release about this case or the sentence that the judge gave me.

In considering this plea bargain, my lawyer told me on many occasions that the government would never win this case if I elected to go to trial.

But the cost of the criminal case was a consideration because it was estimated that it would cost $50,000 to win the case.

Moreover, the president of the company had assured me that I could plead guilty and keep my job as long as there was no publicity. My lawyer had structured the thing so that I could not be hurt through publicity. My wife had suffered a light stroke, which our doctor attributed to the stress from this ordeal. Half her stomach had been removed because of ulcers, and she was having severe migraine headaches almost daily. I simply could not put her through a trial. So, I decided to accept the plea bargain. On balance, I just decided to put behind me this bitter pill by pleading guilty to save my wife, to save the company embarrassment, and to save money.

The case went off exactly as scheduled late one Friday afternoon in April 1981. The pleadings were filed, and the judge heard the case and sentenced me to probation within a half hour of the time that the case started. No outsiders were in the courtroom. So when the case ended, the only information available in the clerk's office was that an Elvis Eugene Johnson of 1100 Milam Street in Houston pleaded guilty to a one count criminal information charging tax evasion in 1975 of approximately $3,500 of tax. Without access to the confidential IRS files, no one would have known that "Johnny" Johnson of Galveston and American National Insurance Company had been convicted of anything.

Immediately after the proceedings in the courthouse were concluded, I talked to the company's president and advised him that the matter was now concluded and that there would be no publicity about the fact that I had pleaded guilty. I offered to explain the plea bargain and my conviction to the Board of Directors, but the president suggested that we sleep on it over the weekend and talk on Monday. On Monday, I spoke to the president again. He told me that no one needed to convince him that I was an honest man. He said the best thing for the company was for me to stay right where I was, doing just what I had been doing. He said the matter was settled, and because there would be no publicity, there was no need to speak with the Board of Directors. He told me to put the matter behind me and get back to work. The final chapter was closed, or so I thought.

THE PRESS RELEASES AND MY DISMISSAL

On the Wednesday after I pleaded guilty and was sentenced to probation, I was at my office in Galveston when I received a call from the public relations officer of the company. He told me that a radio station reporter had just called him about a news release the station had received from the Internal Revenue Service about my pleading guilty. The news release stated.

> INSURANCE EXECUTIVE PLEADS GUILTY IN TAX CASE
>
> Galveston, Texas - In U. S. District Court here, April 10, Elvis E. Johnson, 59, plead (sic) guilty to a charge of federal tax evasion. Judge Hugh Gibson sentenced Johnson, of 25 Adler Circle, to a six-month suspended prison term and one year supervised probation.
>
> Johnson, an executive vice-president for the American National Insurance Corporation, was charged in a criminal information with claiming false business deductions and altering documents involving his 1974 and 1975 income tax returns.

> In addition to the sentence, Johnson will be required to pay back taxes, plus penalties and interest.

I immediately called my lawyer who tried to get various officials of the Internal Revenue Service to withdraw the news release. My lawyer warned the IRS that the information in the press release could only have come from the confidential IRS files, and he asked them to withdraw it immediately to try to stop any further damages.

My attorney also called the Assistant U. S. Attorney who had handled the case. The Government's lawyer confirmed that he knew nothing about the press release, that he had made no press release himself, that this was the first he had heard of a news release, and that the IRS was the only other folks he could think of who might have made a news release. He concluded by saying that if I had been damaged by the news release, that I should "sue the hell out of them."

Despite my lawyer's best efforts to warn the IRS that they were unlawfully issuing news releases that included confidential information from my tax files, the Internal Revenue Service made a second news release that reiterated essentially the same information. These news releases caused the company to ask for my resignation. The controlling shareholder of the company, who was the key member of the board of directors, said that I would have been retained in my position with the company except for the publicity. Because of the publicity I "had to go," as he put it.

Assuming for the moment that the IRS needed some publicity on April 15th of 1981, it should have restricted the news release to the public record. If the IRS had issued a release that followed the information that was in the clerk's offices, my identity never would have been disclosed. No one in the Galveston area would have suspected that the man they knew as "Johnny" Johnson in Galveston had been convicted of a crime if the IRS had published the information that Elvis Johnson of 1100 Milam Street in Houston had been convicted of tax evasion.

There were numerous other erroneous and wrongful disclosures in the press releases that demonstrated the willfulness and gross negligence in the preparation of the press releases. For example, the initial press release misstated the criminal charges by referring to multiple years, when only the year 1975 had been involved in the actual prosecution. By referring to false business deductions and altered documents, the IRS illegally revealed to the public the nature of my tax problems, which may have contributed to the Board of Directors' decision to demand my termination. Another vindictive part of the press release concerned the statement that I would be "required to pay back taxes, plus penalties and interest." In fact, my civil tax liability had not even begun to be resolved.

MY LITIGATION AGAINST THE IRS AND ITS AGENTS

After my forced resignation, I returned to Springfield, Missouri, and began again at the bottom of the insurance industry as a basic salesman for American National. It is probably some measure of respect that American National continued to employ me, even though I could not continue in my position as executive vice-president in Galveston. When I stopped to consider the difference in my compensation and retirement benefits, I realized that I lost at least $5,500,000 as a result of the unlawful press releases that the IRS had issued to at least 21 media outlets in the Galveston/Houston area. My attorneys advised me that Section 6103 of the Internal Revenue Code made it unlawful to publish information from my confidential tax files. In fact, they informed me that it was a crime for IRS agents to knowingly publish information from those confidential files. When I learned that no one would do anything to punish this crime, I decided to pursue my own damages in court.

At the time back in 1981 when the press releases were issued, the Internal Revenue Code only provided for a suit against the individual agent who had violated the confidentiality sections of the Code. My lawyers also thought that a suit could be brought against the federal government under the Federal Tort Claims Act, because the information had been negligently or tortiously released to the press. Thus, I decided to sue both the Government and the individual agents under alternative theories.

In 1986, a federal district judge in Houston granted me a partial summary judgement. His ruling was that the news releases violated the disclosure provisions of the Internal Revenue Code and that I was entitled to minimum damages of $1,000 for each of the media outlets to which the news releases had been released. We tried to discuss settlement of the case at the point, but the Government's lawyers, who were defending both the United States and the individual IRS personnel involved, insisted upon a trial. In 1991, the United States District Court in Houston awarded me a judgment against the United States Government under the Federal Tort Claims Act for damages of $10.9 million caused by the news releases. That case was appealed to the Court of Appeals for the Fifth Circuit and that Court's opinion affirmed the District Court's judgment. Thereafter, the Appeals Court wrote a second affirming opinion. Then the Fifth Circuit, en banc, wrote a third opinion holding that what had happened to me was not a tort under Texas law. Rather, it could only be some kind of a federal tort which was not covered by the Federal Tort Claims Act. The Court of Appeals sent the case back to the District Court to try my alternative claims directly against the individual IRS employees, who, by their misconduct, had damaged me.

The second trial was conducted earlier this year and the jury awarded me a verdict of actual damages of $6,000,000 and punitive damages of $3,000,000. Again, the Department of Justice has filed notices of appeal. It feels like I am on a never-ending treadmill. No matter how many times the judges or juries say they do not believe the IRS employees' version of what they claim happened, my government continues a war with me that should have been settled long ago.

The District Court entered judgment for that $9,000,000 plus interest and attorneys' fees. The judgment is against: (1) the Criminal Investigation Division agent, who admitted that he drafted the press release knowing that the information came from the confidential IRS files and who the judge decided had lied on the witness stand when he claimed that he had confirmed the press release with the Assistant U. S. Attorney; (2) the public affairs officer, who issued the press release without coordinating with the Assistant U. S. Attorney to make certain that it was accurate and should be issued; and (3) the Criminal Investigation Division agent's branch chief, the chief of the Criminal Investigation Division in the district, and the acting district director, all of whom participated in the decision to issue a second press release with the same confidential and damaging information.

In the two trials, we found out and proved that the Internal Revenue Service criminal agent and public affairs officer wrote the news release from the IRS case file without ever having looked at the public record. Moreover, they never asked the Assistant U. S. Attorney to approve the news release. Under the so-called IRS procedures, a news release was supposed to have been approved by the U. S. Attorney. So, there was a deliberate and intentional disclosure of information from the investigatory file. Even after my attorneys pointed out to the IRS that information in the first press release could only have come from the confidential IRS files, the second press release was issued without consulting the original courthouse records to see what information was public.

We had to scour the country to find former IRS personnel who would even be willing to testify against IRS employees. We finally found a former District Director and a former IRS Chief of Criminal Investigation who testified that all of the IRS personnel were willful or grossly negligent in disclosing the tax return information in this case. Amazingly, not one IRS employee other than the individual defendants came to defend what the agents had done to me. Even more amazingly, every IRS defendant stated on the witness stand that they had never bothered to read the Internal Revenue Code provisions that they had violated in order to determine whether they had any real defenses or not. Apparently, they had been on trial facing personal liability for more than 13 years, but the Justice Department had defended them to the nth degree, and the agents did not even care enough to open up the Internal Revenue Code themselves to see that what they had done was wrong.

EPILOGUE

The Department of Justice has now filed a notice of appeal on behalf of the five Internal Revenue Service workers who destroyed my career. The press releases were issued more than 15 years ago, and the IRS audit of my tax affairs began more than 20 years ago. The tortoise-like pace of the judicial process and the Government's unwillingness to settle this case without pursuing every avenue of appeal have left my wife and me without any real remedy. I am now 74 years old, and I fear that even if I recover on my judgment, my time is running short.

After I was forced to resign from American National, I seriously considered suicide because everything that I had worked for in my life from the beginning had been destroyed. I know that there was an appearance of wrongdoing on my part but the absolute truth is I was as innocent in this tax case as a baby. I have been convicted of a crime and I accept that because my tax return was wrong. I couldn't substantiate the cash disbursements that had been made. I pleaded guilty.

However, as the District Judge pointed out in his opinion, this was not a major crime, and the U. S. Attorney and my attorney had reached an agreement in the form of a plea bargain that disposed of the matter in a way that permitted the government to have a statistic of a conviction but at the same time permitted me to go about my life in a productive way. The breaches of the Internal Revenue Code's provisions about not disclosing confidential tax return information were done wantonly, and yet no one has ever prosecuted the Internal Revenue Service agents. I say no one. The District Judge who held the jury trial earlier this year grilled the United States Attorney outside of the hearing of a jury concerning the obvious conflicts of interest in defending the IRS agents after what they had done. The Assistant U. S. Attorney had no answer for this.

Let me say in closing that my country has been good to me. I had opportunities as a farm boy from Southeast Missouri, as a result of being in the Armed Forces during World War II, that I could never have dreamt of as a child. I hope I have been successful in telling my story without sounding bitter toward the government. I told you at the beginning that I was in the United States Army Air Force during World War II. In fact, I flew 29 bombing missions over Europe, and my planes were shot down twice. The rest of my original squadron was not so lucky, and they didn't make it home. The United States of America is my home, and I am still proud to say so.

After I was forced to resign from my job in 1981, I was fifty-nine years old. I am now seventy-four, still working full time trying to sell insurance, just thankful to live in a country where we all have opportunities.

Once again, thank you, Chairman Archer and the Members of the Ways and Means Committee for this opportunity to tell my story. I will be glad to answer any questions the Members of The Committee may have.

Chairman ARCHER. Mr. Johnson, thank you so much for coming and giving us the benefit of your story. It is true Congress has put into the Tax Code so many complexities and so many powers to the IRS that it is very, very difficult to exercise those powers properly, equitably, and in a way that is always considerate of the taxpayer. I appreciated your comments that there are a number of people, many people, in the IRS who do their job as best they can. But it does open the door for potential abuse because the power is so enormous. The old saying of Lord Acton is always true, that power corrupts and absolute power corrupts absolutely. All of us in this country should be concerned about that.

I often ask witnesses before this Committee, "What would you pay not to have to deal with the IRS every year?" And the least valuable answer has been, "What I pay my tax preparer." I am surprised that that is the lowest answer because it ought to at least involve all the preparation work that goes into getting the information ready to send it to the tax preparer, which is worth something.

But we had a middle-income lady from Connecticut testifying here a couple of months ago, and when I got to her and asked her that question, she said, I would give my first-born child. And I think that certainly after your experience you would have given an answer similar to that.

The one thing I think is ignored so much in our society is what is the value of individual freedom and privacy. Different people put different dollar values on that. I am not sure you can put a dollar value on it. It is the basic treasure, the basic foundation piece for this country. And inevitably, with this enormous amount of power, the pressure that is there to bring results will, I fear, continue to lead us into the kind of situation you have told us about today. But I agree with you and I hope your appearance will be helpful in preventing this from happening to anybody else.

Could you tell the Committee just briefly what the facts were about the allegation against you?

Mr. JOHNSON. Surely. I do not mean to sit here today and appear to be blameless. But when my brother died in 1965 from a heart attack, his wife was totally, absolutely naive insofar as his financial condition, what he was doing, what he had and what he didn't have, and what money he made and so on. I was determined that that would not happen to my wife when something happened to me, and so I involved her in my bookkeeping process. She had no work experience. She had no training. I thought in my helter-skelter life I was living that I had her trained to the point she could do this.

When I moved into the home office in Galveston, I was traveling 5 and 6 days a week, and I recounted, reconstructed for her as best I could what I did, what my expenses were, and so on. She never one time confided in me that she was completely confused, and she did such things as put a "1" in front of a "75" on an American Express credit card. There were some 8 or 10 of those, I believe, over a 4-year period.

She as honestly and as fairly as she could tried to cover expenses I had had with items of record that did not actually add up. I learned about this after the Internal Revenue Service started the audit, for which, I might add, I volunteered. They came to audit the company, and in the process, as some of you undoubtedly know, they audit some of the top officers. We were to be audited for the years of 1972 and 1973. At the suggestion of a good friend of mine who was an executive of American National, when the auditor came for my records for 1972 and 1973, I asked him to also audit my 1974 and 1975 records. Also, I had nothing to hide, I thought. And so from the expenses I actually had that were covered incorrectly by my wife's bookkeeping methods, which I found out about after the IRS started talking about bringing a criminal indictment against both of us, the sum of money involved was a few thousand dollars on which I would have owed less than $3,500 additional tax.

Chairman ARCHER. And what happened to that $3,500? Did you tender payment of those taxes?

Mr. JOHNSON. Yes, sir.

Chairman ARCHER. Mr. Johnson, thank you.

Mr. Hancock may inquire.

Mr. HANCOCK. Thank you, Mr. Chairman.

Johnny, you indicated the Department of Justice had filed notice of appeal on behalf of the five IRS employees whom two judges and juries found to have willfully and knowingly violated U.S.Code, section 6103. Unauthorized disclosure of confidential tax return information is a felony punishable by a fine of up to $5,000 or 5 years in prison, or both.

To your knowledge, has the Federal Government ever taken any action to prosecute these individuals for what they did?

Mr. JOHNSON. Absolutely none, as far as I know.

Mr. HANCOCK. Did either of the judges who heard your case have anything to say about what the Internal Revenue Service did here?

Mr. JOHNSON. Well, both judges said that the agent was obviously a liar. He swore a lie under oath.

Out of the hearing of the jury, Judge Hoyt asked the U.S. attorney if he had explained to his five clients the penalties of section 6103. He said he had not. All five said they had not read them, and so as far as I am concerned, nothing has been done or even considered where they are concerned.

Mr. HANCOCK. Thank you, Mr. Chairman. I know Mr. Johnson. I have heard the story. I would like for the other Members to have the opportunity to ask questions they consider pertinent.

Chairman ARCHER. Mr. Coyne.

Mr. COYNE. I have no questions.

Chairman ARCHER. Mr. Laughlin.

Mr. LAUGHLIN. Thank you, Mr. Chairman.

Mr. Johnson, I have read your prepared statement for the Committee, and I commend you for your courage. You know, it probably wouldn't be so bad of an experience if you were the only American this had happened to. But it is extremely tragic that all of us on this Committee in a hearing and in our day-to-day lives representing Americans around this country have heard this same story too many times. In this very room, we heard of people who had their lives broken just like you have, lost their businesses just like you have, and I know much has been made about your plea of nolo contendere, that the judge converted it to a plea of guilty.

Can you simply tell us whether the threats of criminal indictment of your wife had any influence on your decision to enter that plea?

Mr. JOHNSON. It was one of the very important considerations because my wife had had a stroke, which was attributed to the stress from this situation. She had had one-half of her stomach removed with ulcers. She was having migraine headaches on a daily basis. And I frankly had grave concern about her being able to go through a trial.

Mr. LAUGHLIN. As one who was merely an infant during World War II but understands your courage in fighting nazism, I have formed the opinion in reading your statement, as well as Judge Hoyt's judgment, that what you and your wife experienced was very similar to the experience that the Jews and the other people that were subjected to Gestapo treatment, was very similar to your own treatment. As one who fought nazism, do you share the opinion I form from the judge's statement?

Mr. JOHNSON. That has occurred to me, yes, sir.

Mr. LAUGHLIN. Now, I know Mr. Hancock asked you this question, but we have had two Federal judges who have rendered judgments on your behalf and cited the violation of the U.S. Code dealing with release of confidential information. Has anyone from the Justice Department come forward and given any indication that they are going to prosecute any of the IRS agents for violating the Federal law?

Mr. JOHNSON. Not at all, and it is remarkable, I think, in that through the two trials, not one single person from the Internal Revenue Service other than those accused have stepped forward to defend their actions.

Mr. LAUGHLIN. Would you agree with me that in your case the IRS agents involved in the press release calculated that through the use of the press release their conduct would override the judgment of the Federal judge in this case who thought it was fair to keep your plea and the sentence confidential?

Mr. JOHNSON. Oh, absolutely. One time the special agent was in my office, and I said, If you think I have done something wrong, why don't you tell me what it is? Let me see if I can explain it. If I can't explain it, if I owe you something, I will pay you and we will get on with our business.

His reply to me was to look me straight in the face and say, Mr. Johnson, you have to realize the only good advertising the Internal Revenue Service gets is when they bring a big one down, and he said your name is a household word to thousands of people. I said, Right and wrong doesn't enter into it? He said, Not at all, winning does.

Mr. LAUGHLIN. Would you agree with the opinion I formed in reading the judge's opinion that the arrogance of the IRS in doing the press release, in fact, caused you to lose a 30-year record of a reputation of integrity and honesty?

Mr. JOHNSON. There is not even a shadow of doubt. It is the sole cause.

Mr. LAUGHLIN. Mr. Chairman, those are all the questions I have, but I would, as a departing Member of the Congress, suggest that perhaps the Internal Revenue Service and the Department of Justice be called before a public hearing to explain why they have not brought criminal action against the employees of the Federal Government who have violated a Federal law. This law has a very good reason for being in existence, and that is to protect Americans from their own government.

Mr. Johnson, thank you very much not only for your courage in fighting this case, but for your courage in serving in the military forces to defeat the Nazis in World War II.

Thank you very much.

Chairman ARCHER. Mr. Collins.

[No response.]

Chairman ARCHER. Mr. Johnson.

Mr. JOHNSON of Texas. I want to associate myself with Mr. Laughlin's remarks and the fact that we fought for this country for the freedoms we adore, and if we don't protect them, something is wrong. I think it is a travesty that any agency would come after an individual citizen the way they have come after you, and I appreciate your testifying before us this morning.

Thank you.

Mr. JOHNSON. Thank you, sir.

Chairman ARCHER. Mr. Jacobs.

Mr. JACOBS. Mr. Johnson, when you filed your suit under the statute against those agents, do you know who paid their attorneys' fees?

Mr. JOHNSON. I have no idea. No, sir.

Mr. JACOBS. Let me ask you, you tell us in your testimony there may have been some appearance of wrong on your part, but you actually spent the money correctly and it was deductible, as I understand it.

Mr. JOHNSON. Yes, sir. That is my belief.

Mr. JACOBS. Now, put the case where these same IRS agents knew that but obviously don't like you and obviously meant to do you harm when they revealed this information in violation of the Federal law. Put the case that they knew perfectly well you took proper deductions and that you had not violated the Federal Income Tax Code. And let's say the court ordered your attorneys' fees to be paid. Who do you think should pay those attorneys' fees, the ones who meant to do you wrong or your fellow taxpayers, the government itself?

Mr. JOHNSON. I would love to see the people who were involved, who did what they did, be brought to pay those fees.

Mr. JACOBS. Right. I hope this is a little hint to my colleagues here, because since about the time they came after you in the early eighties, I have had a bill before Congress and I have had amendments before this Committee that have provided not honest mistakes by the IRS agents, but where they meant to hurt somebody, where they meant to use their authority or, to use the legal term, acted ultra vires, in the color of authority but above authority to harm another person for whatever reason, using that material. But instead of your fellow taxpayers paying your attorneys' fees, the ones who did the wrong would lose the boats in their driveways or their automobiles or whatever, and I keep hearing the same thing. It would have a chilling effect on IRS agents doing their duty.

Well, to me, that is like saying if you pass a murder law, it will have a chilling effect on American citizens because they will be afraid to shake hands with someone for fear it might kill him.

Nobody should be insulted, nobody should be insulted if he is doing his duty or she is doing her duty correctly simply because there is a law that would charge that person fines if he or she did or whoever does his duties incorrectly.

What I am trying to say is, it is one thing for your fellow taxpayers with their money to indemnify honest mistakes by IRS agents, but it is quite another to force them to pay the attorneys' fees, in essence to indemnify the intentional wrongdoing by an IRS agent. That is it in a nutshell. It has been adopted by this Committee two or three times only to die in the cave of the bones over in the body. The Washington Post goes berserk about it. I am having a chilling effect on IRS agents.

I just hope this testimony today might reinvigorate my effort to make clear to Members of Congress the distinction between honest mistakes, which probably ought to be indemnified by the government or the taxpayers, and dishonest mistakes, which should result in the punishment of the so-and-so or so-and-sos who did it.

Do you agree with that?

Mr. JOHNSON. I certainly do.

Mr. JACOBS. Well, Mr. Chairman, I rest my case.

Mr. HANCOCK. Would the gentleman yield?

Mr. JACOBS. Yes, sure.

Mr. HANCOCK. In your first question, when you first started, you asked if Mr. Johnson knew who paid the agents' legal fees.

Mr. JACOBS. Yes.

Mr. HANCOCK. I don't know for sure about this, but I understand that the Justice Department has handled the entire defense. Now, they may have other attorneys that they have hired, but am I correct on that?

Mr. JOHNSON. I believe that is correct. Yes, sir.

Mr. HANCOCK. So the taxpayers have paid the legal defense——

Mr. JACOBS. Right. Well, then, I tell my colleague from Missouri and I tell my Chairman, I not only rest my case but put it to sleep with that answer.

Chairman ARCHER. Mr. Houghton.

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

Mr. Johnson, good to see you. Clearly, from your testimony, you have been wronged. It is tragic. As a citizen and as a public employee, I am truly sorry about this. But you said there are some good IRS people as well as a few bad ones, and also you hope other people in the future will not suffer the same fate. So it seems to me the only course of action now is to fire these people and to pursue that.

However, at the same time, I understand the Department of Justice has filed a notice of appeal on behalf of the five Internal Revenue agents. What is the basis of that? Are they just going to stick up for their own?

Mr. JOHNSON. Sir, I must confess I am very naive in the way the law is administered, and I don't know what their basis is. I haven't seen a copy of the appeal as yet. And so I—there has not been an appeal. Mr. Steed tells me there has been a notice of appeal filed.

Mr. HOUGHTON. Thank you, Mr. Chairman. That is it.

Chairman ARCHER. Ms. Dunn, do you wish to inquire?

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

Mr. Johnson, I just want to thank you for coming to testify before our Committee this morning, and it has been, indeed, a sad story. Those of us who are interested in being responsible and accountable folks who work on behalf of our constituents within the government want to apologize for everything you have gone through.

I had the good fortune to have had a conversation a week or so ago with my colleague, Mel Hancock, who talked to me about your involvement in the community. And so I would like to ask you—you didn't talk much about what you are doing these days, but I would really be interested in your letting us know what you are doing on the volunteer end of things.

Mr. JOHNSON. Well, in 1983, I helped start an organization in the State of Missouri called the Make-A-Wish Foundation. It grants wishes to children who have life-threatening illness. We have granted, I believe, something over 400 wishes at a cost of approximately $3,000 per wish. I believe I have personally been involved in either 75 or 76 of those wishes.

I also serve on the board of the Ozark Counseling Service, which provides counseling for indigent families, primarily children.

About 2 weeks ago, I believe it was, I donated my 101st pint of blood. A short time ago, 2 years ago, I believe it was, I was given the Jefferson Award for being the outstanding humanitarian in our city that year.

Ms. DUNN. With all the difficulties the IRS has put you through, what would be your wish, Mr. Johnson?

Mr. JOHNSON. That no one else has to do it.

Ms. DUNN. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. And let me thank Mr. Hancock for his concern for an old friend that has gone through this horror story.

In talking with you yesterday and again reviewing your notes, I find we have much in common. You served your country well and came back and went to school under the GI bill, and based on that opportunity, you built yourself a business. I fought in Korea, came back home, went to school on the GI bill, became an assistant U.S. attorney, and both of us have felt this same response from the Internal Revenue Service. You went through this horror story, and I found myself on the Nixon enemy list for 7 years and audited. On the first audit I overpaid, much less broke the law. Please imagine my embarrassment as a former assistant U.S. attorney being warned that anything that I say would be held against me.

As you can see, the problem we do face is really bipartisan. It had gone through Nixon, Carter, Reagan, and Bush. Thankfully, yesterday, President Clinton signed the Taxpayer Bill of Rights, which hopefully, while it doesn't help you that much, should send a signal to the IRS that we have oversight responsibility.

Your courage has been mentioned, and I don't know exactly where that came into the exchange, but your case is presently on appeal, isn't it?

Mr. JOHNSON. Yes, sir.

Mr. RANGEL. And was your testimony discussed with your lawyer before you came here this morning? Are you testifying with the advice of your attorney?

Mr. JOHNSON. Oh, yes. Yes, sir.

Mr. RANGEL. So he didn't suggest anything you might say today, in response to questions, would adversely affect your appeal?

Mr. JOHNSON. No, sir.

Mr. RANGEL. He did not?

Mr. JOHNSON. He did not. No, sir.

Mr. RANGEL. Well, Mr. Chairman, I didn't know Mr. Johnson was going to appear until I spoke with Mr. Hancock yesterday, but believe me, I have a half a dozen people I have known that have had their lives destroyed by the abusive behavior of the Internal Revenue Service. If you could suggest how I could get on this agenda, I would welcome the opportunity to bring in some cases that have been affected by similar, if not comparably destructive, types of behavior. I really didn't see how this fell in line with the agenda. However, if we could have just one person to come in from the various districts, I think that would send a strong signal to the IRS that we are concerned.

Would we be able to work out other cases like this and bring them before the Committee?

Chairman ARCHER. Mr. Rangel, I don't know how long the list would be if we let every Member on the Committee——

Mr. HANCOCK. Mr. Chairman, Mr. Chairman, how many people have actually obtained a punitive judgment against the Internal Revenue Service and against the individual agents? I am not talking about having problems with the Internal Revenue. I am talking about actually obtained a Federal court judgment.

Mr. RANGEL. I have a lady in New York, my God, what she has gone through——

Mr. HANCOCK. Yes, but has she obtained a judgment, sir?

Mr. RANGEL. It has been terrible. It has wrecked her life and——

Mr. HANCOCK. Has she obtained a judgment against the Internal Revenue Service?

Mr. RANGEL. Yes. Her lawyers said they have done everything. Her marriage is over and her kids are now in jeopardy. Really, if you hear exactly what has happened to this lady—not to take away from Mr. Johnson's problems, but——

Mr. HANCOCK. Would you cite me the case, please, sir, so I could look it up? Maybe I would be able to help her.

Mr. RANGEL. I would have to ask her lawyers whether or not I could discuss her name and the case publicly, but if the lawyers would permit it, I would like to bring her here so that all Americans would know we have a big job to do. This woman is a very dear friend of mine.

So I would ask unanimous consent to be able to bring her—it has been reported in the papers, but I am not authorized to name her by name. As a well-known New Yorker, other Members of Congress know exactly who she is. I now ask unanimous consent to be able to bring her to start off the next hearing.

Chairman ARCHER. I am afraid the gentleman's request is not appropriate. If it were, we would have unanimous consent requests to bring witnesses before the Committee at every hearing that we have.

Mr. RANGEL. I ask unanimous consent that it cuts off after my unanimous consent is granted. [Laughter.]

Chairman ARCHER. Well, let the Committee stipulate that there are others who have problems that certainly are similar to Mr. Johnson's.

Let me comment to the gentleman from New York that unfortunately, and I'm advised by legal counsel, that the Taxpayer Bill of Rights not only would not help Mr. Johnson in his current situation but it also would not help any other individual in the future who had his identical situation. We need to look further into this.

The big problem here is there are already criminal and civil sanctions in the law, under section 6103, and they have apparently been violated as evidenced by the testimony Mr. Johnson has given us. But they have not been enforced by the executive branch.

You know, it's like the old story between Jackson and Marshall where Jackson said about Marshall's decision, the Chief Justice has rendered his decision, now let him enforce it. And we depend in general understanding only, that the executive branch will enforce the law.

I yield briefly to Mr. Laughlin.

Mr. LAUGHLIN. Mr. Chairman, I certainly agree with the gentleman from New York, Mr. Rangel, but his request would not be necessary if the Justice Department would enforce this law. You make the point and that's why I said in my comment that I think we need to have someone from the Justice Department before this Committee to find out why they are not enforcing this particular law.

Chairman ARCHER. OK. Mr. McCrery.

[No response.]

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Johnson, thank you for coming today.

I greatly appreciate your story. Being an insurance agent myself, I wanted to find out more about your career as far as how you made your way from a sales agent to a general agent to the corporate headquarters. And along this line of questioning, I wanted to find out about the amount of money you had to give up to move into corporate headquarters.

It is my understanding from a reading of your testimony and then from talking to my friend, Congressman Hancock, that you were pretty much slated to be the next chairman of this company. And even though you have said it's a little bit late for all the money, hopefully the money that eventually will come to you, and God willing it will be there, will go to benefit something that is very important to you and, if not yourself, your family, and charities.

How much money over the last 30 years, if you added up the sale of the company, the mergers and the acquisitions, and the various things that you've given up, do you think has been lost to you in personal wealth?

Mr. JOHNSON. Under those circumstances, sir, I would have to estimate about $15 million.

Mr. CHRISTENSEN. That is $15 million?

Mr. JOHNSON. Yes, sir.

Mr. CHRISTENSEN. Assuming you would have been the chairman of the company, as you were the first person in line to receive that next appointment, and has the company you used to work for merged with another company in the meantime?

Mr. JOHNSON. Yes, sir, they have.

Mr. CHRISTENSEN. Several mergers?

Mr. JOHNSON. They have bought small companies, several small companies. They are a major company themselves.

Mr. CHRISTENSEN. And what is their size now in billions?

Mr. JOHNSON. In actual rankings of the industry I do not know. They have about $40 billion in insurance in force and about $6.5 billion in assets.

Mr. CHRISTENSEN. I guess the thing I get most upset about is the fact that, still today, the Department of Justice and Janet Reno and Margaret Richardson's organization continue to file appeals, notice of appeals; that the second trial that came in was $6 million in actual damages and $3 million in punitive damages; that they refused to pay this amount, not even coming near the amount that would compensate you, let alone the time and anguish you have gone through over the last 30 years; and embarrassment to your family and your name, which nothing can take away.

I guess I would just hope if there are Department of Justice officials or IRS officials in this room today who read the record, that this would serve notice, I would hope, that this would never happen again. As you have said, this would be the beginning of the end of these kind of practices against Americans when their own government is fighting them. But you have admitted and you have paid over 10 or 15 or 20 years ago the pittance of $3,500 and what it has caused you in anguish.

I apologize on behalf of our government and I thank you for your testimony and I hope, too, this would never happen again. But, in light of the fact that the Department of Justice is the perpetrator of this crime and the IRS continues to file notice of appeals, continues to circumvent the law, continues to fly in the face of what two Federal judges have said is the right thing to do in the law, I don't see this administration doing anything to help the plight of the American taxpayer and for that I say, I'm sorry.

Mr. JOHNSON. Thank you, sir.

Mrs. JOHNSON [presiding]. Mr. Neal.

Mr. NEAL. Thank you, Mrs. Johnson.

Just a quick question, Mr. Johnson—and I think it is the most distressing detail that you've offered—would you repeat again what the IRS agent said when he came to your office, when you said, Why don't we just see if we can work this out?

Mr. JOHNSON. I said he had come back numerous times, he and another fellow. And on this one occasion, after it had been going on for about 1 year and all the other audits that were involving officers of the American National Insurance Co. were completed, he kept coming back. I said to him one morning, If you think I have done something wrong, why don't you tell me what it is so I can see if I can correct it. If I can't explain it, if I owe you something, I will pay you and we will get on with our business. He said, Mr.

Johnson, you must realize the only good advertising the Internal Revenue Service gets is when they bring a big one down and he said, your name is a household word to thousands of people.

I said, Do you mean to tell me you think you can take me to a court of law and convict me of wrongdoing on the basis of what you have? And he said, Oh, I don't think that. I could put your name in the paper, that's what I'm after.

Mr. NEAL. Thank you.

Mr. HANCOCK. Would the gentleman yield?

Mr. NEAL. Yes, I will.

Mr. HANCOCK. The news release was released 3 days after this convicted felon pled guilty to one charge to be able to try and save his career and also to protect his wife. It was released 3 days after the revenue department and after Justice, I suppose whomever they are, had agreed not to publicize it. That was on April 13. I don't know whether that means anything or not.

Thank you.

Mr. CHRISTENSEN. Would the gentleman yield?

Mr. Johnson, this person who said that, is he still in the employment of the Internal Revenue Service?

Mr. JOHNSON. I have no idea. He has been listed as a potential witness at both of the trials. He and the other agent have been listed as potential witnesses and neither have ever shown. I have no idea.

Mr. CHRISTENSEN. Do you have any idea if he is still—any idea of where he is currently?

Mr. JOHNSON. No, sir, I have no idea.

His name is Walter O'Connoll.

Mr. CHRISTENSEN. Walter who?

Mr. JOHNSON. Walter O'Connoll.

The other agent involved was Dudley Baker.

Mr. CHRISTENSEN. Thank you, Mr. Johnson.

Mrs. JOHNSON. We do have to vote right now, but before we do I would like to ask you a few questions that would require really very brief answers but I do want them on the record.

First of all, you indicated in your 1975 tax deficiency that your deficiency was only $3,500. Why do you think the IRS prosecuted criminally rather than letting you pay? Now, you have addressed that to some extent, is there anything you would have to add to that answer?

Mr. JOHNSON. Nothing other than I think they were looking for publicity. At the first trial, Judge John Singleton said——

Mrs. JOHNSON. Has anyone from the IRS ever acknowledged to you that what they did was wrong?

Mr. JOHNSON. No, ma'am.

Mrs. JOHNSON. Thank you.

I want to ask a couple of other questions of my colleague because I want to be sure they are on the record.

Representative Hancock, have you and Mr. Johnson ever had any financial dealings or business relationships with one another?

Mr. HANCOCK. Well, back about 15 years ago or longer than that, maybe 25 years ago, we jointly owned one of the best bird dogs that ever hunted in southwest Missouri. I trained it and kept it and Johnny bought the feed.

Then about in 1968, I was licensed under Johnny, Johnny is a good recruiter, he is one of the best ever in the whole United States, and I was licensed to sell insurance and also to sell mutual funds through his agency.

Upon coming into the Congress, those licenses had to be terminated. You know, as a Member of Congress, I can't hold a license. Other than that, no. And it was straight commission sales and no other financial dealings whatsoever, in any way, with Mr. Johnson.

Mrs. JOHNSON. Thank you.

There is a fine line, of course, that Members of Congress must walk and in inquiring into matters involving ongoing litigation, have you ever discussed the substance of Mr. Johnson's case with any Federal official?

Mr. HANCOCK. I have brought Mr. Johnson's case to the attention of Mrs. Richardson, the Director of Internal Revenue Service, on the basis of an inquiry, Have you ever been briefed on the case? I have never discussed it with her in any way except that inquiry.

I also have a letter from her whose response is, Yes, she has been briefed. Congressman Henry Hyde asked me to call Justice and ask a representative of the Justice Department to be here at this hearing to hear Mr. Johnson. I did make that telephone call. I pointed out the only reason I was making the call and the only things that were discussed was a little bit of what was the written document. No opinions were expressed in any way whatsoever.

Mrs. JOHNSON. Are you concerned about retribution from the Internal Revenue Service for the role you are playing in trying to bring Mr. Johnson's case to public attention?

Mr. HANCOCK. Five years ago when this first came up and when I brought it to the attention of a few Members of Congress, that was a concern, yes. Frankly, I am concerned.

Mrs. JOHNSON. But to date it hasn't materialized?

Mr. HANCOCK. It hasn't materialized yet. However, I understand a Member of Congress who just walked out of here said he understands it is kind of routine for retiring Members of Congress to get audited. I don't have anything to hide. I may get audited.

Mrs. Johnson, I am not concerned that the Internal Revenue Service or Department of Justice is going to come after me. I don't think they will. I am concerned about my estate. Quite frankly, I am in the process right now of developing and completing an estate tax return in detail, so my wife and my family will have a complete record of the things that I have in my head that are not on paper.

Yes, I am concerned.

Thank you.

Mrs. JOHNSON. Thank you, Mr. Hancock, it is important to get those things on the record.

Mr. Johnson, it is appalling what you have gone through. It is outrageous what government has done to you and it is impressive what you have contributed in your life, both as a private citizen, volunteer, and as a businessman, father, and community person. I commend you for the quality of the life you have lived and, believe me, we will be looking very, very carefully at how we can hold the Internal Revenue Service far more accountable for the actions of agents that were inappropriate and illegal.

We started looking at that before the last Taxpayer Bill of Rights. We were not able to complete that in time to keep that bill moving but it is high on our agenda, and we will not let this hearing be the end of this matter.

I do have to go vote. When we return, we will move to the next panel.

Thank you.

Mr. JOHNSON. Thank you very much, ma'am.

[Recess.]

Mr. ENGLISH [presiding]. I will call this hearing back to order, please. We will return to the second panel and we appreciate all of you participating and your patience in lieu of some of the things going on, on the floor of the House.

I would like to give each of you an opportunity to offer your opening statement and then as we have some other Members here and I have a number of questions, we will have an opportunity to offer you some direct questions.

I would first like to recognize Hon. W. Henson Moore, who is no stranger to this institution, and he is currently president and chief executive officer of the American Forest and Paper Association.

STATEMENT OF HON. W. HENSON MOORE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN FOREST AND PAPER ASSOCIATION; AND FORMER MEMBER OF CONGRESS

Mr. MOORE. Thank you, Mr. Chairman.

Our trade association is the national trade association that represents the building products and paper industry. We account for 7 percent of the U.S. manufacturing output. We rank among the top 10 manufacturers in 46 States, employing some 1.6 million Americans. This hearing is focusing on manufacturing and natural resources, and certainly this industry fits that mold.

We look at what is going on in the world today in the case of global competition, and we certainly spend an awful lot of time worrying about our competitors around the world. Technological advances we need to do to stay on top, and then the environmental cost and the environmental protection costs we must implement to be able to meet the legal requirements in this country cause us to have to continuously reinvest large amounts of capital.

As a matter of fact, we are one of the most capital sensitive and capital intensive industries in the country. And such things as the need to reduce the capital gains tax, the need to repeal the alternative minimum tax, and the high cost of estate taxes are things that are wrong with the current law that frustrate the ability of this industry to be able to form the capital necessary to meet the high capital cost demands for protecting the environment and maintaining our competitive advantage.

This industry is one that has another facet to it of interest which needs to be looked at when you reform the Tax Code. It normally takes somewhere between 20 and 80 years, depending upon what part of the country you are in, from the time an investment is made in a tree farm until the owner of that farm reaps any benefits.

And during that time period, he's spending money on the front-end expenses to put the trees in, managing and maintaining and protecting the timber, property taxes, interest expenses, and then during that time of 20 to 80 years while he's waiting to get some of that money back, he runs a host of uninsurable risks of nature, such as fire, and storm and insects and disease, along with the full gamut of economic risks associated with any long-term investment.

So, this industry is a little bit different natural resource industry when you look at the time line it takes and the faith it takes for somebody to make an investment in this industry and be around to reap the benefits of it.

For these reasons, we have concluded that the efforts of the Chairman of this Committee and the Members of this Committee to look into tax reform and, perhaps even tear out by the roots, as the Chairman has said, the existing tax system for another one, is a proposition we strongly support.

Unfortunately, the marginal changes we've been waiting for and looking for in alternative minimum tax, and capital gains and estate taxes just don't seem to be coming. Perhaps it is time we reform the Tax Code in general. Our most serious concern, the thing we are really the most interested in is because of our competitiveness—we are the largest industry in the world, nobody produces more building products or more paper than the United States does—for us to maintain our competitive position, to gain in exports which we are currently doing, and to keep up with technology and protect the environment requires so much capital that that is the focal point for us in terms of looking at a reform of the Tax Code: Capital formation.

Something needs to be done to make it easier and more attractive in relation to our competitors around the world to be able to form capital and spend and recoup capital in these industries that employ people such as ours and require the tremendous capital investments that we have.

And, certainly in looking at a new Tax Code, we think that boosting the supply of savings in this country is very important, again, to reduce the cost of capital. If we can have a greater savings rate in the country, our capital costs will be more competitive than they are currently. Capital investment, as I indicated, immediate expensing of all capital investments is something being talked about. We strongly support that as being a much better way to go about recouping the capital we gather and then spend in this industry.

Border adjustability, such as the exclusion of export sales from the tax base, as is done in the USA tax proposal, is something we also think is important, as we are major exporters. We want to export even more in the future.

Eliminating the deduction for compensation of employees as some have talked about doing is something we think would be a mistake and also eliminating the whole mortgage interest deduction is something we think would not necessarily be a good idea. But, basically anything that helps us form capital cheaper and better and helps boost the savings rate in the country is something we are basically interested in and would be supportive of.

There are some transition issues that need to be looked at, such as the unrecovered cost of capital assets and inventory as you move from the system we have now into a new one, as well as the existing tax attributes, such as net operating losses and tax credit carryovers, as these were important and were part of the figuring of the cost of capital investment in the industry at the time we made them.

But, Mr. Chairman, we are very supportive of your efforts. We would like to be very encouraging of your efforts. We certainly stand ready to work with this Committee at any time to indicate how we think or to be of assistance to the Committee as you go through some very difficult deliberations as this becomes a very serious effort, perhaps, in the next Congress.

[The prepared statement follows:]

AMERICAN
FOREST &
PAPER
ASSOCIATION

GOVERNMENT AFFAIRS

TESTIMONY OF
THE HONORABLE W. HENSON MOORE
PRESIDENT AND CEO
AMERICAN FOREST & PAPER ASSOCIATION (AF&PA)

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JULY 31, 1996

ON
THE EFFECT OF TAX RESTRUCTURING
ON MANUFACTURING, ENERGY AND NATURAL RESOURCES

Thank you, Mr. Chairman. My name is Henson Moore, President and CEO of the American Forest & Paper Association (AF&PA). I am pleased to be here today to present a preliminary assessment of the implications that sweeping tax reform measures would have for the forest products industry. AF&PA is a national trade association representing producers of paper, pulp, paperboard and wood products, as well as the growers and harvesters of this nation's forest resources. The forest products industry provides 7 percent of U.S. manufacturing output and ranks among the top 10 manufacturing employers in 46 states. More than 1.6 million people are directly employed by the forest products industry. At the same time, this many-faceted business is also a natural resource-based industry which is responsible for planting, growing, and harvesting trees -- a basic renewable resource. This hearing, with its focus on manufacturing and natural resources, provides a special opportunity to highlight the unique nature and concerns of this industry, and I appreciate the opportunity to share AF&PA's members' views.

The Ways and Means Committee has already seen several important facets of this industry in the faces of witnesses who have appeared before this committee in the 104th Congress. Chester and Lonnie Thigpen, father and son Tree Farmers, whose family business covers 850 acres in Montrose, Mississippi, have testified, as has Andy Sigler, Chairman and CEO of Champion International Corporation, one of the world's leading manufacturers of pulp, paper and wood products, based in Stamford, CT. These witnesses represented just two of the vital forces at work in today's forest products industry.

The U.S. forest products industry is an inter-dependent network of small and large businesses ranging from private tree farmers and independent logging contractors to manufacturers and distributors of paper, pulp, lumber and building products. Woodland owners rely on manufacturers to provide a ready market for the trees they grow. Likewise, manufacturers need these trees to assure a reliable supply of raw materials for the products they manufacture.

We applaud the Ways and Means Committee's efforts, and your personal commitment, Mr. Chairman, to explore the ramifications of fundamental tax reform, and this industry intends to be an involved participant in the debate. The forest products industry has a vital stake in the on-going tax restructuring debate given the unique problems we face. This industry depends on a sustainable source of fiber for its pulp, paper, and solid wood mills. And yet, current tax policies create disincentives to the implementation of sustainable forestry principles, as well as a disincentive to the capital formation necessary for continued investment in sophisticated plant and equipment. Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code discourages that investment in a number of ways. Compared to our major industrial competitors, the U.S. tax code is significantly less favorable for investment.

That is why the forest products industry supports changes approved by this Committee and this Congress earlier this year that would encourage economic growth and investment. We strongly support the proposal to reduce the capital gains tax for individuals and corporations. This would encourage long-term investment and risk taking, lower the country's cost of capital, and enhance the international competitiveness of U.S. producers. For the U.S. forest products industry, a lower capital gains tax rate will encourage private landowners to invest in timber growing enterprises to meet the country's future demand for timber.

We also strongly support repeal of the Alternative Minimum Tax (AMT). The AMT is clearly not working the way Congress intended. This tax falls most severely on cyclical and capital intensive industries. It raises the cost of capital and penalizes capital intensive companies. Instead of acting as a backstop to ensure that truly profitable companies don't escape paying their fair share of tax, AMT has become an almost permanent penalty on capital investment. We must address the problems created by the AMT in order to generate economic growth, strengthen global competitiveness and create new jobs.

The burden of overly high estate taxes on family-owned businesses must be eased. Estate tax reform is particularly important to the more than 7 million people who own most of the nation's productive timberland. Many of these 7 million landowners are also close to retirement age, and without estate tax reform many of their properties will be broken up into smaller tracts or harvested prematurely just to pay estate taxes.

The United States is blessed with an abundant and infinitely renewable resource -- almost 490 million acres of timberland which can be planted, harvested and replanted on a sustainable basis for hundreds of years to come. And with AF&PA's Sustainable Forestry Initiative℠, our members -- who own approximately 90 percent of the industrial forestland in the United States -- are voluntarily, visibly and significantly changing the practices of forestry on industrial forestland. Yet the tax code must recognize the unique aspects of investing in this renewable resource (a 20 to 80 year holding period and the risks from fire and disease, in addition to general market risks).

The forest products industry is also one of the best examples of the positive effect of investment on productivity. As a result of this industry's investment, productivity has improved dramatically, costs are down, and the industry is a strong global competitor. That doesn't mean, however, that we can become complacent. Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code discourages that investment in a number of ways -- high tax rates on capital gains and the alternative minimum tax to name two. Compared to our major industrial competitors, the U.S. tax code is significantly less favorable for investment.

AF&PA has performed a preliminary analysis of two of the major tax reform proposals -- a flat tax (such as the one introduced by House Majority Leader Dick Armey) and an income tax with an unlimited savings deduction (such as the USA tax system introduced by Senators Domenici and Nunn), and we are working to assess the implications of other proposals. Based on this preliminary assessment of the Armey and USA proposals, association and industry economists and tax experts found a number of favorable components. However, any new tax system also raises some significant issues and concerns. My testimony will focus on those particular issues and potential implementation problems related to the unique characteristics of this industry.

Capital Intensive, Internationally Competitive Industry

The pulp and paper segment of the industry is one of the most capital intensive and internationally competitive manufacturing industries in the world. Each employee in the pulp and paper business is supported by $123,000 of plant and equipment. Just since 1980, the industry has invested more than $130 billion in new pulp and paper production and pollution prevention equipment. This amount accounts for about ten cents of every sales dollar from paper products, the highest reinvestment rate of any U.S. manufacturing industry. The U.S. forest products industry is also a good example of the role investment plays in creating good, high-paying jobs.

The future growth of this country's forest products industry lies in export markets, but the U.S. has recently shifted from being a net exporter to a net importer of forest products. One problem is that overseas suppliers, many of whom are given generous tax breaks and other subsidies, have a competitive advantage over U.S. producers. Some foreign countries have taxes, such as value-added taxes, that, in effect, reduce the after-tax cost of manufacturing goods for export and increase the after-tax cost of imports. Foreign governments also provide indirect and direct subsidies of various forms (such as reduced borrowing costs, reduced labor costs and reduced property taxes) to manufacturing companies.

U.S. forest products must successfully compete in the global market, and tax reform must play an important role in creating an economic environment which will help "level the playing field" for American companies competing in the global marketplace.

For the pulp and paper industry, maintaining international competitiveness is a necessity -- not a luxury. Because of its high level of fixed investment, this industry must achieve extremely high operating rates in order to remain profitable--levels that have averaged 92% over the past 30 years. Consequently, even a small loss in international competitiveness can jeopardize operating rates and cause a downward spiral.

Because of the requirements of global competition, technological advances and environmental protection, the industry must continuously reinvest large amounts of capital, yet the current tax code directly discourages that investment through tax penalties such as the Alternative Minimum Tax (AMT), high rates of tax on capital gains, and double taxation of corporate earnings. Moreover, compared to our international trading partners, the U.S. tax code is significantly less favorable for investment.

Planting, Growing and Harvesting Trees

The forests on which this industry depends are a unique and invaluable national resource that can be managed to provide commodities and services. However, good stewardship and wise use of the land is essential to the continued prosperity and vitality of the forest products industry.

Timber growing is unique when compared to every other economic activity. It takes between 25 years and upwards of 75 years for a tree to be ready for harvest. This extraordinarily lengthy holding period requires an unusually strong commitment from investors because capital is literally locked into the ground during the growing period with very little market liquidity. Moreover, timber growing initially requires heavy front-end expenses and, later, on-going expenses from managing, maintaining and protecting the timber, as well as for property taxes and interest.

Over the entire growing period, timber is subject to a host of risks of nature, like fire, storm, insects, and disease, plus the full gamut of economic risks associated with long term investments. Acts of nature are not insurable, so this variable adds to the risk and unpredictability of timber as an investment. Therefore, fair capital gains treatment is essential to making forestry an economically viable investment. Additionally, since much of this land is held by individuals, the current estate tax rules often force liquidation of either the land or the trees just to pay the taxes upon death. Private forest land owners are obviously very sensitive to all factors that affect the economics of long-term forestry investments, especially U.S. tax policy.

Timber harvests on public forests have declined more than 50% from the levels of the mid-late 1980's. With the nation now looking to the private sector for the "working forest" of today and tomorrow, the country's interests require a policy framework that supports private forestry investments. To do otherwise would force both small and large timber growers out of the business of growing trees -- threatening the country's future timber supply and the future availability of products on which the American people have come to rely.

Industry Recommendations/Concerns Regarding Tax Reform

- o Provisions designed to boost the supply of savings should be included in any tax reform system. Much concern has been expressed over the relatively low rates of U.S. savings, and many economists believe that stronger savings will translate into increased investment, which in turn is the key to future growth. Both the flat tax and USA proposals would effectively remove the current penalty against savings, using different approaches.

- o Capital investment is the key to higher productivity and the creation of new and better jobs. Immediate expensing of all capital investments is an essential ingredient of any tax system designed to stimulate economic growth and strengthen international competitiveness. Eliminating or at least minimizing penalties for capital investment is another essential ingredient of any tax system redesign that is intended to stimulate economic growth and strengthen international competitiveness.

- o Border-adjustability, such as the exclusion of export sales from the tax base as provided in the USA proposal, is another essential component of a tax reform system which will strengthen global competitiveness and create new jobs. Under the Armey flat tax, however, there is no rebate of taxes on exports, and the foreign tax credit is eliminated. Thus, this latter proposal further tips the scales against U.S. producers trying to compete in international markets.

- o Eliminating the deduction for compensation would also have an effect on our industry. If, under any tax system, a deduction for compensation is disallowed, the negative impact on job creation should be eased by allowing a compensating credit, such as a credit for Social Security taxes.

- o Another industry concern is the home mortgage interest deduction. Under the Armey flat tax proposal, households would not be permitted to deduct mortgage interest expenses. The USA tax would preserve mortgage interest deductibility, but would not allow non-mortgage interest outlays to be deducted. An analysis by the economic consulting firm DRI/McGraw-Hill estimates that the market value of an average home would drop by 15% if the Armey tax proposal was implemented without a phase-in period. New home construction would also drop sharply during the initial years of the new tax structure, according to DRI, but then would recover in response to an anticipated easing or mortgage interest rates.

Transition Issues/ Recommendations

The introduction of any major tax reform poses formidable transition questions. Therefore, our preliminary analysis also poses more questions than answers at this point.

A particularly significant transition issue for this industry is the handling of unrecovered costs of capital assets and inventory, as well as existing tax attributes such as net operating losses (NOLs) and tax credit carryovers.

Basic equity and fairness requires drafters of new proposals to allow recovery of both. Unrecovered costs relate to property which either produced income subject to tax under the income tax, or <u>will</u> produce income subject to tax under the <u>new</u> system. Thus, taxpayers should be allowed to recover the costs of producing the income. Likewise, taxpayers have the expectation that they will carry over tax attributes, since Congress has historically provided transition relief when major changes were made to the tax code.

We believe a simple yet fair approach for allowing recovery of unrecovered costs of property and tax attributes is as follows:

- o While we recognize that the write-off period may need to be related to the impact on revenue, we nonetheless believe that full recovery of these costs should be allowed as a basis no less beneficial than allowed under current law. Specifically, unrecovered basis and AMT credits that have been generated due to the draconian depreciation scheme of AMT should be allowed to fully offset tax liabilities under the new system.

- o With respect to tax attributes, we believe that NOL's should be converted into credits and that all credits should be utilizable ratably over the same write-off period as unrecovered costs of property.

Thank you for the opportunity to testify today, Mr. Chairman. Again, we applaud the Committee's efforts to tackle this important issue and embark on what will undoubtedly be a lengthy debate. On behalf of the American Forest & Paper Association, I assure you the U.S. forest products industry intends to remain engaged and involved as a commentators and information resources as the efforts of this Committee continue to restructure, simplify and improve our tax code.

Mr. ENGLISH. Thank you, Mr. Moore, and we very much appreciate your time here and your statement.

The Chair would recognize for a statement, Paul Sullivan, chairman of the committee on taxation of the American Petroleum Institute and vice president and General Tax Counsel of the Exxon Corp.

Welcome, Mr. Sullivan.

STATEMENT OF PAUL SULLIVAN, CHAIRMAN, COMMITTEE ON TAXATION, AMERICAN PETROLEUM INSTITUTE; AND VICE PRESIDENT AND GENERAL TAX COUNSEL, EXXON CORP.

Mr. SULLIVAN. Thank you, Mr. Chairman, and good afternoon.

I am Paul Sullivan, vice president and general tax counsel of Exxon Corp., and chairman of the general committee on taxation of API, the American Petroleum Institute, and I am here today on behalf of API.

I would like to thank the Committee for the opportunity to comment on a topic of profound importance to our industry as well as to all the taxpayers of this country. We will be submitting a more detailed statement for the record of these hearings.

As the Committee requested in the hearing notice, I am addressing the various tax reform proposals as total replacements for the current income tax, not as add-on taxes.

The API applauds the Committee and the sponsors of the various tax reform proposals for moving toward the taxation of consumption, rather than the taxation of income. API, like Chairman Archer, has concluded that a properly designed consumption tax is preferable to an income tax. In that regard, we have developed a set of design principles by which to evaluate the effectiveness of any consumption tax proposal. Those principles are set out in our written statement.

While we are supportive in principle of moving toward the taxation of consumption, we urge the Committee to proceed with caution. Because the income tax has been embedded in our economy for more than 80 years, business decisions have been and continue to be premised on economic assumptions that are spawned by that system. Therefore, any radical change is going to have profound implications for the structure of business, the financing of business and business operations, themselves. And those implications must be thoroughly understood before moving to any new system.

This is especially true in the capital intensive oil and gas industry where the results of decisions taken today may take a decade or more to manifest themselves.

For example, here are several issues that we have been wrestling with as we consider the various proposals. First, the tax treatment of imports of all basic commodities for further manufacturing will have significant ripple effects on the economy. Because more than one-half of the crude oil used in the United States is imported, this issue is of major concern to our industry. One of the proposals, the USA tax, imposes a nondeductible import tax which would have a negative effect on the price of energy to consumers. We believe any import tax should be fully creditable or deductible in order to be on a parity with the value-added taxes of our trading partners.

Second, because our industry must operate where we have access to economically recoverable reserves, and significant domestic sources have been foreclosed to oil and gas development, the tax treatment of international operations is critical to our continued ability to supply the Nation's hydrocarbon energy needs.

Third, because our industry's projects require large amounts of capital and are high-risk ventures, the tax treatment of the financing and structuring of these ventures is an essential element of decisions whether to proceed. We are concerned about the impact of these proposals on our access to efficient sources of capital, whether through traditional capital markets or partnerships, joint ventures, and other business structures.

Not only must the Federal tax implications of any proposal be considered, but also, State income tax integration, U.S. financial accounting treatment and securities market effects must be thoroughly understood. Further, consideration must be given to the place of the United States in the global economy. The protections afforded by the current income tax treaty system will have to be replaced by newly negotiated treaties throughout the world.

Time does not permit an exhaustive delineation of all of our concerns. But we believe these few examples illustrate the need for a cautious and deliberative process, one that looks not only at all of the effects, once a new system is in place, but also addresses fair and equitable transition from our current system to any replacement system.

The Committee has asked us to evaluate these proposals in their pure conceptional form. I hope API's testimony demonstrates why, without considering the specific details of a fully developed legislative proposal, we cannot make a considered choice among the several options. At the same time, let me emphasize that while we have identified a number of issues, none of these problems are insurmountable. We are eager to work with the Committee as you continue to develop a replacement for the current system.

Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL SULLIVAN, CHAIRMAN COMMITTEE ON TAXATION AMERICAN PETROLEUM INSTITUTE AND VICE PRESIDENT AND GENERAL TAX COUNSEL EXXON CORP.

INTRODUCTION

1. Background

This statement is submitted by the American Petroleum Institute (API) for the record of the July 31 hearing of the House Ways and Means Committee regarding the effects of various tax reform proposals on manufacturing and energy and natural resources. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing. API appreciates the opportunity to comment on a topic of profound importance to our industry.

Various consumption tax proposals have been offered recently as complete substitutes for the current income tax system. This statement will focus on the business tax aspects of 1) the Armey Flat Tax ("Flat Tax"), 2) the Nunn/Domenici Unlimited Savings Allowance Tax ("USA Tax"), 3) a European-style credit-invoice value added tax ("CIVAT"), 4) the Schaefer/Tauzin National Sales Tax ("NST"), and 5) our current income tax system. API takes no position at this time as to whether the current income tax system should be completely replaced, but there is no doubt that as presently codified, it imposes wasteful and unnecessary burdens on the economy. We commend the Committee and the sponsors of the various proposals for their efforts to improve our tax system and for moving toward the taxation of consumption rather than the taxation of income.

2. Problems With Our Current Income Tax

Over the years, changes to the Internal Revenue Code ("Code") and the regulations thereunder have created the most complex income tax system in the world. Because of this complexity, unreasonable compliance and collection costs (both to the government and to taxpayers) impair the efficiency of the system; obscure or conflicting aspects of the Code and regulations fail to become operative as intended; and administrative implementation of complex provisions often takes years, creating long periods of uncertainty for taxpayers as to their tax obligations.

The current income tax system is biased against savings and investment, and in favor of consumption. It taxes corporate generated income twice. For example, in the case of a dividend, once when the income from which the dividend is generated is earned and again when the dividend is received by the shareholder. Moreover, because recovery of capital costs is spread over time there is effectively a tax on the capital investment itself.

Our income tax system is neither "territorial" nor "border adjustable". Therefore, it does not allow domestic and foreign produced goods to compete on an equal basis in domestic or foreign markets. Rather, the U.S. foreign tax system acts to inhibit American competitiveness. U.S. corporations are taxed on worldwide income, while many foreign corporations are not. U.S. anti-tax deferral rules are the most restrictive in the world; unnecessarily complicated mechanics of the foreign tax credit limitation further reduce the effectiveness of the credit as a means to avoid double taxation; and the volume and frequency of changes in the foreign tax area continue to add compliance costs and destabilize the ability of U.S. businesses to compete worldwide.

Most of our trading partners have some form of value added tax (almost exclusively a CIVAT) that permits the tax, under the rules of the General Agreement on Tariffs and Trade (GATT), to be rebated on exports. Our income tax cannot be rebated on our exported goods (domestically produced goods must bear the burden of our income tax as well as local taxes in foreign markets), while goods imported into the U.S. do not bear the VAT imposed in their country of origin. Whatever comes out of this tax reform process should have as one of its goals to improve the ability of U.S. companies to compete internationally.

3. Principles of a Properly Designed Tax System

API believes that properly designed consumption taxes are preferable to income taxes. In studying consumption taxes over a number of years, we have developed a set of principles by which we evaluate alternative consumption tax proposals. They include the following:

- Minimize economic distortions;
- Ensure that foreign and domestically produced goods compete equally in the market place;
- Permit the current deduction of capital expenditures;
- Impose only one rate or as few rates as possible;
- Facilitate recovery of taxes in the marketplace;
- Exclude from the base separately stated excise taxes, including sales and use taxes; royalty payments to federal and state governments; and non cash exchanges;
- Be relatively easy to comply with and administer; and
- Make the tax rate or amount of tax clear to the ultimate consumer.

4. Concerns with Changing to a New Tax System

While we are supportive in principle of moving towards the taxation of consumption, we urge the Committee to proceed with caution. Because the income tax has been embedded in our economy for more than eighty years, business decisions have been, and continue to be, premised on economic assumptions spawned by that system. Therefore, any radical change will have profound implications for the structure of business, the financing of business, and business operations themselves, and these implications must be thoroughly understood before moving to any new system. This is especially true in the capital intensive oil and gas industry, where the results of decisions may take a decade or more to manifest themselves.

For example, the tax treatment of imports of all basic commodities for further manufacturing will have significant ripple effects on the economy. Because more than half of the crude oil used in the United States is imported, this issue is of major concern to our industry. One of the proposals (USA Tax) imposes a nondeductible import tax that would increase the price of energy to consumers. We believe that any import tax should be imposed in a manner designed to put a new tax system on a parity with the VATs of our trading partners.

Our industry must operate where we have access to economically recoverable reserves. As significant domestic sources have been foreclosed to oil and gas development, the tax treatment of international operations is critical to our continued ability to supply the nation's hydrocarbon energy needs. In addition, since our industry's projects require large amounts of capital and are high risk, long lead-time ventures, the tax treatment of the financing and structuring of these ventures is an essential element of decisions whether to proceed. We are concerned about the impact of these proposals on our access to efficient sources of capital, whether through traditional capital markets or partnerships, joint ventures, or other business structures.

Not only must the federal tax implications of any proposal be considered, but state tax integration, U.S. financial accounting treatment, and securities market effects must also be thoroughly understood. Finally, consideration must be given to the place of the United States in the global economy. A unilateral change in the basic taxation of inbound and outbound transactions by the U.S. will require that new treaties be negotiated in order to maintain the protections afforded U.S. companies by the current income tax treaty system. These include: elimination of double taxation due to overlapping exercise of authority; facilitation of business transactions between countries that might otherwise be inhibited by overly intrusive national taxation; reduction of high rate withholding taxes imposed by many countries on payments to foreigners of items such as dividends, interest, rents, and royalties; and other provisions designed to lessen the burden on international commerce of varying national taxation systems.

The Flat Tax, USA Tax, CIVAT, and NST, all of which are different forms of consumption based taxes, fully or partially satisfy several of API's eight criteria outlined above. However, each also falls short on some of the criteria or leaves issues open to concern. A discussion of each proposal follows.

Armey Flat Tax Proposal (H.R. 2060)

1. General Characteristics

One particular strength of the Flat Tax is that it permits an immediate deduction for capital expenditures. This criteria is very important to capital intensive businesses, such as the oil and gas industry. Another strength of the Flat Tax is that it has a single tax rate (as does the USA Tax and NST), which should contribute to simplicity. However, although the Flat Tax appears simple to comply with and administer, there are a number of areas where the application of the tax is unclear.

2. Territoriality and Border Adjustability

The Flat Tax is an improvement over the current system in that it is "territorial" in nature (as are the USA Tax and NST). This means that tax is generally imposed only on activities within the U.S. In this regard, U.S.-based multinationals spend an inordinate amount of time and resources attempting to comply with the current income tax system, which taxes companies on their worldwide as well as U.S. sourced income. The foreign provisions of the current income tax system are extremely complicated to comply with, including the rules regarding multiple baskets and categories of income, and the resulting incremental revenue to the U.S. government from taxing these foreign operations does not appear to justify the time and expense incurred by either taxpayers or the government. Thus, Congressman Armey should be applauded for proposing a "territorial" approach to taxation.

The Flat Tax is also an "origin-based" taxing system, as opposed to a "destination-based" system. This means that imports into the U.S. are exempt from taxation, but any exports leaving the U.S. would still be taxable. (On the other hand, the USA Tax and NST are destination-based systems and would tax imports and exempt exports.) All other factors being equal, net importers would seem to benefit under an origin-based system such as the Flat Tax, while net exporters would likely be injured.

3. Deductibility of State and Local Taxes

The treatment of excise or other taxes imposed on businesses by state and local governments is another issue of great importance to the petroleum industry. Excise taxes, including severance taxes, environmental taxes, and sales and use taxes, are imposed at almost every stage of our operations and on almost every product because we act as a collection agent for the government. It is unclear whether all of these taxes would be deductible under the Flat Tax. Thus, before adopting a new tax system based on the Flat Tax, we ask for clarification that deductions would be permitted for all excise taxes. This principle also applies to income and franchise taxes, as well as property taxes, paid to states and local municipalities. Disallowing deduction of these taxes would create unfair distortions between sectors of the economy. For example, disallowing a deduction for property taxes may have little effect on a corporation dealing principally in services. However, property taxes may represent a significant factor in determining the net profit for a corporation whose business requires the ownership of extensive real property.

4. Deductibility of Leases and Royalties

Although the Flat Tax clearly permits the expensing of business acquisitions, it should clarify that lease and royalty payments made to federal and state governments are also deductible. In addition, if distinctions are made between active and passive income, with the criterion for classification being the immediate use of property in the business, there must be an allowance for the common practice in the oil and gas business of mineral interests that are not immediately developed. Leases may be purchased with the expectation of finding oil or natural gas quickly, but it may then take several years of seismic testing and test borings to determine when and if the leased property will actually become an active part of the business. During this period, oil and gas interests should not be considered passive investments.

5. In-Kind Exchanges

One issue that is still unclear under the Flat Tax is the treatment of non-cash exchanges. Under current law, tax-free exchanges are a common and important part of the oil and gas business. Inventory exchanges of equivalently (or nearly equivalently) valued barrels of oil or product are everyday occurrences involving extremely high volumes that permit the efficient transportation and supply of crude oil and product throughout the country. Certainly, compensatory cash payments for value differences on these exchanges should be taken into account for tax purposes, but the full value of the exchanged products must not be considered as a taxable transaction.

USA Tax Proposal (S.722)

1. General Characteristics

The USA Tax satisfies several of the API criteria for evaluating taxing systems. Like the Flat Tax, it would encourage investment in durable business assets by allowing the immediate deduction of capital expenditures. API also favors this proposal for recognizing that excise taxes should be excluded from the tax base and for establishing one tax rate for business.

Several aspects of the USA Tax appear easier to comply with and administer than the present income tax system. Allowing immediate expensing of capital equipment is a great simplification compared to the current complex depreciation rules. Since the USA Tax is also a "territorial" system, businesses would no longer have to incur many of the administrative and compliance costs of the current system relating to foreign operations. In certain respects the USA Tax would help to minimize economic distortions as compared to the current system. Our present income tax system contains a large number of complex deductions and credits, many of which create competitive distortions in particular business sectors. Different rules apply depending upon whether a business operates in corporate or partnership form. The USA Tax is more neutral because it would allow much fewer deductions and would apply to all business sectors and forms of business organizations, but there is considerable uncertainty as to how the taxation of partnerships would affect the industry practice of forming joint ventures for high cost, high risk projects.

2. Deductibility of the Import Tax

There are also several areas in which the Nunn-Domenici proposal does not meet API's criteria. The proposal would impose an 11 percent tax on the value of imports. Because the proposed import tax would not be deductible, when an importer sells an imported good in the United States, the importer would be subject to the 11 percent consumption tax on the already paid import tax. This double taxation would create an unwarranted economic distortion by precluding foreign and domestic goods from competing equally in the marketplace. Consideration should be given to whether an import tax is imposed at all on intermediate purchases of goods that will be incorporated into a final product. This is especially the case for raw materials, such as crude oil, that generally have already been subject to high foreign taxes (which would no longer be creditable against U.S. tax under the USA proposal).

The USA Tax system is particularly detrimental to importers by failing to allow the import tax to be either deducted in arriving at the taxable base, or fully credited against net liability as occurs with most credit-invoice VAT systems. While most commentators focus on the payroll tax credit as the key to border adjustability, the real focus should be on the national tax treatment provisions of GATT because, as currently drafted, the USA Tax appears to penalize imports. If a destination-based system such as the USA Tax is ultimately adopted, this major error must be corrected.

3. Tax Visibility

API is also concerned that the USA Tax is not structured in a manner which would facilitate recovery in the marketplace. As is the case with the current income tax, the USA Tax would be imposed on the net income of a seller of goods, rather than on the product sale. Such a system also makes the amount of tax less clear to the ultimate consumer than would be the case with a tax that could be separately stated as a specific percentage of gross sales price.

4. Treatment of Non-Cash Exchanges, State Taxes, Payroll Tax Credit

Further analysis and discussion is warranted regarding many other aspects of the USA Tax proposal. For example as noted in our discussion of the Flat Tax, API believes that non-cash exchanges should be excluded from the tax base. Also, careful consideration must be given to the consequences of the proposed elimination of deductions for state income taxes and the replacement of the wages-paid deduction with a payroll tax credit.

Credit-Invoice Value Added Tax

1. In General

A CIVAT on sales of all goods and services appears to more closely adhere to the principles API has identified for a properly structured consumption tax. A CIVAT is imposed as a multistage sales tax collected at each point in the production and distribution process. A business subtracts the tax paid on its purchases, including capital goods, from the tax due on its sales. If the difference is a positive number, the business remits that amount to the government; if it is negative, as may occur in the case of exported goods, the business claims a refund. Compared to the current income tax, the CIVAT has the advantage of encouraging saving and investment. It does not burden capital outlays, nor does it discriminate against U.S. industry either in the U.S. or abroad.

2. Effective and Neutral Revenue Source

From an economic standpoint, a separately stated CIVAT on the sale of goods and services appears to be the least damaging way of raising revenue. It does not burden capital outlays, nor does it discriminate against U.S. industry either in the U.S. or abroad. It does not favor either capital or labor intensive industries. Wages, rent, interest and profits, i.e., the return of entrepreneurship, each bear the same direct tax burden. A CIVAT levied at the same rate on all consumption should not cause a significant distortion in consumption choices since the relative cost of goods and services would be the same after imposition of the tax as before. A broadly-based CIVAT would not unduly burden the products of any one sector of the economy. Any regional distortions would tend to be minimized since no specific product or geographic region of the country would be the focus of the tax. A uniform CIVAT applied to goods and services would induce fewer distortions within particular industries than other taxes.

3. Border Adjustability

A CIVAT is neutral with respect to goods produced domestically and abroad. Not only are U.S. manufactured goods not burdened with the tax when they are exported, but imports must also bear the same tax as comparable domestically produced goods. This border adjustment feature of the CIVAT, permitted under GATT rules, means that the tax does not handicap U.S. manufacturers, nor does it act to distort consumers' decisions whether to buy domestic or imported goods. Some economists argue that border adjustable taxes are not necessary because monetary exchange rates will adjust to accommodate the change in U.S. taxation. While this may be true in the long run (and not everyone agrees), in the short run the adjustment period could be very harmful to U.S. competitiveness.

4. Differences With Other Taxing Systems

Under the CIVAT, the tax liability of a firm is equal to the tax imposed on its sales net of a credit for the tax it has paid on purchases for business use. Under subtraction-method consumption taxes like the Flat Tax or the USA Tax, liability is determined by applying the tax rate directly to the firm's value added, or the difference between its sales and its purchases. CIVAT is a tax on a product while the other taxes are based on a business's books of account, similar to the current income tax system. From that underlying distinction flow a number of practical differences that API concludes favor the CIVAT.

Most commentators agree that while a single rate consumption tax, without exemption, is preferable, the overwhelming weight of political experience shows that the United States would not adopt a single rate consumption tax with no exceptions. Not one of the more than 45 countries which now have consumption taxes has a single-rate, no-exemption tax. Most have both exemptions and multiple rates. The CIVAT readily accommodates these features. Because the tax a business pays on purchases is credited against the tax it owes on sales, businesses are encouraged to register as taxpayers and to get invoices from their suppliers to document the tax paid. Also, a CIVAT would reach previously untaxed income in the underground economy, since all consumer consumption would be taxed when goods and services are purchased.

National Sales Tax Proposal (H.R. 3039)

1. In General

The NST proposal is fairly easy to understand since it is similar to the various sales tax systems in place in 45 out of the 50 states in the U.S. It is intended to replace the current income tax, estate and gift tax, and most general revenue federal excise taxes. The tax would be imposed at a 15 percent rate on the sale of goods, including both tangible personal property and real property, and services, including financial services such as brokerage fees, banking fees, and insurance fees. Although the NST is intended to be compatible with current state sales tax systems, none of the 45 states that currently have a sales tax in place tax services as extensively as is envisioned under the NST. A lot of work will have to be done with the various state taxing authorities before they will become convinced to administer a uniform NST on behalf of the federal government.

Businesses would collect tax on all their taxable sales of goods and services and remit the tax to the government. Since purchases of inventory for resale are not taxable, the complex inventory rules of the current income tax system would be eliminated. Purchases of equipment and real property used in the production of taxable goods and services are also not taxable, so there would be full expensing of capital assets. As stated above in the discussion of the Flat Tax and USA Tax, the ability to immediately expense capital assets is extremely important to a capital intensive industry like the oil and gas industry.

2. Border Adjustability and Territoriality

Like a CIVAT, the NST is neutral with respect to goods produced domestically and abroad. Not only are U.S. manufactured goods not burdened with the tax when they are exported, but imports must also bear the same tax as comparable domestically produced goods. This border adjustment feature of the NST, which like the CIVAT should be permitted under GATT rules, means that the tax does not handicap U.S. manufacturers, nor does it act to distort consumers' decisions whether to buy domestic or imported goods. The NST, also like the Flat Tax, USA Tax, and CIVAT, is a territorial system, which would help give U.S. multinationals a level playing field with their international competitors.

3. Definitional Problems

Although the proponents of the NST may intend that businesses above the retail level will be outside the tax system, this will likely not happen. Although the NST exempts goods and services "purchased to produce taxable goods and services", it never defines that term. Thus, it is questionable whether headquarters expenses, financial services, or many other kinds of purchases will be judged to "produce taxable goods and services". API is also concerned about the treatment of transactions within a controlled group of business organizations, as well as research and development and pollution control or environmental remediation. Will these items be excluded from the sales tax?

4. Other Concerns

The NST bill would repeal the retail and manufacturer excise taxes, but it does not repeal the environmental trust fund taxes. This issue is of particular concern to our industry because many of these taxes are imposed on our products. Not only would these taxes be imposed, but they would also be in the base of the sales tax on our products. State excise taxes would also be included in the base, as proposed, and this would again be a major problem for our industry. Finally, the NST will allow sellers an option to collect and remit tax from purchasers even for exempt sales, which will then require such purchasers to verify their right to refunds.

Transitional Issues

1. In General

While transitional issues will arise in the context of all tax reform proposals, they become especially critical where, for example, there is a significant shift in the basis of taxation from income to consumption. Capital intensive industries, such as the petroleum industry, have made long-term investment decisions relying on the existing tax structure. Changes in that structure would impact different companies, often in direct competition, in an arbitrary and often inequitable manner. The most obvious examples of transitional issues occur in the areas of capital outlays and borrowings. For example, a capital asset (or inventory) purchased immediately prior to the enactment of certain of the consumption-based taxes would be denied recovery of all but a miniscule fraction of its cost, whereas the same asset purchased immediately following enactment would be permitted an immediate 100% recovery against the tax base. In a similar manner, borrowings based on the anticipation of an interest deduction could become a significant burden on a highly leveraged business after enactment of a consumption tax.

2. Depreciation

The proposed USA Tax Act partially addresses the transition issue but stops far short of providing equitable relief necessary for business taxpayers. The issue of unrecovered basis is addressed in the USA Tax Act through a system of amortization which substantially lengthens the recovery period under current law. This lengthened and arbitrary classification of unrecovered costs into four groups appears based on misconceptions regarding complexity and revenue costs. Continuing the current method for unrecovered basis of assets placed in service prior to tax reform would be preferable to inserting another new capital cost recovery regime. In a recent paper delivered by Robert E. Hall and Alvin Rabushka on their flat tax proposal (The Flat Tax: A Simple Progressive Consumption Tax, Hoover Institution; May 11, 1995), the authors indicate that a 1.1% temporary increase in the tax rate would be all that is necessary "if Congress chose to honor all the unused depreciation from investment predating tax reform . . ." Permitting current law business deductions to be carried out, thus honoring prior business plans and commitments, is necessary to avoid inequitable distortions.

3. Interest on Pre-Reform Debt

Transitional rules that consider only lost depreciation deductions fall far short of measures necessary to ensure the success of tax reform. A continuation of current law interest deductions for pre-reform debt can be as vital to a business as cost recovery. If the interest deduction is offset by interest income on the particular pre-reform debt (i.e., pre-reform obligations continue to be both tax deductible to the debtor and taxable to the lender), there would be no significant revenue impact to the Treasury. Ignoring a continuation of the interest deduction results in arbitrary windfall gains and losses without any apparent justification.

4. Carryover of Other Tax Attributes

Among other items of significant impact to business are net operating loss and capital loss carryovers, business credit, foreign tax credit, and minimum tax credit carryovers as well as other pre-reform adjustments, such as those required under Section 481 of the Code. The USA Tax attempts to solve this problem with a further complex overlay to the depreciation recovery rule. Operating and capital losses are simply a result of the annual accounting convention for tax payment determinations. Their carryforward is a valid claim on future tax payments that would take into consideration the length of business cycles in various industries and other issues of timing. There is no valid distinction between unused business credits and future deductions for depreciation and, in fact, credits are a specific and distinct Congressional incentive upon which business has relied. The Alternative Minimum Tax was intended as an advanced payment of federal income tax. Therefore, unrecovered credits require a reimbursement mechanism. Transitional rules must include a provision clearly permitting the Internal Revenue Service to make appropriate adjustments to ensure that no taxpayer takes a double deduction for any cost, or suffers a double inclusion of any income.

Summary

Reform of the current U.S. tax system is a worthy goal, especially the movement from taxation of income to taxation of consumption. Each of the alternative consumption tax proposals makes important contributions to the reform effort. Any major upheaval such as complete replacement of the current income tax system will, however, require careful analysis of all possible implications. We have lived with this tax system for over eighty years and businesses have structured their affairs within it. Any fundamental change, unless carefully orchestrated, could cause massive turmoil, particularly in the transition period from the old system to the new. At the same time, it should be emphasized that while API has identified a number of issues, none of these problems are insurmountable. We are eager to work with the Committee as it continues to develop a replacement for the current income tax system.

Mr. ENGLISH. Thank you, Mr. Sullivan. I am going to ask the remaining individuals on the panel to suspend until after the vote currently on the floor. When we return we will hear from Michael C. Linn, chairman of the tax committee of the Independent Petroleum Association of America, and I am happy to say president of the Meridian Exploration Corp. near my district in Pittsburgh, Pennsylvania; Paul Huard, senior vice president of policy and communications for the National Association of Manufacturers, and someone who has on a number of occasions testified before this panel; and Richard L. Lawson, president of the National Mining Association.

And for the moment, the Committee will suspend until we have an opportunity to return.

Thank you.

[Recess.]

Mr. CHRISTENSEN [presiding]. Welcome back to the Committee.

We will now hear from Mr. Linn.

STATEMENT OF MICHAEL C. LINN, CHAIRMAN, TAX COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; AND PRESIDENT, MERIDIAN EXPLORATION CORP., PITTSBURGH, PENNSYLVANIA

Mr. LINN. Thank you, Mr. Chairman.

The complexity of the current Tax Code as it affects the oil and gas industry is mind-boggling. Tax restructuring is a most laudable goal and, if accomplished properly, we believe will be good for the U.S. economy, including the oil and gas industry.

I appear today on behalf of 5,500 independent oil and gas producer members of the Independent Petroleum Association of America, where I serve as chairman of the tax committee. Independents, as you may know, are the major force in developing America's oil and gas natural resources. We drill 85 percent of the Nation's wells, produce more than 66 percent of our domestic natural gas supply, and 50 percent of our domestic oil production in the lower 48 States.

My company, Meridian Exploration, is based in Pittsburgh, Pennsylvania, and operates more than 800 wells in Pennsylvania, West Virginia, New York, Kentucky, and Texas.

Since 1980, we have drilled over 1,500 wells in the Appalachian Basin, usually with joint venture partners who are either other oil and gas companies, natural gas distribution companies, or large family trusts. That method of financing projects is common to the independent in the United States.

Independent's toughest business challenge is raising capital to finance drilling and production projects. An astonishing 58 percent of the financing for our projects does come from internally generated funds. But for the remainder, we must compete with oil and gas investments around the world. The acreage available for exploration has increased in the former Soviet Union, Eastern Europe, China, and other countries deciding to open new areas to exploration and production. This has led to vastly increased competition for exploration and development investment funding.

If I'm able to get across one message to you today it is that as you reform the American tax system and, thus, taxation of our industry, we need to end up with a system that makes the taxation of natural resources and our ability to raise capital more competitive with the rest of the world.

The domestic oil producing industry has downsized. As imports have climbed to record levels, domestic production has sunk to a 45-year low. In a real emergency there is simply not enough rigs, trained crews, and needed equipment to rapidly expand the domestic oil production.

For reasons both geopolitical and geological, America's ability to produce its own domestic oil and natural gas supplies continues to erode.

When we look at other countries, from Russia to Canada to Venezuela, their governments go to great lengths to encourage natural resource development. We are the only country in the world that restricts these strategic industries from developing the Nation's resource base. The government must adopt four key policy goals: Reform the Tax Code, reform environmental regulation and key resource legislation, develop a spirit of cooperation between all government levels and our industry, and explain the importance of a strong energy policy to the public.

At the State level there is an appreciation of the need to lower the tax burden on the oil and gas industry and to spur production at no cost to the taxpayer. Several States have, on their own, increased exploration and production by reducing the tax burden on these activities.

Oklahoma, Texas, Louisiana provide exemptions from the State severance tax to maintain existing production from stripper wells and encourage new drilling. Louisiana, as a result of this program, has increased economic activity directly to net the State Treasury in just over 1 year of operation an additional $4.9 million in increased revenues from sales tax, payroll tax, and royalty increases. Local governments in that State received an additional $6.8 million.

Countries that are developing their resource base provide considerable encouragement to come and do business with them because they recognize it is in their national interest to be as energy sufficient as they can. The United Kingdom arguably has one of the most developed and conducive fiscal environments relative to capital cost recovery for the oil and gas industry. This tax regime is paying dividends in increased oil and gas exploration and production.

In February 1996, oil production from the United Kingdom was 2.6 million barrels per day. This is approximately 40 percent of the U.S. production for the same period. A recent study by Petro Consultants, Ltd., indicated that recently the United Kingdom finished second only to Saudi Arabia in hydrocarbon discoveries in the world.

Instead of altering the Tax Code to erode natural resource industries, our leaders should encourage capital investment in developing the Nation's resource base. We support the following proposals which we believe are necessary to ensure a competitive United States based oil and gas industry.

We need a reformation of the alternative minimum tax. We need to reform the percentage depletion allowance. We also need to reform the net income limitations on percentage depletion to allow marginal producers in production to maintain its current status.

We would request a tax credit for marginal producers, in addition to the reform of the depletion allowance, and also a credit to encourage new drilling.

We need to expand the enhanced oil recovery credit and to allow geological and geophysical costs to be expensed. These are some of the few things that need to be modified in our current Tax Code.

Again, we think it is laudable to look at the entire Tax Code and the tax system, as we proceed next year in reforming America's tax system. I urge you to remember that we need to end up with a system that does make taxation of natural resources and our ability to raise capital more competitive with the rest of the world.

Thank you.

[The prepared statement follows:]

Written Statement
Michael C. Linn
President, Meridian Exploration Corp.
representing
Independent Petroleum Association of America (IPAA)
before the
Committee on Ways and Means
U.S. House of Representatives
July 31, 1996

Mr. Chairman, Members of the Committee:

My name is Michael C. Linn. I am the President of Meridian Exploration Corporation and Chairman of the Independent Petroleum Association of America's Tax Committee.

My company, Meridian Exploration, is based in Pittsburgh, Pennsylvania, and operates in excess of 800 wells in Pennsylvania, West Virginia, New York, Kentucky and Texas. Since I joined the company in 1980 until now, we have drilled over 1,500 wells in the Appalachian Basin. A majority of these wells were drilled with joint venture partners who were either other oil and gas companies, natural gas distribution companies, large family trusts or general partners who raised partnership monies for investment.

I am here today speaking on behalf of the Independent Petroleum Association of America (IPAA), a national trade association representing more than 5,500 independent oil and gas producers. Independents are the major force in developing America's oil and natural gas resource base. We drill 85 percent of the nation's wells, produce more than 66 percent of our domestic natural gas supply and 50 percent of our domestic oil production in the lower 48. Although independents range in size from small one person companies to very large public firms, the typical independent is a highly efficient small business. The typical company responding to our survey for the 1996 Profile of Independent Producers has been in business for 22 years and has gross revenues of just under $2.9 million.

First, I thank you and the committee for the opportunity to appear today as you examine the impact of the proposed replacement tax systems on natural resources. I commend you for your willingness to tackle the tough, thorny issues involved in restructuring the present federal tax system. The complexity of the current tax code as it affects the oil and gas industry is mind boggling. Tax restructuring is a most laudable goal and, if accomplished properly, we believe will be good for the U.S. economy including our domestic oil and gas industry. We believe the oil and gas industry is critical to the health of the U.S. economy. When our industry suffers, it puts our consumers and our economy at risk.

The IPAA is beginning a thorough study of the impact of the leading proposals to replace the current federal tax system. We will not have the results of that study available until late fall of this year. However, I do wish to raise significant policy issues affecting the oil and gas industry for the committee to consider as you move to reform America's tax system.

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Need for Capital

Independent oil and gas producers tend to call ourselves Wildcatters and have a heritage of taking calculated risks. We analyze data from geologists, crunch numbers from accountants, and make sales pitches to anyone with the capital to finance our ventures. But in today's global economy, we must consider a plethora of geopolitical factors that potentially affect our bottom line before wholeheartedly committing our blood, sweat and children's college education funds to new drilling programs or acquisitions. You may think I am being a bit overly dramatic when I speak of my children's education funds, but our recent survey shows that the most frequently mentioned source of capital for the financing of independents' projects was from internally generated funds. In fact, our survey indicates that an astonishing 58% of the financing for our projects is derived from internally generated funds, either from our earnings or those of our oil and gas partners earnings.

International Competitiveness for Capital to Finance Projects

A recent article in the Oil and Gas Journal noted that "terms of participation in exploration and development have improved worldwide from the point of view of international oil and gas companies in the past decade." Acreage available for exploration has increased as the former Soviet Union, Eastern Europe, China and other countries decided to open new areas. This has led to vastly increased competition for exploration and developments investment funding.

If I am able to get across one message to you today it is that if you reform America's tax system and thus the taxation of our industry, we need to end up with a system that makes the taxation of natural resources, and thus our ability to raise capital, more competitive with the rest of the world.

The Rise in Gasoline Prices -- A Warning Sign

Given the furor over gasoline prices just a few months ago, political leaders must give more attention to the domestic oil industry's long-term problems. Like it or not, our problems are your problems. And, just as was the case this spring, the American people will turn to Washington for action. Now is the time to act, not in the face of another crisis. Earlier this year, on January 16th, Energy Secretary Hazel O'Leary described the next energy crisis as being "imminent." According to industry reports, "we no longer have much cushion left in most of the world wide oil supply and demand, let alone in the U. S." And, as you know, it is crude oil and natural gas that fuels the world economy.

Let me first say that there are many who share our vision that America needs an improved energy policy; some point to increased reliance on alternative fuels, such as wind and solar energy. They might have a point far down the road when the technology is advanced and competitive enough to help America. But what can we do today as our energy supply is fueled by oil?

We must increase our domestic production of crude oil to stabilize our energy resource base. Fifteen years of inconsistent and ill-advised federal policies that have discouraged domestic production and refining of crude oil has placed us in the position of depending on foreign imports for over 50 percent of the oil needs in America. As our dependency rises, we are edging towards the maximum amount of crude which can conveniently be imported into the U.S. without increasing the chance for environmental harm.

Some public officials and others in the media acted surprised by the recent upswing in gasoline prices. We don't like to say "We told you so," but in fact we did. When world oil prices plunged to the low-teens in late 1993 to early 1994, independent oil and natural gas producers asked Congress and the Clinton administration to work with us to preserve domestic oil production. Over 90,000 U.S. oil workers have lost their jobs since the Persian Gulf crisis. Businesses have teetered on the brink of bankruptcy. Hundreds of thousands of U.S. oil wells have lost money. And oil imports sky-rocketed, pushing the U.S., for the first time in its history, into reliance on imports for more than half of its consumption. We warned back then that America eventually would be vulnerable to the kind of price spike we experienced beginning in early spring.

During the 1993 price plunge, we hoped the federal government would take advantage of low prices to purchase oil for the Strategic Petroleum Reserve, thus stabilizing prices and preserving domestic production capability. Not so. We were told that our industry had to survive or fail in the world oil marketplace. In effect, Congress told us to downsize, lay off people, delay needed equipment repairs or upgrades and cancel new purchases. Although we have been downsizing since 1986, we had no choice. More good-paying jobs were lost, on top of the 500,000 industry jobs wiped out in the preceding six years.

You can imagine how we felt as prices recovered and we tentatively started to bring back our workforce, only to see policymakers reversing themselves and pushing oil reserves sales from the Strategic Petroleum Reserve to manipulate the marketplace. All the while, the industry has had to withstand false, grand-standing accusations of industry collusion and criminal anti-trust behavior regarding the rise in crude oil and gasoline prices.

The domestic oil producing industry is downsized, cut to the bone, running some equipment on borrowed time and a prayer, just to keep afloat. We are running short of offshore drilling rigs, yet no new ones are being built. As imports have climbed to record levels, domestic production has sunk to a 45-year low. In a real emergency, there simply are not enough rigs, trained crews and needed equipment to rapidly expand domestic oil production. You can't mobilize the industry overnight to respond. That's why America needs a new energy policy in place now.

Crude Oil Policy and National Security

Some policymakers recognize the very real long-term problem confronting all of us, so we weren't alone in sending the alarm. In March, nearly two dozen members of Congress took to the floor of the House of Representatives to warn the American people, long before the uptick in gasoline prices, that our inadequate energy policy was making this nation vulnerable in both economic and national security terms.

And just last year (February 1995), President Clinton found our domestic oil supply situation, with over 50 percent of our daily supplies being imported, a threat to national security. In 1994, IPAA and other American oil and natural gas producers filed a petition requiring the Clinton administration to investigate America's growing dependence on imported oil and its impact on national security. The study involved the departments of Commerce, Energy, Interior, Defense, Labor, State and Treasury, as well as the Office of Management and Budget, the Council of Economic Advisors, and the U.S. Trade Representative. The study, like the four that preceded it, concluded that "petroleum imports threaten to impair U.S. national security." President Clinton confirmed that finding. However, neither the Congress nor the Administration has offered new initiatives to lessen the nation's growing dependence on oil imports.

"Solutions" and Misguidance

The cornerstone of the president's 1994 energy investigation was maintaining the Strategic Petroleum Reserve, which he called the nation's "bulwark against a [petroleum import] supply disruption." But, alas, the government is now selling off parts of the oil stockpiles for deficit reduction or, if you believe what is being said, to reduce gasoline prices. I note with great disappointment that the president and the Senate Appropriations Committee has proposed selling even more oil from the Strategic Petroleum Reserve in fiscal year 1997. Now is the time to stop this madness and to think seriously about America's vulnerable energy situation.

In truth, America has two petroleum reserves. One is the 500 million-plus barrels of oil in government storage facilities in Texas and Louisiana. The other reserve is the 22.5 billion barrels of known and recoverable oil reservoirs (and ten times that number in potential resources) located in thirty-three states and on the Outer Continental Shelf. Both are of great strategic importance to America, to our economy and national security.

The past few months have been utterly fascinating. Adjusted for inflation, gasoline prices climbed from a fifty-year low all the way up to the price of the 1960s. In truth, gasoline price increases tracked very closely to the rise in crude oil prices worldwide. There were other, equally predictable and clear reasons why crude oil prices and gasoline prices rose as they did as the requested DOE study quietly reported.

What Happens When the Real Crisis Hits

If this kind of political ruckus gets kicked up by a temporary supply imbalance, Congress better get ready for political disaster when a real crisis hits. And a real crisis is -- again, in the words of the Secretary of Energy Hazel O'Leary -- "imminent." To prepare for that day, we need two things we do not now have -- an aggressive policy to preserve and to expand domestic oil and natural gas production and a long-term view about the role of the Strategic Petroleum Reserve.

America can't do anything easy or painless about worldwide oil price increases. At least, for now, we can get oil and gasoline. The real threat to our economy and national security comes when Americans cannot get enough oil, regardless of price, to fuel our industrial and transportation needs and, in some parts of the country, to heat our homes.

We now get more oil from foreign importers than we do from our own oil production. Most of the world's known oil reserves are controlled by governments that, in the past, have manipulated their oil supplies for nationalistic political goals. The world's most productive oil producing region -- the Persian Gulf -- is also one of the most politically volatile. Most oil exporting regions are producing very near their maximum capacity. OPEC alone is producing over 26 million barrels a day. There is little room for error, and that should be cause for greater concern.

The supply situation is compounded by the fact that demand for oil, both in the U.S. and worldwide, continues to grow and so does our vulnerability to an oil supply disruption. Our allies, especially those in Europe, have economies and militaries even more dependent on oil imports. They will be less capable of paying for our economic exports or, more importantly, less able or, perhaps, less willing to mobilize their military forces to assist the U.S. should oil exports from the Middle East be cut off for any reason. I hope you get the picture; America is the world's petroleum police.

The final piece of this puzzle is domestic oil production. For reasons both geological and political, America's ability to produce its own domestic oil and natural gas supplies continues to erode. Over the last century, America has produced its most accessible, low-cost oil reserves. A recent John S. Herold study has shown that the industries technological advances have lowered finding costs to compete with foreign production. However we are still be hampered by current government policies.

America's future domestic oil supplies, as the President's national security investigation pinpointed, "are likely to be in small onshore deposits, expensive offshore, and Arctic frontier areas." Some progress has been made in getting at these resources. Efforts to reduce costs on marginal wells on federal lands and to expand markets for heavy oil production, especially in California, are helpful. The agreement by Congress and the President to encourage development in the deepest and most costly offshore regions holds great promise. Still, on the whole U.S. laws and regulations make it difficult, costly, or just plain impossible to develop many small onshore deposits, many offshore regions, and the most promising prospects in Alaska.

The conventional wisdom claims that this policy will protect the environment. The conventional wisdom is <u>wrong</u>. What it will do is bring more foreign oil tankers our way, and that's an environmental risk many, many times greater than producing oil with America's strict environmental safeguards. It will also make our nation poorer and rob us of good-paying jobs.

Time is short. We have used up that time. Temporary gasoline price spikes should be the least of our worries. Americans need more domestic production yesterday to meet our needs. We need to do what we can now to get domestic production and refining capacity back on line. There are a number of pending issues that can be brought to closure in a relatively short time that will help now. We need to reduce the tax penalties and knock down the regulatory barriers that stand in the way of increasing domestic production. Our government must begin to work in partnership with this vital industry -- rules and policies must be changed so that today's smaller, leaner industry can produce what consumers demand. If tax reform accomplishes this goal, the nation will be well served.

<u>U. S. Energy Policy; Focusing on Domestic Resources</u>

With a vast remaining resource base, and technologies evolving continuously, it is not too late to revitalize the domestic oil and natural gas industry. This will mean hundreds of thousands of jobs across the economic spectrum which will contribute substantially to the long-term economic health and security of our nation. Revenues will increase for local, state and federal governments.

When we look at other countries -- from Norway to Canada to Venezuela -- their governments go to great lengths to encourage natural resource development. We are the only country in the world that restricts these strategic industries from developing the nation's resource base. So how can our government revitalize the nation's energy industry? The government must adopt four key policy goals: reform the tax code; reform environmental regulations and key resource legislation; develop a spirit of cooperation between all government levels (federal, state and local) and industry; and explain the importance of a strong energy policy to the public.

<u>Current Tax Burden on the Domestic Oil and Gas Industry</u>

According to a survey of our members conducted last year we -- the independent oil and gas producers -- already have a considerable tax burden in the U.S. We asked our members to send in actual information from their tax returns for the past three years. Preliminary results show that the effective tax rates paid by the oil and gas industry were 20 percent higher than those of all industries published in the Statistics of Income.

In the tax years 1992 through 1994, the survey found that our membership paid effective tax rates of 32 percent, 34 percent and 38 percent in the respective years. It is important to note that two-thirds of IPAA's membership has fewer than 20 employees and that most our those members file their returns on an individual basis.

It is important to add that excluded from these calculations are State Severance and Ad Valorem taxes which are taken directly from the producers' gross income from the sale of crude oil and natural gas. These rates vary from state to state, but are another significant tax on the producer. At one of the lowest production levels in recent history, the oil and gas industry paid the states $3.4 billion in 1994. This reduced amount is directly attributable to declining production and price levels since the mid 1980's.

The effective tax rates paid by companies which submitted corporate tax returns to IPAA showed that in 1992 their effective tax rates were 38 percent and 33 percent in both 1993 and 1994.

State Efforts to Lower Tax Burden and Spur Production

At the state level there is an appreciation of the need to lower the tax burden on the oil and gas industry and spur production at no cost to taxpayers. Let us look at the efforts by several states to increase domestic exploration and production by reducing the tax burden on these activities.

Two years ago Louisiana enacted a package of state tax incentives (exemptions from the state's severance tax) to maintain existing production from stripper wells and to encourage new drilling. Those incentives spurred a production climb from 2.6 MMBOE to more than 5.5 MMBOE from existing wells. The production from deep wells increased nearly four-fold and production from horizontal wells increased nearly three-fold. Royalties from existing wells rose more than ten-fold. For deep wells, royalties rose from $4 million to $5.4 million. For horizontal wells, royalties rose from just over $0.5 million to $1.1 million. The Louisiana State University Center for Energy Studies estimates that the increase in economic activity directly related to the incentives netted the state treasury, in just over a year of operation, some $4.9 million in increased revenues from sales taxes, payroll taxes, and royalty increases. Local governments received an additional $6.8 million.

The Texas program, first enacted in 1989 and substantially expanded in 1991, had similar results. The Texas Railroad Commission testified that the Texas severance tax incentive package added, by mid-1994, some 945 million barrels of oil reserves, some one and half times the oil in the Strategic Petroleum Reserve. It is estimated that the wellhead value of that added production would be $14 billion ($15 per barrel) and the total economic value to Texas would be an estimated $41 billion. Indeed, Texas officials estimated that increases in other tax revenues were nearly three times greater than the severance tax losses from the incentive package.

U.S. Tax Policy Vis-A-Vis International Competitors For Capital

Other countries who are also developing their resource base provide considerable encouragement to come and do business with them because they recognize it is in their national interest to be as energy sufficient as they can be. Also, government working as a partner rather than killing the golden goose with overegulation and taxation can provide government coffers with tremendous financial reward.

The United Kingdom arguably has one of the most developed and conducive fiscal environment relative to capital cost recovery for the oil and gas industry. This tax regime is paying dividends in increased oil exportation and production. In February 1996, oil production from the U.K. was 2.615 million barrels per day. This was approximately 40 percent of the U.S. production for the same period. A recent study by Petroconsultants, Ltd. indicated that in recent years the U.K. finished second only to Saudi Arabia in hydrocarbon discoveries worldwide.

The U.K. currently imposes only one level of tax on new oil and gas developments, the Corporation Tax. The rate of tax is a relatively low 33 percent and is applied to net income from activities in the U.K. Certain small companies may pay an even lesser rate of 25%. Generally, immediate deductions, i.e. expensing, are given for all exploration and appraisal drilling and directly incurred seismic and similar work. Tangible and intangible development expenditures qualify for 25 percent declining balance recovery per year.

For existing developments, a two-tier system of industry transfers to government operates: Royalty is levied at the rate of 12.5 percent on the value of petroleum. The Petroleum Revenue Tax (PRT) is a separate tax applying strictly to the oil an gas industry. The current rate of PRT is 50 percent, albeit the life of field rate in present value terms is significantly less. In enacting PRT, the U.K. Government created an investment oriented tax system designed to encourage optimal production of its resources. The use of innovative concepts, such as supplemental expenditure allowance in addition to complete cost recovery, and exempting certain amounts of annual production from tax, ensure that U.K. oil and gas developments earn a reasonable return on capital invested before being burdened with PRT. A project must realize actual cash flow profit and a rate of return before it can be encumbered with PRT. This type of tax regime for existing fields, provides an attractive investment environment for the oil and gas industry.

Effect of Tax Policy on the U.K. Oil Industry

Unlike the U.S., the U.K. government has demonstrated a willingness to adjust taxation policy so as to retain the commercial attractiveness of the region. In an article in the December 1994 Oil and Gas

Journal, an analysis of fiscal terms of 43 tax regimes revealed that the U.K. tax on marginal fields is one of the lowest; ranking second only to Ireland, which is a relatively insignificant participant in world markets. A study performed by Petroconsultants, Ltd. indicated that the U.K. was the second most favorable regime for economic and large fields. By comparison, the same study ranked the U.S. 12th for large fields and 30th for marginal fields.

The U.K. oil industry proved to be very responsive to recent fiscal changes. The Petroleum Economist reported that major U.K. operators announced almost immediate accelerated development plans in response to the elimination of PRT. The abolition put the U.K. in the position of taxing oil ventures solely on the basis of normal company tax. The U.K. directed its tax policy toward ensuring maximum reserve recovery from the older fields and maintaining a good flow of new developments. Tim Eggar, the immediate past U.K. Minister for Energy, indicated in July 1993 that the government's objective continued to be to ensure the maximum economic development of the U.K's resources and to reduce the burden that government imposes on the oil industry. A special report dated August/September 1994 published by The Petroleum Economist indicated that the tax changes have allowed many operators to develop incremental reserves at older fields and that overall, the tax changes have been beneficial.

Comparison of U.S. vs. U.K. and Spanish Tax Systems

The U.K. tax system provides no specific oil and gas incentives, but more importantly, provides no disincentives. The U.K. does not impose an overall disincentive even remotely resembling the U.S. AMT. In the U.S. geological and geophysical costs (G&G) are capitalized until proven worthless or recovered over the depletable life of a property. In the U.K. G&G is 100 percent deductible in the year incurred. AMT worsens this comparison. Tangible expenditures, once placed in service, are recovered in the U.S. over an extended life. By contrast, the U.K. generally allows a 25 percent annual allowance.

The impact of the tax system can perhaps best be shown by comparative project analysis. The economics of an exploration and production project were analyzed under the U.S. tax system and under the U.K. tax system. The results indicate that the project, if done in the U.K. by a U.K. company, would have a net present value which is 30 percent higher than that of the project done in the U.S. by a U.S. company. This kind of economic difference is cause for concern. It is also notable that the Petroconsultants, Ltd. study ranked the U.K. second in overall net present value per barrel for marginal field. The U.S. ranked 46th.

Reform of the U.S. tax system as it applied to the oil industry is critical. The AMT should be repealed or substantially reformed, and capital cost recovery rules should be modified. Foreign tax systems have many positive characteristics which encourage exploration and production activity. The result of the U.K. fiscal changes demonstrate the dramatic effect tax policy has on business investment.

The worldwide basis of U.S. taxation as applied to the oil industry creates competitive disadvantages. As discussed, the U.S. foreign tax credit limitations tend to increase the risk of double taxation in multiple jurisdictions. U.S. tax policy that singles out oil companies for adverse tax treatment is inappropriate, potentially detrimental to the economy and adversely impacts the competitiveness of U.S. oil and gas companies in the world market.

The Spanish tax regime is even more favorable in encouraging capital formation for oil and gas exploration and production. The Spanish tax regime offers a 25% depletion allowance. Even more useful to promoting capital formation, under this investment-oriented regime, companies which plow back their profits into additional investment for research and exploration are rewarded. As long as they make such investments within five years of the profit they may defer taxation on that income until they spend, or otherwise distribute the profits, for activities not related to oil and gas exploration and production.

Reform the Tax Code Now

Taxes on the oil and gas industry have evolved and have become increasingly punitive over the last several years. In fact, a 1995 survey of independent oil and gas producers found that the effective tax rate for the industry is 20 percent greater than other industries (when state and local taxes are added in, the percentage jumps three points). Meanwhile, critics argue that the industry is a recipient of "corporate welfare," because it receives legitimate business deductions. But, indeed, these ordinary and necessary business deductions are the same type of deductions all other businesses "write off." They're just called a different name in the tax code, and hence, have caught the eye of the extreme environmental lobby. When the "corporate welfare" mantra is used to advocate changes in the tax code, lawmakers must realize that these extreme groups are really talking about raising taxes.

Speaking of the "corporate welfare" debate, I wish to raise the alarm about an action taken in the "other body," last week. IPAA is extremely concerned about the actions of the Senate Government Affairs Committee in approving S.1376. Senator McCain's bill would create a BRAC-like commission to draft a list of "corporate subsidies" including tax provision, for Congress to terminate with minimal review and almost no debate. We have not always prevailed before this committee or the Senate Finance Committee, however, we reject the notion contained in S. 1376 that our tax system should be revamped without your expertise and judgment.

Instead of altering the tax code to erode natural resource industries, our leaders should encourage capital investment in developing the nation's resource base, especially to encourage drilling and to preserve so-called "marginal" production which just earns enough money to operate. Therefore, to protect the future of our industry and the benefits it provides to the entire economy, we strongly support making modifications to the current system to make it more fair, efficient, and administerable, rather than creating an entire new system. We support the following proposals, which we believe are necessary to ensure a competitive U.S.-based oil and gas industry:

- **Reform of the Alternative Minimum Tax (AMT).** The AMT doesn't allow full deductions of intangible drilling costs. These ordinary and necessary business expenses need full recognition in the tax code.
- **Reform the percentage depletion allowance.** Increasing the percentage depletion allowance rate for all producers and royalty owners from 15 percent to its historical level of 27.5 percent would encourage the maintenance of substantial U.S. reserves and increase cash flow to finance domestic drilling. Further, repeal the net income limitation on percentage depletion. This limitation effectively prevents most low volume wells from qualifying for percentage depletion during periods of low oil prices. The cost of operating a marginal well frequently exceeds the revenues received from the well's production. Repeal of the limitation will target depletion from those domestic properties which most need improved cash flow.
- **A tax credit to preserve marginal production and to encourage new drilling.**
- **Expand the Enhanced Oil Recovery Credit.** The Treasury Department allows deductions to be taken on certain advanced technologies, allowing new technologies to be used more often. However, Treasury has not updated its rules to allow deduction of some expensive new technologies used in the production of oil and natural gas. If the rules were updated, new technology and natural resource recovery techniques would help to expand our existing natural resource base.
- **Allow geological and geophysical costs to be expensed.** The industry has made enormous strides in seismic technology. Beginning with the Department of Energy's Natural Gas and Oil Initiative, the administration has promised a review and recommendation regarding the expensing of this costly, high-tech imaging technology that can, in some instances, account for 70 percent of the cost of drilling a new well. For nearly three years now, we have waited for even a hint from the administration on what, if anything, it can or will do about this open question. This technology is expensive, and unless today's tax laws are updated, smaller oil and natural gas producers cannot gain access to these technological marvels. If allowed to expense the costs incurred, these technologies could be used more often, leading to improved "finding rates" of oil and gas reserves (up to a 50 to 85 percent improvement rate). Also, the use of this new technology significantly improves the odds of drilling a successful well initially (reducing the number of wells drilled), thus leaving less of a "footprint" on the environment.

Conclusion

Again, Mr. Chairman and Members of the Committee, as you proceed next year in reforming America's tax system, I urge you to remember that we need to end up with a system that makes the taxation of natural resources, and thus our ability to raise capital, more competitive with the rest of the world.

I appreciate your kind attention and welcome any questions you might have.

Mr. CHRISTENSEN. Thank you, Mr. Linn.

Next, Mr. Huard.

STATEMENT OF PAUL R. HUARD, SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman.

In view of the hour, I will introduce my statement for the record and summarize as fast as I can.

I think it should go without saying that tax burdens are of critical importance to manufacturing competitiveness. This is because in today's highly competitive global economy increased tax burdens, which are an increased cost of doing business frequently, cannot be passed forward in price increases. So, the ability of manufacturers to maintain their market share and to sell a competitively priced product is very closely related to the tax burden that is imposed upon them.

In the manufacturing sector, we have concluded that the current Tax Code is the single biggest obstacle to growth that we now face. There are several reasons for this. One is that the aggregate levels of taxation are simply excessive and the second is that compliance with the existing tax system, particularly the income tax system, is much too costly.

In the case of small firms, there have been any number of studies that demonstrate that the cost of compliance for small firms, say with revenues under $1 million, is a large multiple of the taxes raised. One study by the Tax Foundation suggested the multiple was seven.

Even in the case of larger firms, there are certain arcane areas of compliance, most notably the alternative minimum tax, as well as the entire cadre of foreign source income provisions of the Code, where the cost of compliance is so high as to make the value of the provisions very questionable.

We have, therefore, concluded that replacement of the entire system is really the way to go. That the current system is beyond repair or salvage or retrofitting to make it viable. In designing a replacement system, we've examined various proposals that are out there and were set forth in the hearing notice. We haven't taken a position for or against any of them.

We do believe the design of a replacement system should take various conceptual principles into account. The first is that there should not be any net tax increase on either individuals or business. Tax increases basically deter growth. They don't stimulate growth.

Simplicity should be a major factor to eliminate wasteful compliance costs. Closely related to that should be stability. Since the late seventies we have had a nasty habit of making major changes in the rules of the game every 12 to 24 months. This makes business planning very difficult and it makes for a very complex situation for many taxpayers who basically are doing things under a multiplicity of depreciation schedules and other rules, depending on when they put an asset in service, or when they bought a particular asset or business. So, stability is almost as important as simplicity.

We should have a system that is much more conducive to capital investment. The current system, particularly for those taxpayers that are caught up in the alternative minimum tax, is one of the worst depreciations systems in the industrialized world. Ideally, to improve it and to also achieve the goal of simplicity, we ought to be moving toward something that looks like first year expensing.

As a number of witnesses have already mentioned, compatibility with the systems of our trading partners, sometimes referred to as border adjustability, is important so that products manufactured in the United States, particularly exports, do not bear an unfair burden of taxation relative to products manufactured outside the United States.

In terms of replacing the existing system, the goal should be to eliminate multiple taxation and tear that particular defect of the current system out by the roots. That means properly integrating the individual and corporate income taxes, and it means not double-taxing savings. Multiple taxation of payroll by both the Social Security tax and the income tax is a problem for workers.

Finally, if you do address payroll taxes—and I realize the hearing notice said they weren't necessarily part of this—you should do it in the context of also looking at reform of the Social Security system which is going to self-destruct somewhere out there in the future when the baby boom generation starts to retire. If you don't do that, and that may be too big a mouthful to chew on, you should at least make Social Security taxes deductible against income taxes so that you are not double taxing workers.

Thank you. That concludes my testimony.

[The prepared statement follows:]

TESTIMONY ON THE IMPORTANCE OF TAX REFORM
TO
DOMESTIC MANUFACTURING

BY PAUL R. HUARD
SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS
NATIONAL ASSOCIATION OF MANUFACTURERS

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

JULY 31, 1996

Thank you, Mr. Chairman. I am Paul R. Huard, Senior Vice President of the National Association of Manufacturers. It is a pleasure to be here this morning to present the NAM's views on the importance of tax reform to domestic manufacturing.

The NAM is the nation's oldest and largest broad-based industrial trade association. Its nearly 14,000 members include more than 10,000 small firms having fewer than 500 employees each. Our members are located in every state, produce about 85 percent of U.S. manufactured goods and employ about 85 percent of the U.S. industrial workforce.

The need for tax reform is urgent. We have concluded that the single biggest obstacle to increased economic growth and rising living standards is our impossibly complex and ever-changing tax code. While the problems of the current federal tax system are many, two are of paramount concern: [1] the system's generally excessive levels of taxation on income from work, savings and investment; and [2] the almost universally excessive costs of complying with the system. I will comment on each of these in turn and include some specific observations on the effects on manufacturers.

The ways in which the current tax code penalizes work, savings and investment are almost too numerous to mention. Here, however, are a few of the more egregious examples:

-- Wages, salaries and self-employment income are subject to both income taxes and payroll taxes, and the latter have risen so high that many workers now pay more in payroll taxes than they do in income taxes.

-- The regime for taxing capital gains fails totally to reward entrepreneurial risk-taking and, even more perniciously, often taxes as a "paper gain" what is actually an economic loss if inflation is taken into account.

-- Our capital recovery system is one of the worst in the industrialized world, particularly in those numerous instances when an already weak depreciation system is further exacerbated by the applicability of the corporate alternative minimum tax [AMT].

-- The personal and corporate tax systems are not properly integrated, so that corporate earnings paid to shareholders are doubly taxed.

-- Whether earned or unearned, taxable income that is saved and re-invested -- rather than consumed -- is taxed again and again and again, until withdrawn from savings or investment and consumed.

Tax rates were lowered substantially under the Tax Reform Act of 1986, although for manufacturers, many of which are capital intensive, this rate reduction did not fully compensate for the loss of the investment tax credit and the significant weakening of the depreciation system that also occurred under the 1986 Act.

The governing principle of the 1986 Act -- much touted at the time -- was the trade-off of lower rates for a larger taxable base. Some skeptics at the time expressed the fear that rates would soon be raised again without any commensurate narrowing of the base. This, of course, is precisely what has occurred. The top marginal rate of tax on both personal and corporate income have increased since the 1986 Act, yet any narrowing of the base has been nonexistent or at best negligible.

Furthermore, the negative effect of all this on a family held capital-intensive small manufacturing firm whose owners pay taxes under the personal rate structure is hard to overstate at a top marginal rate of about 42%. This rate, which includes back-door increases through reductions in personal exemptions and itemized deductions, represents a staggering 50 percent increase since 1986! And, the vast majority of U.S. businesses pay tax at the personal rather than the corporate rates because they are either sole proprietorships, partnerships or S corporations. Approximately 4000 of the NAM's 10,000 small manufacturers are S corporations.

In order to grow and create jobs, such a firm must constantly make new investments in plant, machinery and R&D. More often than not, such investments are financed from current cash flow rather than by raising new debt or equity capital. This is where the current tax system is extraordinarily harmful.

Let me now turn briefly to the issue of the cost of complying with a system whose complexities have grown so byzantine as to be incomprehensible to all -- whether the legislators who wrote it, the Internal Revenue Service personnel who have to enforce it, or the taxpayers who have to live with it.

Few would challenge the proposition that the costs of complying with the current federal income tax are grossly excessive. This is especially true of smaller firms which tend not to have in-house tax departments. One Tax Foundation study estimated that small corporations having assets of $1 million or less paid <u>over seven times more in compliance costs than in actual taxes</u>! That's at least $7 billion in compliance costs for each $1 billion in taxes collected from these firms. The cost of compliance by all *Fortune 500* companies is an estimated $815 million. Collectively, all businesses will pay an estimated $105 billion in 1996 to comply with the federal income tax according to the Tax Foundation. The lost economic opportunities due to these excessive compliance costs is inexcusable and detrimental to optimal economic growth.

That's why tax reform is so urgently needed. The NAM believes a reformed system should have the following characteristics:

-- <u>Simplicity</u>. What's needed is a simple low-rate system with relatively few deductions or other adjustments, so that the many billions of dollars currently wasted on complying with the current system can be applied to more productive uses.

-- <u>Elimination of Multiple Taxation</u>. Income once taxed should not be taxed again just because it is saved or reinvested rather than consumed. Wage income should not be subjected to both income and payroll taxes. Similarly, business income should be taxed only once so that, among other things.

corporate profits paid as dividends should not be taxed to both the corporation and the shareholder. Further, business taxes under any new system should be compatible with the border adjustable systems of our trading partners so that, for example, American exports are not double taxed by the U.S. and the destination country.

-- Stability. Present taxes are both disliked and hard to deal with in large part because they are in a constant state of flux. Procedures such as supermajority voting requirements should be adopted to ensure that future revision is both difficult and infrequent.

-- No Net Tax Increase. There should be no net tax increase on either individuals or business. Tax increases deter economic growth.

Adoption of a simple tax system that taxes all income but once and that is not biased against work, savings and investment should be one of the nation's highest priorities. The resulting dynamic increase in economic growth would benefit businesses and their employees alike. We can see no other way to improve incomes and living standards for all Americans while at the same time maintaining the global competitiveness of U.S. businesses, especially manufacturers.

Thank you, Mr. Chairman. That concludes my prepared remarks on this subject. I would be pleased to address any questions you or other members of the Committee might have.

Mr. CHRISTENSEN. Thank you, Mr. Huard.
Mr. Lawson.

STATEMENT OF RICHARD L. LAWSON, PRESIDENT, NATIONAL MINING ASSOCIATION

Mr. LAWSON. Thank you, Mr. Chairman.

I also, for purposes of time of the Committee, will ask that my remarks be submitted for the record, and I will attempt to cut them short with some of the most important aspects of our concerns.

As you know, the National Mining Association involves all of the mining activities that occur in this country, and we have strong feelings about our tax system. I would like to begin by expressing the industry's commendation for this inquiry into the flaws and failures of the income tax system. And in my time this morning, I will discuss some fundamental concepts but we will submit a detailed statement for the record, which would include a compilation of the taxes and fees the industry pays and the specific features of the current Tax Code which are of great concern to the industry.

From my standpoint, speaking for the industry, the Nation requires a tax system that raises sufficient revenue to operate the government without habitual resort to deficit finance, that attempts to hide no taxes, that does not allow for taxes to be easily or casually raised, that encourages the kinds of investment and behavior that produce an expanding and internationally competitive economy and more jobs, and finally, that allows the delivery of industrial resources to the economy at the lowest possible cost, which also encourages the use of competitive domestic resources, especially to enhance energy security for the country.

Any possible replacement for the present system should provide incentives for mining companies to explore for, discover, and develop new reserves as present ones are used up, the continuation of the depletion allowance or a provision that serves the same purpose in the same way. And whether the present system is replaced or simply reformed, the application of the alternative minimum tax to capital intensive industries such as mining is harmful, not only to the Nation, but appears to be, to us, to be punitive, should be eliminated, and certainly should be revised in terms of our international competitiveness.

Mr. Chairman and Members of the Committee, the mining industry of the United States endorses the spirit and direction of this inquiry and although it won't be a tea party, we can establish a system that is designed for a purpose and it should be in the American tradition of taxation.

Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD L. LAWSON
PRESIDENT
NATIONAL MINING ASSOCIATION

TO THE
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

HEARING ON
THE IMPACT ON REPLACING
THE FEDERAL INCOME TAX
JULY 31, 1996

Mr. Chairman, members of the committee, I am Richard Lawson, the president of the National Mining Association.

NMA's members deliver to Americans the industrial resources and electric power that produce a competitive, modern economy and good jobs. America is one of the world's energy and resource rich countries. Each form of mining makes both individual and combined contributions to the continued growth, security, and competitiveness of the United States economy.

The U.S. is first or second in world production and reserve holdings of most important metallic and non-metallic minerals. Products of domestic mining are required for virtually all forms of economic activity. Ores become tools and capital goods, including computers and tractors. Non-metallic minerals go into industrial processes, chemicals and fertilizers. Many mining products and much equipment fabricated from mined materials are exported.

American coal perennially delivers almost three-fifths of the nation's electric power and comprises two-fifths of all domestically produced fossil fuel. Coal-fired electricity is a principal reason America's industrial power rates are 49 percent below our primary economic competition in Europe and 73 percent below our principal competitors in Asia.

The saying is, "If it can't be grown, it has to be mined." That certainly is true in America. In 1995 the U.S. economy required new metals and minerals at an annual rate of 40,000 pounds per person. Add to that the billion-plus tons of coal U.S. miners produce and you begin to see the contribution of the U.S. mining industry to America and Americans.

I want to begin by expressing the industry's commendation for this inquiry into the flaws and failures of the federal income tax system. A former Secretary of the Treasury once said, "The nation should have a tax system that looks like someone designed it on purpose." The mining industry feels that such purpose ought to be an America that is economically strong and capable of responding to all challenges, and for that reason our industry intends to be a full contributing participant in the policy process now underway.

There are two fundamental approaches to taxation. One is basically European and rooted in the attitudes of feudal times. It assumes that government should simply take what it needs and that people would be permitted to keep a share of the fruits of their labor and investment -- but only a share. I sometimes think of it as the King George of England system.

This philosophy gives to things left untaxed names such a tax expenditures and middle-class subsidy. In it, taxes have two purposes: To raise revenue and to coerce behavior for social and other policy purposes; and revenue is not always the first purpose of a tax provision.

The other approach is distinctly American and stems also from the time of King George, tea parties and America's ultimate tax reform: It is based on the conviction that the people grant to government a share of their earned wealth in exchange for the efficient and orderly conduct of national affairs.

In it, taxes also have two purposes: To raise revenue and to encourage behavior. Tax expenditures are taxes paid, not activities left untaxed. I urge the committee to re-emphasize the American approach. America requires a tax system that:

- Raises sufficient revenue to operate the government without habitual resort to deficit finance;
- Attempts to hide no taxes;
- Does not allow for taxes to be easily or casually raised;
- Encourages the kinds of investment and behavior that produce an expanding and internationally competitive economy, and more jobs;
- Allows delivery of industrial resources to the economy at the lowest possible cost; and,
- Encourages the use of competitive domestic resources -- especially to enhance energy security.

A major deficiency of the present tax system is the corporate alternative minimum tax, which, as the Committee is well aware, operates as a parallel tax system. The end result is a tax structure that penalizes investment and gives capital intensive industries the worst capital cost recovery system in the industrialized world. We applaud the Committee's efforts to repeal and reform the AMT in the 104th Congress.

The AMT hits nearly every mining company at nearly every stage of a mine's investment and life cycle--exploration, development and production. This makes many mining companies permanent AMT taxpayers and as a result they pay higher effective federal income tax rates than other businesses.

A review of information in the public domain indicates that the mining industry pays higher taxes than most industries. Some commodities, such as coal, already bear an extremely high tax burden. Information on total tax burden is useful to better understand the full impact and implications of fundamental tax reform on any given industry or segment thereof.

The coal industry provides a good example of the amount of non-income based taxes paid by an industry. Like other industries, coal producing companies pay federal and state income taxes, property, sales and use tax, and federal and state mandated payroll taxes. Coal companies also pay a variety of industry specific taxes and fees including state (and local) severance taxes, federal abandoned mine lands fees and federal Black Lung Excise tax. A significant amount of coal production occurs on lands subject to federal or Indian royalties. Also, many coal companies must pay a federally mandated retired miner health care tax.

Revenues provided by severance taxes are a significant source of funds for coal producing states. The total coal severance tax collected by all coal producing states in 1993 totaled $559 million. To illustrate the importance of these taxes, Wyoming, the nation's largest coal producing state, collected $100.4 million in coal severance tax in 1993 representing 15% of this states total tax receipts.

At the federal level, the coal industry paid $329 million in federal and Indian royalties in 1993. The nation's coal production subject to federal or Indian royalty accounted for 31% of total coal production in 1994. The coal industry paid $605 million in coal black lung excise tax in 1993 and abandoned mine lands fees of $238 million.

The impact of these non-income based taxes is significant. For example, a Wyoming coal company selling Powder River Basin coal for an average price of $3.33 per ton FOB mine will pay $1.23 per ton or 36.9% of selling price in non-income, non-payroll taxes and fees:

State (and county) severance	$.33
Black Lung Excise Tax[1]	.15
Federal royalty	.40
Abandoned mine land fee	.35

	$1.23
	=====

Subtracting the $1.23 in non-income based taxes from a selling price of $3.33 leaves only $2.10 per ton to cover production costs, overhead, payroll and income taxes. As a result, profit margins are razor thin.

Any alternative tax system should take into account all excise taxes, fees and industry - specific taxes paid to government entities--federal, state and local, including Indian tribal entities.

Historically, the federal income tax system has recognized the fundamental and essential role of this country's mining industry. Mining's importance has been long acknowledged through such provisions as the deduction for exploration and development expenditures and the percentage depletion allowance. These and other provisions affecting capital cost recovery have helped to foster an assured availability of raw materials for manufacturing and energy production while helping to generate needed cash flow for the industry.

One of the distinguishing characteristics of mining compared to other forms of commercial endeavor is the necessity to discover through high risk exploration and development activity, the primary asset of the business--its mineral deposits (reserves). The tax code must encourage the entrepreneurial risk taking activity inherent in these activities.

A mineral deposit is a wasting asset that requires investments in exploration, acquisition and development in order to yield a flow of commodities over its productive life. As is true of other assets, the value of a mineral deposit diminishes with its depletion. The present tax system recognizes these characteristics:
(1) a mineral deposit is a unique wasting asset for which the percentage depletion allowance is necessary to provide meaningful capital recovery; and (2) the massive capital requirements, above average risks and long lead times from exploration to commercial production inherent in the mining industry.

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[1] Other coal operators pay considerably more Black Lung Excise Tax--up to $1.10 per ton.

Any modification to the present system, or a change to a new system, that results in an increase in the tax burden on mining companies is the same as an increase in production costs. Because minerals are commodities traded in the international marketplace at prices determined by world-wide supply and demand factors, mining companies cannot increase prices to recover higher costs. Ultimately, higher tax burdens will have a chilling effect on investment in both existing mines and proposed mining projects and damage the long-term viability of the mining industry. Any downsizing in the U.S. mining industry as a consequence of tax hikes means good, high-paying jobs will be exported and we will import mineral products to offset lost domestic production.

NMA is concerned that the flat and USA alternative tax systems, as presently drafted, could result in a major tax increase on the mining industry which will have adverse consequences not only to mining companies but their employees, suppliers and other entities with a stake in the success and viability of the domestic mining industry.

Any possible replacement for the present system should provide incentive for mining companies to explore, discover, and develop new reserves as present ones are used up -- the continuation of the depletion allowance or a provision that serves the same purpose. And whether the present system is replaced or simply reformed, the application of the alternative minimum tax to capital-intensive industries such as mining is harmful and punitive and should be eliminated.

Mr. Chairman, members of the committee, the mining industry endorses the spirit and direction of your inquiry. It won't be a tea party, but we can establish a system that is designed for a purpose; and it will be in the American tradition.

Mr. CHRISTENSEN. Thank you, Mr. Lawson.

Mr. Collins, do you have any questions?

Mr. COLLINS. Mr. Chairman, no, I won't ask any questions. It seems like we have quite an event going on across the street that we all have to attend about every 15 minutes. But we do appreciate each of you coming, and we are very concerned, as you are, with the tax structure in this country and how it affects jobs domestically as well as how it affects exports. I prefer to export goods rather than exporting jobs.

And I think our Tax Code has a tendency for us to export jobs more favorably than it should. We solicit your support in our efforts to change the Tax Code as we attempt a change in this Congress. And I am sure that the Chairman, within the next Congress, will continue to move forward with more changes, changes our critics say are in effect, giving corporate welfare to business. But in the long run, these incentives are for the welfare of those who work in this country.

Because I've always been a believer that no matter where you implement a tax, who you implement it on, what product you implement it on, working people of this country pay the bill, when they buy those products or buy those goods and services.

We appreciate your efforts, your interest, and your patience with the procedural vote tactics that are going on today.

Thank you very much.

Mr. CHRISTENSEN. As Mr. Collins stated, there is another vote on the floor. There are a number of procedural things that are happening. In light of that, I will probably have to pass at this time. I want to thank the Committee and thank the panel for their time and spending here, the whole morning. And your full statement will be entered into the record, and we appreciate the fact that you've given your time to come to testify this morning.

Thank you very much.

[Recess.]

Mr. ENGLISH [presiding]. We are going to reconvene this hearing and introduce a new panel. Each of the witnesses will have 5 minutes to testify and then we will have an opportunity for questions and answers.

Our panel on this round will consist of James F. McMahon, vice chairman of the taxation committee of the Edison Electric Institute, and general tax counsel of the Consolidated Edison Co. of New York, and he is accompanied, I believe, by Peter Merrill, a partner at Price Waterhouse.

We have with us Dawn Erlandson, executive director of Americans for a Sustainable Economy; Brent Blackwelder, president of Friends of the Earth; and Gary Rogliano, senior vice president for the Pittston Co. of Stanford, Connecticut, speaking on behalf of the Coal Industry Tax Committee.

Thank you all for coming and participating today.

We anticipate having a few more Members here before this panel is completed, to ask questions. I would like to start with Mr. McMahon, and then Mr. Merrill.

STATEMENT OF JAMES F. MCMAHON, VICE CHAIRMAN, TAXATION COMMITTEE, EDISON ELECTRIC INSTITUTE; AND GENERAL TAX COUNSEL, CONSOLIDATED EDISON CO. OF NEW YORK, INC.; ACCOMPANIED BY PETER MERRILL, PARTNER, PRICE WATERHOUSE LLP

Mr. MCMAHON. Thank you, Mr. Chairman. Good afternoon.

We welcome the opportunity to speak before the Committee with respect to tax reform. We support your efforts to develop an alternative tax system. Now we have reviewed the various tax proposals, and I will just break them down, in the interest of time, for short analysis.

The USA tax encourages capital investment by expensing our expenses. We, as you know, in public utilities, make large investments, and this particular expensing will be a great capital investment for us.

The national retail sales tax is similar to the sales taxes imposed in 45 States. It is also similar to the VAT tax. EEI has found significant merit to the VAT tax and has prepared written comments, which we gave to the Committee last June.

The flat tax also allows expensing and does have the advantage of capital investment. However, while it does enhance our competitive position, it is, as far as foreign taxes are concerned, not border adjustable.

As to the effect on electric utilities, I would just point out a few things.

In our compliance, one of our major problems in taxes is the distinction between expensing and capitalization. All three proposals eliminate that problem, which is an excellent idea.

We do have, however, transition problems regarding cost recovery issues and losses, and other transitional questions. We ask that the Committee examine other issues as they are important to the electric utility industry.

In the regulatory area, reductions or elimination of deferred tax liabilities could result in temporary but significant reductions in cash flow and limited investment opportunities for public utilities.

We also ask that the Committee take a careful review of the normalization provisions that are in the Tax Code, and be careful about abandoning them.

In the foreign tax area, we are now facing global competition and electric utilities are looking forward into foreign investments. The flat USA tax and the sales tax do not tax offshore activities, but the flat tax does tax exports, and is not border adjustable.

As the Committee is aware, there have been changes in the electric industry primarily because of the Energy Policy Act of 1993. It has brought forth retail competition and a new class of nonutility generators. We ask that consideration be given to a level playingfield, and a fairness in taxation, and that tax advantages enjoyed by municipal government-owned utilities be equated with public utility taxation.

In summation, we have five points I would like to make.

One, EEI and the public utility industry support any proposal to eliminate the income tax and replace it with a broad-based consumption tax.

However, we do not support the addition of a compensation tax on top of existing income taxes.

We favor the consumption tax, but we would want the public utility to collect the tax, but the tax would be placed on the end user.

We urge you to look at the transition issues raised by the recovery of bases and by losses.

We also ask that consideration be given to the normalization, and finally, we ask for fairness and a level playingfield, so that our long-term goal is to tax all electricity at the same rate, regardless of who produces it or who sells it.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES F. MCMAHON VICE CHAIRMAN, TAXATION COMMITTEE EDISON ELECTRIC INSTITUTE, AND GENERAL TAX COUNSEL, CONSOLIDATED EDISON CO. OF NEW YORK, INC., ACCOMPANIED BY PETER MERRILL, PARTNER, PRICE WATERHOUSE LLP

Mr. Chairman and Members of the Committee:

I am James F. McMahon, General Tax Counsel of the Consolidated Edison Company of New York, Inc. I appreciate the opportunity to appear today representing the Edison Electric Institute (EEI). EEI is the association representing the nation's shareholder-owned electric utility companies. Its members serve 99 percent of all customers served by the shareholder-owned segment of the electric utility industry. EEI's members generate approximately 79 percent of all the electricity produced in the United States and serve 76 percent of the nation's customers. EEI and its member companies appreciate the opportunity to present our comments on this important issue, and look forward to working with the Committee in its search for an alternative tax system to replace the federal income tax.

A number of Members of Congress as well as others believe that the current federal income tax system should be repealed and replaced by a new tax that is designed to facilitate savings and investment, international competitiveness, and tax simplification. House Ways and Means Committee Chairman Bill Archer (R-TX), Senate Finance Committee Chairman William Roth R-DE) and Ways and Means ranking member Sam Gibbons (D-FL) have all expressed an interest in sweeping tax reform. EEI applauds these efforts.

Our current tax system is extremely complicated and burdened with a multitude of complex and tangled regulations, exemptions and loopholes. It punishes success and rewards consumption at the expense of savings and investments, and is extremely difficult and expensive to administer. The administration of the system can, at best, be described as inefficient and adversarial. EEI supports the Committee on Ways and Means' efforts to develop an alternative tax system that is fairer and encourages savings and economic activity. Our remarks will address the principal options most frequently discussed as alternatives to the current system. The proposals include a flat tax, a national sales tax, and an income tax with an unlimited savings deduction.

Three fundamental tax reform proposals introduced during the 104th Congress have received the greatest amount of attention: the Flat Tax introduced by House Majority Leader Dick Armey (R-TX) and Sen. Richard Shelby (R-AL), the "Unlimited Savings Allowance" (USA) Tax introduced by Senators Pete Domenici (R-NM) and Sam Nunn (D-GA), and the National Retail Sales Tax (NRST) introduced by Reps. Dan Schaefer (R-CO) and Billy Tauzin (D-LA). Each of these proposals would repeal the current federal individual and corporate income taxes and introduce a new consumption-based tax system. We agree that a new tax should not be added on top of the current income tax system.

Adoption of any of these proposals would represent a radical change in U.S. tax policy. While over 100 countries have adopted national value-added taxes (VATs), none has repealed its corporate or individual income tax system. Change of this magnitude would raise numerous issues for the electric utility industry. The purpose of these comments is to identify the potential impact of fundamental tax reform on our industry.

CHANGES IN THE ELECTRIC UTILITY INDUSTRY

The electric utility industry has entered into an era of increasing competition. The Energy Policy Act of 1992 has stimulated wholesale competition by opening the nation's transmission system and creating a new class of non-utility generators at the wholesale level. With regard to retail sales to the ultimate customer, forty-seven states and the District of Columbia are addressing reforms to traditional retail electric service. Several states are conducting retail competition experiments.

At this time it is not known how future electricity markets will be constructed. But there will continue to be a regulated and an unregulated part of what is now the electric utility business, at least for the forseeable future.

We point this out because whether or not an electricity company is regulated has income tax implications. One of the major differences is that, in calculating the cost of service for providing electricity, regulators determine the income tax expense that is chargeable to the customer in rates. The treatment of deferred tax is another area of significant difference.

Thus, any restructuring of the tax system must take into consideration the changing nature of the electricity industry. Some parts of the business such as distribution will, in all likelihood, continue to be regulated. Other parts of the business, such as generation, may be partially or fully deregulated.

In order to ensure that all electricity suppliers compete under the same rules, the tax system should not give an unfair advantage to any market participant.

USA TAX

Introduced by Senators Pete Domenici (R-NM) and Sam Nunn (D-GA), the "Unlimited Savings Allowance" USA Tax (S. 722) imposes two consumption taxes: (1) a consumed income tax on individuals with progressive rates up to 40% and (2) a subtraction method value added tax on businesses at an 11% rate. Businesses generally would compute their USA Tax base by deducting from gross receipts the cost of goods and services purchased from other businesses, including materials, energy, plant and equipment, advertising, accounting and legal fees, and other costs. The primary business expenses that would not be deductible under this system are employee compensation and benefits, interest payments and taxes (other than product taxes). Dividends, interest and capital gains income from sales of financial assets would not be included in the tax base of non-financial companies. Dividends and interest payments would not be allowed as deductions under the USA Tax for non-financial companies. Rent and royalty income would be includable in business receipts, while rent and royalty expenses would be deductible, as under the corporate income tax.

Capital purchases, including the entire cost of property, plant and equipment, would be fully deducted in the year of purchase. Gross proceeds from the sale of assets would be included in the USA Tax base. Depreciation, depletion and amortization rules would be eliminated. Transition rules would apply to the unrecovered basis of assets purchased before the effective date of the USA Tax. The proposal would retain the accrual method of accounting for purposes of determining the timing of recognition of taxable receipts and deductions of business purchases.

The USA Tax is a territorial tax with "border adjustments." Income from foreign branches and dividends from foreign subsidiaries would be excluded. Gross receipts from exports of goods or services from the United States would also be excluded from the tax base. Foreign source rents, royalties, commissions, service fees, etc., received by a U.S. business would be treated as export receipts and excluded from the tax base. Imports of goods and services would be treated as taxable receipts to the importer. The import tax could not be reduced by any deductions or credits.

The USA Tax accomplishes some important tax policy objectives. First, it encourages capital investment. Utilities make substantial investments in plant and equipment, and capital expenditures would be expensed rather than depreciated. Secondly, the USA Tax enhances the electric utilities' competitive position abroad. The electric utility industry has become significantly more involved in offshore projects which generate foreign source income, all of which would be exempt from the USA tax base. Although the USA Tax does not allow for deductions for wages and other forms of compensation, on balance, we believe the USA Tax provides an appropriate base of taxation. The immediate deductibility of capital expenditures promotes capital investment that is vital to productivity and economic growth and would lower the cost of capital. In addition, the exclusion of income generated offshore encourages additional activities by U.S. domiciled utilities operating in foreign countries. These foreign projects create jobs in the United States. They do not export jobs. These projects involve U.S. service personnel as well as U.S. based technology. The power plants abroad will be built and operated either by a U.S. company or by a foreign competitor. It is an inherent economic advantage for the United States that these plants be built, equipped and operated by U.S.

companies rather than our foreign competition. The USA Tax does little, however, to level the playing field for all electricity producers.

FLAT TAX

Although there are different versions of a Flat Tax, perhaps the one most frequently discussed is the one introduced by House Majority Leader Dick Armey (R-TX), H.R. 2060 and Senator Richard Shelby (R-AL), S. 488. Their proposal imposes a flat 17% tax on businesses and individuals. Robert Hall and Alvin Rabushka of the Hoover Institution suggested a 19% rate should be implemented. A January 1996 U.S. Department of the Treasury analysis estimated that a 20.8% rate would be required for the Flat Tax bill to be revenue neutral. Under the Flat Tax, a business generally would compute its tax base as it would under the USA Tax with some significant differences:

- In contrast to the USA Tax, wages and salaries and contributions to qualified pension plans would be deductible under the Flat Tax. Other fringe benefits such as health care would not be deductible as under the USA Tax.

- Unlike the USA Tax, the Flat Tax would not tax imports, nor exempt exports. Like the USA Tax, the Flat Tax would be calculated on a territorial basis; only domestic operations would be included in the determination of tax liability and income from foreign operations would be exempt. Foreign source royalty, rental, commission and service fee receipts would, unlike the USA Tax, be included in the tax base under the Flat Tax.

- In contrast to the USA Tax, Flat Tax legislation generally would require the use of the cash method of accounting.

BROAD BASED CONSUMPTION TAX

Representatives Dan Schaefer (R-CO) and Billy Tauzin (D-LA) have introduced legislation -- (H.R. 3039) the "National Retail Sales Act of 1996" -- that would repeal the corporate and individual income taxes, the estate and gift taxes, most federal excise taxes. It also imposes a new 15% national retail sales tax (NRST). The Schaefer/Tauzin NRST is generally similar to retail sales taxes (RSTs) now imposed by 45 states. The Schaefer/Tauzin NRST, however, would apply not only to goods but also to most services. The bill would encourage states to take over administration of the NRST by allowing administering states to keep 1% of the amount of NRST collected as an administration fee. The bill also would eliminate funding for the Internal Revenue Service after FY 2000.

Under the NRST, businesses would pay tax equal to 15% of the gross amount received for sales of goods and services. Sellers would be required to provide an invoice with respect to taxable sales stating the amount of tax and certain other information. Sales to other businesses for resale or for use in the production of taxable goods and services would be exempt as would exports. Taxpayers would be allowed an administrative credit equal to 0.5%

of tax collected as well as a credit equal to 50% of the cost of equipment purchased to comply with the invoice requirement.

Employers would be required to pay each employee a "family consumption refund" equal to 15% of the lesser of (1) the poverty level for the employee's family unit; or (2) the employee's annual compensation. The refund would be creditable against the employer's payroll tax.

The NRST is similar to a value added tax (VAT). A VAT taxes the difference between the value of a business' sales and its purchases from other businesses. A value added tax is a tax on businesses that is collected as goods move through different phases of production. VATs generally tax consumption rather than investment and are border adjustable.

Because a retail sales tax such as the NRST and a credit-invoice VAT (with the same rate) generally impose the same amount of tax on the same tax base (i.e., total final sales), economists generally believe that the taxes will have largely the same impact on savings, international trade and distribution of income. Thus, the differences between a retail sales tax and a credit invoice VAT are primarily matters of administration and compliance. EEI believes that a traditional VAT has substantial merit and provided this Committee with written comments on the subject on June 22, 1995. As in the case of the other approaches to fundamental tax reform addressed in our remarks, we believe that these measures have the potential to be significantly more efficient and administrable than the present corporate and individual income tax and that they would also better promote the important goals of capital formation, domestic job growth, and foreign competitiveness.

Ratemaking Under a Broad Based Consumption Tax

The interaction of a broad based consumption tax with state rate-making raises significant issues for the electric utility industry. The "revenue requirement" of an electric utility includes its tax liability and is in principle recovered through the rate-making process. State gross receipt taxes, state franchise taxes and income taxes are all expenses included in a utility's revenue requirements. Utilities cannot automatically adjust rates to reflect changes in such taxes since these changes require approval of regulatory authorities. A sales tax imposed on customers is not part of the revenue requirement. A sales tax is generally a liability of the consumer with utilities serving solely as collection agents for the government. Utility bills therefore automatically reflect a sales tax.

Treatment of a broad based consumption tax for rate-making purposes should ensure that the ultimate consumer of electricity bears the cost. However, the design of a national sales tax raises several issues. The design could be such that utilities are simply collection agents. This is how the House drafted the proposed BTU tax in its version of the Omnibus Budget Reconciliation Act of 1993. An invoice-method national sales tax would be a liability of the ultimate consumer and would be collected and remitted by the utility. It would not be part of the utility's revenue requirements. Instead, the tax would be a separate calculation outside the rate-making process.

Alternatively, the design of a broad based consumption tax could designate the seller as the taxpayer. Such a design would create regulatory problems for the utility. For example, under a subtraction method VAT, such as the USA Business Tax, utilities would likely be required to obtain regulatory approval in order to include the amounts in rates.

COMPLIANCE AND TRANSITIONAL ISSUES

For many taxpayers, the prospect of relief from the compliance burden associated with the current federal income tax system is one of the most attractive features of fundamental tax reform. Proponents of the various tax reform proposals have focused on this taxpayer concern. The major fundamental tax reform proposals we have discussed are likely to provide some, perhaps significant, relief from the present compliance burden but the transition to a new system will create different compliance burdens, and each of the proposals contains at least some potential complexities. In addition, each of these restructuring proposals may make it more difficult to use financial accounting data as a starting point for the calculation of tax liability.

For the electric utility industry, a significant amount of tax complexity relates to the question of whether to deduct or to capitalize an expenditure. The Flat Tax, the USA Tax and a national sales tax would eliminate this major source of complexity since all expenditures would be expensed. Significant cost recovery issues relating to existing property and other transitional issues, however, would be inherent in the adoption of any new method of taxation.

Another significant source of complexity relates to the United States taxation of offshore business activity. The Flat Tax, the National Retail Sales Tax and the USA Tax are territorial systems and would not tax the offshore activity of U.S. corporations. A national sales tax and the USA Tax would be border adjustable and eliminate the extraordinary complexities involved with the taxation of U.S. entities abroad. The Flat Tax would be border adjustable and would tax royalties and other payments received for exports of services and intangibles. As a result, transfer pricing would remain a significant source of complexity in the administration of the Flat Tax. Moreover, the taxation of foreign-source royalty payments - with no deduction or credit for foreign withholding taxes on these royalties could result in an increased tax burden on the development and commercialization of technology by U.S. companies. It is critical that any new tax system maximize the competitive position of U.S. utilities operating abroad.

Depending on how a national sales tax is constructed, significant administrative burdens may result. For example, the NRST would impose significant compliance burdens with its "family consumption refunds." Coordination would be required where a family unit has more than one working member. This process would raise significant compliance problems. Another example is that, under the NRST, sellers would need to maintain exemption certificates for each business customer for a period of three years and would bear the burden of ascertaining that these certificates are not fraudulent.

Another area of complexity involves interstate sales. Under the NRST, interstate sales would be taxable in the same manner as intrastate sales. However, the destination state would have tax jurisdiction over these sales. Consequently, utilities would need to ascertain the residence of all nonexempt customers and calculate tax separately for each customer based on the state of residence.

A publicly-traded company's incremental cost of compliance with the present tax law is significantly influenced by the degree to which information developed for other purposes (such as the financial statement) can be used for tax purposes. Generally, a company will not calculate all of the elements of taxable income separately, but rather will use the financial statement measure of income as a starting point and make the adjustments necessary to determine taxable income. A corporation is required to summarize these adjustments on Schedule M-1 of the corporate income tax return Form 1120. Obviously, extensive and complex adjustments to the financial statement that may be required to determine taxable income increase the cost of tax compliance. Unlike present law, neither the Flat Tax nor the USA Tax uses a single existing figure such as book income as the starting point of its calculation. While continued use of financial accounting information may be possible, it may no longer be able to serve as the starting point for the calculation of tax liability as it does under present law, necessitating the creation of a new, unique calculation of taxable income.

FINANCIAL ACCOUNTING AND TRANSITION ISSUES

If tax reform retains some definition of income as part of the tax base, continued financial accounting measurement of tax expense and liability will be required. This will result in both transitional and ongoing financial accounting implications.

The main transitional effects are the benefit due to a reduction in net deferred tax liabilities resulting from a tax rate reduction; and, absent transitional relief, the burden resulting from the loss of tax basis in existing assets. The positive and negative transitional effects may be recognized immediately or over time, through earnings or directly through the equity account. Whether an individual utility will experience a net positive or negative effect will depend upon the size of the reduction in tax rates, the utility's deferred tax account, the utility's adjusted tax basis in its depreciable assets, and the transition rules provided. Additionally, EEI member companies have accumulated over $1 billion of minimum tax credit carry-forwards under the current alternative minimum tax system. Consequently, the transition rules for utilizing these credits are of extreme importance to EEI.

Ongoing implications of tax reform that will affect the determination of a utility's effective tax rate includes the change in the statutory tax rate and the numerous permanent and temporary differences between the USA and Flat Taxes and the present corporate income tax. Although the deferred tax liability account may be decreased by the transition to the new system as a result of the change in statutory rates, it is expected to be increased on an ongoing basis as a result of allowing the current deduction of capital expenditures.

REGULATORY ISSUES

Some regulatory issues are raised by fundamental tax reform. The regulatory treatment of the reduction or elimination of deferred tax liabilities is an issue of concern. Its incorporation into the rate-making process could result in a temporary (but potentially significant) reduction in the cash flow of the regulated utility. Such a change could be detrimental to the electric utility industry. A one-time refund would be unfair to a majority of customers.

The need to normalize future investment in depreciable property also must be addressed. Under the Flat Tax and the USA Tax, capital expenditures are deductible immediately. Failure to normalize the tax benefits of expensing plant and equipment would produce undesirable fluctuations in rates as well as compromising tax reform's intended incentive for investment.

Introduction of a consumption-based tax system like the NRST or the USA Business Tax may cause a one-time increase in the price level because employee compensation and benefits are not business deductions. By contrast, the Flat Tax, because it taxes wages at the household rather than the business level, is less likely to cause an increase in the price level. The potential inflationary effect of the USA Tax and the NRST are of particular concern to regulated industries, such as the electric utility industry. Regulated industries generally cannot rapidly adjust their prices to reflect the impact of inflation on costs. Consequently, a burst of inflation may depress income, reduce the value of shareholder equity, and make it more difficult for utilities to finance investment. To avoid this result, regulators would need to allow rates to increase commensurately with the overall price level in the economy.

EQUAL TAXATION FOR SIMILAR TRANSACTIONS

As compared to investor-owned utilities, cooperative and government-owned utilities generally are not subject to entity level taxation and, in many cases, have access to tax exempt financing. We believe that it is imperative that all of the fundamental tax reform proposals create a level playing field and subject all providers of electricity to the same level of taxation in the evolving, competitive electricity market. Of the principal types of fundamental tax reform proposals discussed above, the USA Tax would do the least to level the playing field. Government-owned electric utilities would retain their tax-exempt status because the provision of public utility services is considered an essential government function under the USA Tax. Cooperative utilities would be subject to the business tax;

however, cooperative electric companies would be allowed to treat patronage dividends as a refund of a portion of the amount paid by the patron for services. Under the USA Tax, income from tax exempt bonds would continue to be exempt from taxation although the value of the exemption would likely be reduced because of the deduction for net additions to savings. We believe that Congress should use fundamental tax reform to help establish a level playing field in the evolving, competitive electric industry.

Under the Flat Tax, government entities and organizations exempt from tax in present law would continue to be exempt from the Flat Tax on businesses. However, government entities and tax exempt organizations would be subject to a separate tax, at the Flat Tax rate, on "excludable" compensation. Unlike present law, government-owned and mutual and cooperative utilities would not be entirely free of tax at the entity level. The Flat Tax would treat taxable and tax exempt bonds identically, and thus at least one aspect of the playing field would be leveled.

The NRST would subject the sales of all electricity, regardless of the type of ownership, to the same level of taxation. Thus, from a federal tax perspective, investor-owned, government-owned and cooperative utilities would compete on a level playing field. This does not mean that the shareholder-owned electric utility necessarily favors the NRST over other fundamental tax reform proposals. Rather, we believe that all of the major proposals can be structured in a way which accomplishes, in the long-term, the all important goal of taxing all electricity at the same rate regardless of who produces and sells the electricity.

CONCLUSION

We applaud this Committee's efforts to take a long overdue look at the current federal income taxation system. Although we believe that a new system can be designed that accomplishes the national objectives of encouraging savings and investment and raising revenue in a far simpler and economically-productive manner, any such system will create significant transitional issues. With respect to the electric utility industry, fundamental tax reform also provides an opportunity to level the playing field and produce equal tax results for all participants in the evolving, competitive electricity market. In addition, tax reform should consider the impact of rate regulation.

We would be pleased to provide this Committee with more information about our industry's views on fundamental tax reform and its impact on the shareholder-owned electric utility industry as the process moves forward and as the specifics of various proposals become more clearly defined. We thank you for the opportunity to participate in this process.

Chairman ARCHER. Thank you, Mr. McMahon.

My apologies. I wish I could apologize to the previous panel, but this is a three-ring circus here on Capitol Hill right now, and one person has a lot of difficulty being in three different rings at the same time. Actually, it is four rings now, counting these hearings.

So I apologize for that. But we are delighted to have your testimony today, and our next witness is Peter Merrill. If you would identify yourself for the record, you may proceed.

Mr. MERRILL. I am accompanying Mr. McMahon today and do not have a separate testimony.

Chairman ARCHER. All right. So you will associate yourself with his remarks?

Mr. MERRILL. One hundred percent. [Laughter.]

Chairman ARCHER. Our next witness is Dawn Erlandson. If you will identify yourself for the record you may proceed.

STATEMENT OF DAWN ERLANDSON, EXECUTIVE DIRECTOR, AMERICANS FOR A SUSTAINABLE ECONOMY

Ms. ERLANDSON. Certainly. Good afternoon, Chairman Archer, and Representatives English and Ensign.

I am Dawn Erlandson, executive director of Americans for a Sustainable Economy.

We work on better integrating economic, social, and environmental goals, particularly in the area of tax policy.

I would like to thank you today for allowing us to testify.

We offer three basic principles, which any tax reform proposal should embody, beyond ease of compliance and enforceability.

The first principle is equity, meaning that any new tax system should, as a minimum, retain the progressivity of the current personal and corporate income tax system.

We believe this is particularly important, given the regressivity of the Federal payroll tax, and many of our State tax systems.

Second, the tax system should promote job creation and rising real incomes for ordinary families, as well as foster overall economic vitality.

Third, the tax system should encourage protection of the environment and wise use of natural resources.

As we examine the four tax options before the Committee, and their effects on industrial sectors, one potentially positive element stands out for us.

To the extent that all of these options eliminate preferential treatment of and subsidies for the extraction of natural resources, they would provide an important environmental benefit missing from the current tax system.

Nonetheless, the environmental advantages of eliminating this special treatment may be more than offset by the advantages to capital intensive industries, such as mining, that these new alternative systems would create.

The question of whether savings and investment will increase in response to lower tax rates is an open one.

The evidence from the United States economy in both the sixties and the eighties does not demonstrate that high effective tax rates on investment income inhibited investment or decreased national savings, nor does it suggest that investment incentives increased total investment.

The switch, then, to consumption taxes shifts the burden from capital to labor, regardless of whether that shift creates additional investment.

If the shift encourages investment, there may be some growth advantages to offset negative distributional burdens, provided the investment in physical capital caused by the tax cut to capital is not offset by a reduction in investment in human capital from the labor tax increase.

As a result, these tax systems would favor capital-intensive investment over labor- and knowledge-intensive investment.

This will move the United States economy in the wrong direction, back toward earlier industrial age, based primarily on high levels of investment in physical capital, and inefficient use of energy and natural resources, rather than pushing forward into the information age, and beyond, in which investment in human capital is the key to economic success.

Instead, we must position the United States to compete in the global economy for high-growth, knowledge-intensive industries that are energy efficient and clean, while creating more energy-efficient and less polluting production in our traditional industry sectors.

If the tax changes discussed today, despite evidence to the contrary, do stimulate increased capital investment, then we may see more pollution and greater energy consumption due to increased growth.

It is true that new physical capital investment is usually more energy efficient and less polluting than the physical capital that it replaces. But in order to ensure the environmental benefits are realized, this burst of new investment needs to occur in an atmosphere of strong environmental standards.

Without a climate of strong environmental protection, and with declining or flat natural resource prices, the overall impact on the environment is apt to be negative.

Each of these four basic tax systems shifts taxes to those whose earnings are from labor and away from those whose earnings are from capital.

While this shift raises substantial equity questions, it also raises the issue of directing capital investments that move the country economically and environmentally in the wrong direction.

In our economy, only one-quarter of our capital stock is physical capital. The other three-quarters of our capital stock is human capital. Wages reflect a return to human capital investment in education and training.

Studies show that a skilled labor force has more influence in a manufacturer's investment decision to locate in one country or another than the tax rates on capital; therefore, a tax structure that encourages physical capital over human capital investments does not address the potential of three-quarters of our capital stock nor does it encourage expansion of high-growth, energy-efficient and clean industry sectors, or strengthening of our traditional industry sectors that are both reliant on highly skilled labor.

Simply put, these four tax proposals do not achieve the goal of a high-wage, clean, and energy-efficient economy that will take the United States into the next century.

We recommend that in addition to these proposed reforms, that the Committee examine an alternative, which is not part of the hearing today.

Such a proposal would lessen the tax burden on human capital rather than increasing it. Instead, it would increase the tax burden on consumption of natural capital which these proposals do not.

Under this reform, the United States would encourage what is abundant, human know-how and labor, and would discourage what is scarce, consumption of natural resources.

Such a reform would be better for equity, long-term economic vitality, and the environment.

Thank you for the opportunity to testify.

[The prepared statement follows:]

Ms. Dawn Erlandson
Executive Director
Americans for a Sustainable Economy

Testimony Before the
Ways and Means Committee
U.S. House of Representatives

Hearing on
Impact of Replacing the Federal Income Tax on
Manufacturing and Energy and Natural Resources

July 31, 1996

Good morning, Chairman Archer and Members of the Committee, my name is Dawn Erlandson. I am the Executive Director of Americans for a Sustainable Economy. Thank you for allowing us the opportunity to submit our views. We work to better integrate economic, social and environmental goals, particularly through tax policy.

We believe the Committee's interest in major tax reform is timely. We offer three basic principles which any tax reform proposal should embody, beyond ease of compliance and enforceability. The first principle is equity, meaning that any new tax system should as a minimum retain the progressivity of the current personal and corporate income tax system. This is particularly important given the regresivity of the federal payroll tax and most state tax systems. Secondly, the tax system should promote job creation and rising real incomes for ordinary families as well as foster overall economic vitality. And thirdly, the tax system should encourage protection of the environment and wise use of natural resources.

As we examine the tax options before the Committee, a flat tax, a national sales tax, a value-added tax, and an income tax with an unlimited savings component and their effects on industrial sectors, one potentially positive element stands out. To the extent that all of these options eliminate preferential treatment of and subsidies for the extraction of natural resources, they would provide an important environmental benefit missing from the current tax system. Natural resource extraction has consistently received special treatment not afforded to other industrial sectors. Nonetheless, the environmental advantages of eliminating this special treatment may be more than offset by the advantages to capital-intensive industries, such as mining, that these new alternative systems would create.

The question of whether savings and investment will increase in response to lower tax rates is an open one. The evidence from the US economy in both the 1960s and the 1980s does not demonstrate that high effective tax rates on investment income inhibited investment or decreased national savings, nor does it suggest that investment incentives increased total investment (though they may affect where investment dollars go). The switch to consumption taxes shifts the burden from capital to labor regardless of whether that shift creates additional investment. If the shift encourages investment, there may be some growth advantages to offset negative distributional burdens---provided the investment in physical capital caused by a tax cut to capital is not offset by the reduction in investment in human capital from the labor tax increase.

As a result, these tax systems would favor capital-intensive industries, such as mining and basic materials production, over labor- and knowledge-intensive manufacturing, such as software and pharmaceuticals. This will move the U.S. economy in the wrong direction, back towards an earlier industrial age based primarily on high levels of investment in physical capital and inefficient use of energy and natural resources, rather than pushing forward into the information age and beyond, in which investment in human capital is the key to economic success. Instead we must position the US to compete in the global economy for high-growth, knowledge-intensive industries that are energy-efficient and clean., while creating more energy-efficient and less polluting production in traditional industry sectors.

If the tax changes discussed today, despite evidence to the contrary, do stimulate increased capital investment then we will have more pollution and greater energy consumption due to increased growth. It is true that new physical capital investment is usually more energy-efficient and less polluting than the physical capital it replaces. But in order to ensure that the environmental benefits are realized this burst of new investment needs to occur in an atmosphere of strong environmental standards. Without a strong climate of environmental protection and with declining or flat natural resource prices the overall impact on the environment is apt to be negative. And the recent emergence of incentives offered by some electric utilities to consumers for increased consumption of electricity.

Each of the four tax systems we are looking at today shifts taxes to those whose earnings are from labor and away from those whose earnings are from capital. While this shift raises substantial equity questions that should be addressed in another hearing, it also raises the issue of directing capital investments that move the country economically and environmentally in the wrong direction.

In our economy, only one quarter of our capital stock is physical capital. The other three quarters of our capital stock is human capital. Wages reflect a return to the human capital investment in education and training. Studies show that a skilled labor force has more influence in a manufacturer's investment decision to locate in one country or another than the tax rates on capital; therefore, a tax structure that encourages physical capital over human capital investments does not address the potential of three quarters of our capital stock nor does it encourage expansion of high-growth, energy-efficient and clean industry sectors or strengthening of our traditional industry sectors that are both increasingly reliant on highly skilled labor.

Simply put, these four tax proposals before the Committee today do not achieve the goal of a high-wage, clean, and energy-efficient economy that will take the United States into the next century. We recommend that in addition to these proposed reforms that the Committee examine an alternative tax proposal not part of the hearing today. Such a proposal would lessen the tax burden on human capital rather than increasing it. Instead, it would increase the tax burden on consumption of natural capital (e.g. fossil energy and minerals), which these proposals do not. Under this reform, the United States would encourage what is abundant, human know-how and labor, and would discourage what is scarce, consumption of natural resources. Such a reform would be better for equity, long-term economic vitality, and the environment.

Thank you, again, for the opportunity to share our views.

Chairman ARCHER. Thank you, Ms. Erlandson.

Our next witness is Brent Blackwelder, and if you would identify yourself for the record, you may proceed.

STATEMENT OF BRENT BLACKWELDER, PRESIDENT, FRIENDS OF THE EARTH

Mr. BLACKWELDER. Yes. I am Brent Blackwelder, president of Friends of the Earth, United States. We are part of Friends of the Earth International with member groups in 54 countries. Some of our affiliates are very interested in tax reform and Tax Code changes.

I have four basic points to make in summarizing my statement.

One is we think that there are three conditions under which any tax shift, or tax reform, ought to be judged. One is, Is it improving the quality of life and standard of living?

Second, Is it creating more and better jobs?

Third, Is it producing a clean environment for our children, and our children's children?

The present Tax Code—my second point—is not friendly toward these conditions. In particular, the Tax Code seems to reward short-term exploitation, and in a report which we did and submitted to the Committee last year called Dirty Little Secrets, we itemized 15 tax breaks, not for business as a whole, but for certain businesses, which cause extensive environmental damage, or create large amounts of pollution.

And we suggested these tax breaks ought to be eliminated so as to have a more level playingfield for innovation, and alternative approaches to the energy sources on which we would run our economy.

So we do need to make some changes in the Tax Code and we are supporting an option and an alternative.

So my third point is that instead of the proposals pending before us for this hearing, consumption tax, a value-added tax, a flat tax, which tend to treat consumption uniformly, we need a different approach to consumption, which I would call an ecological tax shift.

Not all forms of consumption are the same. Certain forms of consumption cause extensive pollution or problems for other people. They have unintended side consequences or they involve lots of externalities.

We have an opportunity with an ecological tax shift to put more of the burden on these and really send a price to consumers that reflects those burdens and costs, the pollution and health consequences.

If we did the ecological tax shift, we could substantially improve the functioning of our economy and our society and meet these three conditions I laid out; improve the quality of life, create more jobs, and create a cleaner environment.

So the final point is that this idea of an ecological tax shift is not an extreme or far-out proposal. Rather, it is one which we find support for in the President's Council on Sustainable Development report.

We find it also occurring in Europe, where Sweden already enacted, 5 years ago, an ecological tax shift, reducing income tax, but putting more tax burden on carbon and on sulfur dioxide. Other countries in Europe have embraced this, including the German Ministry of the Economy.

And so we see, now, the possibility, if the United States could take the leadership, for revising our Tax Code in a way that would meet these conditions, and is different in approach from the pending proposals, flat tax, consumption tax, and others.

So this is the kind of approach which we have outlined in our testimony, and we would urge the Committee to consider.

[The prepared statement and attachments follow:]

Statement of

Brent Blackwelder
President
Friends of the Earth

prepared by
Brian S. Dunkiel
Director of Tax Policy
Friends of the Earth

On Behalf of

Friends of the Earth

Before the

Committee on Ways and Means
United States House of Representatives

Hearing on
The Effects of Fundamental Restructure of the Tax Code on the Domestic Manufacturing Industry and on Energy and Natural Resources

July 31, 1996

Introduction

Mr. Chairman and Members of the Committee, Friends of the Earth is a global environmental advocacy organization with organizations in 54 countries. On behalf of Friends of the Earth, I thank you for the opportunity to testify before you today. Through hearings like this we hope that the critical link between tax policies and the environment will be acknowledged and respected. Friends of the Earth urges you and this Committee to recognize that tax policy has profound impacts on environmental quality.

To begin, my comments focus on the effects a consumption tax will have on environmental quality, because most discussions and proposals have focused on a shift from an income-based tax to a consumption-based tax in the form of a flat tax. A discussion on how ecological tax reform will better serve the public's interest will follow.

Friends of the Earth supports tax reform that ensures progress toward three compatible and critical goals:

i. **an increase in the standard of living for American families,**
ii. **more, better paying jobs,** and
iii. **cleaner air and water for our children and our children's children.**

For the sake of our environmental and economic well-being, we believe that any tax reform proposal must be measured against its ability to meet these three goals. Moving toward these three goals together will move us toward a truly Sustainable America.[1]

Unfortunately, the flat tax, which has garnered so much public attention, the national sales tax and the value added tax proposals would all fail when measured against this three-pronged

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[1]See the attached pages from Sustainable America: A New Consensus for Prosperity, Opportunity, and a Healthy Environment.

criteria. Friends of the Earth believes that these proposals will not ensure environmental sustainability, will not improve standards of living, and will not create better jobs.

Borrowing from Future Generations

Persuasive evidence exists that today's lifestyles are dependent upon borrowing from future generations. The threat encompasses more than the federal government's level of debt. For example, the United States ranks last among industrialized nations in the fraction of Gross Domestic Product (GDP) devoted to investment and savings. Economists say our saving rate is so low that it risks a strong economic future for our children. Similarly, our current behavior is contributing to a mounting environmental debt that will compromise the future. For example, the U.S. ranks first among industrial nations in emitting pollution that contributes to global warming. Scientists tell us that our present CO2 pollution rate threatens the fundamental health of the global environment.[2] *Present generations are unfairly borrowing from future generations' economic and environmental well being.*

How do these facts relate to tax reform? They are critical to tax reform because the single largest influence on the health of the environment is the federal government's budget and how the government collects revenue to fund the budget. All too often the Tax Code and government spending subsidize activities that harm the environment. In fact, the Tax Code is often in direct conflict with our environmental laws' laudable goals. In effect, we take one step toward cleaning up our nation's air and water by passing strong environmental laws, and then we take two steps back by subsidizing industries and behaviors that pollute. This is why Friends of the Earth focuses on tax policy and government appropriations.

Criteria to Evaluate A Tax Shift

Friends of the Earth suggests that any proposal to make fundamental changes to the Tax Code should be evaluated based on the goals listed above. Let me elaborate.

First, tax reform should **increase the standard of living for American families**. The standard of living of most Americans has stagnated during the past two decades. Traditionally, three general ways have been used to measure standard of living: earning power, purchasing power and individual worker productivity. The U.S. has lost its lead in the first and is losing its lead in the other two. Unfortunately, these measures give only a crude indication of how well each nation lives. There are severe problems with measuring a nation's well-being by productivity alone. When one considers exactly how each nation spends its Gross Domestic Product, the weakening of the U.S. position in the world becomes even more apparent. GDP contains contradictory goods and services. For example, it includes the production of cancer-causing pollutants as well as cancer-curing medicines. *The Tax Code should not treat all production equally. Production that increases the standard of living of American families should be favored over those that decrease it.*

Second, tax reform should **create more, better paying jobs**. Worker's wages have been falling. Median family income fell in every year from 1989 to 1993. Under the present Tax Code that treats all production uniformly, worker wages continue to fall despite the fact that GDP and corporate profits continue to rise.[3]

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[2]On average, 19.5 metric tons of CO2 are emitted per person in the United States each year. This compares with 7.3 metric tons for Europe and the 1.7 metric tons scientists predict necessary to hold global warming in check. With less that one-twentieth of the world's population, we manage to use more than one-third of its annual energy production.

[3]See the attached graphs from the U.S. Bureau of Labor Statistics that contrast the fall of production worker wages and the fall in manufacturing jobs with the rise in GDP. Note also the data from the Organization for Economic Cooperation and Development that graphs the increase in corporate profits in the corresponding time period.

Big government is a popular scapegoat for the erosion of income levels. Representative Armey asserts that people are working harder and getting less because government is taking a bigger bite out of their paycheck But, in reality, it is pre-tax pay that has decreased According to the Congressional Budget Office, the effective federal tax rate on the middle class is stable or declining. *We believe that the way to create more and better jobs requires looking beyond how much we tax to what we tax. Tax reform that stops subsidizing pollution and encourages work by decreasing the tax rate on labor and shifting the tax onto pollution would improve family wages.*

Finally, we must improve upon our environmental performance, and tax reform should give us **cleaner air and water for our children and our children's children**. The Tax Code should encourage economic development in ways that protect our shared natural wealth Clearly, the economic growth we promote must not create irreparable environmental harm *A shift in the Tax Code needs to halt the current and deep subsidy to sectors of the economy that degrade the environment. A new Tax Code should discourage dependence on fossil fuels and polluting industries.*

A fundamental and well-understood flaw of market-based economies is their failure to reflect the true costs of many products, services and activities A large portion of "true cost" includes adverse impacts on the environment and on public health Without higher prices to serve as "red flags," warning consumers of these hidden costs, environmental quality will continue to grow worse. *The Tax Code is perhaps the most efficient way to introduce red warning flags to guide buying decisions away from environmentally destructive and towards environmentally benign goods and services.*

Friends of the Earth believes that any plan to reform the Tax Code should be evaluated based on how well it meets these three important goals. Although our comments are not directed to any specific tax reform proposal, we believe it is clear that all the consumption-based tax plans that treat all consumption uniformly fail to meet these goals We urge this Committee to adopt these criteria as their own and to thoroughly explore whether specific proposals would accomplish each of these goals

When evaluating tax reform, we understand it is also necessary to keep in sight additional policy issues These issues might include fairness, deficit reduction, budgetary requirements, simplicity and other policy reforms We believe Tax Code reform that promotes the three goals cited above could be crafted to meet these needs as well

An Evaluation of the Uniform Consumption-Based Tax Proposals

Friends of the Earth believes that the current proposals for a flat tax, a value-added tax and a national retail sales tax are all variations of a tax on consumption Each effectively exempts investment or capital income from the tax base To ensure that we are clear, the Chairman's consumption tax plan, Representative Army's flat tax proposal and Senator Domenici's U.S.A. tax are all versions of a consumption tax[4] Therefore, our comments will focus on how a consumption tax, as defined broadly by these proposals, would impact the environment

Would any of the consumption taxes proposed advance the three goals?

No All of these proposals treat all forms of consumption uniformly; consumption patterns that pollute the air and water, deplete non-renewable resources and threaten public health are on par, in these proposals, with those that conserve resources, promote new, green technologies, reduce or recycle wastes and otherwise protect our natural heritage With that environmental blind eye, none of these plans will help to create an environmentally sustainable economy or raise the standard of living of American families. In fact, they allow the present downward spiral to continue, effectively ensuring lower worker wages and environmental destruction. None of the

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Congressman Gephardt's tax reform proposal is not included in this list because it is calls for a flat income-based tax. However, like the consumption tax proposals, Representative Gephardt's would continue to subsidize environmental damage and the dirty industries of the past consumption tax proposals would make significant strides to increase the standard of living of American families. All fail to restructure the economy for the next century.

Because all investment is treated as though it has the same social value, investments into more efficient, cleaner technologies is not encouraged. Some might view a flat tax as benefitting the environment, if it eliminated all the tax breaks in the present Tax Code that reward investment into environmentally destructive activities.[5] On one level, that would, in fact, be an improvement. *However, a flat tax still misses important opportunities to improve Americans' quality of life, because it leaves unchanged the existing anti-sustainability bias in the Tax Code.*

A flat tax would also fail to encourage the type of investments needed to prepare society for the future. For example, under a flat tax, the purchase of an automobile and money spent on education would be treated equally. Both are consumption. Studies consistently show that quality of life is critically linked to education level, but no signal exists to remind the consumer that to invest in education maybe more desirable for the individual, the economy and society.

Some policy makers argue that increased saving and investment alone will relieve stagnant wages, and a consumption tax would encourage saving and investment. However, we find conflicting economic statistics on this point. For example, in the early 1980s historically low taxes on savings were accompanied by historically low savings rates. We believe that more is needed than increased savings rates to improve economic well-being.

Again, the consumption tax proposals before us today treat all forms of production uniformly whether or not they harm the environment. Therefore, under these proposals, unfair and unwise destruction to the environment will still be encouraged. Unfair subsidies for unsustainable fossil fuel usage, for polluting industries, and for activities that dirty our air and water will continue. This means that the oil wasted through leaks, spills and inefficiency that studies show is equivalent 1,000 Exxon Valdez oil spills per year will continue to be subsidized. *Unwise subsidies for the development of the dirty industries of the past would continue, and an opportunity to encourage the cleaner industries of the future will be missed.*

Without a visionary level of Tax Reform, industries will continue to invest in technologies that produce waste and pollution. The Tax Code will continue to be at odds with environmental laws, leaving command and control regulations as the only line of defense for the environment and public health. While a handful of market signals have been created to warn industry that certain polluting and depleting activities entail heavy societal costs, *our Tax Code, for the most part, continues to foster rather than stem the types of behavior that our environmental regulatory programs struggle to control. The consumption tax proposals before this Committee today do not correct that fundamental flaw in the existing system and therefore, fail to secure a cleaner and healthier environment for our children and our children's children.*

An Ecological Tax Shift Satisfies the Three Criteria

In contrast to the proposals before you, a sustainable and ecological tax shift would be simple, fair, efficient and environmentally sound. Ecological Tax Reform, a form of a consumption tax, would raise the revenue necessary to fund government operations while working to accomplish crucial societal goals. In a nutshell, ecological tax reform (ETR) shifts taxes off employment to stimulate job growth and onto pollution to correct market failure. ETR can tackle three problems at once while raising the same amount of revenue as under the present Tax Code. *ETR can create better jobs, encourage wiser use of our natural resources and foster economic efficiency. This means a higher standard of living for American families.*

A fundamental tenet of a system like ours is that product demand is frequently based on price. As a product's price increases, demand for that product generally decreases. Capitalizing on that rule, ETR taxes products that harm the health of society, so that the price for products

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[5] The attached Friends of the Earth report entitled, Dirty Little Secrets, exposes fifteen tax breaks that subsidize wealthy corporations' environmentally destructive activities.

that are good for society are comparatively cheaper. In effect, ETR removes the subsidies prevalent in the current Tax Code that foster unwise consumer decisions by using prices as a red flag to warn consumers that a particular product is harmful.

Ecological tax reform would create more, better paying jobs because the Tax Code would stop subsidizing waste and start encouraging work. As mentioned earlier, these days we often hear complaints about the economy's performance. Workers' wages are stagnant. There are jobs, but they do not pay well. Often households with two workers are not doing as well as those in the past with only one wage earner. American workers are frustrated. One part of this problem is that the present Tax Code taxes labor, and by making labor more expensive, discourages what is beneficial to society, the availability of good paying jobs.

We believe that a tax shift should favor investment in human capital. By reducing the tax burden on labor, ETR would encourage more labor which, in turn, will create more better paying jobs. Reducing the tax burden is also important as we head into the next century and the era of an information based economy. The developing economy will be more service oriented and therefore human labor intensive. It is in our interest to adapt to and encourage this economic change.

The Tax Code is often used to encourage activities allegedly in the public's interest. For example, long ago the government chose to provide favorable tax treatment to investments associated with resource extraction. By giving corporations that undertake these activities a tax break, the government intended to encourage more mining or oil exploration. The subsidies, however, have long outlived their societal benefit, and we believe it is time for Congress to recognize that an economy well prepared for the next century will not be based on polluting industries of the past. Therefore, these activities of the past should no longer receive favorable tax treatment. *A 21st century tax shift should favor an investment in human capital, education and technical job training, not activities that use up or destroy limited natural resources.*

This Committee should be aware that many other nations appear to be embracing an ecological type of tax reform. In fact, it appears that acceptance of an ecological tax shift might reach beyond political affiliation. In the United Kingdom, for example, both the Labour Party and the Conservative Party have recognized the merit in shifting taxes off labor and onto waste. In addition, Switzerland, Denmark and Sweden are introducing pollution taxes as part of their overall tax restructuring.

For the United States to implement a flat consumption tax that is blind to environmental impacts risks our economic and environmental health and surely will be recorded as a policy folly of monumental proportions.

Conclusion

The primary flaw of the consumption tax proposals before you is that they continue the unwise economic policies of the past. These tax plans would continue to prop up the environmentally destructive industrial sectors that do not offer the jobs of the future. In the duration, the new business sectors that do offer the jobs of the future compete at a distinct disadvantage with the firmly established industries still receiving tax breaks. By failing to tax environmentally damaging activities at a higher rate than desirable ones, all of these tax shift plans miss an important and unique opportunity to create an environmentally sustainable economy or improve our standard of living.

An ecological tax shift, another form of a consumption tax, would encourage wiser savings and investment, foster an environmentally sustainable economy and raise the standard of living of American families.

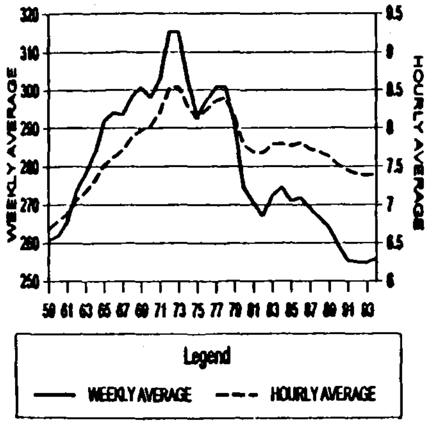
In closing, we urge this Committee to accept as your own the following criteria to evaluate any proposal for tax reform:

- **an increase in the standard of living for American families**
- **more, better paying jobs,** and
- **cleaner air and water for our children and our children's children.**

Again, thank for the opportunity to testify today. We look forward to working with you on these important issues.

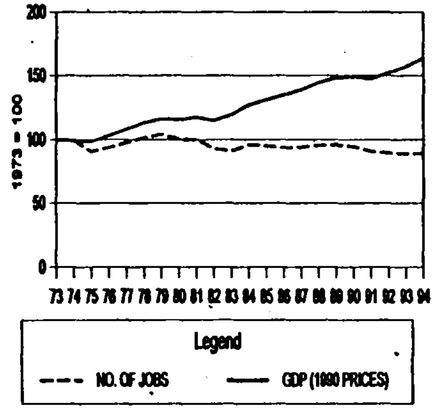
US: PRODUCTION WORKERS WAGES FALL

(IN 1982 US DOLLARS)



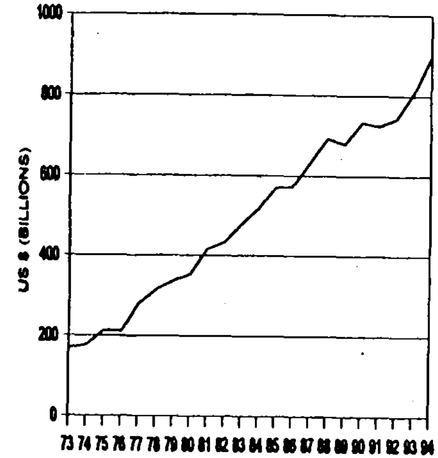
Source: *US Department of Labor, Bureau of Labor Statistics.*

US: EMPLOYMENT IN MANUFACTURING FALLS AS GDP RISES



Source: *US Bureau of Labor Statistics, and the International Monetary Fund.*

US: CORPORATE PROFITS RISE



Source: *Organization for Economic Cooperation and Development.*

Definition and Vision Statement

DEFINITION OF SUSTAINABLE DEVELOPMENT

". . . to meet the needs of the present without compromising the ability of future generations to meet their own needs."

— The World Commission on Environment and Development (The Brundtland Commission), *Our Common Future* (Oxford: Oxford University Press, 1987), p. 43

VISION STATEMENT

Our vision is of a life-sustaining Earth. We are committed to the achievement of a dignified, peaceful, and equitable existence. A sustainable United States will have a growing economy that provides equitable opportunities for satisfying livelihoods and a safe, healthy, high quality of life for current and future generations. Our nation will protect its environment, its natural resource base, and the functions and viability of natural systems on which all life depends.

— The President's Council on Sustainable Development

We Believe Statement

There are certain beliefs that we as Council members share that underlie all of our agreements. We believe:

1 To achieve our vision of sustainable development, some things must grow — jobs, productivity, wages, capital and savings, profits, information, knowledge, and education — and others — pollution, waste, and poverty — must not.

2 Change is inevitable and necessary for the sake of future generations and for ourselves. We can choose a course for change that will lead to the mutually reinforcing goals of economic growth, environmental protection, and social equity.

3 Steady progress in reducing disparities in education, opportunity, and environmental risk within society is essential to economic growth, environmental health, and social justice.

4 The United States made great progress in protecting the environment in the last 25 years, and must continue to make progress in the next 25 years. We can achieve that goal because market incentives and the power of consumers can lead to significant improvements in environmental performance at less cost.

5 Economic growth based on technological innovation, improved efficiency, and expanding global markets is essential for progress toward greater prosperity, equity, and environmental quality.

6 Environmental regulations have improved and must continue to improve the lives of all Americans. Basic standards of performance that are clear, fair, and consistently enforced remain necessary to protect that progress. The current regulatory system should be improved to deliver required results at lower costs. In addition, the system should provide enhanced flexibility in return for superior environmental performance.

7 Environmental progress will depend on individual, institutional, and corporate responsibility, commitment, and stewardship.

8 We need a new collaborative decision process that leads to better decisions; more rapid change; and more sensible use of human, natural, and financial resources in achieving our goals.

9 The nation must strengthen its communities and enhance their role in decisions about environment, equity, natural resources, and economic progress so that the individuals and institutions most immediately affected can join with others in the decision process.

10 Economic growth, environmental protection, and social equity are linked. We need to develop integrated policies to achieve these national goals.

11 The United States should have policies and programs that contribute to stabilizing global human population; this objective is critical if we hope to have the resources needed to ensure a high quality of life for future generations.

12 Even in the face of scientific uncertainty, society should take reasonable actions to avert risks where the potential harm to human health or the environment is thought to be serious or irreparable.

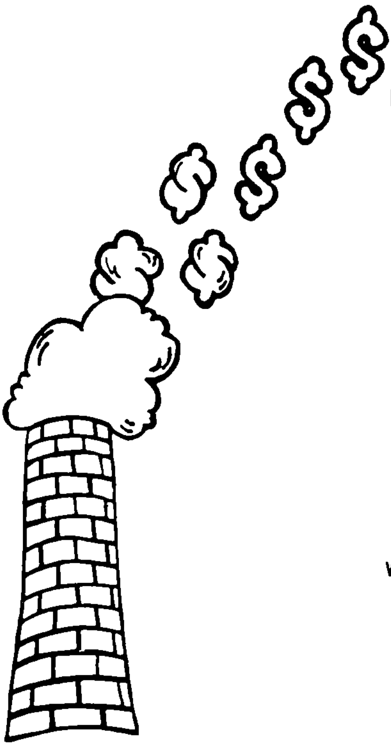
13 Steady advances in science and technology are essential to help improve economic efficiency, protect and restore natural systems, and modify consumption patterns.

14 A growing economy and healthy environment are essential to national and global security.

15 A knowledgeable public, the free flow of information, and opportunities for review and redress are critically important to open, equitable, and effective decisionmaking.

16 Citizens must have access to high-quality and lifelong formal and nonformal education that enables them to understand the interdependence of economic prosperity, environmental quality, and social equity — and prepares them to take actions that support all three.

Dirty Little Secrets



Polluters save while people pay: exposing 15 of the tax code's most unfair tax breaks

by Friends of the Earth

With support from Citizens for Tax Justice, Natural Resources Defense Council, Progressive Policy Institute, U.S. Public Interest Research Group, and The Wilderness Society

April 1995

Contents

Overview

This report is dedicated to the millions of Americans who diligently pay their taxes and hope the government will spend them wisely. No one enjoys paying taxes. But Americans have a right to expect that taxes are spread equitably, that the same rules apply to everyone, and that everyone has to pay for the services tax dollars provide.

Close inspection, however, reveals that some taxpayers are paying less than their fair share. Through powerful lobbying, polluters have carved out special treatment in the tax code. What they do is not illegal, but it is unfair. It is also a disaster for the environment and human health.

In Washington, politicians are clamoring for a balanced budget and "an end to welfare as we know it." The face of welfare has been that of the poor, but Secretary of Labor Robert Reich has offered another face: that of rich corporations. He has challenged Washington to "ask Corporate America to get off welfare and play by the rules as well."

Friends of the Earth has accepted the challenge. In January, we published *The Green Scissors Report* with other environmental and taxpayer groups. The report called for the elimination of 34 federal programs that harm the environment and cost the taxpayers $33 billion. *Dirty Little Secrets* addresses the other side of government spending -- tax expenditures.

"Tax expenditures" are a form of government spending. They are special exclusions, deductions, credits and other tax breaks that result in lost government revenue. Many of these tax breaks serve worthwhile public purposes, but the breaks cited in this report undermine the public good. Not only is the government subsidizing environmental degradation, but average citizens must make up for the lost revenue by paying higher taxes or suffering under the burden of increased national debt. In effect, they function as a reverse Robin Hood, taking from average working people and giving to rich, polluting businesses.

Every year, these polluting tax subsidies cost taxpayers close to $4.5 billion each year. What could the government do with $4.5 billion a year? If these subsidies were eliminated, the resulting revenue would equal all federal income taxes paid by close to 13 million low-income taxpayers, about 1 in 9 taxpayers. The revenue gained from cutting these subsidies could also roughly offset all federal income taxes paid by the citizens of Kansas. Or Oklahoma. Or Iowa. Or New Mexico and West Virginia. Or Arkansas and Montana.

Too long the domain of corporate lobbyists and tax lawyers, tax policy must be made more equitable and reclaimed by the people.

Close Up Polluter Loopholes

This report calls for the elimination of tax subsidies that:

* **conflict directly with federal health and environmental policies.** It makes no sense to subsidize pollution that the federal government and the private sector spend billions of dollars a year to clean up.

* **subsidize practices that harm the environment and human health.** For example, the federal government currently taxes the production of most chemicals that destroy the stratospheric ozone layer like chloroflourocarbons (CFCs) and halons. However, two types of ozone-depleting chemicals are slipping through. Methyl bromide and HCFCs are not taxed despite international agreements and EPA action to eliminate them. These chemicals contribute to an increase in the sun's harmful rays that can cause skin cancer and threaten the health of sensitive ecosystems such as coral reefs.

* **favor declining, polluting industries over growing, clean industries.** These tax subsidies hurt competition. They lock-in dinosaur technologies, such as coal-fired electricity, and make it harder for new, cleaner, more efficient technologies such as solar or wind energy, to take hold and compete. Also, subsidizing the logging and extraction of virgin minerals makes recycling and pollution prevention less competitive.

* **distort market decisions about investments.** Tax subsidies undercut the normal market pressures for firms to become more efficient. They weaken America's overall economic prospects by placing every unsubsidized sector and firm at a disadvantage. Tax subsidies substitute political micromanagement for normal market forces that govern the allocation of capital. They encourage more rapid depletion of our scarce natural resources.

* **exacerbate the federal budget deficit.** These tax breaks drain the treasury of revenue year after year. They operate like entitlements, unchecked with no spending limits.

* **benefit the few at the expense of the many.** To pay for these tax loopholes, the rest of us, both individual and corporate taxpayers, have to pay higher taxes. Furthermore, the beneficiaries of these special tax favors are rarely low- and middle-income working people but usually wealthy investors.

The Tax Code Plays Favorites

The industries most responsible for polluting our environment and depleting our natural resources are the beneficiaries of special tax treatment. In stark contrast, tax benefits are rare for clean industries, or even for better practices within polluting industries. Studies have found that extractive and polluting industries such as coal mining, petroleum and natural gas, and hardrock mining industries have lower effective tax rates than other industries. The effective tax rate is the tax rate on actual profits.

Incredibly, this coddling of polluters in the tax structure exists alongside a comprehensive set of federal laws that seek to maintain clean air, water, and soil and preserve species of plants and animals. It appears that one hand of government does not know, or has chosen to ignore, what the other hand is doing.

This report is not comprehensive.[1] More research would almost certainly find additional

[1] For reasons of brevity and uncertainty, a number of issues are not addressed in this report. One major example is the case of ethanol. Great controversy surrounds the overall environmental impact of ethanol on the environment. In fact, Friends of the Earth is party to a lawsuit that would require the Treasury Department to issue an Environmental Impact Statement relating to the extension of ethanol tax breaks to ETBE, an ethanol derivative. In the meantime, this report does not target the generous tax subsidies for the production of ethanol. In addition, this report does not address several environmentally damaging tax breaks that broadly benefit many Americans: for example the treatment of employer-provided parking benefits as tax-free fringe benefits. These provisions need reform, but as part of a larger dialogue that assures equity and fairness. This report also does not address the failure of certain industries to fully pay for their use of government services. Examples include fees on the use of our

provisions that are unfair and hurt the environment. That said, simply eliminating these subsidies would be a major step toward greater tax equity and improved environmental protection.

The industries that benefit from special tax breaks for polluting activities are:

* **Chemicals** -- Polluters can write off almost all the costs of cleaning up hazardous substances, including lawyers fees. Companies that spill oil and dump toxic wastes receive this tax subsidy even when the actions are intentional or the result of gross negligence.

* **Mining** -- The industry enjoys outright tax subsidies for mining toxic substances such as lead, mercury, and asbestos. These subsidies can exceed the value of the owner's investment in the mine.

* **Oil & Gas** -- The oil and gas industry enjoys the best targeted tax treatment available to any industry. For example, investors can write off "passive" losses from oil and gas investments but not from investments in other industries.

* **Agribusiness** -- The tax code provides tax breaks to huge, chemical-intensive agriculture without helping small farmers nor promoting sustainable agricultural practices.

* **Timber** -- Special tax benefits for the industry drive up profits but do nothing to promote sustainable forestry. For example, special rules permit timber companies to deduct capital costs immediately while other businesses cannot deduct such costs.

Polluter Welfare: "Get out of the wagon and help pull"

At a time when there are no guarantees of government support for the poor, the young, or the infirm, one might ask whether there should be guarantees of government support for businesses, particularly those that degrade our natural environment and threaten our health.

While federal appropriations provide plenty of "pork" for polluters, at least these expenditures are subject to annual review. Typically, they cost millions of dollars. Polluter "pork" in the tax code, on the other hand, is not subject to annual review. Once a tax loophole is in law, it is more likely to become embedded in the tax code than repealed, thus costing hundreds of millions and even billions of dollars.

In the debate over welfare for the poor, some have made distinctions between the "deserving" and the "undeserving." If there are to be government handouts to business, it is clear that established businesses that pollute the environment do not belong in the category of "deserving."

It is time to end these extensive tax breaks that have produced a culture of dependency. Generations of businesses have grown up dependent upon the public dole rather than upon their own initiative. It is time these businesses took responsibility for their success. Senator Phil Gramm has said during the welfare reform debate that it's time to ask able-bodied men

highways by heavy trucks and the use of the nation's inland waterway system by commercial barges. Finally, current tax regimes that could be made more environmentally effective are not included, such as Superfund taxes and the tax on gas guzzling automobiles.

and women who are riding in the welfare wagon to get out of the wagon and help the rest of us pull. We believe this sentiment applies to polluters, too.

Throwing Stones

Defenders of these tax breaks will make any number of arguments to defend their special favors. They will say:

This tax relief is needed to maintain the viability of "strategic industries" that are essential to American national security.

The oil industry justifies its tax breaks this way. Unfortunately, America is reliant on foreign sources of oil to meet roughly half of its current appetite for oil. Given the limited oil reserves in the United States and the pattern of increasing consumption, to believe that we will ever again be self-sufficient is to believe in fairy tales. If reducing American dependence on foreign oil is the true goal, it is more prudent to curb demand, through higher fuel efficiency and fewer miles traveled by car, than to increase supply.

Repealing these tax breaks will cost jobs.

Many of the industries receiving tax breaks are actually very poor job-producers. They are relatively capital-intensive and produce fewer jobs per dollar of investment than other unsubsidized industries. For example, oil and gas extraction produces 7.02 jobs per million dollars invested, coal mining produces 12.88 jobs, and other mining produces 13.51 jobs. By comparison, health services produce 23.15 jobs per million spent, construction produces 20.97 jobs, and transportation and communications produce 16.37 jobs.

Our business is uniquely risky, and so these tax breaks are needed to attract investment.

Investing in oil and gas exploration is risky; however, tax policy should not promote pollution over stewardship. In reality, the major effect of these special industry entitlements is to divert capital to politically well-connected businesses at the expense of their less politically influential competitors. For example, staff size of the American Petroleum Institute, the big oil trade association, is about 470 people while the staff size of the Solar Energy Industries Association is 30 persons.

There are tax breaks that help the environment, too.

Targeted tax breaks to assist clean, infant technologies to gain a foothold and grow bear some merit. They are transition assistance, not permanent subsidies. In addition, they may be necessary to meet the goals of national environmental legislation as well as international environmental commitments. Removing the subsidies for the polluting competition is important as well and lessens the need for "clean" tax subsidies. Clean technologies, unlike the dirty ones they replace, provide environmental and technology benefits that flow to the public and not the firms that receive the tax break. Studies show that previous tax breaks for renewable energy, for example, were necessary for the development of renewable energy technologies that now are quickly becoming competitive with coal-fired electrical generation.

Eliminating these tax breaks is tantamount to raising taxes.

Tax subsidy reforms are not tax increases. As Senator Bill Bradley noted, "spending is spending whether it comes in the form of a government check, or in the form of a special exception from the tax rates that apply to everyone else. Tax spending does not, as some pretend, simply allow people to keep more of what they have earned. It gives them a special exception from the rules that oblige everyone to share in the responsibility of our [government]". Nothing is free, including a tax break. Someone has to pay for it.

The Challenge Ahead

In 1996, the federal government will spend approximately $450 billion through special tax breaks. In comparison, total collected revenues amount to about $1.3 trillion. This means that for every dollar the federal government collects, it gives back about 35 cents through loopholes and special tax breaks. This report does not suggest that all of these tax breaks should be revoked. We do believe, however, that in their zeal to cut the federal budget, the Administration and Congress -- especially members of the powerful House and Senate tax committees -- have not adequately examined the Internal Revenue Code.

Tax policy is a rarefied, obscure realm. Much of tax policy is very complicated, not to mention boring. Yet it is too potent to be ignored. Seemingly trivial provisions or phrases can mean billions of dollars in revenues. Over the years, tax bills have been a playground for powerful special interests. Over the last few decades, a $13 billion industry of tax lawyers and accountants has emerged to promote and exploit the loopholes and inequities of the tax code as well as enforce the law, according to the Tax Foundation.

With all these forces conspiring to protect polluters, cutting polluter subsidies out of the tax code will be a daunting challenge indeed. The hope lies with the American people. Only if citizens become savvy and speak out about how our tax system contributes to planetary degradation will we wrest control of the tax code from the lobbyists, tax lawyers, and dependent businesses.

We cannot release this report without putting it in context of what is happening on Capitol Hill. The House of Representatives completed its Contract with America by passing the "crown jewel," a massive tax cut. If enacted into law, the House Republican tax plan would undo many of the tax reforms passed in 1986. These reforms eliminated tax shelters while bringing down tax rates. The House Republican bill would bring back the days of massive tax shelters and no-tax corporations. The bill calls for large cuts in capital gains taxes, elimination of the corporate Alternative Minimum Tax, and accelerated write offs for investment in capital equipment. These changes, by and large, would particularly benefit resource and capital intensive industries such as oil and gas and timber.

Gold Diggers: Percentage Depletion Allowance

PROPOSAL: Eliminate the percentage depletion allowance for mining operations. This would save $2.8 billion over five years according to the Congressional Joint Committee on Taxation.

BACKGROUND: The percentage depletion allowance, first codified early in this century, is based on the idea that as minerals are extracted, the mine is worth less. The percentage depletion allowance permits mining companies to deduct a certain percentage from their gross income to reflect the mine's reduced value over time. However, instead of allowing deductions that reflect the actual loss of value, the percentage depletion allowance allows mining companies to deduct a fixed percentage of gross income. The percentages range from 22 percent allowance to a 5 percent allowance, depending on the mineral. For example, clay, sand and gravel receive 10 percent while uranium, sulphur, and lead get 22 percent. This fixed deduction often bears no resemblance to the actual lost value or to the amount of investment. In fact, the money that mining companies recoup through this tax subsidy generally exceeds the total investment in the property. In other words, the public provides more investment than the owner.

TAXPAYER ARGUMENT: The billions of dollars the percentage depletion allowance costs directly benefits the mining industry and burdens taxpayers and the environment. Average taxpayers must pay taxes on things such as college fellowships and telephone ownership to pay for tax breaks to bolster the profits of mining interests. Such a large subsidy also distorts the market for minerals and other extracted resources, providing financial incentives for mining and drilling regardless of the real economic value of the resource. The result is overinvestment and poor allocation of resources.

ENVIRONMENTAL ARGUMENT: The percentage depletion allowance makes a mockery of the notion of conservation. The subsidy encourages wanton mining regardless of the true economic value of the resource. The result is more tailings piles, scarred earth, toxic byproducts, and disturbed habitats.

Ironically, the more toxic the mineral, the greater the percentage depletion allowance subsidy is. Mercury, zinc, uranium, cadmium and asbestos are among the minerals that receive the highest percentage depletion allowance while less toxic substances have lower rates.

In many instances, this tax break creates absurd contradictions in government policy. For instance, federal public health and environmental agencies are struggling to come to grips with a vast children's health crisis caused by lead poisoning. Nearly nine percent of U.S. preschoolers, 1.7 million, have lead poisoning. Federal agencies spend nearly two hundred million taxpayer dollars each year to prevent lead poisoning, test young children, and research solutions. At the same time, the percentage depletion allowance subsidizes the mining of lead with a 22 percent depletion allowance.

Money for Mining: Expensing Exploration & Development

PROPOSAL: Eliminate expensing, or immediate write off, for mining exploration and development costs and special capital gains treatment for coal and iron ore. This proposal would save about $675 million over five years according to the Congressional Joint Committee on Taxation and Office of Management and Budget.

BACKGROUND: Section 617 of the Internal Revenue Code (IRC) allows certain costs associated with the exploration and development of mineral resources to be deducted in the year the costs are incurred, rather than over the productive life of the mine. Under normal tax rules that apply to other businesses, such "capital" costs are investments in property like buildings or mines that last more than one year and are written off over time as the property wears out, or is depleted in the case of a mine. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out. The result is that tax bills early in the life of the property, or mine, are lower and consequently save the mining company money.

Exploration and development costs include site location, determination of quality and amount of mineral resource, and construction of shafts and tunnels. Covered minerals include coal, uranium, and hard rock minerals such as lead, gold, copper, and asbestos. Congress enacted immediate write off of mine development costs in 1951 and exploration costs in 1966. In 1982, such expensing for corporations was limited to 85 percent of costs.

The other tax break for for mining companies is Section 631 of the IRC which treats the sale of coal and iron ore as a capital gain. Capital gains are profits reflecting increased values of stocks, bonds, investment real estate, and other "capital," or lasting assets. Under normal tax rules, the sale of coal and iron ore should be treated as ordinary income (e.g. wages, interest), not capital gains income. It is preferable to have one's income treated as capital gains rather than ordinary income because the tax rate on capital gains is lower than the tax rate on ordinary income for well-to-do taxpayers. This special capital gains treatment for coal was granted in 1951.

TAXPAYER ARGUMENT: When combined with other tax subsidies, effective tax rates in the mineral industry are reduced to rates below those of other industries. These tax breaks stimulate increased investment in mining at the expense of other business investments. At the same time, the taxpayer underwrites the risk of exploration rather than the mining company. It is patently unfair to burden average working Americans with higher taxes in order to cut tax bills for mining companies.

ENVIRONMENTAL ARGUMENT: A scarred landscape and polluted water attest to the environmental degradation caused by mining. Over the past 25 years, coal mining has disturbed almost 2 million acres of land, only half of which has been reclaimed to minimum environmental standards. The legacy of hardrock mining has littered 32 states with more than 557,650 abandoned sites. The exploitation of the land caused by mining activities has altered the topography of sites to the extent that they will never be able to be restored to their previous conditions and uses. Strip mining has resulted in landslides, which have scarred more than 3,000 miles of land. Mining related activities have introduced dangerous levels of lead, mercury, iron, and sediment to our water supplies. If there are to be tax breaks for materials, they should be for recycled materials, not extraction of scarce, raw materials.

Play Now, Pay Later: Reclamation Deduction

PROPOSAL: Require that mining companies establish a separate trust fund that is adequately funded and escrowed in order for mine reclamation and closing costs to be deducted immediately. Otherwise, repeal the special rules that allow costs for reclamation to be deducted before they have actually been paid. This provision costs the treasury $200 million over five years.

BACKGROUND: Section 486 of the Internal Revenue Code permits reclamation and closing costs to be deducted immediately when mining begins even though the eventual closing of the mine and reclamation of the mine site will not occur for some time. Without this special provision, general tax rules would require the companies to wait until the mine site is closed, restored, and the costs associated with these activities are paid before the companies can deduct these costs.

This provision was adopted as part of the Deficit Reduction Act of 1984. The stated intent of the provision was to encourage reclamation, but there is no requirement that actual payment into a reclamation and mine closing trust fund actually occur in order to get the tax break, nor even that the reclamation and closing actually occur. Reclamation of coal mining sites is required by the Surface Mining Control and Reclamation Act (SMCRA) of 1977, but is not well enforced. There is no similar reclamation requirement for hardrock mineral sites.

TAXPAYER ARGUMENT: The tax treatment of closing and reclamation costs is flawed for several reasons. The law does not require that a separate trust fund be set up or that funds actually be available when it is time to close and reclaim (clean up) the mine. This exposes funds for mine closing and reclamation to the risk of default as well as claims by creditors in the case of bankruptcy of the mining operator. Simply put, there is no guarantee that there will be money available for clean up or mine closing. In the end, taxpayers may well get stuck paying for closing and reclamation of the mines even though the mining company had already claimed a deduction for mine closing and reclamation.

ENVIRONMENTAL ARGUMENT: The tax code delegates to local authorities the power to control the nature of the reclamation or closing activity, but enforcement has been lax. Since 1977, there have been more than 6,000 coal mines closed but not reclaimed. There are more than 550,000 abandoned hardrock mines. A current deduction without a requirement for a separate trust fund raises the possibility of non-compliance and a deduction for activities that are never performed. Until proper standards exist regarding environmental impacts of mining, no tax subsidy should be available to the industry. According to the U.S. Bureau of Mines, 12,000 miles of rivers have been polluted by mining activities and waste. In California, wastes from one closed mine delivers an average daily dose of 4,800 pounds of iron, 1,466 pounds of zinc, 423 pounds of copper, and 10 pounds of cadmium into the Keswick Reservoir on the Sacramento River, which serves as the source of drinking water for Redding.

Pumping the Tax Code: Percentage Depletion Allowance

PROPOSAL: Eliminate the percentage depletion allowance for independent oil and gas companies. This will save about $2 billion over 5 years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Independent oil companies -- those oil companies that are not substantially involved in retailing or refining activities -- can use a special "percentage depletion" method to write off oil and gas investments. The percentage depletion allowance allows these oil and gas companies to deduct a flat 15 percent of their gross income, or sales revenue, to reflect the declining value of the wells as they are drained. This flat deduction bears little resemblance to the actual loss in value over time and the independent oil and gas companies often end up deducting more than the value of the investment.

Percentage depletion allowances were established by Congress early in this century. In recent years, Congress has gradually pared back the subsidy. Nonetheless, the percentage depletion allowance is still an enormous benefit which serves little purpose other than subsidizing production from certain oil and gas companies.

The 15 percent deduction actually gets bigger for some smaller "marginal production" oil companies. According to current tax law, if the price of oil drops below $20 per barrel, the company can increase its deduction -- one percent for every dollar less than $20 per barrel.

TAXPAYER ARGUMENT: The percentage depletion allowance amounts to a simple production subsidy for the oil and gas industry. The special subsidy benefits certain oil and gas producers to the disadvantage of competitors. The deduction can amount to 100 percent of an operation's net income. In other words, for some companies all profits may be due to government tax subsidies.

The percentage depletion allowance distorts the market by attracting investment that could be used more productively elsewhere in the economy. Because the percentage depletion applies only to independent producers, the subsidy encourages the draining of scarce domestic energy resources. In combination with other subsidies for the oil and gas industry, the percentage depletion allowance subsidy often exceeds 100 percent of the actual value of the energy produced.

The general effect of this subsidy is to promote oil production and energy waste rather than efficiency or conservation. Increased profits for polluters are not the best use of taxpayers' money, especially when the tax breaks encourage overproduction of scarce resources at the expense of clean alternatives.

Tax law has been very generous to the oil and gas industry. It has propped up the industry in the face of stiff competition from cheap, imported oil.

ENVIRONMENTAL ARGUMENT: Oil and gas tax policy has focused on production while doing little to increase energy efficiency throughout the oil and gas system or conservation of petroleum in the transportation sector. The percentage depletion allowance not only drains the treasury but also taxes the environment. It encourages producers to prematurely tap marginally economic oil and gas fields, resulting in the exhaustion of energy reserves and the destruction of environmentally sensitive areas such as estuaries, bays, and wetlands. In addition, the oil and gas industry enjoys special exemptions under our environmental laws including Superfund, the Clean Air and Clean Water Acts, the Safe Drinking Water Act, and the Emergency Planning and Community Right-To-Know Act.

Bad to the Last Drop: Enhanced Oil Recovery

PROPOSAL: Repeal the 15 percent credit for "enhanced oil recovery" and disallow expensing, or immediate write off, of so-called tertiary injectants until proper environmental regulations for the industry are adopted and the current waste and inefficiency in the oil and gas industry are dramatically curbed. These special tax breaks cost the treasury $500 million over 5 years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Section 43 of the Internal Revenue Code provides for a 15-percent income tax credit for the costs of recovering domestic oil by a qualified "enhanced-oil-recovery" method. Qualifying methods involve injecting fluids, gases, and other chemicals into the oil reservoir, and use heat to extract oil that is too viscous to be extracted by conventional techniques. Costs covered by the tax credit include the costs of equipment, labor, supplies, repairs, and injectants. The tax credit was adopted in 1990.

In addition, Section 193 allows for expensing, or immediate write off, of so-called tertiary injectants used in enhanced oil recovery. According to standard tax principles, tertiary injectant expenditures should be written off over the income-producing life of the oil and gas property. Such "capital" costs are investments in property like buildings or oil wells that last more than one year and should be written off over time as the property wears out, or is depleted in the case of an oil well. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out. The result is that tax bills early in the life of the property, or oil well, are lower and consequently save the oil company money. This provision became law in 1980.

These provisions were adopted in order to reduce the costs of producing oil from abandoned reservoirs and to increase the domestic supply of oil. The combined effects of the enhanced oil recovery credit and immediate deduction of tertiary injectants result in a net subsidy due to a negative tax rate.

TAXPAYER ARGUMENT: Oil production in the United States peaked in 1970 and has been declining about 4 percent every year since then. Having depleted our most accessible oil reserves, the U.S. is increasingly a high marginal-cost producer. Reliant on foreign sources for about half of our country's oil needs, it is unlikely that the U.S. can reverse the long-term slide in domestic production and growing dependence on imports, given current trends. Even if subsidies such as the enhanced oil recovery provision do manage to relieve short-term dependency by increasing domestic production, less oil will be available in the longer-term. All of this begs the question of why taxpayers should subsidize production at $30 per barrel when it costs only $18 to buy a barrel of oil on the global market. If and when the price of oil increases due to real or politically-induced scarcity, production from these wells will become economical without subsidy.

ENVIRONMENTAL ARGUMENT: In general, it is environmentally desirable to extract all the oil in a well to avoid waste and seepage. That said, much greater energy savings could be gained by eliminating current waste in the oil and gas industry. Today, the oil and gas industry tolerates a degree of energy waste and pollution that is hard to believe: an energy loss -- through spills, emissions, evaporative loss, venting and flaring, waste generation, inefficient processing, pipeline and storage tank leaks -- that is equivalent to 1,000 Exxon *Valdez* oil spills every year, according to Friends of the Earth's Crude Awakening.

Enhanced oil recovery methods themselves often are bad for the environment. They force oil and sometimes chemical injectants into surrounding surface and groundwater, which can lead to contamination of drinking water, soil, crops, and wetlands. Additionally, reliance on oil imports could be totally eliminated by energy efficiency improvements and aggressive conservation. This would negate the need for enhanced oil recovery in the near future.

Drilling for Dollars: Intangible Drilling Costs

PROPOSAL: Repeal the tax provisions permitting oil and gas producers to immediately deduct "intangible" drilling and development costs (IDCs). Instead, require IDCs to be deducted over time. This reform would raise approximately $2.5 billion over 5 years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Section 263 of the Internal Revenue Code permits integrated oil companies such as Exxon and Chevron to immediately deduct 70 percent of intangible drilling costs (IDCs). IDCs are the costs of wages, fuel, repairs, hauling, supplies, and site preparation. The other 30 percent must be deducted over five years. Under normal tax rules that apply to other businesses, such "capital" costs are investments in property like buildings or oil wells that last more than one year and should be written off over time as the property wears out, or oil is depleted. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out, or the oil is depleted. The result is that tax bills early in the life of the investment are lower and consequently save the oil and gas company money.

Smaller, independent oil and gas producers, who are not involved in retailing or refining activities, can immediately deduct all of their IDCs. In addition, independent producers enjoy special treatment of IDCs under the Alternative Minimum Tax (AMT). The AMT is an alternative tax system that was created to ensure that profitable businesses do not avoid taxation because of extensive write-offs. However, in the case of independent oil and gas producers, the AMT is less effective because write-offs are permitted.

IDCs typically account for 75-90 percent of the costs associated with developing an oil and gas well. When combined with other tax subsidies, the ability to deduct IDCs effectively reduces tax rates on oil and gas producers significantly below tax rates on other industries. Unlike the percentage depletion allowance, this tax break is largely claimed by corporate producers rather than smaller, independent producers.

IDCs were first determined to be immediately deductible in 1916. Since then, various courts have tried to rule that IDCs should be deducted over time, but Congress and precedent have overturned the rulings. Congress justified the special treatment of IDCs in order to stimulate exploratory drilling, which could increase domestic oil reserves and enhance energy security.

TAXPAYER ARGUMENT: According to the Congressional Joint Committee on Taxation, this special treatment of oil and gas expenses effectively lowers income taxes for oil and gas companies to zero, a huge benefit. This tax break erodes fairness in the tax system. While wealthy oil companies save, other taxpayers, including middle class Americans, pay the bill for the subsidy. In addition, this tax break, along with others that promote exploitation of domestic reserves, unnecessarily charges taxpayers in order to "pump up" oil industry profits.

ENVIRONMENTAL ARGUMENT: The oil and gas industry enjoys many special tax breaks, which creates perverse incentives for irresponsible treatment of scarce natural resources and environmentally sensitive areas such as wetlands, estuaries, and bays.

The intended purpose of special tax treatment for IDCs is to encourage domestic oil and gas production in order to curb foreign oil imports. The environmentally sound way to reduce our reliance on foreign oil imports would be to reduce our demand for oil rather than increase our supply. Incentives for increased automobile fuel efficiency and greater use of mass transit and ridesharing are two key steps to lessen our demand for oil.

Lucky Loser: Passive Loss

PROPOSAL: Eliminate the "passive loss" tax shelter for investors in oil and gas. This change would save $665 million over 5 years according to the Office of Management and Budget.

BACKGROUND: The 1986 Tax Reform Act greatly limited the ability of taxpayers to use losses, deductions, and credits from so-called "passive" business investments to offset other income such as salary or portfolio income (e.g. interest, royalties, dividends, annuities, and gains from the sale of investment property). Prior to these changes, taxpayers with substantial sources of income from salaries or portfolio income could eliminate or sharply reduce tax liability by investing in tax shelters. One of the most infamous results of tax sheltering involved commercial real estate. Investors built office buildings for tax purposes even though there was no economic demand for the buildings.

Today, investors have to "materially participate" in a trade or business in order to offset salary and portfolio income with passive losses. A taxpayer "materially participates" in an activity only if he or she is involved in the operations of the activity on a regular, continuous, and substantial basis.

These rules, however, do not apply to oil and gas investments. Passive losses are still allowed to be used to offset other income in the case of investors who have a "working interest" in oil and gas. "Working interest" is defined by the existence of an unlimited and unprotected financial risk proportionate to the oil and gas investment and is a weaker test than "material participation." Congress decided that the financial risk associated with oil and gas investments outweighed the need to clamp down on tax sheltering. At the time, this boon to the oil and gas industry was intended to alleviate the impact of worldwide competition and low prices.

TAXPAYER ARGUMENT: This tax loophole makes oil and gas investments more attractive than other investment opportunities, thus diverting investment capital from more productive activities and distorting sound economic decisions. Oil and gas investors can be less cautious in their investments because losses actually have tax advantages.

With plenty of cheaper oil available to consumers, it does not make sense to prop up expensive domestic production with costly subsidies and special treatment that benefit rich investors at the expense of average working Americans.

ENVIRONMENTAL ARGUMENT: This oil and gas tax shelter attracts investors that might otherwise invest in cleaner, growing industries. In addition, the tax break encourages the overproduction of oil and gas, which has many attendant damaging environmental consequences affecting air, land, water, and soil quality. Streams and rivers have been fouled and beaches coated with oil. Waterfowl and other wildlife have died from spills at sea, and millions of birds have been killed onshore after diving into unnetted waste pits and ponds. Oil products seep through the ground in hundreds of communities across the country, threatening drinking water supplies and depressing property values.

Oil and gas are polluting, non-renewable resources. Tax policy would do better to provide incentives to conserve oil and gas rather than stimulate additional production.

Syn Sins: Nonconventional Fuel Production Credit

PROPOSAL: Repeal the "nonconventional fuel" production credit, except for the capture of coalbed methane from active coal mining and landfills and for clean biomass technologies using agricultural waste and wood. This provision costs the treasury roughly $5.8 billion over 5 years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Section 29 of the Internal Revenue Code provides for a production tax credit of $5.75 per barrel of oil-equivalent for certain types of liquid and gaseous fuels produced from alternative energy sources. These fuels include oil produced from shale or tar sands, synthetic fuels produced from coal, and gas produced from geopressurized brine, Devonian shale, tight formations, biomass, and methane from coalbeds. The credit applies to facilities "placed in service" between 1979 and 1993 and may be claimed through 2002. The credit is available for gas produced from biomass and synthetic fuels produced from coal or lignite until 2007 if the facility is placed in service by 1996. Although set to expire, the "placed-in-service" rule has been extended three times since first enacted.

The credit was originally passed in 1980 as part of the Crude Oil Windfall Profit Tax Act. Its purpose was to provide incentives to increase development of alternative domestic energy resources due to concern over oil import dependence and national security that resulted from the 1979-80 Iran-Iraq war.

TAXPAYER ARGUMENT: In theory, the credit was supposed to lower the costs of producing nonconventional substitutes for imported petroleum. Instead, the credit has distorted fuel markets without displacing imports. With oil prices low and costs of nonconventional fuel production high, the credit has proven ineffective. Total production of nonconventional fuels has not increased since the credit was enacted, according to the Joint Committee on Taxation. So, in effect, the credit has been a windfall for a few producers and a waste of taxpayers' money.

The credit has, however, favored the development of one domestic fuel over another. Due to the generosity of the credit, which at times has equaled the price of natural gas, as well as declining production costs, coalbed methane production has boomed. This increased production has occurred at the expense of conventional natural gas production.

ENVIRONMENTAL ARGUMENT: A remnant of the $88 billion "synfuel" program under the Carter Administration, the Section 29 credit has had unintended environmental consequences. Unfortunately, coalbed methane developers in states such as Colorado, New Mexico, Wyoming, and Alabama have been overlaying a new grid of wells on top of older fields of abandoned oil and gas wells that have not been properly plugged. When new methane wells are drilled, the gas not only moves up the new wells but also can move into underground aquifers and escape through older oil and gas wells and even water wells. The result has been contaminated drinking water and irrigation systems, and even explosions. As a whole, the credit simply adds to the volume of tax-subsidized fossil fuels and the pollution that results from burning them.

This report recommends retaining the credit for certain narrow applications. One is for coal beds that are emitting methane into the atmosphere. When coal beds are opened for mining, methane escapes. Methane is a powerful greenhouse gas that contributes to climate change. A "Section 29" well can trap the methane so that it does not escape into the atmosphere. For this narrow purpose, the credit is useful environmentally and should be retained. A similar situation exists at landfills that emit methane as the rubbish decomposes.

Logging Loopholes: Special Tax Treatment of Timber

PROPOSAL: Require sustainable forest management plans to be adopted before timber companies and investors can receive special treatment. Alternatively, repeal the timber industry's ability to deduct its costs immediately. Instead, require the capitalization of multi-period timber growing costs. In addition, repeal special capital gains treatment for timber sales. These provisions cost the treasury about $2.6 billion over five years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Timberland owners and the forest products industry enjoy special tax benefits, including capital gains treatment of timber income and expensing, or immediate write off, of capital costs.

Timber income has been treated as capital gains since 1944 and thus has been taxed less than other kinds of income. Capital gains are profits reflecting increased values of stocks, bonds, investment real estate, and other "capital," or lasting assets. Under normal tax rules, the sale of timber should be treated as ordinary income (e.g. wages, interest), not capital gains income. This provision benefits richer individual taxpayers who prefer to have income treated as capital gains rather than ordinary income because the tax rate on capital gains is lower than the ordinary income tax rate for well-to-do taxpayers.

"Expensing" of costs to maintain a timber stand has been available since the early 1900s. These costs include silvicultural practices after seedling establishment, disease and pest control, fire protection, insurance, property taxes, and management. Under normal tax rules that apply to other businesses, such "capital" costs are investments in property like buildings or land that last more than one year and are be written off over time as the property wears out or timber is harvested. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out, or before the timber is harvested. The result is that tax bills early in the life of the investment are lower and consequently save the timber company money. In 1986, President Reagan proposed eliminating the bulk of these special benefits, but the Congress rejected the idea.

To receive either of these tax benefits does not require sustainable forestry practices, including replanting a diversity of native species after harvest or allowing natural reforestation. A more sustainable approach would tie receipt of these tax breaks to adoption of a sustainable forestry management plan. At minimum this plan should adhere to the standards of the National Forest Management Act (see 36 cfr 219.19), which calls for the viability of all native tree types and native wildlife and limits clearcutting. Ideally, selective cutting should be adopted.

TAXPAYER ARGUMENT: Unlike other businesses, timber producers are able to deduct costs before the product, in this case, timber, is sold. This gives timber producers an interest-free loan from the government and effectively reduces their tax rate on investments to zero. When combined with capital gains treatment, timber receives a negative tax rate or a net benefit. This lowers the tax burden on timber in general. It distorts the market by diverting investment into timbering that might have otherwise gone to other businesses. In addition, the bulk of these tax benefits flow to corporations and wealthy investors.

ENVIRONMENTAL ARGUMENT: Forests serve multiple purposes. They provide habitat for wildlife, medicines, recreational benefits for hikers, fishers, and hunters, as well as timber products. Unfortunately, the current tax breaks treat forests like farms rather than ecosystems, which must contain a diversity of plant and animal life to survive. In addition, these breaks make timber production more profitable for investors and forest products cheaper, which hurts recycling efforts. Better than tax incentives for timber production would be incentives that encouraged recycling, and environmentally friendly pulp and paper alternatives.

Loophole in the Sky: Tax Ozone-Killing Chemicals

PROPOSAL: Include methyl bromide and HCFCs in the list of taxed ozone-depleting chemicals. This is consistent with earlier efforts to tax new chemicals and is worth $1.6 billion over 5 years according to the Congressional Budget Office.

BACKGROUND: In 1989, Congress enacted a tax on ozone-depleting chemicals to provide an economic incentive to reduce production and use of these destructive substances. The tax complements international and domestic measures to reduce and phase out these chemicals.

Ozone-depleting chemicals include chloroflourocarbons (CFCs), methyl chlorform, carbon tetrachloride, halons, methyl bromide, and HCFCs (CFC substitutes). These chemicals are found in various consumer products and used in agricultural and industrial processes. Release of these chemicals into the atmosphere causes damage to the stratospheric ozone layer which shields the Earth and its inhabitants from the sun's damaging ultraviolet radiation.

In 1985, scientists confirmed the existence of a "hole" in the ozone layer over Antarctica. Since its discovery, the ozone hole has grown to cover an area of approximately nine million square miles, roughly the size of the North American Continent. This ecological crisis spurred more than 120 countries to negotiate and approve the Montreal Protocol on Substances that Deplete the Ozone Layer in 1987. While the Protocol called for the phase-out of many ozone-depleting chemicals, some chemicals such as HCFCs and methyl bromide were not included in the original agreement. In 1992, however, parties to the Protocol amended the original agreement to include HCFCs and methyl bromide. The Protocol requires industrialized countries to cap methyl bromide production at 1991 levels and to phase out all HCFC production by 2030. Due to the delay in listing methyl bromide and HCFCs under the Montreal Protocol, however, these chemicals were not included when Congress passed the tax on ozone-depleting chemicals. Since then, however, political pressure on Congress has kept methyl bromide and HCFCs off the tax list.

TAXPAYER ARGUMENT: No policy rationale exists for the inconsistency of taxing some ozone-depleting chemicals while leaving others untaxed. This disparate treatment is simply the result of timing and politics. Methyl bromide is the only Clean Air Act Class I ozone-depleting chemical that is not taxed. While HCFCs are listed as Class II chemicals, they are more potent than other chemicals that are already taxed (i.e. methyl chloroform).

Taxing these chemicals makes good economic sense. The existing tax has very successfully accelerated the phase-out of harmful chemicals while at the same time spurred development of ozone-safe alternatives. Too often our tax code punishes desirable behaviors and businesses while rewarding ecological destruction. The tax on ozone-depleting chemicals does the right thing, and it works.

ENVIRONMENTAL ARGUMENT: Methyl bromide and HCFCs are a direct threat to human health and ecosystem integrity. Their destructive impact on the stratospheric ozone layer has been conclusively established. Ozone layer destruction causes increased ultraviolet radiation which can lead to higher rates of skin cancer and eye diseases such as cataracts. Increased ultraviolet radiation also can suppress the immune system and weaken its response to a host of diseases. In addition, the radiation may decrease crop yields, stunt animal reproduction, and cause fast degradation of materials such as plastics, wood, and rubber.

Methyl bromide is extremely noxious and is acutely toxic. It can cause fatal damage to the central nervous system and severe damage to the lungs, kidneys, eyes and skin. Workers that handle methyl bromide run the greatest risk of toxic exposure and injury.

HCFCs serve as transition chemicals between the more damaging CFCs and safer alternatives. However, ozone-safe substitutes are available for nearly every use of HCFCs.

Cooking the Books: Cash Accounting

PROPOSAL: Disallow the use of "cash accounting" method for agricultural businesses with gross sales of more than $1 million. This proposal would save about $1.3 billion over five years according to the Congressional Joint Committee on Taxation.

BACKGROUND: The cash accounting method does not require a farmer to accurately match expenses to income when paying income taxes. The rules date back to the early part of this century when the IRS determined that many farmers were not sophisticated enough to use more complex bookkeeping procedures that are required for most businesses. Since 1919, however, farms have gotten much larger and most farms are run more like businesses. Today, large agricultural operations are able to take advantage of cash accounting under current law and they are able to significantly reduce their taxes by manipulating expenses, inventory, and income.

Cash accounting is one of a number special tax breaks and loopholes that once lured nonfarmer investors into agricultural tax shelters and speculation. This speculation drove up land prices and caused havoc in the farm economy. According to a 1982 U.S. Department of Agriculture report entitled The Effects of Tax Policy on American Agriculture, "the tax preference may overstimulate production and lead to lower product prices, or may cause the values of limited inputs, such as land, to be bid up." In general, these tax breaks, and the game-playing they invite make it difficult for smaller-scale farming to compete and survive.

In the tax reform of 1986 and subsequently, many of the worst tax shelters in agriculture were eliminated. However, some, like cash accounting, survived. Since cash accounting tends to benefit richer farmers it plays a role in the increased concentration of farmland ownership with high-income farmers and businesses.

TAXPAYER ARGUMENT: The ability to defer taxes and immediately deduct costs creates an enormous tax benefit for large farm operations and invites inappropriate mismatching of income and expenses. The fact that farmers with up to $25 million in gross sales can use cash accounting methods means that many large farm operations benefit from a provision intended primarily for smaller, family farms. Agriculture Department studies show that the cash accounting makes farming more profitable to farmers in higher tax brackets while making it harder for farmers with low incomes to compete. According to the 1982 USDA study, "in a tax-favored industry such as farming, success depends not only on entrepreneurial skill and luck; it also depends on the successful management of the tax system and assets and liabilities. The rules of the game demand not only agricultural expertise but also tax expertise and a number of other skills."

ENVIRONMENTAL ARGUMENT: Experts in agriculture policy argue that the mismatching of expenses and income actually subsidizes the purchase of agrichemicals such as fertilizers and pesticides. U.S. agriculture has become reliant on chemicals. Today, crop production systems in most areas of the country rely on at least one pesticide and often several to control weeds, insect pests, and plant disease. Added to the pesticides is a huge volume of synthetic fertilizers. In 1987, for example, U.S. farmers were applying some 10 million metric tons of nitrogen to the land, with the vast majority of it synthetic. Pesticides, which by their very nature are poisons, have been dispersed widely throughout our food supply and environment. The EPA estimates that every year farmworkers suffer more than 27,000 acute illnesses due to pesticide exposure. Pesticides and nitrates have become pervasive contaminants of water supplies, with EPA estimating that at least one of every ten public water wells in the country contains at least one pesticide. Millions of American children, whose diets are high in particular fruits and vegetables, receive -- by age 5 -- up to 35 percent of what is considered an entire lifetime's "safe" dose of cancer-causing pesticides.

Pigs in a Poke: Dairy and Livestock Expensing

PROPOSAL: Disallow immediate deduction for costs related to raising livestock and dairy. This would raise about $700 million over five years according to the Congressional Joint Committee on Taxation.

BACKGROUND: Under current law livestock breeders and dairy producers enjoy special rules which provide favorable tax treatment for their business. When their livestock and cattle are sold, the profits are counted as capital gains income which is taxed at the rate of 28 percent even if the taxpayer is in a higher tax bracket. However, the costs of purchasing, breeding, and raising the livestock are not treated as capital investments, but rather as ordinary expenses. This is the best of both worlds for livestock and dairy producers. Costs are deducted immediately and income is taxed at a relatively low capital gains rate rather than as regular income. This inconsistency is highly favorable for dairy livestock producers and has helped to make cattle and other livestock operations profitable tax shelter ventures.

TAXPAYER ARGUMENT: Livestock producers get a special deal in their business. They can immediately deduct the costs associated with raising the diary and breeding livestock. Yet when they sell, the income is treated as a capital gain and taxed at a 28 percent rate for high-income taxpayers instead of the higher rate at which it should be taxed. Other businesses must treat the income from sales of product as regular income. Most other farmers must treat their sales income as regular income.

This tax break attracts farm investments into animal breeding that might otherwise be directed toward growing crops. It also serves to benefit livestock and dairy breeders at the expense of other taxpayers.

ENVIRONMENTAL ARGUMENT: This tax break subsidizes agricultural activities, which are becoming increasingly controversial in their impact on environmental quality and rural communities. In many rural communities, industrial hog farming and large dairy operations are meeting growing resistance due to significant waste problems (they are smelly and cause water pollution) and because they tend to crowd out smaller scale, diversified farms.

In addition, this tax break distorts farming and animal husbandry decisionmaking. The tax code requires that livestock be sold as breeding stock and not for slaughter in order to receive special tax treatment. Farming and husbandry decisions should be driven by the biology and resources, not tax policy.

Up in Smoke: Tax Exempt Bonds for Incinerators

PROPOSAL: Subject tax-exempt bonds sold to finance incinerators (solid waste facilities that produce electric energy) to the private-activity bond annual volume cap. This would raise about $900 million over five years according to the Office of Management and Budget.

BACKGROUND: Current law provides a tax exemption for interest income on state and local bonds used to finance construction of certain energy facilities. These bonds are classified as "private activity bonds," instead of government bonds, due to the fact that a substantial portion of their benefits is reaped by individuals or businesses rather than the general public. Most private-activity bonds, including hydroelectric facility bonds, are subject to certain limits set by each state. However, bonds issued for government-owned solid waste disposal facilities are not subject to these limits.

In general, the 1986 Tax Reform Act repealed the tax-exempt status of most bonds used to finance projects with substantial private involvement due to the fact that they served as tax shelters for wealthy investors and oftentimes subsidized projects with little overriding public benefit, such as golf courses. Tax-exempt bonds for incinerators and a few other private-activity bonds escaped reform.

TAXPAYER ARGUMENT: Tax-exempt bonds in general distort investment decisions. Because the interest from the bonds is tax free, wealthy investors buy them to shelter income rather than buying taxable corporate bonds or stocks. While tax-exempt bonds continue to help state and local government finance important public projects, construction of environmentally harmful projects for private profit do not merit such special tax treatment. Further, this kind of tax break violates the "polluter pays" principle. Those who create the solid waste should pay for its disposal rather than the taxpayer.

ENVIRONMENTAL ARGUMENT: Although called "renewable" energy facilities by the 1980 tax bill, incinerators as currently used are not environmentally friendly. They emit harmful levels of highly toxic substances into the air such as cadmium, lead, and dioxins. The EPA has not yet issued regulations regarding safe emission levels for incinerators. Providing tax benefits for construction of incinerators before incinerators have met environmental standards is ludicrous.

Cloaking Profits: Publicly-Traded Limited Partnerships

PROPOSAL: Eliminate the corporate tax exemption provided for the development of natural resources through publicly traded limited partnerships. There is no estimate available for how much this reform would save.

BACKGROUND: Certain "publicly traded limited partnerships" enjoy tax benefits not available to many other similar business entities. On the one hand, these partnerships enjoy the advantages of being treated like corporations in that investors can trade their interests in public markets and investors have limited financial liability. On the other hand, they do not pay corporate income tax, essentially skipping a level of taxation. In 1987, the Congress changed the law to treat publicly traded partnerships like corporations for tax purposes. However, major loopholes were left after the reform. Partnerships primarily involved in natural resource development were exempted. Thus, publicly traded partnerships involved in mining, geothermal energy, fertilizer, and timber enterprises can continue to avoid a corporate-level tax while retaining the advantages of being traded like a corporation.

TAXPAYER ARGUMENT: This exemption means that certain businesses can avoid paying taxes that other similarly situated businesses must pay. Such subsidies distort the market and tend to attract artificially high levels of investment in business activities eligible for the publicly traded limited partnership exemption. According to a 1994 investigative report of the House Natural Resources Committee, this tax loophole can radically reduce tax revenues from companies. For instance, one timber company was reportedly able to reduce its tax liability from about 59 percent to about 3 percent. In fact, some companies engaged in natural resource development have restructured as partnerships to avoid corporate-level tax.

This tax break is nothing but a massive giveaway of taxpayer dollars to rich investors and the polluting businesses they support.

ENVIRONMENTAL ARGUMENT: This tax loophole creates an unfair advantage for investment in the extraction and depletion of natural resources and provides yet one more encouragement for business enterprises to deplete the nation's natural resources. The subsidy makes natural resource development cheaper and devalues the natural resource. A better system would let the market determine the rate and manner of extraction of a finite supply of resources.

Spoils of Spills: Pollution Deduction

PROPOSAL: Disallow corporate income tax deductions for future costs associated with illegally released pollution. Cleanup of existing pollution or contamination should be exempted. No estimate is available for how much this proposal could save taxpayers.

BACKGROUND: Under current law, polluters who cause environmental harm can fully deduct all the costs related to illegally released pollution including cleanup costs, legal costs, court settlements, even the cost of the polluting substance itself. Even gross violations of law can qualify for normal business deductions. For instance, when Exxon's *Valdez* oil tanker spilled 11 million gallons of oil into Prince William Sound, nearly all the costs related to the disaster were deductible. This included all the costs of litigation, legal settlements, cleanup, studies, public relations, etc. Exxon settled a criminal case in court with the United States and the State of Alaska for about $1 billion. However, except for a paltry $25 million criminal fine, the entire settlement was tax deductible for Exxon. The value of this deduction is approximately one-third of the settlement, or $300 million.

This situation arises because under tax law, a business may deduct nearly all the expenses incurred as a matter of conducting business. The law allows deduction of "ordinary and necessary" business expenses and the IRS has been very liberal in its interpretation of this clause.

While the vast majority of business expenses are deductible, Congress has disallowed a deduction for some egregious or ethically complicated activities. For instance, illegal bribes, kickbacks, and fines are not deductible. Damage payments for anti-trust violations are not deductible. Lobbying expenses and political campaign contributions are not deductible. Paying CEOs more than $1 million is not deductible to corporations. But the costs associated with breaking environmental laws, including punitive damages, are deductible.

TAXPAYER ARGUMENT: Companies that deduct the costs of oil spills and chemical discharges avoid paying taxes and save money while damaging the earth. For many corporations, environmental disaster is just a cost of doing business. An average of about 16,000 oil spills every year stretches the definition of "accident." In reality, many polluters would rather take their chances with pollution, litigation, and cleanup than prevent the disasters in the first place. That's not a calculus the taxpayers should subsidize.

This perverse tax treatment of costs associated with illegally released pollution means that taxpayers finance a portion of these costs due to the polluter's tax write offs. In addition, taxpayers usually have to pay to help the polluter clean up, as they did in the case of the Exxon *Valdez* oil spill. Finally, the citizens who live near the pollution site bear enormous costs associated with loss of a natural resource, whether it is clean water or clean air.

ENVIRONMENTAL ARGUMENT: Eliminating the business deduction for illegally released pollution would reduce the incentive to cut corners or to knowingly risk dangerous accidents. Currently, the tax code allows costs such as cleanup for negligent oil spills, intentional dumping of toxic pollutants, and litigation on the illegal filling of wetlands to be immediately deducted. However, the costs to avoid these problems with investment in pollution prevention are not immediately deductible. For instance, an oil distributor whose pipeline bursts and spills oil into a river can immediately deduct the costs of repairing the pipeline and cleaning up the spill. However, if the company wanted to double-wall the pipeline or make other improvements to prevent leaks, those costs would likely have to be deducted over many years. In other words, deductions for failure are immediately deductible while the deductions for prevention must come over several years, which costs the taxpayer more money. Eliminating the deductibility of environmental harm due to gross negligence or illegal pollution would begin to turn the balance of incentives in the right direction.

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Chairman ARCHER. Thank you, Mr. Blackwelder.

And thank you also for summarizing your testimony. Your entire written statement will be inserted in the record, without objection.

Our last witness of this panel is Gary Rogliano. If you will identify yourself for the record, you may proceed.

STATEMENT OF GARY ROGLIANO, SENIOR VICE PRESIDENT, CONTROLLERSHIP AND TAXES, PITTSTON CO., STANFORD, CONNECTICUT; ON BEHALF OF COAL INDUSTRY TAX COMMITTEE

Mr. ROGLIANO. My name is Gary Rogliano. I am a senior vice president for the Pittson Co. I am appearing on behalf of the Coal Industry Tax Committee, an ad hoc group of companies whose primary product is coal. Its membership represents over one-fourth of the annual coal production in this country. We welcome the opportunity to testify on tax reform from the perspective of the coal industry and applaud the House Ways and Means Committee for analyzing impacts of tax reform on all sectors of the economy before making changes to the tax system.

I would like to give you a brief overview of the coal industry.

The U.S. coal industry is essential to a reliable and low-cost supply of electricity for America. Coal comprises one-third of the Nation's primary energy and is a source generating over 55 percent of our Nation's electricity.

Coal is used in all 50 States and provides the Nation with abundant, clean, and affordable energy. At present rates of recovery and use, U.S. coal reserves will last more than 250 years.

The industry directly employs over 100,000 workers and indirectly supports several hundred thousand more jobs in the United States.

Coal produced in the United States is also exported to over 40 countries, resulting in a positive contribution of over $3 billion annually to the United States balance of payments.

I will discuss three tax issues today. The first issue is that simplification of the Tax Code should take into consideration the total tax burden on specific industries.

The coal industry is among the most heavily taxed industries in the United States. Coal companies are burdened with a host of taxes specific to the industry.

They have more industry taxes than any other sector of the economy. In addition to Federal and State income taxes and payroll taxes, a typical coal operator also pays Federal black lung tax, Federal abandoned mine land fees, and for many companies, a federally mandated coal miner's retiree health care tax.

In addition, coal companies also pay Federal royalties on all coal mined on Federal land, State severance taxes, sales and use taxes, and substantial real and personal property taxes, which significantly support the communities in which these companies operate.

By any objective standard, the coal industry is carrying a heavy tax burden. In fact the effective tax rate on the collective earnings of the Coal Industry Tax Committee members, using all taxes paid in 1995, was 66 percent.

In other words, $2 of taxes are paid for every $1 of profits. Simplification of the Code should take into consideration the total tax burden on specific industries. In the case of coal, it should consider all taxes paid.

Second, the alternative minimum tax should be reformed. While the AMT was originally enacted as a parallel system, it has actually become a permanent tax system for many coal companies, resulting in a higher effective tax rate.

Finally, international competitiveness should be a consideration of tax reform. While the United States has the most productive coal miners in the world, the cost of the industry-specific taxes paid by the U.S. coal industry, and the high cost of compliance with U.S. regulations, generally cause the costs of coal to many markets to exceed those of our major foreign competitors. This cost disadvantage applies not only to exports, but also enables some countries to import coal into this country, which is ironic, because we have the largest reserve base of coal in the world.

In summary, the Coal Industry Tax Committee would ask the House Ways and Means Committee to consider the following points as you contemplate tax reform.

The Committee supports reform of the Tax Code if it results in simplification with greater tax equity.

Industry specific taxes should be considered in tax reform.

The AMT should be simplified, and international competitiveness should be one of the considerations during tax reform.

I thank you for allowing me to testify on behalf of the Coal Industry Tax Committee.

[The prepared statement and attachment follow:]

STATEMENT OF GARY ROGLIANO
SENIOR VICE PRESIDENT
CONTROLLERSHIP AND TAXES, PITTSTON CO.
ON BEHALF OF COAL INDUSTRY TAX COMMITTEE

Introduction

Mister Chairman and Members of the Committee. my name is Gary Rogliano. I am Senior Vice President, Controllership and Taxes for the Pittston Company. I am appearing on behalf of the Coal Industry Tax Committee, an ad hoc group of companies whose primary product is coal. Member companies in the group include Peabody Holding Company, Inc., Zeigler Coal Holding Company, The Pittston Company, Drummond Coal Company, Ashland Coal, Inc., and AMVEST Corp. The Committee has been in existence since 1984 and focuses exclusively on tax issues impacting the coal industry. Its membership represents over one-fourth of the coal production in the United States.

The Coal Industry Tax Committee welcomes the opportunity to testify on the impact of tax reform on the coal industry. The Committee applauds the House Ways and Means Committee for analyzing the impacts of tax reform on all sectors of the economy before making changes to the tax system.

Extensive changes in the structure of the U.S. corporate and individual income tax systems are currently being explored by this Committee. Some changes in the tax code could substantially alter the tax liabilities of many industries and businesses. For businesses facing increases, the higher taxes will translate into increased costs, which in turn will result in higher product prices or lower profit levels. Thus. tax reform may affect the competitiveness of one business or industry as compared to another. Some businesses will find it more difficult to compete in product markets and for capital needed to expand and become more efficient. I would like to speak today specifically about the impact of tax reform on the coal industry.

The Coal Industry

The U.S. coal industry is essential to a reliable and low cost supply of electricity for America. Coal comprises one-third of the nation's primary energy and is the source generating over 55 percent of our nation's electricity. Coal is produced in 26 states but is used in all 50 states and provides the nation with abundant, clean and affordable energy. Chart 1 depicts coal usage in the states represented on the House Ways and Means Committee.

There are an estimated 285 billion tons of recoverable coal reserves in the United States encompassing 38 states. At present rates of recovery and use, U.S. coal reserves will last more than 250 years.

Mechanization, robotics, lasers and computers are common components of modern coal mine operations. The end result of this mechanization is safer and more productive mines.

The U.S. coal industry directly employs over 100.000 workers and indirectly supports several hundred thousand more jobs in the U.S. Coal miners are among the highest paid and best trained workers in the United States.

Coal produced in the United States is also exported to over 40 countries, resulting in a positive contribution of over $3 billion annually to the U.S. balance of payments.

The Coal Industry is One of the Most Heavily Taxed Industries in the U.S.

The coal industry is among the most heavily taxed industries in the United States. According to Bureau of Mines data, coal is also heavily burdened with a multitude of comprehensive and expensive federal and state taxes as well as health, safety, and environmental regulatory costs far more than our principal international competition.

The coal industry is also burdened with a host of taxes specific to the industry and has more industry specific taxes than any other sector of the economy. In addition to federal and state income taxes and payroll taxes, a typical coal operator must also pay federal black lung tax, federal abandoned mine land fees, and for many companies a federally mandated coal miner's retiree health care tax. In addition to all of these various taxes, the industry also pays federal royalties of up to 12 1/2 percent on all coal mined on federal land. Added to all these taxes, the industry also pays state severance taxes, sales and use taxes, and substantial property and personal property taxes. By any objective standard, the coal industry is already carrying a very heavy tax burden. In fact, the effective tax rate on the collective earnings of the member companies, using all taxes paid in 1995, was 188 percent. In other words, committee members collectively paid almost twice as much in taxes as they earned in profits.

By way of illustration, Chart II shows the collective tax burden of the Coal Industry Tax Committee as a percentage of the total cost of a ton of coal. As outlined in the chart, taxes and royalties represent 21 percent of the cost of a ton of coal, compared to salaries and benefits of our employees of 27 percent. Taxes represent an unusually high percentage of the costs of the coal industry.

Simplification of the tax code should take into consideration the total tax burden on industries; in the case of coal, it should consider all taxes paid, especially those federally imposed taxes such as black lung and abandoned mine land fees.

Discussion of the Alternative Minimum Tax

Although the intent of the alternative minimum tax (AMT) was to ensure that all companies reporting profits pay some tax, the AMT actually does much more than that. The AMT adds to the complexity of the tax code by creating a parallel tax system that requires a totally different set of tax calculations in addition to those required for regular corporate income tax.

The alternative minimum tax imposes a severe penalty on productivity investments in capital intensive industries. The AMT has actually become the permanent tax system for many coal companies, resulting in a higher effective tax rate than many other industries pay under regular corporate income tax.

Coal mining is a very capital intensive industry. Companies must make substantial capital investments for new mine development, technology and efficiency improvement, and for environmental, health and safety compliance. The bias against capital intensive industries built into the AMT system makes it very difficult for coal companies to make the needed investments.

The added tax burden of the AMT increases the cost of capital and reduces the cash flow needed for operations. Ironically, companies are more likely to be AMT taxpayers when they are making large capital expenditures or when they have low taxable income; in other words, when the need for cash is greatest.

The AMT inhibits the growth of capital intensive industries, resulting in sluggish or even negative job growth. Any simplification of the tax code should certainly include substantial reform or repeal of the alternative minimum tax.

Several studies have confirmed the negative impact of the AMT.

1. Joel L. Prakken, Chris P. Varvares and Laurence H. Meyer's (PVM's) study entitled "Investment, Economic Growth and the Corporate Alternative Minimum Tax" for the American Council for Capital Formation Center for Policy Research argues that the AMT has the potential to reduce investment spending because AMT-filers pay a higher average tax rate and consequently generate less internal cash flow than they would under the regular tax. This, in turn, may curb investment by firms with impeded access to capital markets.

   PVM's results show that firms permanently on the AMT face capital costs significantly higher than firms that pay the regular corporate income tax. PVM's econometric simulations show that if all firms were to face the AMT indefinitely, the result would be to reduce the level of output by approximately $60 billion annually relative to the case in which all firms paid the regular income tax.

2. Research by Arthur Andersen and Co. confirms that U.S. firms paying the AMT recover their investment costs for new equipment much more slowly than do companies in major competitor nations.

International Competitiveness

Congress has long recognized that capital investments in natural resources are different from investments in other assets such as buildings and equipment. Unlike buildings and equipment, natural resource deposits contain a finite amount of economically recoverable minerals. As the minerals are extracted, the available reserve is depleted. Any changes to the current tax system as a result of tax reform should continue to recognize the finite characteristics of natural resources. Many foreign coal producers enjoy favorable tax treatment compared to U.S. producers even under the current system. Any changes that would further penalize U.S.

companies would likely have a detrimental impact on U.S. industry. While the U.S. has the most productive coal miners in the world, the cost of the industry specific taxes paid by the U.S. coal industry and the high cost of compliance with U.S. regulations generally cause U.S. costs of coal to many markets to exceed those of our major foreign competitors such as China, Colombia, Australia and South Africa. This cost disadvantage applies not only to exports from the U.S. but also enables some countries to import coal into this country, which is ironic because we have the largest reserve base of coal in the world.

Summary

In summary, the Coal Industry Tax Committee would ask the House Ways and Means Committee to consider the following points as you contemplate tax reform.

1. The Committee supports reform of the tax code if it results in simplification with greater tax equity.

2. The coal industry's tax burden is higher than most industries because of the specific taxes imposed on it. These specific taxes should be considered in the tax reform process.

3. The alternative minimum tax should be eliminated as part of tax simplification because it has a negative impact on the economy and inhibits growth.

4. The finite characteristics of natural resources should be considered during tax reform to ensure the U.S. remains competitive in the world market.

Mr. Chairman, I thank you for allowing me to testify on behalf of the Coal Industry Tax Committee.

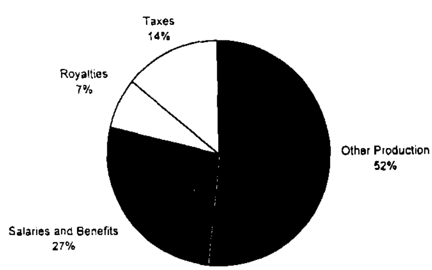
COAL USE IN SELECTED STATES

	Coal Consumption (million tons) (1994)	Percent of Electricity Produced by Coal (1995)
Texas	93.8	47
Indiana	60.0	98
Ohio	56.7	88
Pennsylvania	54.1	57
Illinois	39.1	43
Kentucky	38.1	95
Michigan	35.7	71
Georgia	29.3	65
Missouri	27.7	82
Florida	26.1	42
Tennessee	25.4	71
Wisconsin	21.7	71
Iowa	19.3	85
Minnesota	18.7	63
Louisiana	14.1	29
Virginia	12.8	46
New York	11.5	20
Maryland	10.5	61
Nebraska	9.3	64
Nevada	8.0	70
Washington	6.3	6
Massachusetts	3.9	39
California	2.5	**
New Jersey	2.0	19

**Majority of coal-fired electricity is generated in neighboring states.

CHART II

COAL INDUSTRY TAX COMMITTEE
PERCENTAGE OF COSTS REPRESENTED
BY TAXES AND ROYALTIES



Mr. McCRERY [presiding]. Thank you very much.

First of all, I want to apologize for everybody running in and out today. There is a lot of action on the floor we did not anticipate. We are trying to get the welfare reform bill up for a vote this afternoon, and some on the floor are hesitant to get that bill before us, so they are using some delaying tactics, and causing us to run back and forth to vote on silly things like whether it is permissible to use an exhibit on the floor, and things like that.

So I want to apologize for Members having to be out so much.

Before I ask Mr. Ramstad if he would like to ask some questions, let me just ask all of you, generally, whether, in your opinion, whatever tax code we develop, or even if we could tinker with the current Tax Code, should our tax system be neutral on production of natural resources, energy resources, the production of energy?

Or should we favor, in our Tax Code, development of our resources, and production of energy in this country? Anybody have a thought on that?

Mr. ROGLIANO. Speaking on behalf of the Coal Industry Tax Committee, what we would prefer is that all industry taxes be taken into consideration. Whether it favors production of natural resources, that would be fine, but already the coal industry is burdened with excess taxes. We are looking for something that would be fair and put the coal industry in the same taxation burden as other industrial segments of the economy.

Mr. BLACKWELDER. On behalf of Friends of the Earth, I would reply that the current Tax Code is overly generous to those industries that cause the greatest amount of pollution and the most rapid depletion of natural resourœs, and we are looking for at least a more level playingfield, but we think you ought to actually do more. That there are ways of running the economy much more energy efficiently. Thus, products become more competitive.

The problem now is the price of any product does not tell the full truth from society's standpoint, or an ecological standpoint.

The price of oil does not reflect all of the extraordinary costs we go to to protect it in the Persian Gulf, and we are importing, as we heard earlier, over one-half of our crude oil.

The cost of utilizing fossil fuels, to the extent we have, does not reflect the tremendous health damage, loss of life, hospitalization costs, all the medical costs you are confronted with trying to pay for.

If we ran an economy on a more energy-efficient basis, and a solar basis, which we could do over 20 years, then it seems to us we would meet the conditions we laid out in our testimony.

We would improve our standard of living. We would create more jobs, better jobs, and we would have a cleaner environment for our children and grandchildren.

So the answer is we should not treat natural resources as we have been doing in the past. Our tax system should encourage appropriate and efficient use, recycling and that sort of action, and it has got to really reorient itself.

Mr. McCRERY. Anybody else have an opinion on whether the tax system should encourage development of our natural resources?

Mr. McMAHON. Well, I hear we get a lot of tax incentives and tax breaks, but my company pays over $2 billion a year in taxes.

I fail to see all the incentives that are being mentioned here. I would think, as I said in my testimony, I would prefer a level playingfield, a neutrality as far as different industries are concerned, so that everybody is being—competition on a level playingfield.

Mr. MCCRERY. What do you mean by everybody? You mean everybody within the energy——

Mr. MCMAHON. Well, within the particular industry, and compare industries to industries.

Mr. MCCRERY. OK. I would just point out, Mr. Blackwelder, that it is hard to have it both ways. You say we do not take into account the cost of protecting oil resources, for example, in the Persian Gulf area. Well, if we produced more here, domestically, we would not need to depend so much on those resources. So maybe we could reduce the cost, then, if we would spend more of our resources here, developing known reserves here in this country. For example, in Alaska, and other places.

But that is a different Committee, so I will leave that alone.

Well, I think Mr. Ramstad has left.

Just generally, before I let you go, the primary alternatives, I think we can say, to the current tax system are switching from an income tax to a consumption tax, or going to some kind of single rate income tax.

Do you have any, just general thoughts, as to how each of those would affect your industries in comparison to the current Tax Code?

Mr. ROGLIANO. If I could, a lot depends on what taxes will be taken into consideration if a consumption flat tax were to be imposed.

As I mentioned earlier, the coal industry pays Federal black lung taxes and abandoned mine land fees, coal miner's retiree health care tax, and a number of other industry specific taxes. If a consumption or flat tax is imposed, over and above these other taxes, without at least providing for a credit of these taxes, it could cause serious harm to the coal industry. The question is whether these taxes will be taken into consideration or not.

Mr. MCMAHON. I would say, sir, as a capital-intensive industry, in the public utilities the movement from the present tax system to a consumption-based tax system would be more beneficial for the overall economy. So we would support that.

Mr. MCCRERY. So you think the current tax system is overly burdensome on capital-intensive industries?

Mr. MCMAHON. Extremely so.

Mr. MCCRERY. Mr. Merrill, do you agree with that?

Mr. MERRILL. Yes, I do. Our current income tax system, as you know, double taxes corporate income, both at the corporate level and when it is received by the shareholder as a dividend, or capital gain. So there is a double taxation on capital.

Mr. MCCRERY. And Ms. Erlandson, do you have any thoughts on——

Ms. ERLANDSON. With regard to a flat tax versus a consumption tax, disregarding equity effects, we would prefer a consumption tax, if it incorporates all of the externalities that are now not currently incorporated in our pricing system, and a tax mechanism can do that.

If that were the case, it is possible that we could support something like that, although we are concerned about competitiveness and border adjustability issues.

Mr. MCCRERY. OK.

Mr. BLACKWELDER. The one thought Friends of the Earth would offer on these is we should look at the problems with the current Tax Code and its bias against labor and employment, and the burden it puts on people, as we want to hire more people.

If you reward capital-intensive industries, you are exacerbating a problem now, where we are finding more and more Americans having to hold down two jobs just to bring in the same kind of family income that our fathers brought in 25 or 30 years ago, when we were raised.

The figures from the U.S. Government on average production worker wages show they have dipped to the level they were at in the late fifties, and shifts to some of the proposals we have before us, the consumption tax, flat tax, have a labor penalty associated with them.

That is why we think you have to distinguish among the types of consumption because certain types of consumption will create more jobs, more employment, and others will, if you favor capital intensity, actually lead to, we think, growing unemployment.

Mr. MCCRERY. Do you think if we had more industry in the United States, we would have more unemployment?

Mr. BLACKWELDER. I would say if you based the economy more on high-efficiency renewables and solar, you will have many more jobs per BTU expended than you do under the present energy system, and you would greatly improve the overall health of the economy and the population.

Mr. MCCRERY. OK. Well, thank you very much. We appreciate your testimony before the Committee today and look forward to continuing to hear your ideas and thoughts as we go through this process.

Thank you. The hearing is adjourned.

[Whereupon, at 1:12 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

COALITION AMT FOR ECONOMIC GROWTH

FIX THE ANTI-MANUFACTURING TAX

STATEMENT ON THE
IMPACT OF FUNDAMENTAL TAX REFORM ON DOMESTIC MANUFACTURING

BY THE
AMT COALITION FOR ECONOMIC GROWTH

SUBMITTED TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
FOR THE HEARING RECORD OF JULY 31, 1996

The *AMT Coalition for Economic Growth* is a broad-based coalition formed to advocate repeal or substantive reform of the Alternative Minimum Tax (AMT). The coalition consists of small, medium, and large companies and associations representing a wide range of manufacturing-related industries including: airlines, automotive, chemicals, energy, mining, paper, steel, transportation, and utilities.

Mr. Chairman, the members of the AMT coalition commend you and this committee for having a hearing on the impact of fundamental tax reform on domestic manufacturing. The best evidence for fundamental tax reform is underscored by the mere existence of the AMT. The AMT is overly complex as a parallel tax system, fueling unnecessary administrative burdens and excessive compliance costs. Supporting this assertion of complexity is a **Tax Foundation** study citing the AMT as the second most complex area of the tax code. Companies are required by law to calculate annually their tax liability under both the Alternative Minimum Tax (AMT) and the regular corporate income tax systems. The AMT is an anti-competitive, anti-investment, Anti-Manufacturing Tax.

In considering tax overhaul, Congress should ensure that the burden of taxation is as broad-based as possible, so that it does not fall disproportionately on U.S. manufacturing, the nation's key source of high-wage, high-skilled jobs. Our existing business tax code is an impediment to U.S. economic growth and competitiveness. There are some areas of the tax code that simply cannot wait for overall reform. The committee recognized this need during 1995 by passing legislation (H.R. 2491) that was ultimately vetoed by President Clinton. This legislation would have made substantial progress toward eliminating the penalty imposed on investment under the AMT.

In fact, a recent DRI/McGraw-Hill study showed that AMT reforms, similar to those passed last year, could result in as much as a 1.6 percent increase in GDP. Without these kinds of changes to the AMT, the economy will continue its less than optimal performance, and more specifically, tens of thousands of high-paying jobs will not be created. Therefore, we hope the committee will act as soon as possible to make these limited reforms a reality.

While we are hopeful for the future, we cannot ignore the fact that another economic downturn will come, and when it does, the AMT will make it longer and deeper than would otherwise be necessary. The AMT's negative reinforcing effect on the economy was clearly evident during the recession of 1991 by further constraining cash flow at a time when companies could least afford it. AMT repeal, or at least substantive reform, is one of the most important actions Congress can take to improve the current tax code bias against productivity-improving investments.

<u>AMT: The Anti-Manufacturing Tax</u>

The AMT originally was intended to ensure that all profitable U.S. corporations pay at least some tax. Mr. Chairman, that goal has been turned on its head. Enactment of the AMT in the 1986 Tax Reform Act (TRA) has had the unintended effect of placing many capital-intensive companies in a near-permanent AMT status with taxes being payable even in years when economic losses were incurred. One company, for example, reported losses to shareholders of more than $1.3 billion over five years (1990-1994), yet paid more than $200 million in AMT. As a result, the AMT is having a serious, adverse impact on U.S. capital-cost recovery and a highly distorted effect on U.S. investment flows.

The AMT continues to be a critical problem for U.S. manufacturers -- namely, the grossly inadequate capital-cost recovery system in the United States, especially as it affects AMT payers. The AMT's discriminatory depreciation methods and excessively slow recovery periods have had especially harmful effects on U.S. manufacturers. That's because the AMT is most damaging to (1) companies that must invest heavily and continuously in new equipment, (2) companies in cyclical industries, and (3) companies whose profitability is subject to dramatic swings because their prices are set by the global market. These criteria define much of the U.S. manufacturing sector.

The primary problem continues to be the AMT's extreme bias against capital investment. This anti-competitive tax treats accelerated depreciation as an adjustment (an increase in income) that must be added back into the AMT calculation, even when profits are low or non-existent. Insofar as many manufacturing companies have no choice but to invest heavily and continuously -- in good times and bad -- it is this "add-back" that increases taxable income and, thus, forces many capital-intensive companies into long-term, if not permanent, AMT status.

Since passage of the Tax Reform Act of 1986 and its harmful AMT provisions, many companies with significant reported losses (for both financial and regular tax purposes) have been forced to pay AMT and defer any tax benefits associated with losses until regular taxes exceed the AMT, which may be never. Adding insult to injury, companies have remained stuck in the AMT and have been unable to use their accumulated minimum tax credits (AMT credits) that accrue in the years when the AMT exceeds regular tax liability.

AMT credits can be used only to the extent that a taxpayer's regular tax liability exceeds its AMT liability. The intent of the AMT credit was to ensure that over time no company would pay more tax than if it were in a regular tax position. Many capital-intensive companies are expected to remain in the AMT indefinitely and, thus, will generate AMT credits that would not be usable. Therefore, the AMT, in effect, has become for these companies a permanent tax increase relative to what they would have paid as regular taxpayers. Many other companies are unable to use credits against regular tax within a meaningful time frame. For these companies, this prepayment of tax and limited use of AMT credits result in an interest-free loan to the government.

In addition to the negative treatment of depreciation, companies also find they pay a significant penalty due to the AMT's limitations on the use of business credits such as research and development, alternative fuels, target jobs credits, net operating losses and foreign tax credits. Many of the broad policy objectives instituted through the tax code and reflected in these credits do not work as intended. The effect of these limitations, again, is to put the AMT firm at a competitive disadvantage. In the case of foreign tax credits, it is indefensible to double-tax foreign-earned income by arbitrarily limiting the use of foreign tax credits to 90 percent.

The AMT is anti-competitive because it places capital-intensive, cyclical companies at a severe disadvantage, particularly against their foreign competitors, who pay no income tax when they have no profits and whose depreciation is not subject to an AMT. The fact that the AMT is the <u>worst</u> capital-cost recovery system among industrialized nations gives further credence to the anti-competitive effect of the AMT.

The AMT is imposing a tremendous administrative burden because it requires numerous depreciation and inventory calculations. It is inherently inequitable because it is applying vastly different tax treatment to similar investments made by similar taxpayers. It is acting as a competitive drag on U.S. manufacturing. It is penalizing, in particular, those companies that invest the most in relation to their profits. And by denying the use of pre-paid regular tax -- *i.e.*, AMT credits -- at all, or within a meaningful time frame, the value of these credits is rendered worthless.

Absent fundamental reform, many manufacturing companies are likely to remain stuck in the AMT for the remainder of this century and beyond. The reason is twofold. First, although many companies have seen profits in the short term, they have not been high enough to offset all of the losses and AMT credits generated during the last recession. Second, companies continue to face substantial new investment requirements to meet both global competitive pressures and new environmental rules (stemming from legislation and agency-initiated efforts).

Fundamental Tax Reform and Transition Rules

The Coalition fully supports repeal of the AMT, and as such, urges that repeal be included in any fundamental tax reform proposal seriously advanced by Congress. Should such reform occur, Congress is not without precedent in providing transition rules when the tax code has been significantly changed to ensure fair and equitable treatment for taxpayers who committed substantial business resources based on current tax law. Current, unused, accumulated AMT credits exceed $23 billion. Given that the AMT credit is a pre-paid tax payment generated largely as a result of the punitive depreciation system under the AMT, the Coalition urges that existing AMT credits be either refunded or permitted to reduce future tax liabilities under a new tax system.

Absent Tax Overhaul, AMT Reform Recommended

The AMT Coalition favors complete repeal of the AMT. We believe the United States should have a single, reasonably understandable tax system that applies equally to all corporate taxpayers. The current dual tax system of the AMT is unequivocally poor tax policy. If complete repeal cannot be accomplished, however, then there are several reforms short of repeal that would help minimize the anti-competitive impact of the AMT.

With respect to AMT reform, the coalition recommends you consider the following principles: Capital-cost recovery provisions should promote, not impair, manufacturing investment and competitiveness; recovery lives and method under the AMT should be conformed to the regular tax; AMT credits and other business credits should be made available to companies that find themselves in the AMT; and, foreign tax credits should not be limited.

Given these principles, we urge enactment into law of the following proposals that were previously passed by Congress as part of the vetoed 1995 Balanced Budget Agreement, H.R. 2491:

- **Eliminate the depreciation adjustment for new investment under the AMT.** Today, a company's depreciation system (method and length of asset lives) is determined less by the type of asset and more by the profitability of the company. Some profitable firms recover their cost of investment through tax depreciation more than twice as fast as less profitable firms subject to the AMT. For example, steel assets are depreciated over a 7-year period under the regular tax but over a 15-year period using a slower depreciation method under the AMT. Treating regular tax-accelerated depreciation as an adjustment under the AMT violates the most basic tax policy principle that investment in similar assets should be taxed in the same manner. It makes no economic sense to continue to penalize capital investment in this way.

- **Change the way the AMT credit operates to make it usable for industries that are near-permanent AMT payers.** The AMT was never intended to tax capital investment at a higher rate than the regular tax on a permanent basis. But this is exactly what happens when AMT payers are denied use of the credit. Since many AMT payers will not have enough regular taxable income to use their AMT credits fully in a meaningful time frame, a mechanism should be established to allow partial use of credits against AMT liability. This would monetize these credits and, thus, decrease the cost of capital. It would also stimulate economic growth by liberating funds for additional capital investment.

The coalition also recommends additional AMT reforms. Specifically, remove the unfair limitations on the use of business credits, NOLs and foreign tax credits that apply only to AMT payers. Since the AMT is essentially America's second business-tax system, with its own rules and limitations, many of the broad policy objectives instituted through the tax code do not work as Congress intended. This is true for many business credits, including R&D, target jobs, alternative fuels (Sec. 29), etc.. Arbitrary limitations on the use of NOL deductions and foreign tax credits are equally unfair.

Conclusion

The *AMT Coalition for Economic Growth* urges your serious attention to the significant anti-growth, anti-investment problems posed by the AMT in designing a new, improved, simpler, tax system that promotes capital investments in productivity-improving assets. Absent imminent fundamental tax reform that includes repeal of the AMT, the coalition recommends substantive changes now to the AMT. Thank you for your interest in rectifying one of the most egregious examples of complexity and unfairness in the tax code: the AMT.

TESTIMONY OF
THE HONORABLE W. S. STUCKEY, JR.
FOREST LANDOWNERS ASSOCIATION AND
FOREST LANDOWNERS TAX COUNCIL
ON THE IMPACT OF
REPLACING THE FEDERAL INCOME TAX ON
MANUFACTURING AND ENERGY AND NATURAL RESOURCES

WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

JULY 31, 1996

On behalf of the Forest Landowners Association, and as Chairman for the Governmental Affairs Committee, I am privileged to submit, for the record, our thoughts about the importance of replacing the federal income tax with a flatter, fairer tax and the effect it will have on individual landowners who manage this country's vital natural resources.

Forest Landowners represents approximately 6,000 members whose combined holdings total over 47 million acres of privately held non-industrial forestland, primarily in 17 southern states. Nationwide there are over ten million independent forestland owners in the U.S. managing over 300 million acres of trees. This private, non-industrial segment of the forestry community compromises over 60 percent of the timberland available to supply our nations lumber and paper needs.

The forest ownership patterns among the private landowner community in the Southern United States can be summarized by looking at just one region of the area that includes seven states -- Alabama, Arkansas, Louisiana, Mississippi, Oklahoma, Tennessee, and Texas. There are 99 million acres of total forest area in that seven state region. Two thirds, or 66 million acres, are owned by private, non-industrial landowners. Public forests make up just 10 million acres, or 10 percent of the forested area. Private, non-industrial landowners hold over six times the forest land the government controls in these seven states.

There are over 1.5 million individual landowners in this seven state region alone. Fifty percent of these individuals own less than 500 acres. Twenty percent own less than 100 acres. The average tract size is 80 acres. By ownership type, 28 million acres are under sole proprietorship, 19 million acres are owned by husband and wife. In total, 52 million acres of the private forest are in individual ownership.

While some non-industrial timber growers own tracts of forested land in hundreds, or even thousands, of acres, most are small landowners with ten, twenty, or fifty acres of trees. <u>These are not wealthy Americans seeking a tax break.</u> Rather, most forest landowners are hard working, middle-class taxpayers. They are farmers, retirees, and school teachers, who love their land and work diligently to manage and make productive the natural resource asset they are privileged to own.

Today, the independent forestland owner is being asked to supply more wood fiber and is being pushed to manage more intensely his acreage because of both market conditions and government policy. When government policy discourages the planting of trees through excessive taxation and increased regulation, fewer trees will be grown which is not only bad for the economy, but bad for the environment.

Increasingly strict environmental regulations place limits on the timber acreage that is available for harvest from public lands. At the same time, since the capital gains increase in 1986, the reforestation rates on small non-industrial tracts of land have declined in many parts of the country. The disparity between acres harvested and acres planted continues to grow. Environmental groups, private forestland owners, and the forest products industry all agree it is crucial our U.S. tax policy be changed to provide greater incentives for reforestation efforts. As a direct result of higher capital gains taxes, some forestland owners, particularly in the South, are selling their forestland and investing in something that will provide them with a more certain return. Others are not investing in forest management practices or in reforestation activities, as they once were. Timber land will regenerate significantly faster producing better quality wood if it is managed and reforested properly.

The Capital Gains tax provisions in the 1996 Balanced Budget Act would have provided a much needed tax relief. However, an alternative to incorporating these provisions in a budget plan to provide this country with two very beneficial results – more trees and a better environment, would be to replace the Federal income tax. Simply put, allowing tree farmers to keep more of what they produce means they will have more to reinvest in tree production while ensuring proper management of existing forest land. Ultimately, lower taxes on trees means more wood for homes at lower cost to the home buyer.

The Forest Landowners Association is working to see that a more balanced tax treatment of timber restored. I want to commend the Congress of its passage of the Balanced Budget Act, vetoed by the President last December, that contained provisions to exclude 50% of capital gains from taxation. The legislation would have made the effective top rate on capital gains 19.8% for capital assets, including timber, held for a year or longer. The corporate capital gains rate would also have dropped from 35% to 28%, and assets would have been indexed prospectively. It is our ardent hope that Congress will continue to move forward with this important legislation.

Included in his veto of the Balanced Budget Act, President Clinton eliminated an opportunity to bring about estate tax relief for "family-owned business interests". That legislation would have excluded the first million of value from a decedent's estate, and also excludes 50% of the value between $1.0 and $2.5 million. That legislation would have required surviving members of the family to keep the business for 10 years to avoid additional estate taxes. Even the 7-year balanced budget which did include a provision to provide a modest amount of estate tax relief including family farms and closely-held businesses is a modest amount that does not begin to adequately address the problems.

We are grateful for the support of a majority of Congress for the goals of the Balanced Budget Amendment. The Federal Income Tax System, with a flatter, fairer tax, will benefit all citizens of our nation, including forest landowners. In particular, I am hopeful that the provisions of capital gains and estate taxation will continue to be considered by the Ways and Means Committee this election year and during upcoming debates. This change in the treatment of taxes is needed to ensure that small land owners are not penalized for exercising proper management of their lands. It will also benefit citizens who own land that has been passed down from generation to generation from having to sell part of their farm just to pay off death taxes.

I appreciate the opportunity to submit the Forest Landowner Association's views for the record. We applaud your efforts to provide tax relief and reform to our nation. We are encouraged that legislation has emerged to provide the necessary incentives to allow non-industrial forest landowners to invest more money in reforestation, management, and maintenance of forestlands so they can continue to provide this country with an abundant, affordable supply of timber. We eagerly await the passage of these tax provisions.

Comments on the
Impact of Fundamental Tax Reform on Domestic Manufacturing

August 14, 1996

Submitted by
The Tax Reform Study Group
within the Council on Tax & Fiscal Policy
An Initiative of Joint Venture: Silicon Valley Network

These comments are submitted pursuant to the House Ways & Means announcement of July 18, 1996. They are submitted for inclusion in the printed record of the hearing held on July 31, 1996 on the impact of fundamental tax reform on domestic manufacturing and on energy and natural resources; our comments focus only on domestic manufacturing. The Tax Reform Study Group previously submitted comments for the written record of the May 1996 hearing on the impact of tax reform on state and local governments, and the July 1996 hearing on the impact on international competitiveness.[1] The Tax Reform Study Group is also working on a more comprehensive comment letter to submit to the tax writing committees at a later date; such letter will expand upon the topics covered in this submission.

Background on the Tax Reform Study Group

The Tax Reform Study Group was formed in October 1995 and consists of individuals from business, state and local government, and academia who are interested in studying the proposals for reform of the federal and state tax systems and tax reform in general and their impact to Silicon Valley. The Group provides objective forums for people in Silicon Valley to learn about tax reform and how it affects them and their employers. The Group has sponsored several seminars on tax reform and maintains a Web page where interested people can obtain objective information on tax reform:

http://www.svi.org/jointventure/tax/tax_fed.html

Joint Venture: Silicon Valley Network is a dynamic model of regional rejuvenation with a vision to build a community collaborating to compete globally. Joint Venture brings people together from business, government, education, and the community to act on regional issues affecting economic vitality and quality of life. One of its initiatives is the Council on Tax & Fiscal Policy.

Drafting: The views expressed in the comment letter represent the collective views of the Tax Reform Study Group within the Council on Tax & Fiscal Policy of Joint Venture: Silicon Valley Network, and not necessarily the views of any individual members of the Study Group, the Council or of Joint Venture. The primary draftspersons of these comments was William C. Barrett, Director: Tax, Export & Customs, Applied Materials, Inc., Annette Nellen, Professor, San Jose State University, and Donald J. Scott, Director: Tax Compliance, Oracle Corporation; substantive contributions and review were provided by Jean Alexander, Counsel to the Chairman, California State Board of Equalization; Dan Kostenbauder, General Tax Counsel, Hewlett-Packard Company; Larry R. Langdon, Vice President - Tax, Licensing & Customs, Hewlett-Packard Company; David W. Mitchell, Hoge, Fenton, Jones & Appel Inc.; and Dr. John E. Thomson, Adjunct Fellow, Tax Foundation.

[1] These comments can also be found at http://www.svi.org/jointventure/tax/tax_fed.html, and 96 STN 142-36 (July 23, 1996) or State Tax Notes, Vol. 11, No. 4, July 22, 1996, pg. 253.

Introduction

These comments focus on selected issues relevant to manufacturers that have not received much attention in the tax reform debate relative to other issues. These topics include:

- The importance of R&D incentives to manufacturing and service companies;
- Accounting methods; and
- Impact on financial statements and stock prices.

Importance of R&D Incentives to Manufacturing and Service Companies

Various government and private studies have indicated that government incentives for research are justified in that society's rate of return on research exceeds that of the company incurring the research costs and risks. Thus, the company conducting the research and incurring the costs will not be able to completely reap the rewards of its research because some of the benefit will spill over to others.[2] For example, although research leading to an innovative new drug can be protected by a patent to help a company obtain the economic benefits of its research, the fruits of the research will be enjoyed by others upon the patent's expiration. Because a company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research.[3]

Research incentives also benefit society. Both government and private studies have shown that the credit for increasing research activities (IRC §41) has had an impact on the amount of research conducted. A 1989 General Accounting Office (GAO) report, "The Research Tax Credit Has Stimulated Some Additional Research Spending," stated that the research credit "raised corporate spending on R&E above the level that otherwise would have been achieved."[4] This study, based on a sample of 800 corporations and economic models, concluded that the credit "stimulated between $1 billion and $2.5 billion of additional spending for the 5 years 1981 through 1985." Such an increase represented an increase of 15 cents to 36 cents for every dollar of foregone tax revenue due to the credit.[5]

A 1994 private study concluded that the GAO study underestimated the benefits of the research tax credit. This study estimated that the credit stimulated additional

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[2] "Businesses may not find it profitable to invest in some research activities because of the difficulty in capturing the full benefits from the research. Costly technological advances made by one firm are often cheaply copied by its competitors. A research tax credit can help promote investment in research, so that research activities undertaken approach the optimal level for the overall economy. Therefore, the Committee believes that, in order to encourage research activities, it is appropriate to reinstate the research tax credit and to modify certain rules for computing the credit." From: Small Business Job Protection Act of 1996 (H.R. 3448), Senate Finance Committee Report on H.R. 3448, S. Rpt. 104-___, June 1996, Explanation of Present Law.

[3] "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," a staff study prepared for the Joint Economic Committee of the U.S. Congress, S. Rpt. 99-73, August 23, 1985, pg. 4 ("'spillover benefits' ... put R&D into the class of goods such as public health and sanitation, education, clean air and water, and defense that fall into the sphere of governmental responsibility.") Also see Congressional Research Service Issue Brief "The Research and Experimentation Tax Credit," by D. Brumbaugh, November 17, 1993 ("because the level of investment a firm undertakes depends on the return it alone can earn from the investment, without public support firms are willing to undertake less research than is warranted by its return to society.") Also see study and testimony of Barents Group LLC of KPMG Peat Marwick LLP; 95 TNT 65-20 (4/4/95); ("Social rates of return to R&D investments are typically about twice as high on average as private rates of return.")

[4] GAO, "The Research Tax Credit Has Stimulated Some Additional Research Spending," GAO/GGD-89-114, Sept. 1989, pg. 22.

[5] 1989 GAO report, *supra*, pg. 22.

spending in the short run of about $2 billion per year (in 1982 dollars) with foregone tax revenues of about $1 billion per year.[6]

The economy also benefits from research activity. It has been estimated that at least half of the economic growth in the U.S. stems from advances in technology.[7]

Manufacturers are the primary user of the research tax credit. In 1993, 75.2% of the aggregate amount of research tax credit claimed was claimed by manufacturing companies; 12% was claimed by service companies.[8]

Impact of a consumption tax on R&D. Two important R&D rules under our income tax system are IRC §41, *Credit for increasing research activities,* a tax incentive, and IRC §174, *Research and experimental expenditures,* a positive accounting rule. These R&D rules are particularly important to computer software development and hardware manufacturing companies. A significant element of both the deduction and credit for research expenditures relates to employee labor. Under a consumption tax, expenditures related to employee labor, including wages, fringe benefits and payroll taxes do not reduce the taxable base. Thus, a consumption tax will eliminate a significant deduction attributable to R&D activity.

The treatment of R&D under our income tax system versus a consumption tax can be compared as follows:

R&D Expenditure:	Income Tax	Consumption Tax
Employee labor	Currently deductible under IRC §174.	Not deductible.[9]
Outside labor (such as independent contractors).	Currently deductible under IRC §174.	Deductible business purchase.
Equipment	Not currently deductible, depreciation may be treated as a current deduction under IRC §174(a) & (c).	Deductible business purchase.

There appears to be some belief among tax reform proponents that the loss of R&D incentives (research tax credit and wage deduction) is more than offset by the benefit attributed to the current deduction of equipment. While this may be true for some capital intensive manufacturers, not all manufacturing R&D processes require significant equipment purchases. The software industry, for example, is highly labor intensive in both the development and manufacturing stages and the loss of the research tax credit and the wage deduction is not offset by a deduction for capital equipment. Tax reform proponents who seek to improve economic growth for the U.S. must consider how the tax burden is distributed among both labor intensive and capital intensive industries.

We suggest that more attention be paid to the potential impact of moving completely from an income tax with R&D incentives to a consumption tax with no R&D incentives (no research tax credit). Because R&D activity is a growth engine for the U.S. economy, further study must be made as to whether R&D activity will

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6 "R&D Tax Policy During the 1980s: Success or Failure," by Bronwyn H. Hall, National Bureau of Economic Research, Reprint No. 1872, April 1994, pg. 29.

7 See July 18, 1996 testimony of The High-Technology Tax Restructuring Group before the House Ways & Means Committee, fn. 3. The statement is based on a 1995 report by the Office of Technology Assessment, "The Effectiveness of Research and Experimentation Tax Credits."

8 Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax,* (JCS-3-96), April 23, 1996, pg. 95.

9 However, the Armey flat tax (H.R. 2060, 104th Cong. 1st Sess.) would allow a deduction for cash wages and certain retirement plan contributions; the USA tax (S. 722, 104th Cong., 1st Sess.) would allow a credit for payroll taxes.

decrease under a consumption tax, and if so, reformers must then consider the impact to one of the key goals for tax reform - economic growth. This further study must consider:

- the impact of changed R&D tax incentives, along with other changes, such as reduced tax rates and the move to a territorial tax system, on a company's cost of doing business;[10]
- the impact of R&D incentives provided by other countries;
- the possible changed behavior of companies in response to reduced tax benefits for R&D activity;[11]
- the varying impact of reduced R&D tax benefits among different industries;[12] and
- the possible impact to economic growth from reduced R&D tax benefits.

Accounting Methods

Current proposals: Only two of the current reform proposals include provisions on accounting methods: the USA tax proposal (S. 722, 104th Cong., 1st Sess.) and the National Retail Sales Tax proposal (H.R. 3039, 104th Cong., 2d Sess.). Under the USA tax proposal, a business would generally be required to use the accrual method of accounting; the all events test and economic performance requirement of present law would continue to apply. Generally, if a business was allowed to use the cash method of accounting under present law, it could continue to do so under the USA tax. The USA tax proposal directs the IRS to provide regulations (consistent with present IRC §447 and IRC §448) under which a new business might be able to adopt the cash method of accounting. The USA tax proposal also provides that certain changes or expansions of a business may result in it no longer qualifying for use of the cash method, under regulations to be provided by the IRS. Under the USA proposal, the present rules on changes in method of accounting and bad debt expense, would remain.[13]

Under the National Retail Sales Tax proposal, the cash method is the general rule. However, a vendor could elect to adopt the accrual method to determine when tax is due on its sales. For taxable property and services sold under the installment method, tax is due when payment for the property and services is actually received. With respect to property and services returned to the vendor, the vendor would be entitled to a credit (refund) when actual payment for the returned property and services is made by the vendor.[14] Apparently, a similar rule would apply to bad debts of a vendor using the accrual method (but a specific rule is needed to this effect).

The Armey flat tax (H.R. 2060, 104th Cong., 1st Sess.) does not mention accounting methods, but it implies, as does the Hall-Rabushka model upon which the Armey flat tax is based, that a cash method of accounting would be used. The subtraction VAT proposal of Congressman Gibbons also does not discuss accounting methods.

Considerations in Developing Accounting Method Rules: We suggest that the following principles be considered in developing accounting method rules for any tax reform proposal:

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[10] See July 18, 1996 testimony of The High-Technology Tax Restructuring Group, *supra*, for an example of how a consumption tax could increase the cost of U.S.-based R&D activities.

[11] Changed behavior may include changes in a company's mix of domestic and foreign R&D spending, and increased use of outside contractors for R&D activity, relative to employee labor.

[12] The level of R&D spending among manufacturing industries varies. For example, in the automotive industry, R&D expenditures as a percentage of sales revenue is about 4%, while it is about 10% for the semiconductor industry and approximately 14% for the software industry. As reported by the Semiconductor Industry Association (SIA), based on a *Business Week* report; SIA Annual Databook, 1995, pg. 41.

[13] The accounting method provisions of the USA tax proposal are at S. 722, *supra*, §§220 to 226.

[14] H.R. 3039, 104th Cong., 2d Sess., §22(e).

- One of the desired simplification provisions of many businesses is for increased book-tax conformity.[15] However, conformity is not possible if the income tax system is replaced with a consumption tax, because books will still report income (not consumption). However, wherever possible, the goal of increased book-tax conformity should be followed.
- Under a consumption tax, where a business is allowed to immediately write-off purchases of business assets, including land and inventory, timing rules will not be as important as under our current income tax system. For example, uniform capitalization rules and depreciation rules will be eliminated. Thus, the emphasis of current law on "clear reflection of income" from the perspective of the IRS (IRC §446(b) and Treas. Reg. §1.446-1(a)(2)) should no longer be the focal point of proper reporting of income and expenditures. Instead, emphasis should be placed on the methods used for book purposes (IRC §446(a) and Treas. Reg. §1.446-1(a)(1)), in order to achieve greater book-tax conformity.
- The cash method of accounting should be considered an acceptable method of accounting for businesses with average annual gross receipts of $5 million or less.[16]

Example: ABC Corporation is a publicly-traded company that prepares its financial statements according to generally accepted accounting principles (GAAP). For its year ended December 31, 1998, ABC's income statement reports:

Net sales		$2,600x
Cost of sales		
Beginning inventory	$500x	
Direct materials	$600x	
Direct labor	$700x	
Indirect costs	$300x	
Ending inventory	- $400x	$1,700x
R&D		$300x
Selling, general and administrative		$320x
Operating income		$280x
Interest, net		$120x
Income from operations before income taxes		$400x

Because ABC's financial statements are based on income, but its tax return is based on a consumption tax system, many book-tax differences will exist. However, for purposes of simplification, ABC should be allowed to start with the above numbers in determining its tax base under any of the consumption tax proposals. For example, under a subtraction method VAT, ABC would make the following adjustments:

a) Eliminate labor, fringe benefits, taxes, interest and beginning and ending inventory included in its expenditures;
b) Eliminate net interest income.
c) Eliminate depreciation and amortization amounts;
d) Remove gain or loss amounts from the sale of fixed assets;
e) Include a deduction equal to the book amount of equipment, building and land acquired and placed in service during the year (rules are required to

[15] See Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems*, (JCS-1-96), March 14, 1996, pg. 77.

[16] As under IRC §448. Arguably, under a system where inventory is deducted when acquired, rather than when sold, a small business with inventory should not be precluded from using the cash method of accounting for tax purposes (this is not allowed under current law per Treas. Reg. §1.446-1(c)(2)(i) which requires a taxpayer with inventory to use the accrual method for purchases and sales). Rules can be provided to prevent possible abuses, such as large year-end inventory purchases made solely for tax purposes where the inventory is returned in the next year; see Revenue Ruling 79-188, 1979-1 C.B. 191.

ensure that there is no interest expense element included in this deduction); and

f) Increase its tax base for the book sales price of equipment, building and land sold during the year.

The above adjustments should *not* be expanded to require ABC to apply the all events test and economic performance requirement to determine when it incurred expenditures and had basis in assets purchased. Similarly, ABC should not be required to apply the existing income recognition rules of IRC §451 and the regulations; instead, it should be allowed to use its book revenue amounts.

Impact on Financial Statements

Regardless of how U.S. tax reform evolves, the need to accrue state and foreign income tax liabilities in financial statements will continue under GAAP accounting although the geographic mix of income tax liability could change dramatically.[17] For many companies, foreign income tax liabilities will likely increase in proportion to the corporate U.S. (state) tax liability. Income tax accounting with respect to foreign operations will become much more important to the global income tax provision and accordingly increases the administrative burden to U.S.-based tax departments in managing the income tax accounting work.

Discussion of transition issues in the tax reform debate so far have focused on the tax and economic reasons of either providing transitional rules or not providing such rules. However, another important aspect of transitioning from an income tax to a consumption tax is the impact on financial reporting. The impact of moving from an income tax to a consumption tax can have a significant impact on a company's income statement and balance sheet, and potentially on its business decisions and stock price. Financial reporting (GAAP) aspects of major federal tax reform include:

- the impact on a company's net deferred tax assets or net deferred tax liabilities in existence at the transition date;
- how the change from one set of rules to another should be reported on financial statements for the year of change; and
- what the incidence of the new tax is and whether or not it should be reflected on a company's income statement as the income tax currently is. For example, would the financial accounting rule for federal taxes be the same under the Armey flat tax, USA tax and national retail sales tax proposals?

A company's mix of deferred tax assets[18] and deferred tax liabilities[19] and whether the company is in a net deferred tax asset or net deferred tax liability position can vary from year to year for a variety of reasons. The type of transitional rules provided can have a significant impact to companies, particularly those with net deferred tax assets. Tax reformers should consider the impact of limited transitional relief on both the tax and financial reporting positions of companies. Transition rules should take into account ways to prevent undue burdens for companies with significant tax attributes at the transition date.

GAAP (FAS #109) requires tax law changes to be reflected in financial statements in the year enacted. Assuming that FAS #109 would continue to apply to a consumption tax, the value of net deferred tax assets and net deferred tax liabilities would decrease. Again, this would affect companies differently depending on their prior tax attributes. Whether or not transition rules exist to allow a tax benefit for loss and credit carryovers and undepreciated asset basis at the transition date will

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[17] Financial Accounting Statement (FAS) #109, Accounting for Income Taxes.

[18] Deferred tax assets tend to represent non-deductible current expenses that will be deducted in the future and may represent such items as inventory reserves, deferred revenue, loss carryovers, and foreign tax credits.

[19] Deferred tax liabilities may exist for such items as book-tax depreciation differences.

have an impact on corporate financial statements, stock prices, and transitional planning.

There are many unknowns with respect to the impact of tax reform on financial statements. For example, will the current income tax reporting rule under GAAP (FAS #109) apply to consumption taxes, or will a new rule be required? Also, what is the proper reporting of the particular consumption tax on the financial statement? For example, a national retail sales tax collected by a taxpayer should not be reported on the income statement. However, it is not clear whether the same would be true for a subtraction method VAT, although theoretically, the economic incidence of a subtraction method VAT is the same as for a sales tax (tax imposed on the final consumer). Additional uncertainties stem from these accounting unknowns which may have significant impacts on the economic impact of fundamental tax reform. For example, how will the stock market react to changes in balance sheets (likely improvements for companies with deferred tax liabilities, but likely reductions to earnings for companies with deferred tax assets) and effective tax rates?

Example: In the first year of the flat tax, Young Corporation (YC) has $600 million in domestic revenue and flat tax deductions of $330 million. Thus, YC's pre-tax income is $270 million and its flat tax liability is $54 million (20% tax rate). YC has $70 million in prepaid tax assets on its books, attributable to inventory reserves, loss carryovers and research tax credit carryovers. Assuming no transitional rules exist to allow YC to ever obtain benefit of the prior inventory purchases or carryovers, the prepaid tax asset must be removed from YC's financial statements. YC's income tax provision for the first year of the flat tax would be:

Flat tax	$54M
FAS #109 adjustment	$70M
Total	$124M
U.S. pre-tax income	$270M
U.S. effective tax rate	46%

Without the FAS #109 adjustment, YC's effective tax rate would have been 20%. This example is a simplified one involving only three book-tax differences; a typical manufacturer would have significantly more book-tax differences to analyze. The impact of tax reform will raise many difficult accounting issues for companies due to the significant nature of the contemplated changes - analyzing the specifics of reserves, moving from a worldwide system to a territorial one, lack of transitional rules, and uncertainty as to the incidence of the tax burden.

Congress must consider the need for financial statement guidance that must follow reform of the federal tax system. The impact of tax reform on financial statements (and stock prices) must be included in the tax reform debate with respect to the technical and economic points, as well as providing a sufficient time frame for the accounting issues to be resolved.

Conclusion

Major federal tax reform presents significant accounting, economic, social and political issues. Our comments above only identified and discussed three of these significant issues. To summarize, manufacturing companies are particularly sensitive to changes to the current treatment of R&D expenditures. Consideration of a consumption tax must take into account possible reduction in U.S. R&D spending and whether economic growth may be impacted adversely. Also, accounting method rules for any consumption tax proposal must consider how to best reach the simplification goal of tax reform, and realize that income tax standards for what is a proper method of accounting might not automatically apply to a consumption tax. The financial reporting (GAAP) issues indicate the need to consider the very broad brush tax reform sweeps over businesses beyond just their tax obligations to the government. In addition, financial reporting issues indicate the need to have a broad spectrum of parties involved to some degree in the tax reform process, including the Financial Accounting Standards Board (FASB).