TAX FOUNDATION

SEMINAR PROCEEDINGS

REBUILDING THE U.S. INDUSTRIAL BASE:

THE ROLE OF TAX POLICY IN ECONOMIC GROWTH

Edited with an introduction by
Edward A. Sprague

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A seminar held May 22, 1991 in Washington, DC

Edited with an introduction by
Edward A. Sprague

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FOREWORD

The title of this seminar, "Rebuilding The U.S. Industrial Base: The Role of Tax Policy and Economic Growth," reflects the current concern over how our federal tax code impacts corporate strength and economic growth. Too often over the past decade, we have seen major tax policy changes which were implemented simply as quick-fix revenue raises. These were done without proper analysis or proper debate as to what their economic consequences would be — what they would do to America's competitiveness. These are the issues examined in the proceedings of our May 22, 1991 seminar.

We brought together a group of leading experts from business, government, and academia to objectively examine how our current tax policies are impacting economic growth and what policies would be necessary to form a pro-growth tax policy for the long term. Their comments and conclusions point to the need for significant reforms.

The current recession has re-awakened concern over the relationship between tax policy and economic growth. How does our current tax system impact the industrial base, both in manufacturing and the service sectors? This question, we believe, should be at the forefront of every tax policy debate because without a strong and growing economy, the tax base itself is eroded. And, if the U.S. is to continue as a world leader, we must set tax policies that will put us on a path of expansion to induce more investment, more research, increased productivity and increased employment.

The presentations at the seminar and our precis of each are contained in these proceedings.

Instrumental in putting together the program were James Q. Riordan and James C. Miller III, co-chairmen of the Tax Foundation, along with Robert Hannon, M.D. "Buck" Menssen and Glenn White, co-chairmen of the Tax Foundation's Program Committee. The Foundation's special thanks go to Edward A. Sprague, consultant to the Tax Council, for editing the proceedings.

Dan Witt
Executive Director

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Charles Hahn is Assistant Tax Director at Dow Chemical Company. He is a member of the Wisconsin State Bar, American Bar Association and the CMA tax policy committee. He attended the University of Wisconsin in Madison, receiving his B.A. in Economics in 1973, and both an M.B.A. in Finance and J.D. degree in 1976.

Edmund K. Harding has since 1979 been Manager, Tax Planning & Litigation for Xerox Corporation. He received his B.S. in Accounting at the University of Detroit and his J.D. at Wayne State University. Prior to joining Xerox, he worked for General Motors Corporation in Detroit in a variety of tax-related positions. He is a member of the Connecticut and Michigan Bar Associations and numerous tax-related organizations.

Lawrence B. Lindsey is a member of the Board of Governors of the Federal Reserve and recently served as Special Assistant to the President for Policy Development at the White House. He is on leave from Harvard University where he is an Associate Professor of Economics. He received his A.B. magna cum laude from Bowdoin College and his Masters and Ph.D. from Harvard. He served three years during the Reagan Administration on the staff of the Council of Economic Advisers where he was Senior Staff Economist for Tax Policy.

Alan J. Lipner is Senior Vice President of Corporate Taxes at American Express Company. He is a member of the Tax Executive Institute, the Committee on State Taxation, the International Tax Association, the Business Roundtable Tax Committee, and is the chairman of the Policy Committee at the Tax Council. Mr. Lipner holds a L.L.M. and J.D. degree from New York University School of Law; he received his B.S. at Pennsylvania State University.

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Catherine T. Porter is a Partner with the law firm of Miller & Chevalier, Chartered. Previously, she was the Tax and Trade Legislative Aide to United States Senator John H. Chafee (R-RI), Assistant Counsel to the Subcommittee on Oversight of the House Committee on Ways and Means, and Tax Counsel to the House Committee on Small Business.

Marlin Risinger is Acting Deputy International Tax Counsel at the U.S. Department of the Treasury where he has also served as the Associate International Tax Counsel. Before joining the Treasury Department, he worked at the law firm of Caplin & Drysdale, Chtd., in Washington, DC, from 1985 to 1988. He received his J.D. from the University of Virginia in 1983 and has been an Adjunct Professor at the Georgetown University Law Center.

Henry Ruempler has served as Director of Tax and Accounting for the American Bankers Association since 1986. He advocates the industry's position before Congress, the regulatory agencies, FASB, and the courts. Before joining the ABA, he served as Vice President of Citibank for three years. He is a graduate of the University of California at Santa Barbara, and earned both a law degree and a master's degree at Georgetown University.

Richard T. Schulze (R-PA) is serving his ninth term in the United States House of Representatives. He has been a member of the Committee on Ways and Means since 1977 and has served on the Subcommittees on Social Security, Trade and Select Revenue Measures. He is a member of the Republican Study Committee's Executive Committee. He attended the University of Houston where he majored in business administration, foreign trade and transportation. He also attended Villanova University and Temple University.

Emil M. Sunley joined Deloitte & Touche in 1981 as Director of Tax Analysis. He served at the Department of the Treasury from 1968 to 1981, first as economist in the Office of Tax Analysis, then as the director of that office, then beginning in 1977 as Deputy Assistant Secretary of the Treasury for Tax Policy. As an authority on tax reform, he has advised numerous foreign and state governments. He received his doctoral degree in economics from the University of Michigan and graduated from Amherst College.

Dan Witt is Executive Director of the Tax Foundation. Prior to joining the Tax Foundation, he was Director of Membership with Citizens for a Sound Economy, a Washington-based public interest group. He has been a visiting economist with the New Zealand Institute of Economic Research and Victoria University of Wellington and has served as a consultant to the President's Commission on Privatization. He received his M.B.A. from Western Michigan University.

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Keynote Address

The Honorable Lawrence B. Lindsey
Governor, Federal Reserve Board

Lawrence Lindsey, who at the time of the seminar was Special Assistant to the President for Policy Development and had been nominated as a governor of the Federal Reserve Board, led off the seminar with insights on how the presentation of economic data can affect our perception of public policy issues. This is particularly important, according to Lindsey, because it can affect our final choice of economic programs dealing with income maintenance, national savings, and growth.

In the case of social security and individual retirement accounts (IRAs), Lindsey notes the failure of most data presentations to make present value calculations. The social security payroll tax is most often described as regressive but when it is linked to the benefit structure, in present value terms, the overall income transfer system is "quite progressive." Similarly, the way current budget scorekeeping mostly ignores present value tends to exaggerate greatly the revenue cost of IRAs, discouraging what is probably an effective program to build national savings. Lindsey also regrets that the poverty statistics do not account for the effect of the recently liberalized earned income tax credit, which is a more effective program for expanding the labor market than it is given credit for.

Lindsey emphasizes the importance of using economic analysis beyond the provincial restrictions of current scorekeeping and income distribution tables.

The lesson of tax policy analysis that the Tax Foundation provides is the importance of presenting material in a clear fashion. It turns out that in Washington, presentation makes a big difference. There are always many ways of presenting accurate figures. But often, these equally accurate approaches produce different interpretations. Indeed, I guess that is what keeps us economists employed.

I would like to look at three current issues in tax policy, and say a few words about an alternative set of presentations of these tax policy issues that I think tax professionals should pay more attention to. Now, all three issues are controversial, but I deliberately selected them as being non-partisan. There are Republicans and Democrats on both sides of these issues. I do not mean to imply any criticism of the existing presentations of data, but I do think that it is important to reflect on what's being presented today as yet another angle on the material.

None of the three bear directly on the topic of rebuilding the U.S. industrial base, but they certainly have an important indirect effect. Two of the issues are important for national saving; the third for providing opportunity in our labor markets.

The three issues I would like to talk about briefly today are social security, the earned income tax credit, and retirement savings plans. As you see, I am not staying clear of controversy.

Social Security as an Income Transfer

We have had a number of proposals to change the social security tax. The issue that I would like to focus on is the regressivity of the social security tax. Simply looking at the tax, there is no question that it is regressive. Levied up to a cap, it is a proportional tax, but as it only taxes wage income, with capital income exempt, the tax would be regressive, looked at in the standard distributional table.

I would argue that social security is a unique kind of tax. It really is a mandatory, defined benefit pension plan. The tax contributions that are made are not so much to fund a public benefit such as national defense or the building of a bridge, but very much a private good — meaning how much an individual is going to receive. There is a direct statutory formula linking one's contributions with how much one gets in retirement or in the other forms such as survivor's benefits. There is a redistributive element in the formula, but I think it is important to look at the system, not just as a tax, but as a tax-benefit system.

Look at the baby boomers, such as workers who retire in 2012. Consider for example, someone retiring in 2012, earning $10,000 in annual wages today and maintaining that place in the income distribution as wages rise over time until he or she retires. According to the Office of the Actuary of the Social Security Administration, the ratio of benefits to taxes paid for that individual is 142 percent. In other words, for every dollar paid in, that individual will get back, in present value terms, benefits of $1.42.

How then best to describe the tax the individual pays? Well, right now the statutory OASI tax rate is 12.8 percent. But really, when that individual makes another dollar contribution, he can expect to get $1.42 in the future. So, the right way to think of it is really as a tax of minus 42 percent times the statutory tax rate. Someone earning $10,000 who is 36 years old really has a tax of minus 5.2 percent under the social security system. The net benefit from that person's earning another dollar and participating in the system is 5.2 cents on every dollar earned. On net, he is a beneficiary.

Now consider someone making $50,000. The benefits-taxes ratio in this case is 80 percent. What that means is that on net, that individual will get back only 80 cents for every dollar he contributes. He or she is therefore a net tax payer, but not to the tune of the total 12.8 percent tax rate. His net contribution is only 20 percent of that. So, the way to impute the tax to him is really as an effective rate of 2.5 percent, 20 percent of the statutory rate.

Thus, when we look at it in terms of a tax transfer system, we really see that instead of having a regressive system for future retirees, the system tends to be quite progressive. Coming to that conclusion does not necessarily alter the issue of inter-generational transfers which are currently taking place. There clearly is redistribution going on that may not be progressive. But holding people constant, looking at any given cohort, the tax transfer system through social security is progressive, not regressive, as is often thought. So, one change that we should make in the way we present things in this town, in my opinion, is to consider present social security as a defined benefit pension plan, not as a tax.

The Earned Income Credit and the Poverty Level

The second presentation is the earned income tax credit. This has been around since the Nixon administration, but last year in the Omnibus Budget and Reconciliation Act, it was greatly liberalized. Let me say it was liberalized with broad bipartisan support. It is, from a tax professional's point of view, a very good program. It is well targeted and cost effective.

What happened last year was a substantial increase in the earned income tax credit. The base rate for a single child was raised from 14 percent of earnings to 23 percent. The second child got an extra 2 percent, and if the child is young, 5 percent more was added. A low income worker could, therefore, get a maximum effective wage subsidy of up to 30 percent. Let me emphasize what that means. To a single parent supporting a child, and earning the minimum wage, the earned income tax credit is worth $1,642. That is on top of wages of $8,840 and represents roughly a 20 percent income boost.

Looking at it another way, a minimum wage earner's income is raised from below the poverty level to 117 percent of the poverty level. Because of this program, a taxpayer was moved out of poverty. I think that is the kind of program that Congress should get positive feedback for endorsing.

The catch is that the poverty statistics that the Census Bureau collects don't include the earned income tax credit as income. Of course, they don't include many transfer payments, such as food stamps. But here we have an undisputed cash transfer that is excluded from the Census data. By increasing the earned income tax credit, we are clearly making those most in need better off. By normal measures, we are lowering the poverty rate, but because of the way that we do things in this town, Congress will not get any positive reinforcement for what was a very wise action in expanding the earned income tax credit last year.

The Real Cost of IRAs

The third issue that I would like to take a look at is retirement savings. Here I would cite what really has to be the greatest anomaly of our budget process — the way of scorekeeping over time.

I'm sure those of you representing the private sector use some form of present value accounting. We use present value accounting in the government too. We don't discount any cash flows for the first five years at all, and any cash flows after five years, we discount fully. It seems like an odd way of doing things, but that is the way we do it. In no issue does that distort the appearance of an effective program as much as in the case of a retirement saving program. Let's think about how that might work.

Consider the Individual Retirement Account, for example. When you put your money in an IRA, the government takes an up-front hit in revenue. Now, if you are going to leave it in there at least five years, the way we would score that is simply as a revenue hit. IRAs are, therefore, very expensive programs in the realm of current budget arithmetic. But let's think about what happens to the lifetime of that IRA. You put the money in, it builds interest, then you take the money out at the end, the principal and the interest. Well, what is the present value of principal and interest several years from now? By definition it is the principal you put in. So, assuming the taxpayer has the same tax rate, the present value of the revenue coming at the end just offsets the present value of the revenue that is lost when it finally goes into the system. From that very narrow perspective, the net cost of an IRA program to the government, in present value terms, is zero.

There is a cost because what the government does is to forgive taxing you on the compounding of interest in the interim. That is clearly a loss in revenue, but it is far smaller than the loss in revenue the way we score things now, which is simply to look at the up-front costs for the next five years.

* * *

What I have tried to do is highlight what I think are three very important issues with regard to the presentation of data. The way the data is presented now is neither right nor wrong, but there are many ways of looking at the same kind of data. In the case of measuring the poverty rate and the Earned Income Credit, we should include it in accounting for the poverty level. In the case of a savings plan that is going to go on for many years, we should treat it the same way we treat social security scoring, which looks at present value over the next 75 years. In the case of the social security system itself, when we think about its incidence, we shouldn't just look at the tax, but we should realize that it is a link to the tax transfer program, and we need to look at both sides of the ledger.

Session One

Assessing Pro-Growth Tax Policies for the 1990s and Beyond

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House Ways and Means Committee

Leif H. Olsen

Inherent in our political system is a pervasive tendency to denigrate those who accumulate capital — those we call wealthy or rich. When the most recent debate raged over lowering the capital gains tax, it was pointed out that the rich would disproportionately benefit.

I pointed out before, in other settings, that we embrace a great many contradictions in our political consciousness as a nation. We extol private ownership of capital in contrast to state-owned and managed capital in command economies. Yet, in political debate, given the opportunity, speakers to the left will frequently use language which implies that owners and managers or private capital contribute little to the well-being of the economy. They are treated as adversaries in the political community.

These are the manages, incidentally, of the nation's wealth. Every year when *Fortune* or *Forbes* reports the compensation packages of the heads of large corporations, it touches off a wave of criticism in the media which is seldom matched by criticism of the much larger compensation that is paid to rock stars, television personalities, sports figures, and others, which is an indication of the bias in our thinking.

Many members of Congress believe that they can increase their political good will by supporting tax and regulatory legislation which seems to benefit society as a whole, at the expense of owners and managers of private capital. If society benefited from the voluminous tax and regulatory legislation enacted in prior years, why do we continue to find no solutions year after year to the continuing problems of employment, housing, inadequate standards of living, productivity, international competitiveness, and so forth. The objective in the design and enactment of tax legislation on both the federal and state level seems to be to collect the largest amount of revenues with the least present political cost. This does not lead to the design and enactment of legislation which necessarily benefits the economy or society as a whole.

I would just recommend to you a study that was done by the Federal Reserve Bank of New York this past winter by Ethan S. Harris and Charles Steintel on the decline in U.S. savings and its implications for economic growth. This article examines the saving data and finds that concerns about low savings are indeed well founded, and we are on a collision course with a decline in productivity and a decline in the total capital stock of the nation. In time, this will reduce the standards of living of the country.

The idea that we must encourage saving, applaud the accumulation and efficient management of capital is an idea whose time cannot be denied for long. This is an idea that must be implemented in tax legislation. The elimination of the corporate income tax and the capital gains tax, and the replacement of these with a value added tax or a Uniform Business Tax (UBT), as Congressman Schulze is proposing, are among those ideas that should at least be open to thorough examination and debate. Those who think that these are ideas whose time should never come should read the article in the quarterly review of the Federal Reserve Bank of New York.

William C. Dunkelberg

Dean Dunkelberg lists five major ways in which taxation affects national growth: 1) the total tax burden, by which he means total government spending, not just tax receipts; 2) the tax structure and how marginal tax rates apply, particularly to savings and investment; 3) what he calls regulatory taxes or mandates to business to perform social tasks; 4) tax complexity; 5) the inflation tax. Reducing the budget deficit per se is not necessarily going to encourage growth, according to Dunkelberg, particularly if it is attempted through tax hikes that negatively affect productivity. Real expenditure control is obviously the key to limiting the tax burden and to meaningful reform of the tax structure.

Dunkelberg is most concerned with the impact of regulatory taxes on small business and entrepreneurs. Citing surveys of the National Federation of Independent Business and other sources, Dunkelberg points out how much the small business sector has been responsible for past growth in employment but also how vulnerable it is to the cumulative burden of regulatory taxes such as increased minimum wages, mandates on family leave and dependent care, environmental issues, etc. He says regulatory taxes have a disproportionately negative impact on the human capital of small business.

Dunkelberg decries a lack of understanding in both Washington and the state legislatures of what creates economic growth and the relationship between growth, jobs and wealth accumulation. He calls for a better framework for evaluating legislative proposals in Congress and in the states with respect to their impact on economic growth.

I would like to address the whole growth issue and tax policy in a large context, and raise with you some of the fundamental issues that I think we have to think about. One is the total tax burden. Usually most people think of the tax burden as all the taxes that are paid. But I will submit to you that when deficits exist, that is not a very meaningful term. The best way to characterize the tax burden is total government spending, because that is the measure of resources that the government takes away from the private sector to do something with. That is the real measure of the tax burden, along with something else I will discuss shortly.

The second very important issue is the structure of that tax code, in particular, marginal tax rate in various forms, and the activities that we choose to include in the tax code to have these marginal tax rates apply to.

A third major issue is the complexity of the tax code, the cost of complying, the time I for one have to spend just getting ready to pay taxes on just one income and one little, measly shore property. It is tough stuff. It shouldn't take the kind of effort but it does.

The fourth item, which ties back into the first in terms of the total tax burden, is the regulatory tax. The regulatory tax is immense, it is hidden, it has a tremendous impact on the allocation of resources and the productivity of those resources, and it is something that we have to consider if we are talking about pro-growth tax policy. Regulation is very similar to a tax. The only difference is that instead of taking the money and doing something, the government just says, you use your money and do this our way. Maybe it is a better deal because maybe it may be done a little more efficiently than direct government programs, without a lot of middle people, but nonetheless, regulatory changes are taxes just like income taxes.

The fifth item, we fortunately have been able to forget about somewhat over the past decade, but it is nonetheless critical—is the inflation tax. We've got to keep in mind that inflation is perhaps the most pervasive, insidious, and most distorting tax that we have managed to invent. It is so pervasive and so insidious that we tend to ignore it You are all familiar with the issue of inflation is effect on saving and what it does without indexing and with indexing. So, I don't think I have to go into a lot of detail there.

Total Tax Burden

Let me talk about the first issue — the total tax burden. As I said, a very simple measure of that is the share of GNP going to government spending. That is certainly one quick measure of the resources that are taken out. Of course very important to us too is the composition of that spending, in particular, the division between income transfers versus investment spending for infrastructure — things we regard as fairly productive and conducive to growth. How that total amount of spending is allocated is certainly a major issue .

Eliminating deficits, you see, per se, is not a pro-growth move. If we, in fact, decide to close the deficit by raising taxes and we do it in a very unproductive way, the value having no deficit or much smaller deficit really is lost. There may be some longer term interest rate effects. It may be nice to eliminate the government from competition for funds. But those effects are minimal compared to some of the other gains we could achieve by looking directly at total government spending at all levels, and asking ourselves, is that the right level at the margin. Are we doing things with this money that is more productive or less productive than what we might do with those same funds if they were left in the hands of the private sector?

Tax Structure

The second issue is structure. As a fundamental premise that I think we keep forgetting about as we look at the tax code and consider tax reform, and that is anything you tax, you get less of it. We have many kinds of taxes, including parking tickets and speeding tickets. A lot of things are devised to discourage behavior, certain kinds of behavior that we don't want to happen. But, we also tax work, savings and investment, and we have negative taxes on education and some other things that we think we like. Those taxes are critically important to the growth issue. If you want more savings, and therefore more investment, and if you want more work effort, then of course you can't tax those things or you have to make the tax impacts on those items as small as possible.

In Philadelphia we have a tremendous budget deficit and they are talking about raising taxes. If we raise taxes in Philadelphia and we use the taxes to improve the quality of life in Philadelphia, they will be a winner because then we will retain the tax base we have, attract new taxpayers in, attract new businesses in, and so on. But, if we raise taxes and there is no discernible change in the quality of life, then firms leave, taxpaying residents move out, and of course what we are left with are the same problems from pot holed in the street on up or worse problems and a smaller tax base. Of course, a spiral of higher taxes gives you a lower tax base and lower asset value that eventually ends up in major asset flight, major human capital flight, and a disaster — in fact the death of the city. Those kinds of things can happen. So, how those taxes get spent is critical to the productivity of the tax increase itself. I think that is a very important issue that has to be considered.

Basically, what we are trying to do is take entrepreneurs who know how to make good products cheaply, and how to run experiments, and turn them into managers of social programs — something which they are not good at doing.

Regulatory Taxes and Entrepreneurship

In particular, I am concerned about entrepreneurship. You've seen a lot of studies over the last 10 years that tell you that small firms are critically important to job creation and wealth creation which, by the way, are synonymous terms in my mind for the United States. You've seen studies done by David Birch at MIT that suggest most job creation happens at small firms. I guess it is true that GM and IBM don't generate a lot of new jobs. They are capital intensive by nature and they tend to be labor saving by nature. Ninety percent of all of the firms in the U.S. have 20 or fewer employees, and ninety-eight percent have under 500 employees. So, what happens in the whole small business arena, I think, is critically important to our future from a growth perspective.

If we are going to compete, then we are going to have to depend on human capital. That is really going to be the key to our competitive posture in the 1990s — the ingenuity, the creativity, and the hard work that these individuals, these entrepreneurs put into their businesses.

At FIB, which has about 500,000 member firms, we started a study in 1985 that followed about 5,000 new firms. We've published a monograph with the first three years of results. We find out that after three years, 77 percent of the firms were still in business, and 10 percent of them had grown in terms of employment by 50 percent, with the minimum of an increase of four employees per firm to put them into that category. So, one in ten really grew dramatically. Our study was stuck right in the middle of the longest expansion in the U.S. history which has some impact on some of these numbers. But, we did find out, for example, that the median amount of capital spent to start a firm was $20,000, that most of these entrepreneurs work 70 hours a week or more, and a quarter of them use unpaid family members for help.

Now, when you think about what is happening at that entrepreneurial level in the context of tax reform, and in particular, new regulations, you see things get very messy. For example, if you are a new firm with two workers who work 2000 hours each annually, and you have an increase in the minimum wage of $1.00 per hour, you are talking about an increase in labor cost of $4,000 in a year, which relative to the $20,000 capital you started with at the beginning is a very large number at a time when sales maybe aren't coming in like they should. In a sense the increase in the minimum wage impaired one-fifth of your working capital for the beginning of the year as a new firm. This is not a good situation to be in, not to mention the fact that maybe the minimum wage is not particularly helpful for job creation anyway.

Then have all these mandates that are being proposed now. We have mandates on family leave, on parental care, on access, on environmental issues, and so on. Basically, what we are trying to do is take entrepreneurs who know how to make good products cheaply, and how to run experiments, and turn them into managers of social programs — something which they are not good at doing. It is a tax on human capital and a very inefficient way to use up this incredibly valuable human capital.

Small firms are the R&D of the U.S. economy. They are what give us our strength. With a just a little bit of money, you can try an idea out. If it works, you make a lot of money. People copy you, which is the sincerest form of flattery. You expand, and if you had the wrong idea, you might have an individual failure and you might have another Dun and Bradstreet statistic. But we don't lose the human capital, we don't lose the physical capital, we just re-price it or we run another experiment. That is the strength of this system — you get to run experiments until you find out a way to make money, which by the way, means that you've done something positive to somebody's values. That is what makes this system work and why the Eastern European system failed so miserably.

It is not a bad thing to accumulate wealth because many other people benefit along with you — that is what we want to happen.

So, these regulatory taxes, these marginal tax rates are critical, especially when we think about the importance of the human capital and how we tax human capital here in Washington and our state legislatures.

Dead Weight Loss

The third item is complexity and compliance. The whole idea is one which we've taught in economics courses for years. Any time a resource is spent on filing and paying taxes is a dead weight loss to society. But we've created an incredible industry, including the IRS, involved with this whole process of collecting taxes and monitoring whether or not we pay taxes. I am currently being audited for my 1989 return, and after two days of going through every little detail of my record, they decided that everything was okay, except for some nitty-gritty issues about passive losses which we are still arguing about. If we had a very simple tax form, then this tax guy investing my taxes would be able to determine very quickly whether or not I was in compliance. As it is, he has taken almost a week himself, not to mention my time, and the only issue is going to be how we interpret "significant other services" and a passive loss. That is a terrible waste of time and energy to society, and we really ought to do a better job on it.

Inflation, I am not going to say much about, only to point out that for example, if you worked your rear end off and retired in 1970 with enough money to take care of yourself and the bank, by 1976 or 1977 you had half of your wealth cut in half because we had more than doubled the price level. You can't play that game if you really want to have fundamentally sound capital accumulation and investment in this economy.

Fundamentals Needed

My conclusion is this — that what we are really missing, here in Washington and at the various state legislatures, is a fundamental understanding of what it is that really creates growth and what the value of growth is, and what the relationship is between growth, jobs, and wealth accumulation. As Leif Olsen pointed out, it is not a bad thing to accumulate wealth because many other people benefit along with you — that is what we want to happen.

The second thing we don't understand is how the tax code impacts these very important factors that affect growth. In short, we need a framework and a philosophy for evaluating proposals of all sorts that come to us on this Hill and all the other Hills around the country, for evaluating them in terms of their impact on growth. What we've seen in recent years is a scramble for revenues that abandons the fundamental tax principles uniformity, neutrality, equity, and of course, efficiency for financial government spending. We have $300 billion budget shortfall, and we haven't had a match or a surplus in at least 20 years. We have failed miserably. We've got to stop having witch hunts, looking for millionaires to pay for the problems. Millionaires can't solve the problem.

We ought to keep in mind that we cannot have meaningful tax reform or tax reduction without expenditure control. Expenditures are out of control and we are just running like crazy try to even stay close. We are failing miserably and we are falling farther and farther behind. Until we get control of the spending, the real measure of the tax burden, we aren't going to get fundamental tax structure change that will really help direct growth in this economy for the 1990s. We need to re-incorporate these fundamental tax principals with expenditure controls and a framework that will provide us with a mechanism to reject the unusual, dumb proposals that we get all the time and that will provide us instead with a road map to real tax reform and real tax simplification to give us strong fundamental growth during the 1990s. This cannot be a one year effort, but it has to become our number one priority for the decade of the 1990s if we are going to remain competitive in this big, new, global environment.

Charles Hahn

Hahn discusses two specific tax code problems that are affecting U.S. business' ability to compete abroad. These are what he calls "schizophrenic" policy regarding research and development (R&D) and the operation of the alternative minimum tax (AMT). Emphasizing the importance of R&D to growth and the long-term commitment necessary to sustain a corporate R&D effort, Hahn says government policies to encourage R&D must be stable and provide certainty for corporate planners. At first blush, the ability to expense R&D activities and the existence of the 20 percent incremental R&D credit would seem to signal that. But, according to Hahn, the realities facing corporate planners are much more complex.

Using the example of a hypothetical company trying to build markets abroad, Hahn shows how the R&D policy incentives can be vitiated by a combination of concurrent tax restraints: the reduction of depreciation if the R&E credit is employed; the uncertainty over whether Congress will extend the credit's life; the possible application of the alternative minimum tax disallowing the credit; the threat of having to allocate more expense of U.S. performed R&D to foreign source income, thereby raising domestic tax liability; and finally, the extreme complexity of tax code requirements on royalties and Section 482 transfers to foreign subsidiaries. The operation of these tax provisions not uncommonly can cause U.S. companies to refrain from expanding R&D, particularly in the U.S.

Hahn advocates making both the R&D credit and the expense allocation rules permanent, eliminating the basis adjustment for the R&D credit, and reform of Section 482 rules.

As for the AMT, Hahn believes it to be "very poor economic policy" which is going to hurt our future growth. It represents a very real increase in cost for the manufacturing sector, but its impact is not limited to capital intensive industries. The AMT adversely affects companies that need to invest much capital in relation to their profits at any time, particularly younger, entrepreneurial companies. The AMT also exaggerates the business cycle by penalizing companies in recession. The best thing would be to repeal it entirely, but if that is not possible what Hahn describes as the pernicious "phase-in" effect with respect to AMT depreciation should be eliminated.

Hahn describes his proposals as modest nibbling around the edges toward a really pro-growth policy, but he believes that wherever we can make marginal improvements, they should be pursued.

A key thing that I intend to focus on, and what I think needs to be focussed on when you are talking about pro-growth tax strategies, is that we live in a world of global markets. Those markets are particularly going to affect manufacturing industries, but they also will affect services and international finance. That means for the U.S. to have any sort of growth whatsoever in the 1990s, we are going to have to be competitive.

You want our companies to be very innovative and the economy to be very innovative. What do you want to do in that context? Well, you want to go ahead and encourage R&D. You also want to encourage the young, growing companies that tend to push the economy along, and push innovations along. The other thing I think you want to do is make sure that once we have these innovations, we get some benefit from them. In other words, you set up your policies so that, in fact, you can manufacture competitively in the United States and create jobs.

I want to talk about two specific tax code provisions. One is the U.S. tax code and its effect on R&D, and the second is the alternative minimum tax (AMT).

Looking at the tax code and its treatment of R&D, I think the key thing that we want to do in the U.S. is to encourage companies that are going to manufacture here to do more research and development, and hopefully to do that here as well, because there are spin-off values.

Long-Term R&D

One of the key things I think people need to look at is the nature of R&D. I think it is sometimes misunderstood whether it is something that is short term that can be turned on and off, or something that is a longer term process. Think what you have to do in an R&D program. First you have to get the people together. They have to be talented people. You've got to put them together in groups. They've got to get used to one another. Secondly, you have to have a laboratory. This is not something that you can go ahead and just set up in a garage someplace. You have to have facilities. That takes time to put together. Third, a lot of these projects are long term. It is not simply something that you can start and complete in one year. My only point is that it is not something that you can turn on and off that easily. So, if we are going to develop policies to encourage R&D, we need to make sure that they are long term policies and they provide some certainty so that managers of R&D can, in fact, do some planning based on those policies.

For a moment, put yourself in the position of the R&D director. I am going to be tax director, and I am going to tell you a little bit about what the U.S. Internal Revenue Code does to R&D, and whether or not you ought to go ahead and expand in the U.S. and do more in the U.S.

Let's start off with the good news. First of all, you are going to get a tax deduction. That's nice. So, if you spend $100 on R&D, you are going to get to deduct it. That is worth 34 percent, so that is pretty good. It reduces your cost. Does everybody else in the world, our competitors, do the same sort of thing? To the best of my knowledge, they do. There is nobody who denies a tax deduction.

Even better news, we've got a U.S. tax credit for U.S. R&D. How does it work? Well, it is incremental. The credit is equal to 20 percent of your increased effort. So, if you increase your R&D as a percentage of your total sales, over what you had in the period 1984 to 1988, you are going to get a credit of 20 percent of that increased effort. If you are the R&D director, you start doing your sums for a little bit, and you say, R&D is growing at about 10 percent, so that is worth about 5 percent of total R&D. Now you have better than deductibility. You've got 34 percent on deductibility, you've got another 5 percent from the credit per year—not bad. At this point, though, I start looking out the window a little bit because it is not quite that simple.

The Disappearing Deduction

The first thing that happens is I have to explain to the R&D director that when you get the credit, you have to reduce your tax deduction. That takes away one-third of the benefit. So the credit really isn't 20 percent, it is 13.2 percent. And your 5 percent drops to 3 percent and now your advantage is around 37 percent.

Still not bad.

But then I've got to talk to you a little bit more. If you happen to be a young, growing company, you're very likely to be subject to the AMT for a period of time, especially when you are doing an awful lot of research. At that point, I've got to tell you that if you are exposed to the alternative minimum tax, you can't use a research credit at all. Maybe you are willing to take that chance, but now I have to tell you that the credit is going to run out in 1991. However, I believe it is going to be extended. No problem — they've done it almost every year since 1981. They've extended it four times. But in fact, if it is not on the books, and if you are prudent, you aren't going to count on that credit. You can say that it is very nice and you certainly hope to get it, but you are not going to build a research facility based on that. At this point, you might think that at least you got your tax deduction — you are not disadvantaged. But now come some further complications.

It turns out that you are a young, growing company. That's great. You expand overseas, you are selling overseas, and I have to explain to you that the U.S. tax system allows tax credits for the taxes you pay outside the United States. That is great. It avoids double taxation, but it also places a limit on that foreign tax credit. When we go ahead and calculate that limit, we have to allocate certain expenses against it. For a company like our hypothetical company that has excess foreign tax credits, allocating a dollar of expense abroad means that you basically don't get a tax deduction. Guess what? R&D is one of the things that you have to allocate.

Well, that is not good news. The general allocation rule in the regulations is to take 30 percent of your R&D and allocate it to the United States. You get a tax deduction for that. But that remaining 70 percent gets allocated based on your sales. In our hypothetical example, 40 percent of sales are outside the United States; that means 28 percent of the money you spent on R&D cannot be deducted at all. That costs you 9.5 percent. So now, instead of having your 34 percent deduction, you are down to about 24.5 percent. Does anybody else in the world do this sort of thing? No, nobody else does, nor do any companies that I know of in the outside world, our competitors, get less than a full deduction for their R&D expense.

Congress has recognized that and imposed a series of moratoriums on these regulations. The latest rule basically takes 64 percent of your U.S.-conducted R&D and allocates it to the United States, and takes 64 percent of your foreign R&D and allocates it to foreign source income. The rest is split on a gross income or sales basis — whichever helps you the most. But in our hypothetical company, what that means for U.S.-performed R&D is that we are losing about 14.5 percent of our deduction. It is not as good as a full deduction, but we are doing okay. Maybe the research credit will make up for it.

But what about the foreign side? It is a very strange process if you think about it because one of the things that U.S. companies have been criticized for is not going ahead and acting like the Japanese who tend to reach into other countries, look at the good ideas, pull them out and use them.

How does a U.S. company go ahead and get those ideas? Well, they don't send the marketing manager over to Japan. What you need to do is you have to have some people out there doing some research. They have to go ahead and tap into some of the good ideas that are outside the United States. But as U.S. R&D director you are going to have to know that when you do that, and if we want to own the technology that results, you don't get a tax deduction for it. Also, you need to know that particular moratorium on the allocation regulation has not been extended either. So, now things are looking a little grim for you. But you say what the heck, we are going to go ahead. We are disadvantaged but we are more productive. We get better results from our R&D and we are going to invent something good and make up for this disadvantage.

Royalties and Section 482

But at this point, I've got to tell you that, well, that is fine when you use R&D in the U.S., but when you try to transfer it out, you are going to hit some potential problems. Where? Well, in some countries the only way you can exploit this R&D is by going ahead and forming joint ventures. A lot of times we run into things: either the country's particular laws prohibit the payment of royalties, or the particular business deal denies it.

The Internal Revenue Code says that if we don't charge a royalty and don't receive one,

If you look at the overall tax treatment of research and development, you probably feel like picking up your papers, throwing them away, and deciding you don't want to do any R&D in the United States.

we are going to have an imputed royalty, and it's U.S. source income. So, we get taxed here, we get taxed there. The tax rates on a joint venture might be 70 percent. That means we don't participate. Somebody else does. Some foreign competitor goes ahead and participates.

So, as the friendly R&D director, now you are going to say you've got to find a country that allows royalty payments. We will establish a subsidiary there. That is good because, of course, you know that we have more R&D in the United States, 15 percent more, because we have a bigger market. We can afford to spread that cost over a bigger market.

Even there, however, we have a little bit of a problem. We've got the famous Section 482 which requires that when we transfer this business abroad, we charge a royalty, but that royalty has to be commensurate with the income on the intangible, which, of course, is a very tough thing to figure out. That is not so bad. We folks in the tax department will do our best and go ahead. But by the way, if we guess wrong, we get a 40-percent penalty.

So, if you look at the overall treatment of research and development, you probably feel like picking up your papers, throwing them away, walking out and deciding you don't want to do any R&D in the United States. Probably it is just too tough.

Schizophrenic Policy

I would say that right now we have a schizophrenic tax policy toward research and development. It is not doing us any good. At Dow we have looked at to determine where we should be doing research; it is a very close call whether it ought to be done in the United States or not. It depends a lot on things such as the exact amount of credits we might expect, and whether or not this particular moratorium on allocation of expenses exists or doesn't exist.

The problem, as I said before, is that this is a long-term project. When you make decisions, there is a lot of inertia as to R&D planning. You have your labs, you have your people, you have your setup. Once you decide that a location is not good and that now you are going somewhere else, or you decide you can't undertake the R&D at all because it is just too expensive, that is not an easily reversible decision.

So, I would suggest that we need to take a good look at our policy. It has aspects that both promote and punish R&D. We ought to get one unified policy. I would suggest that first we ought to make the research credit permanent. A key thing we ought to do is leave it at 20

The AMT is going to punish companies that invest a lot of capital in relation to their profits.

percent; that's fine, but give us the full amount. Don't reduce the deduction. Make it worth something so that it has an incentive effect on people.

Second, we need to make the allocation permanent. If you'll allow me to dream for moment, I would say that the proper thing to do is allocate all research and expense in the United States to U.S. source income so we get a full deduction. We would do at least as well as our competitors. But, when we've looked at it, a proper economic result would occur for Dow, at least, if we could allocate about 67 percent directly to U.S. source and the remainder on a sales basis. We would get what really reflects the relationship between research and our various sales.

Finally, I think they ought to go ahead and switch over to using international norms for pricing. That would take some of the uncertainty out of it.

AMT

I would like to switch subjects and talk about the alternative minimum tax. This is another policy which I think doesn't make a great deal of sense. I think it is going to hurt our growth tremendously in the future. It is a very poor economic policy for a number of reasons. First of all, if you look at the preferences that are there, they relate mostly to manufacturing — depreciation, LIFO inventories — that sort of thing. So, you can make a case that the AMT is really an increase in costs on the manufacturing sector. As I said before, this is the sector that is going to face the toughest international competition, where the battle is going to be fought to a great extent.

The AMT is often looked at as hurting capital intensive industries. You can feel one way or another about that, but the statement is a little overly broad. More accurately, the AMT is going to punish companies that invest a lot of capital in relation to their profits. There are two categories of companies that fall into that group. The first category is capital intensive companies with low profit margins.

The second group is even more worrisome — young entrepreneur-type companies. These companies are also going to be spending a tremendous amount on capital and equipment, even if they aren't capital intensive, because they are growing so fast. Their ratio of capital expenditures to profit is going to be very high, and they are likely to fall into the alternative minimum tax which is precisely the opposite of what the policy should be.

Third, the AMT is a very pro-cyclical type of policy. It makes some sense from a tax design standpoint, and no sense whatsoever from an economic standpoint. What happens when times are tough? You are in a recession, you don't have cash, you aren't making money, and they take away more with a minimum tax. When you recover from that, you are making lots of money, you have lots of cash, and they give it back to you. This is a backwards economic policy.

Phase-in Effect Pernicious

Finally, I think there is a very pernicious effect. I don't know if it was intended or not, but there is a major phase-in effect that people seem to have overlooked with respect to depreciation under AMT. Regular tax depreciation exceeds alternative minimum tax depreciation for the first five years, then reverses. This tends to increase preferences that throw you into alternative minimum tax in the first five years, and then after that, you get negative preferences which tend to take you out.

The key point here is when we enacted the minimum tax, we started with 1987 assets. So, what happens to your preferences? In 1987, you had the preference amount that is shown in year zero because you just have one year of assets. Then, in 1988, you have the 1987 assets which are now in year two, and the 1988 assets which are in year one, so the preferences are additive, and so on for the first five years. After five years, you start getting some negative pref-

The AMT is a very pro-cyclical type of policy. It makes some sense from a tax design standpoint, and no sense whatsoever from an economic standpoint.

erences which tend to bring the whole thing down.

So, we have this phase-in effect, and solely because of that, we are putting companies into the alternative minimum tax position right in the midst of a recession. I think that is going to be dangerous. I would suggest the best thing would be to go ahead and repeal the alternative minimum tax. At least, we ought to try to eliminate the phase-in.

Those are some very modest proposals. They aren't as broad as other people might advocate, but I think they are, nonetheless, necessary.

Congressman Richard T. Schulze

Congressman Schulze (R-PA) describes his bold proposal for a uniform business tax (UBT) to replace entirely the federal income taxes on corporate and noncorporate businesses, a proposal that shortly will be introduced in Congress with bi-partisan support. Under the proposal, the UBT would be a 9 percent flat tax on business receipts, net of purchases of goods and services, including capital expenditures. The tax would be imposed on imports and rebated on exports. Following the territorial principle, no tax would be imposed on foreign operations of U.S. businesses. Because of its broader base, the UBT also would replace the employer share of payroll taxes. According to Congressman Schulze, the plan would be revenue neutral with respect to present taxes on U.S. businesses but would yield approximately $60 billion a year in additional revenues from imposing the tax on imports.

Schulze stresses that his program is not a European value-added tax or a "consumption tax" although the base of the UBT is basically the same as a subtraction-type VAT. The principal advantages that Schulze sees for the UBT are: 1) eliminating the administrative inefficiency of the present corporate income tax, said to cost as much as 66 percent of its yield; 2) lowering the cost of capital for U.S. businesses through expensing of capital investment; and 3) making the U.S. more competitive abroad by adoption of territorial principles of taxation.

Congressman Schulze places great emphasis on international implications, expecting a positive response from the U.S. business community to more trade and investment opportunities as a result of the UBT program.

In response to questions, Congressman Schulze maintains that his proposal is not a consumption-type VAT because a large part of its incidence will continue to be borne by the business sector. He also maintains that the UBT is "GATT-legal," and that it would be acceptable under the general agreement on tariffs and trade to be imposed on imports and rebated on exports.

Your seminar is not only especially interesting, but "Rebuilding the U.S. Industrial Base: The Role of Tax Policy and Economic Growth" — what could be more timely? In our history, if you step back and look at where we are and what is happening in the world, I can think of no topic more pertinent than that which you are addressing here.

We all know there is a crying need for simplicity. The NAM study last year showed that in 1983, the corporate income tax cost corporate America $.66 for every dollar of tax that it produced — that $.66 was spent in accounting and bookkeeping and generating the tax. It is extremely inefficient. If we would just wipe out the corporate income tax, we would make American business more efficient by at least $60 billion, and perhaps as much as $80 billion a year, because since 1983, we have had OBRA and COBRA and DEFRA and TEFRA and the whole alphabet soup of tax reform. Consequently, there are estimates all over the place of what the business community's cost per dollar is. But whatever it is, I think it is relatively high, as that study did show. We can make American businesses more efficient and if we do, we will make them more competitive.

I look into the 1990s and the turn of the century and say, what kind of business community do we want. I realize that there are those who say that what we do in the tax code does not affect behavior. But I am not one of those. I think that what we do definitely affects behavior, and so it is incumbent upon us to sit down and ask ourselves what kind of business community we want, how we get there, how we stimulate it, how we aid it, how we push it to do the things which we need to do without having big daddy government sitting on every corporate board. It seems to me that we do that now through the tax code with a series of rewards and/or shocks or punishments or fines. But we need simplicity.

The American business community, through the 1990s and past the turn of the century, is going to be more deeply involved with international trade than ever before. I don't think anybody disagrees with that. The future of jobs and employment in the United States of America depends on what we are going to do as an exporting nation. If we sit down and look at the kind of America we want, I am inclined to think we do not want to be servicemen to the world only; that we do want to be a full, well-rounded nation, producing, developing, manufacturing, selling goods which we manufacture all around the world — everything, in my opinion, from chairs and tables and desks and glasses, to automobiles and locomotives and heavy equipment. We want to have an American business community that is oriented toward trade and we want a tax code that will at least go toward some form of level playing field in the international arena.

But look at EC'92, what's developing in the United States with the North American trade zone, and the Pacific Basin. We know that we have to be ready to compete in a very tough, competitive world. We've got to try to encourage business to be competitive.

The studies show that the cost of capital has increased by some 80 percent or more in the last decade. If we are going to be a manufacturing, producing, exciting, dramatic nation, we've got to lower the cost of capital.

The Ways and Means Oversight Subcommittee on which I sit has been holding some hearings on transfer pricing. It is a problem. If we just step back and look at the statistics, there is a problem. But, how to solve it is another question. I had lunch with the Tax Court a couple of weeks ago and they said, "Congressman, try not to force us to make judicial decisions in areas where business motives may have created what is viewed as a problem." It is not always simple for them to clearly and adequately describe transfer pricing. But, when we look at the overall figures, we know there is a problem. So that is an area that we should hopefully get to without micro-managing it.

There have been a lot of complaints about non-economic or infeasible leveraged buy-outs, mergers, and acquisitions. There have even been some horror stories of their causing catastrophe, failure, and bankruptcy. There is a great feeling in Congress and in the body politic that we should do something about LBOs, and I share the concern. But I don't want to be policeman to corporate America, and I don't know of anyone else who has the intelligence and the ability to do so. And I don't think the government should say to somebody else, go ahead and do that. So, there must be a way that we can sort of nudge people in the right direction.

The studies show that the cost of capital has increased by some 80 percent or more in the last decade. If we are going to be a manufacturing, producing, exciting, dramatic nation, we've got to lower the cost of capital.

UBT, The Answer

The Uniform Business Tax (UBT), we think, answers, solves, or goes in the direction of solving all of those policy questions that I have just laid out. It is the height of simplicity. We have one 8 1/2 x 11 sheet, this is the tax form for the UBT, and it would be the tax form for everybody from the corner hardware store to General Motors and Chrysler. Maybe that is why Chrysler endorsed it, because they liked the tax form. Just think how easy it would be to have almost any of the vice presidents of corporations sit down and in a matter of a couple hours fill out that tax form. Efficient, slim, trim, mean — that's what we want and I think we can accomplish that.

As for the cost of capital, under the UBT we give immediate expensing on every capital expense. There are people who think the American business community just sits out there devising methods to avoid or evade taxes. If that is true — I don't think it is true — but if it is true, the way they are going to avoid taxes under this is to modernize, buy new equipment and new machinery, and make themselves more efficient, more productive, and more able to produce better goods at lower prices.

The UBT would involve a significant broadening of the tax base and a lowering of the tax rate. We end up with about a 9 percent rate. All we are trying to do is replace that $110 billion we now get from the corporate income tax. The preliminary figures tell us that somewhere between 8 and 10 percent will do it. So we are using 9 percent; it might be 8.6 or 9.2 percent, but somewhere in that range.

As we broaden the base and flatten the rate, the UBT also acts as a territorial tax and there is a border tax applied. So, if a company is deliberately increasing its price as it sends products across our border, in order to enhance profits at its home base, it is going to pay more for it. This will help solve the transfer pricing problem and help the Tax Court out of its dilemma.

The border application of the tax will have trade ramifications. Every one of our major trading partners has some form of border taxes. Most of them are VATs, and most of them are higher than 9 percent, but in this instance, we will collect it as it comes across the border, and we have a line on the UBT form subtracting export sales and foreign income receipts. So, it is just subtracted from the gross.

Thus, for a proposal to rebuild the industrial base of America, to create growth in an increasingly competitive world, we think the UBT answers most of those policy questions.

What we want is to develop a tax policy that will rebuild the industrial base of America, and will guide us into the new century as a lean, mean, dynamic economy that is willing to take on the rest of the world and beat them at their own game.

Are we presenting this as if everybody should stand up and say hosanna? No. This is going to be a slow year in the Ways and Means Committee. It is an ideal time to discuss such things so that we can talk about them in a calm, deliberative fashion. I don't want to sew land mines down the tax path of the business community of the United States of America and have someone find something important a year after this is enacted that we hadn't foreseen. What I am asking the business community, as I go around the country, is to look at it, crunch the numbers, see what it does to you or for you. See if there is a way that we can modify it to make it better. I am also coining a phrase that I don't really want to go too far, but we are really talking about economic patriotism. Let me tell you what I mean by that.

Economic Patriotism

Let's say it does cost you a million dollars a year more under this proposal, but it makes your customers much more viable. It creates a larger market for them and eventually it is going to help you. What I am asking is that you don't just look at the bottom line this minute, this week, this day, this month. Take a good look at this and ask what it is going to do for America, and what your role in America is. Are we really trying to accomplish policy goals which will fulfill the destiny of our nation? If we are, let's help support it. If not, stand up and say, "Whoa! This thing is a problem because of a, b and c." You will find us receptive. We are not trying to cram this thing down anybody's throat. In fact, if you ask me the preferred method of garnering support, it is going to be that those of you from out across the country will talk to colleagues in your city or your town or your area, and have them crunch the numbers and have them tell their representatives in Congress and tell them why they like or dislike it. We need and want your input.

The bill has not yet been introduced. We have a little more than 20 people who have said they want to co-sponsor it when we get it into legislative form. We are working on that right now. We hope to introduce it within the next two weeks or so. Even at that point, it is certainly not written on tablets of stone. We want and need your input into this as it develops. What we want is to develop a tax policy that will rebuild the industrial base of America, and will guide us into the new century as a lean, mean, dynamic economy that is willing to take on the rest of the world and beat them at their own game.

SESSION TWO

Are U.S. Tax Policies Impeding Transborder Investment?

Moderator: Catherine Porter
Partner
Miller & Chevalier

Edmund K. Harding
Manager, Tax Planning & Litigation
Xerox Corporation

Alan J. Lipner
Senior Vice President - Corporate Taxes
American Express Company

Marlin Risinger
Associate International Tax Counsel
Department of Treasury

George N. Carlson
Director of the Economic Analysis Group
Arthur Andersen & Company

Catherine Porter

On this panel, our business representatives will talk about specific ideas or problems that they have encountered while competing in the global economy. Then the Treasury and the accounting sector will respond. What we are focussing on today are tax issues. Obviously, it is sometimes hard to ignore trade issues and other government policies that might impede the competitiveness of American industry, but today we are concentrating on tax policy.

Edmund K. Harding

Harding outlines a growing tax problem facing a U.S. multinational firm wanting to streamline its overseas operations in the EC to take advantage of the single market coming in 1992. The problem stems from the 1986 Tax Reform Act's revision of Subpart F rules subjecting more intercompany transactions to current U.S. taxation, even when they are in high-tax countries and where there is no question of U.S. tax avoidance. This applies in particular to companies such as Xerox, who do not have excess foreign tax credits and whose assets' mix make them vulnerable to Subpart F depreciation restrictions. The result has been to frustrate market-based plans to centralize operating functions in the EC, which would be far more efficient than maintaining separate companies in each country. While the specific problem is most pertinent to Xerox's situation, it is a good example of the counterproductive tax policy affecting U.S. international business.

Harding describes Xerox's effort to seek legislative redress. It received a sympathetic reaction in the House Ways and Means Committee for a

proposal to define the EC as a single country for purposes of computing foreign-based company sales and service income under Subpart F rules. But the U.S. Treasury was quite negative even though the proposal would be limited to EC countries with a maximum tax rate equal to or greater than 90 percent of the U.S. rate and don't allow such income a tax holiday. Harding maintains that this should have minimal revenue consequence to the U.S. Treasury, and it might be positive by increasing the competitiveness and productivity of the U.S. multinationals involved. The Treasury, however, initially assumed a large revenue loss based on a shift of U.S. manufacturing and/or marketing to the EC, which Harding says would not happen. Xerox has attempted to refine the legislative proposal with further safeguards to satisfy Treasury, but to date the official position remains negative.

Harding maintains that our major competition, including the Japanese, have already restructured to take advantage of market realities in the united Europe and that "we must make similar adjustments now, in order to remain a player."

My objective today is to lay out for you in general terms a problem in the so-called Subpart F rules, how it has specifically inhibited Xerox's ability to meet the competitive challenge in EC 92, and explain what we are attempting to do about it.

Under the Tax Reform Act of 1986, income from inter-company transactions involving production by company A in one country, warehousing by country B in a second, and sales by company C in a third, subjects the income of the sale from B to C to immediate U.S. taxation under the Subpart F rules, even though no cash flows to the United States. An exception to this rule is where such income is subject to an effective foreign income tax rate equal to or greater than 90 percent of the maximum U.S. tax rate.

Prior to the 1986 Tax Act, such transactions were not subject to U.S. tax under the so-called Subpart F rules, when neither the creation of the foreign corporation nor the transaction itself were designed to avoid U.S. tax.

One might question the application of the rule to purely foreign transactions, since stringent Section 482 transfer pricing rules police the U.S.-to-foreign unit sales. That is, why should the U.S. be concerned with any further transactions outside its territorial limits when it has already gotten its fair share? The response, as I understand it from at least some in Treasury, is that we should be the leader in international tax morality. That makes you want to stand up and salute, doesn't it?

However, since most U.S. multinationals can and do have separate companies in each country for a variety of reasons, one could question why shipments can't be made directly from the country of manufacture to the country of sale to avoid the Subpart F rules. My reply is, "How do you think Honda would do against Ford and GM in the U.S. if Japanese tax law required that it create separate companies in each state, with each forced to maintain separate inventory, distribution systems, and the like for cars and parts imported from Japan?"

If you think they wouldn't be that dumb, I agree. But that is exactly where Xerox will be in the European community, vis-a-vis our non-U.S. competitors under the current U.S. tax law.

One Country Approach

The simplest way to fix this problem would be to define the 12-country European community, or EC as it is commonly known, as one country for purposes of computing foreign-based company sales and service income under the Subpart F rules. This simple and direct approach would level the EC playing field by giving U.S. multinationals the same structural options as their non-U.S. competitors.

But wouldn't it also open a loop hole, enabling tax-driven restructuring? That is a legitimate concern which should be addressed by limiting the application of any such change to EC countries that have a maximum statutory tax rate greater than 90 percent of the U.S. rate and don't exempt foreign-based company sales or service income from taxation under a tax holiday.

How do you think Honda would do against Ford and GM in the U.S. if Japanese tax law required that it create separate companies in each state with each forced to maintain separate inventory, distribution systems, and the like for cars and parts imported from Japan? ... That is exactly where we will be in the European community, vis-a-vis our non-U.S. competitors under the current U.S. tax law.

Who is going to pick up the tab? Well, revenue estimating isn't my specialty, but on this one, it doesn't take a rocket scientist to know intuitively that there wouldn't be much revenue involved. First, the rules governing foreign-based income don't generate much revenue anyway, and they are expensive to administer. Moreover, taxpayers like Xerox can and do avoid their application by complex and less efficient structures, where the cost of such inefficiency is at least less than the tax.

What we have then with our proposal should be pretty much a zero sum game that might even operate to increase U.S. revenue by increasing the competitiveness, and hopefully the profitability, of U.S. multinationals.

For the sake of discussion, let's assume I've convinced you that this isn't a bad idea. You might still legitimately say that it doesn't have a chance in hell, given the history of foreign source income treatment. Let's face it, the Subpart F rules have been around for almost 30 years. And over that period, they have been consistently made tougher, not easier. We know too that all but true tax "techies" have pretty much given up trying to understand any tax in the international arena. Eyes tend to glaze over when you begin talking about foreign source income and credits and Subpart F. Going to Treasury for help on a foreign issue might be fun for a masochist, but most reasonably sane people find it a pretty depressing experience.

Back in the 1960s, when Subpart F was first introduced, the U.S. was the leading export nation and the dominant international military and economic force. But because overseas investments by U.S.-based multinationals were perceived as creating potential political balance-of-payment problems, Treasury, in its wisdom, came up with Subpart F. Today, we are the leading debtor nation and are facing pretty fierce competition in world markets from Japanese and European multinationals. Further, most also agree that EC-based multinationals will be even more competitive after Europe 1992. Thus, when it is now clear that world leadership depends on economic rather than military strength, we are no longer clearly the leader.

On the tax side, most practitioners are ready to acknowledge that there is no way to effectively do all that is required under the complex compliance requirements, even though we are all spending lots of money and making a tremendous effort attempting to do so. Even many in the IRS admit that it will not be possible for them to audit the anticipated widespread non-compliance, both intentional and inadvertent, caused by the new provisions. There is also a growing concern on the part of some knowledgeable Ways and Means and Senate Finance Committee members that the foreign income provisions are not only too complex, but also too harsh on U.S. companies. As a result, meaningful hearings have been conducted with indications of even more proactive steps by Congress. In short, I think that the time for change is ripe.

Xerox Interest

The next question some of you might have is why Xerox is interested. We operate in Europe through Rank Xerox Company, Ltd., a U.K. corporation that is 49 percent owned by our British partner, the Rank Organization. Rank Xerox, in turn, has subsidiary companies in each of the 12 members of the European community. They were put into place in order to provide a corporate presence, when that was important; some manufacturing, re-manufacturing, assembly and warehousing, servicing, sales marketing and the like are performed in each country. Most of our own Xerox equipment is still manufactured in Webster, New York for shipment to the various European operations.

As we have grown, our private base has become more complex, making the current structure pretty cumbersome. For example, the maintenance of equipment sold at least within the EC requires an inventory of more than 120,000 different spare parts, making the centralization of inventory and a move toward "just-in-time" delivery of needed parts vital to our success.

Changing an established structure is easier said than done, but Rank Xerox recently finalized plans to streamline its European set-up to centralize many operational functions and prepare for the more competitive environment of the emerging single market. Enter the bloody tax fools from U.S. headquarters who halted the restructuring in order to analyze the Subpart F tax implications.

We at Xerox, like a lot of other U.S. multinationals, view the European community as a major growth market for the 1990s. The ability to reinvest foreign earnings to capitalize on this opportunity, free from the penalties of Subpart F, is therefore critical. Thus, we were as disappointed as our British colleagues when we found the suggested streamlining of operations to have many potential Subpart F problems, including: that sales from the U.S. through the U.K. to the rest of Europe would trigger the base company sales rules; that purchases of equipment from an operation in one country for refurbishing at a central services/remanufacturing facility in the second and resale to a third European country could also violate the base company rules; and that centralizing inventory would often trigger cross-border transactions subject to Subpart F.

As I mentioned earlier, prior to the Tax Reform Act of 1986, the desired restructuring of our European operations wouldn't have triggered any Subpart F problems, since it would not have been "formed or availed of" to avoid U.S. taxation. Moreover, the countries in which Rank Xerox operates within the EC have a high statutory tax rate, and neither it nor its subsidiaries manufacture in Ireland or otherwise avail themselves of tax holiday opportunities.

As some of you may know, there is also a 90 percent high-tax exception to the Subpart F rules now, but this doesn't provide effective and predictable protection in cases such as ours, because our asset base is heavily weighted toward short-lived assets. I should mention at this point that in order to determine whether a firm has a Subpart F problem, its foreign operations must recompute their income using U.S. tax rules. At any rate, the difference between the actual foreign depreciation and that allowed under Subpart F is so significant in our case that it makes meeting this test very difficult. The silliness of the requirement is such that some U.S. companies paying taxes at the full 34 percent statutory rate wouldn't make the 90 percent test even in the U.S. if their taxable income were recomputed using the Subpart F depreciation rules. Moreover, U.S. multinationals that want to consolidate their EC operations in a single EC country are unable to use accumulated losses attributable to non-

Subpart F activities in calculating the effective tax rate for purposes of meeting the high-tax exception.

The technical tax rules and resulting problems are actually a little more complicated than the gobbledygook that I've just tried to describe, and believe me, they are real for some of us. While, in theory, the problems of the current 90 percent test impact all U.S. manufacturing companies, many are currently in an excess credit position and are not adversely affected by the current taxation of Subpart F income, since the tax on such income can be offset with otherwise unused credits. Others, particularly the computer manufacturers who have a more generous Subpart F depreciation rule, do not get whipsawed by the timing differences. But for us, and some other corporations which are neither in an excess credit position nor have the advantage of a special alternative depreciation rule, the potential Subpart F costs exceed the costs of inefficiency built into our current European structure.

Legislative Effort

That brings me to how we are attempting to rectify the difficulty. In January 1990, we testified at the Ways and Means EC'92 hearings, proposing that the Subpart F rules be modified to treat the EC as one country for purposes of the sales and services test. As mentioned earlier, we explained that this would allow for the development of a corporate structure within the EC to maximize efficiency in everything from manufacturing to warehousing to invoicing. To protect against any "low-tax" country abuses, we suggested this rule only apply to EC countries maintaining statutory corporate tax rates equal to or greater than 90 percent of the U.S. rate, and where the income in question did not benefit from a tax holiday or similar special rule. This concept generated a lot of interest and questions from the members at the hearing and also was endorsed by several other witnesses.

After the hearing, Chairman Rostenkowski wrote Treasury asking for its views on treating the EC as one country for Subpart F purposes. Subsequently, the chairman of the Trade Subcommittee, Mr. Gibbons, along with nine other members of the full committee, introduced H.R. 4136, laying out the limited one-country approach. The proposed legislation was also supported by a number of trade associations.

Treasury responded to Rostenkowski's request with a letter that can only be described as negative. It included a revenue estimate that was startling, in that it projected a revenue loss for this one very limited change larger than the cumulative effect of all Subpart F changes that were included in the 1986 Act. In fairness to Treasury, it is clear that the estimate was based on the general concept outlined in the Chairman's letter, and did not take into account the restrictions included in the subsequently introduced Gibbons bill. However, we understand the estimate assumed virtually no negative revenue impact from companies like Xerox already operating within the EC. Rather, it assumed a significant shift of U.S.-based manufacturing and/or marketing operations from the U.S. into the EC to take advantage of the anticipated "low-tax" opportunities.

Such an assumption ignores the fact that under current law, U.S. manufacturers so inclined can even now move production to Ireland and then sell into Europe at low Irish tax rates, free from Subpart F. On the marketing side, Treasury's assumptions ignore the current European corporate tax rate structure, and must assume that the U.S. and the EC tax authorities will ignore inter-company pricing standards.

Well, as you might imagine, this letter prompted a long series of meetings and telephone conversations with Treasury. We entered these meetings with several goals: to communicate our business problems openly and candidly; to understand the nature of the concerns and the assumptions used to generate the revenue estimate; and to seek out common ground on a possible solution.

From our perspective, the meetings, which took place over six months, were disappointing. As it now stands, Treasury continues to be opposed to the one-country concept, fearing pockets of low- or no-tax opportunities within the EC. While we don't share this concern, we worked with them to see if an alternative solution to the problem might be possible.

For example, we have explored whether an 80 percent standard, rather than the current 90 percent exception, would help to address legitimate problems generated by depreciation and other timing differences in high-tax jurisdictions. As to the difficulty created by net operating losses under the tax rules of the foreign country, the situation is less clear. As we understand it, our Treasury staff feels that the present rules should be sufficient to allow for the use of foreign country NOLs without triggering Subpart F tax. In fact, there was much confusion as to how a corporation could have income for U.S. tax purposes, and yet a loss in the U.K. The answer in our case is that dividends received in the U.K. from other lower tier European subsidiaries typically bring with them full foreign tax credits. These dividends increase earnings and profits for U.S. tax purposes but don't reduce the U.K. tax loss because of the foreign tax credits. Finally, we understand Treasury has reservations about limiting any Subpart F change to one geographic region, such as the EC.

Our major competitors, including the Japanese, have already restructured to take advantage of the realities of united Europe. We must make similar adjustments now in order to remain a player.

In response to some of these concerns, Mr. Gibbons introduced a revised version of the legislation, H.R. 2277. This lowers the 90 percent test to 80 percent and allows the NOLs earned prior to the date of enactment of this legislation to be factored into the calculation. In the spirit of the EC effort, the proposal is limited to countries included in the single market. A similar bill will be introduced in the Senate.

As to cost, Mr. Gibbons has written a letter to the Joint Committee outlining this new approach and requesting a new revenue estimate. In introducing the revised bill, Mr. Gibbons has tried to be sensitive to the Treasury's concerns, while crafting a solution to the legitimate concerns raised by U.S. companies. The new bill remedies the immediate problem for companies like Xerox, yet it does so in a manner that we recognize remains complex and requires corporations to continue to test the movement of all assets within the EC for Subpart F purposes. In considering the issue in the context of this year's legislative effort to simplify certain aspects of the U.S. tax treatment of foreign source income, we hope the staff will take a fresh look at both approaches to this problem from a positive perspective, as well as from technical and revenue perspectives.

We believe that real simplification in this area of the tax law would provide an immediate benefit for U.S. corporations by allowing them to take full advantage of the dynamics of the single market. As it now stands, our current structure makes little economic sense in today's environment. Our partner is frustrated with the delays in streamlining its operations due to the application of U.S. laws to non-U.S. activities. Our major European customers are frustrated by dealing with so many legal entities and want us to provide the efficiencies of scale that the single market is intended to generate. For example, as our customers centralize their own European operations, they will want to deal with one Xerox relative to billing, service and other day-to-day contacts. If we can't accommodate them, they will go to our competitors who can. Our major competitors, including the Japanese, have already restructured to take advantage of the realities of a united Europe. We must make similar adjustments now in order to remain a player.

Indeed, in our opinion, the time for change is here.

Alan J. Lipner

Lipner describes another adverse impact of the Tax Reform Act of 1986 — this one on the financial services industry — which was swept under Subpart F rules subjecting U.S.-controlled foreign companies in banking, finance or insurance to current taxation. He uses as an example American Express' 1983 purchase of the fourth largest bank of Switzerland, based on an effective tax rate of 10 percent in Switzerland, with no U.S. tax until dividends were repatriated. The 1986 Act provision caused an incremental U.S. tax burden of 24 percent even though the Swiss banking subsidiary had no U.S. investment and dealt only with non-U.S. citizens. As a result, the bank was sold in 1989 because the planned return on investment just was not there. Lipner avers that the U.S. is probably the only industrialized country in the world that would tax a foreign investment in such an unproductive manner.

Another example Lipner cites is American Express' attempt to participate in the common market through the purchase of a large life insurance company in the United Kingdom. Because of Subpart F provisions and their application to insurance reserves, the U.S. tax burden would have amounted to 300 percent of the company's net income. "Needless to say, we did not make the acquisition." Instead, the company was acquired by a Dutch insurance company which did not face the problem. Lipner says that while the Treasury and Joint Committee on Taxation staffs understand the nature of the problems, the Treasury feels "handcuffed" and the Joint Committee does not seem to care whether or not U.S. companies participate in the insurance business in Europe.

Everyone thinks of American Express, the charge card, but we also have quite a few other businesses. We own a large bank that is only permitted to do business outside the United States. We own some non-bank banks in the United States. We own quite a few life insurance companies both within the United States and outside the U.S. We also provide various types of processing services and we also own a company that does financial planning for individuals. That is just a smattering of our businesses.

Many of these businesses are overseas. One of our banks operates exclusively outside the United States, yet we have run into the provisions of the Tax Reform Act of 1986 that are both unfair and complex. For the most part, we are able to deal with the complexity because we have a large group of tax people throughout the company, approaching 200. What a smaller company does in dealing with business outside the United States, God only knows. I would like to show you some ways that the 1986 Act has been unfair to financial services companies.

Let's go back before 1962 for a second. The general rule was that a U.S. taxpayer was taxable on worldwide income. This applied both to individuals and U.S. corporations. But if a U.S. corporation owned a foreign subsidiary, that company's income was not subject to tax until brought back to the United States. That was the general rule.

In 1962, under the Kennedy Administration, Professor Stanley Surrey, who was then Assistant Secretary of Treasury, got the law changed. What was put into the law in 1962 was a section called Subpart F. That section, in effect, subjected to current taxation income of foreign subsidiaries considered to be tax haven income. Wisely, the government exempted from current taxation foreign true manufacturing income and also the income earned by foreign companies owned by U.S. companies in the active conduct of banking, finance and insurance business.

The complexity, for the most part, we are able to deal with because we have a large group of tax people throughout the company, approaching 200. What the smaller company does in dealing with business outside the United States, God only knows.

In 1986, the rule as to banking, financing and insurance business was changed. As explained to me by some Members on the Hill, they would have liked to have ended all deferral with respect to taxation of income of controlled foreign subsidiaries of U.S. companies. But the Joint Committee felt that they didn't have the clout to do it, and the weak link was the banking industry. So, in 1986 they repealed what is called deferral of U.S. tax on foreign income earned by foreign companies, controlled by U.S. companies, in the banking, finance, and insurance area. In fact, the insurance area was not even discussed initially. It was slipped in to the 1986 bill at the very last minute.

So, we now have income earned in the pursuit of banking, finance, and insurance by companies owned and controlled by U.S. companies subject to current U.S. tax. I would like to explain to you how that is unfair and how it has affected American Express in the international arena. Have U.S. tax policies impeded transborder investment? The answer is "yes."

Tax-Forced Sale in Switzerland

Let me give you two examples. In 1983, we purchased the fourth largest bank in Switzerland. The bank paid approximately an effective tax rate of 10 percent in Switzerland. We spent hundreds of millions of dollars to acquire this bank, and we knew what our return on investment should be and what the tax would be: 10 percent there and no U.S. tax until we brought back dividends. In fact, the plan was to keep expanding overseas and not bring back dividends during the period of growth.

This Swiss bank dealt with only non-U.S. citizens, and had no U.S. investments. All of its investments were outside the U.S. All of its clients were outside of the U.S. It paid a 10 percent Swiss tax rate effectively. But after 1986, we found ourselves having to pay the difference between the U.S and the Swiss tax rates because all the earnings of the Swiss company were subjected to U.S. tax at the 34 percent rate, less 10 percent Swiss tax. Incrementally, then, we had to pay approximately 24 percent additional tax in the U.S. on the Swiss company's income.

We sold this company in 1989 because our planned return on investment was just not there — we couldn't run this business profitably. There is one real-life example of what the U.S. tax law does to a U.S. multinational company. I think we are probably the only industrialized country in the world right now that would tax a controlled foreign company in this manner.

Tax-Foiled Entry to the E.C.

Let me give you another example of how the U.S. tax law has affected our investment overseas. A couple years ago we had decided we wanted to own a life insurance company in the common market. We looked at a U.K. company, a large U.K. life insurance company that was up for sale. We diligently started to investigate how the U.S. tax rules would affect this company. And when we did our calculations we found that the company paid virtually no tax in the United Kingdom. However, after going through all of the U.S. tax rules, we found that the effective U.S. tax rate on this company's profits would have been 300 percent of the company's profits — again basically because of the 1986 tax law.

The U.S. law now says that all of the company's income has to be translated in accordance with U.S. tax rules. The life insurance industry was started, by the way, in Scotland, but under U.S. rules, none of the policies sold outside the U.S. qualify as insurance. Therefore, all the insurance reserves that the U.K. company had set up were not considered good tax deductions in the U.S. So the company's income was, from a U.S. tax standpoint, substantially larger than the company's real income. That created a 34 percent tax on fictitious income, and therefore we were faced, in this particular proposed acquisition, with a 300 percent tax on the company's net income. Needless to say, we did not make the acquisition. The company subsequently was acquired by a Dutch insurance company.

This was to have been our entry into the common market. What we decided to do was to start an insurance company ourselves in England in a smaller way, and we've been now knocking on the doors of the Joint Committee, Treasury, and Members of both the Senate and the House, trying to get someone to recognize this as a problem for U.S. insurance companies in Europe. So far, this has been done to no avail. People either look at us in disbelief when we tell them there is a 300 percent U.S. tax on U.S.-controlled insurance companies in Europe, or they just don't understand what we are talking about.

The Joint Committee does understand what we are talking about. The Treasury does too, but Treasury feels hand-cuffed. The Joint Committee, for the most part, is unsympathetic and really could not care less whether U.S. investment includes insurance companies in Europe. So that is my tale of woe.

I read recently where a very large U.S. bank sold off 51 percent of its main subsidiary in Europe; 51 percent, of course, would mean that it is outside of the U.S.-controlled Subpart F area, and this would mean that its subsidiary would not be subject to tax. I am told by people at that bank that the U.S. tax law was the reason they did sell off 51 percent; so other insurance and banking companies are having difficulty with the law.

Being competitive overseas means paying no greater tax on overseas profits than your foreign competitors. Requiring U.S. companies to pay 2, 3, even 10 times as much tax is creating a terrible problem.

Marlin Risinger

Risinger defends the Treasury position with respect to Subpart F provisions that were attacked by Edmund Harding and Alan Lipner. He says that all such problems should be considered less severe now in the context of significantly lower statutory rates of corporate income tax. As to the EC one-country proposal, Risinger questions why it should be adopted there and not elsewhere. This could complicate relations with other countries. He also questions the use of statutory rates of tax in the EC as a safeguard against tax haven opportunities because some countries with high statutory rates have other provisions lowering the effective rate of tax. However, Risinger does recognize problems that U.S. multinationals have with accounting rule differences between the U.S. and foreign jurisdictions and says the Treasury has not "shut the door" on proposals to change the threshold of the Subpart F exclusion from 90 percent to a lower figure.

Risinger says that income from financial services is under Subpart F because the business is regarded as "highly portable" and easy to put in low-tax jurisdictions. He claims that since most multinationals have excess foreign tax credits now, Subpart F should not be a widespread concern, and that Subpart F continues to cause problems only "in pockets."

Risinger comments on a number of tax simplification issues in the international field, including allied deferral rules, the number of foreign tax credit baskets per return, translation of foreign taxes under section 986, possible use of GATT to compute earnings and profits of foreign subsidiaries, and regulations on reorganizations/restructurings of foreign subsidiaries in general.

We at Treasury are not going to support the all-out repeal of Subpart F which is, I think, the gist of some of what was said earlier. In general, we still strongly support Subpart F. We think it is the right policy.

I am a little surprised that Subpart F continues to be such a controversial set of rules since we lowered our tax rate to 34 percent in 1986. We are talking about people who are paying less than 34 percent in tax. I think this would have been regarded as a pretty good deal ten years ago. Apparently, it is not a good enough deal.

In terms of revenue, if we were to repeal deferral totally, the most recent tax expenditure in our budget analysis said that we would gain only about $200 million. There is not a whole lot of money in deferral generally anymore because we have lowered our tax rate so significantly.

Let me turn to some of the specifics that were mentioned. Ed Harding talked a lot about the one-country EC'92 proposal. We haven't taken any formal positions on any legislation that may be introduced this year, and so these have to be understood as only general remarks. We will have to develop and then clear Administration positions on particular proposals. But it is not entirely clear why the EC one-country proposal is right for the European community and not right for everywhere.

One of the problems is that if you start saying that you can treat a bunch of countries as one country for purposes of Subpart F, you are on a pretty slippery slope. There are a lot of other areas of the world where people would argue that there are common economic interests and regional concerns for grouping of countries that might be appropriate for treating as one country under Subpart F.

Another problem is that there are countries within the European community that have low statutory rates and even the ones that have high statutory rates oftentimes will have provisions that allow a foreign subsidiary of a U.S. multinational to benefit from a low effective rate of tax. For that reason we are uncomfortable with the idea of looking not to the effective rate of tax as under current law, but instead to the statutory tax rate.

We recognize the problem that U.S. multinationals have with the difference in accounting rules between the United States and the foreign jurisdictions.

Let me say also that we are not entirely unsympathetic to some of the complaints that have been made. I think Congressman Gibbon's proposal this year, and one of his proposals last year, was aimed not at treating the European community as a single country, but rather at changing the 90 percent test for the high-tax exclusion under Subpart F to an 80 percent test. That may be something that is worth looking at. We recognize the problem that U.S. multinationals have with the difference in accounting rules between the United States and the foreign jurisdictions. We acknowledge that those differences in accounting rules may produce a lower effective rate in a particular year than the 90 percent rate that we have under the current statute; so we have not shut the door on proposals to take a second look at how that threshold works.

However, I think we are uncomfortable with the idea that we would ignore the effect of carry-overs in determining what the effective rate of tax is on a foreign subsidiary. It is our feeling that if you have generated a lot of losses in a year and then carry those forward, it is the special tax provisions in certain foreign countries that we are concerned about — the benefit of those special tax provisions that would allow you to write off capital expenditures in the first year, for example — if that creates a loss which is then carried forward to another year and continues to reduce your foreign tax. If we ignore that carry-over in figuring out what your effective rate of tax is in the carry-forward year, then, in effect, we are allowing you to get the benefit of the special write-off provision that we were trying to prevent in the first place. So, my guess is that we would be probably unsympathetic, at least to the type of proposals that I have seen that would ignore loss carry-over provisions in determining what the effective rate of tax is.

Alan Lipner was complaining about the way that we have treated financial services under Subpart F after 1986. I think the explanation for that, and this is no surprise, is that financial service income is regarded as highly portable, in that it is easy to put financial services income into jurisdictions which bear a very low rate of tax. You have to be paying a pretty low foreign tax rate in order to be caught up in this in the first place. Most multinationals are complaining about having excess foreign tax credits. If all of their income were subject to Subpart F, they wouldn't have a big problem because they've got enough foreign tax credits that they don't pay any U.S. residual tax. Subpart F doesn't cause a problem for them, so it is my sense that it is only in pockets that Subpart F continues to cause this big problem.

Simplification Moves

Turning aside from Subpart F, Catherine Porter asked me to speak for just a second about simplification. Treasury has been involved in discussions with the Joint Committee and the Ways and Means and Finance Committees. It is the Hill that is developing these proposals, but we have been joining them in technical discussions of the provisions.

One of them that has gotten a lot of attention is the proposal to rationalize the allied deferral rules. We have certainly participated in discussions on that and I hope that there will be a simplification provision in the near future that will try to combine the PFIC rules, the foreign investment company rules, the CFC rules, and the foreign personal holding company rules in a way that makes a little more sense than it has since 1986.

Another provision that is very controversial from the 1986 Act is the 1050 basket for foreign tax credits. The Joint Committee proposed last year in its letter to Chairman Rostenkowski that they would allow people out of the 1050 basket on the condition that they elect into Subpart F. Some people would complain that that is mixing apples and oranges, that getting out of the 1050 basket has nothing to do with getting into Subpart F. We will have to wait and see how that turns out. In general, Treasury is sympathetic to the problem that the 1050 basket causes, particularly for oil companies that may have joint ventures that reportedly generate hundreds of 1050 baskets for one return for one year.

It is my sense that it is only in pockets that Subpart F continues to cause this big problem.

Another proposal that has received some attention is a proposal to change the rule on how to translate foreign taxes under Section 986 of the Code. Current law requires translation on the date on which the taxes are paid, and there have been some bitter complaints that this requires a tremendous amount of bookkeeping, which is particularly difficult when a lot of it has to be done through foreign subsidiaries, particularly in countries where there may not be sophisticated accounting in the first place. I think there is some sympathy for that problem. One possibility would be to allow the use of a period exchange rate rather than a date of payment exchange rate — in a quarter, a half-year, or a year — depending on how the rule is written.

Finally, a provision that really has gotten much attention is a proposal to use GATT to compute earnings and profits for foreign subsidiaries. My understanding is that a lot of multinationals feel that would introduce a tremendous amount of simplification. One of the problems, of course, is that there may be provisions in foreign accounting rules that are radically inconsistent with our U.S. tax accounting rules, requiring a review of the accounting rules to figure out what sort of adjustments would be made to the GATT books to use for tax purposes. There is such a proposal under consideration. The TEI recently made a submission on it, and we would encourage other interested parties to let their voices be heard on that.

One final thing that may be of interest to some people is an area of particular obscurity in the tax regulations over the last 15 year — the Section 367 regulations which govern reorganizations and restructurings of foreign subsidiaries in general. I think their particular impact is on the restructuring within a group just because that is where those transactions most often occur. The current rules which were put out in 1977 require a tremendous amount of bookkeeping. Treasury and the IRS have taken a very close look at that in the last year to year and a half, and we are right on the verge of issuing proposed regulations that I think will introduce significant simplification in the area. They also close up some loopholes, but I think the main impact will be to make those rules work a lot better, particularly in the situation where they most often become relevant, and that is in internal restructurings.

George N. Carlson

Carlson questions whether the basic system of worldwide taxation of U.S. business income is still applicable in the global economy of the 1990s. He says that notions of fairness, neutrality, and the obligation of being U.S. residents, which underlay the existing system of worldwide taxation, may not be as persuasive today, at least not in the corporate sector. According to Carlson, more attention should be paid to the penalty effect of income taxation on savings and investment and less to the allocation of a given capital stock. Before World War II, competitiveness was not even considered pertinent to our international position. It now dictates a fresh look at the overall tax system.

Carlson believes we should look more carefully at value-added taxation, which exempts capital spending and exports. Since most of the industrialized world employs VAT, we may be losing out. If the U.S. tax structure were more like our industrialized competitors, including adoption of at least partial integration of individual and corporate income taxes, U.S. businesses probably would be paying lower taxes. Other things to reconsider are the U.S. Section 482 transfer pricing rules and the expense allocation rules which tend to be much more "onerous" here than abroad.

Carlson concludes that we would be in a better position to compete with a more "balanced blend" of direct and indirect taxes, some corporate/individual integration and some "bows" toward a territorial system of taxation.

I will make a few broad remarks related to tax policy issues. Really, I have only one suggestion that I want to leave you with. That suggestion is that it is high time, indeed it is probably past time, for a careful reassessment of the way the United States taxes international income. By that, I mean the international operations of U.S.-based business.

The primary premise for that suggestion is that the basic way we tax international income was crafted a long time ago, perhaps 50 years ago or longer. It was based on certain principles, objectives and ideas that probably were very germane and relevant at the time but may no longer be so important.

As just a brief overview, the basic system that we have for taxing international investment is worldwide taxation. U.S. business goes abroad and is taxed on that income once it is repatriated. We have a foreign tax credit to alleviate double taxation, and an idea that there ought to be equal taxation of income from domestic and foreign investment.

Thinking back, there were many reasons why the system was crafted as it was. One was a notion of tax fairness — that it was important not to provide, for example, an artificial incentive for U.S. business to go abroad. Indeed, those of us who can remember the debate over the Burke-Hartke type of legislation in the early 1970s will recall that this was one of the main arguments advanced at that time by the advocates of that legislation.

I think there are a number of problems with the fairness objective that need to be reconsidered. Typically, fairness is thought about in terms of individuals rather than corporations. Frequently, for example, when the Treasury or the Congress think about fairness and get into distributional issues, they prepare tables showing the level of tax borne by individuals, depending upon their income class. But here we are talking about taxation of corporations, not individuals.

Moreover, I would suggest that looking at U.S. taxation of business when it goes abroad is only one element in the fairness equation. How U.S. business is taxed in the host country is another element, and indeed, how other companies from so-called third-world countries are taxed in that host country is yet another. So, there is a lot of layers to the fairness issue that need to be reconsidered.

U.S. business, for example, clearly can go abroad in pursuit of lower labor costs and lower material costs, but not lower tax costs.

Another objective that has frequently been advanced as a rationale for U.S. tax policy is the idea of efficiency, that the tax system ought to be structured so that capital flows where the pre-tax return is the highest, something known as capital export neutrality. One problem with this objective is that it is concerned simply with the allocation of a given capital stock while overlooking the fact that the income tax in itself can be viewed, to some degree anyway, as being anti-savings, anti-investment, and anti-growth. Therefore, perhaps policymakers ought to focus on ways to increase that capital stock rather than to allocate it in a particular way.

Another reason that was advanced on behalf of the original system was that of benefits — that is, when U.S. businesses go abroad, they ought to pay U.S. taxes because they are benefiting by being U.S. residents in some sense. Again, this is probably a concept that applies better to individuals than to businesses.

So, when I think back to the initial reasons that were advanced for taxing U.S. business when it went abroad, the conclusion I reach is that perhaps those reasons are not as persuasive as they were at one time. In particular, I am struck by the fact that growth and competitiveness were not considered at the time. Indeed, since the basic system was crafted well before World War II, perhaps competitiveness was not even a very important reason. But now it clearly is. I think we need to ask whether these initial principles — fairness, efficiency, and benefits received — have diminished relevance in a world in which U.S. business is faced with competition virtually around the globe. In short, does it make sense to tell U.S. businesses that wherever they go in the world, they are going to pay, in effect, the level of U.S. taxes? U.S. business, for example, clearly can go abroad in pursuit of lower labor costs and lower material costs, but not lower tax costs. Does that make sense given the competitive position which U.S. businesses face?

Material Changes Invite New Policies

I think it is also important to be mindful of the fact that things have changed materially in the last two or three decades. For example, previous speakers have talked about the global economy. Just think about what has happened in the last two decades. If you want to go back to the end of World War II: in Europe we had the Marshall Plan; we had the restoration of Germany; then in the 1950s, the Treaty of Rome that set up the European Economic Community. Shortly we will have an integrated economy in Western Europe; perhaps Western Europe and Eastern Europe will be integrated as well; and similar developments are possible in the Asia-Pacific region. In short, there is a lot of competition for U.S. business.

On the tax side, I think there have been significant changes as well in the tax structure and tax system of other countries — the countries whose home-based businesses U.S. business must compete with in the world arena. For example, some other countries have territorial type systems for taxing international investment where they, in effect, either directly or implicitly exempt foreign source income: Belgium, France and the Netherlands. Other countries, France, Germany, and the United Kingdom, have tax systems in which the corporate and individual tax systems are integrated to a greater or lesser degree. The objective is to reduce or alleviate the so-called double taxation of income associated with the two-tiered tax system where income is taxed at the corporate level and taxed again when it is paid out in dividends. In short, these other countries have decided to alleviate or reduce that tax in some way.

Previous speakers have talked about consumption taxes and value-added taxes. Virtually all European countries have value-added taxes. Canada and Japan have more recently weighed in with their own value-added tax. There are two salient features, for the purpose of this discussion, of those value-added taxes. First, they exempt capital. Second, they exempt exports. So, in the United States, by not having such a tax, one can argue that U.S. business is not benefiting from those features of those tax systems. I am mindful of the fact that some of those other countries have higher taxes, but again the point here is one of tax structure. If the United States' tax structure were more like those of other countries, perhaps U.S. business would be paying lower taxes.

There are other contentious issues as well, such as the Section 482 transfer pricing rules and the Section 861 expense allocation rules. Many of the other countries have transfer pricing rules similar to ours, but the expense allocation rules in the United States, dealing with interest and research and development, tend to be more onerous than those of other countries.

Finally, there is the issue of state taxes. We also have a situation where some states, such as California, have seen fit to tax foreign source income earned by U.S. business.

So, looking at the overall situation, the conclusion I come to is that if the U.S. tax system simply mirrored or reflected the tax systems of many other countries, if we had a more balanced blend of direct and indirect taxes, if we had some corporate and individual tax integration, and perhaps some bows toward a territorial system of taxation and more reasonable rules on expense allocation, U.S. business would be paying lower levels of tax than it now pays on its foreign activities. As a result, we would be in a better position to compete.

Session Three

Rejuvenating Service Sector Strength

Moderator: Emil M. Sunley
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Thomas S. Neubig
Director - Financial Sector Economics
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Henry Ruempler
Director - Office of Tax & Accounting
American Bankers Association

Jane G. Gravelle
Senior Specialist in Economic Policy
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Emil Sunley

Our session this afternoon is going to focus on rejuvenating the service sector. Our three speakers are all students of tax policy and the service sector.

As an example of how complicated things have gotten in this area, I would like to recount a little story about bad debts and the 1986 Tax Reform Act.

The Treasury had proposed that a taxpayer could only take a bad debt write-off for tax purposes when he had booked it for financial purposes. That had been the rule for partial worthlessness, but had not been the rule for a total write-off. This ended up in both the House and Senate versions of the legislation, and then someone suddenly realized that instead of being a restriction on the poor taxpayer, it was going to be a benefit, because for financial accounting purposes, accountants don't much care when something is written off, as long as there is adequate reserve for the loss. So, if the only thing that is going to determine the timing of a tax deduction is when it is actually written off the books, the taxpayer can, in effect, choose what year he wants to take the deduction by choosing the year he wants to take the write-off.

As a result, Congress didn't follow the booking rule, dropping that in conference and deciding the debt should be written off when it was worthless. Then, all of a sudden, we got more more pressure on the subject of determining when something is worthless. Treasury was to study that issue, and it has since been known affectionately as the "worthless Treasury study," which like many studies mandated in the 1986 Act, has never been completed.

This sets the stage for our discussion of tax treatment of services.

Thomas S. Neubig

Neubig comments on state taxation of financial institutions. He claims that the most significant tax increases affecting business are occurring at the state level rather than the federal level, and this trend is likely to continue as budget pressures on the states intensify. Large interstate financial institutions, both banks and insurance companies, make "very inviting targets" because of state politicians' "desire to export taxes away from their constituents" and because these institutions have special tax rules. While

the trend at the federal level has been toward greater uniformity of taxing financial and non-financial institutions, at the state level, there is growing disparity.

In banking, Neubig describes the spread of "destination source taxation" whereby the nexus for establishing tax liability is a nominal economic presence rather than the traditional physical presence standard. This has occurred already in four states — Minnesota, Indiana, Tennessee, and West Virginia — and in Tennessee's case, nexus is established for an out-of-state bank by mere solicitation of twenty potential customers or loans and deposits of $5 million from Tennessee residents, even without any employees or structures in the state. Because the states generally do not allow any credit for taxes paid in the headquarters' state, these practices lead to multiple taxation of the same income, aggravated by the single factor receipts formula used for apportionment.

As for insurance companies, state premium taxes are rising very fast — 80 percent faster than total state tax collections since 1985. Moreover, the premium tax structures are very complicated and some tax hikes have been indirect, and thus hidden from public view. Some have been implemented through administrative action.

These significant new tax burdens will cause financial institutions to price products and loans on a geographic basis, raising interest rates or premiums in particular for high risk small businesses and cause distortion in capital flows. Neubig says the states' actions are particularly worrisome because the financial services sector consistently has been a large net exporter. If states' tax burdens reduce the efficiency of U.S. capital markets, they could also adversely affect the sectors's expansion efforts abroad.

For the rest of 1991 and throughout 1992, we are going to see that the largest tax increases on businesses will be at the state level, not at the federal level. In many cases, large interstate financial institutions, both banks and insurance companies, are very inviting targets. Since politicians desire to export taxes away from their constituents and financial institutions have unique tax rules, tax increases in the financial services area are fairly likely.

When I talk about financial institutions, I don't mean just banks and insurance companies — many corporations have finance companies and captive insurance companies. All those involved with financial services, defined broadly, need to be watching the action at the state level very closely, because we are seeing a trend away from the efforts at the federal level during the 1980s to try to move the taxation of financial institutions closer to the tax rules of non-financial institutions. In effect, we are now seeing a greater disparity.

I would like to discuss two state tax issues, one dealing with banks and another affecting insurance companies. As we see attempts to reduce the cross-border regulatory barriers within the European community, we should think twice before tolerating the new tax barriers being erected by states within the United States market. These state tax barriers can have the effect of reducing the efficiency of U.S. capital markets, and also diverting attention away from expansion efforts overseas to issues in the U.S.

Looking at the net exports from banking, security brokerage, and insurance firms, we find that the financial services sector contributed $3.5 billion in net exports in 1989 and has consistently been a net exporter. These net exports are expected to grow as trade regulatory barriers to financial services are lowered in Europe and elsewhere. It would be a shame if our financial services industry should be stymied by inconsistent state tax rules that result in multiple taxation and differential inter-industry taxation.

Destination Source Taxation

In banking, a number of states, four in particular, have enacted what I am going to call "destination source taxation." Destination source taxation is a move away from the traditional physical presence rule for attributing income to a particular state. Rather, it moves toward an economic presence standard.

According to the Tennessee nexus standard, as few as 20 potential solicitations of customers, or as low as $5 million of total loans and deposits from Tennessee residents or businesses, can cause nexus to occur from an out-of-state bank, even if there are no employees or physical structures in Tennessee. Most other states currently tax banks and other financial institutions on a residence basis, whereby 100 percent of the income is subject to tax, irrespective of where the income is earned. What is happening now is that four states — Minnesota, Indiana, Tennessee and West Virginia — are increasing the tax burden, generally without providing any credit against the tax that is paid in the headquarters state. As a result, we are seeing income from cross-border lending and cross-state financial transactions that is bearing more than 100 percent of tax. This can affect more than just regulated financial institutions. The definition of "financial institution" that is used in these states will often pick up finance companies of other non-regulated corporations.

Not only does multiple taxation occur because the same income is being attributed to both states, but these states are also tending to use a single factor receipts formula — they apportion the income on the basis of receipts — so that 100 percent of the income from this economic activity is attributed to the destination or market state.

According to the Tennessee nexus standard, as few as 20 potential solicitations of customers, or as low as $5 million of total loans and deposits from Tennessee residents or businesses can cause nexus to occur from an out-of-state bank, even if there are no employees or physical structures in Tennessee.

Essentially, interstate financial institutions are caught in the middle of a revenue tug-of-war between the states, and the states are in serious straits. They have large budget deficits. School finance reforms are requiring significant tax changes. Moreover, as states run out of one-year accounting tricks to generate revenue, they are looking for ways to export taxes. The financial services industry is one of the industries that is currently caught in this revenue tug-of-war. The result is that the financial services sector is being whipsawed at the state level, and other industries could soon find themselves in this predicament.

In response, interstate financial institutions are going to have to begin pricing their products and loans on a geographic basis. The destination source tax is going to cause distortions in capital flows within the United States, reducing the amount of capital that is flowing into those states, and very likely increasing the price of credit and financial services for residents in those states. Usually, the impact of these types of economic restrictions is similar to the usury law effects, i.e., the heaviest impact falls on low-income and higher-risk small businesses. I think the trend for destination source taxation is likely to continue as the budget pressures at the state level grow, and that this new tax distortion will be a growing cause for concern.

Premium Taxes

State taxation of insurance companies is also subject to budget pressures. Since 1985, insurance premium taxes have increased 80 percent faster than total state tax collections. Insurance premium taxes have an impact on non-financial corporations in the prices that they have to pay for property, casualty, and health insurance.

A number of studies have shown that state premium taxes result in higher effective tax rates than if the insurance companies were simply subject to the regular state corporate income taxes.

An insurance premium tax should be a very simple concept — it is just a percentage of the premium paid. But we have looked at the premium tax structures in the 50 different states and found them to be almost as complicated as the foreign tax rules. As a result of this complexity, several states have found ways to increase insurance premium taxes significantly through administrative actions in indirect ways that are not immediately apparent.

For instance, state guarantee fund assessments, which are going to be very important these days with the large insolvencies occurring, are usually creditable against premium taxes in most states. But a number of states, including Florida, recently eliminated the credit for state guarantee fund assessments, significantly increasing the total insurance tax burden.

A number of studies have shown that state premium taxes result in higher effective tax rates than if the insurance companies were simply subject to the regular state corporate income taxes, thereby encouraging the use of self-insurance.

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The U.S. financial services industry has demonstrated its innovativeness and expertise. That is why we see a large trade surplus in the financial services area, and I think there is just cause for concern about higher state taxes on this sector. During the next two years, you should be watching the 50 state capitals. You need to be ready and able to convince the 50 state legislatures that what they are doing has an adverse impact upon the economic development of their own state, on this important industry, and on U.S. capital flows.

Henry Ruempler

Ruempler discusses tax changes that the banking industry advocates "to facilitate banks playing an active role in long-term economic growth." One is to allow full amortization of intangible assets over a reasonable period. Ruempler describes this as a "simple request" that makes economic sense, but there is a prejudice in Congress against intangibles, expressed as 'if you can't touch it, you can't depreciate it.' Forbidding amortization of intangibles overtaxes the service sector and discourages mergers and acquisitions that would strengthen the efficiency of the industry.

Secondly, Ruempler says the treatment of income accrual and loan loss deductions has gotten off track. The IRS is claiming that income taxes should continue to be paid on non-income accruing loans, even if "no money is coming in." Also, in the case of actual loan losses, bank regulators are no longer providing the type of written evidence necessary to claim a loss deduction and satisfy the presumption of worthlessness under the Section 166 regulations. Neither situations are in accord with economic realities and are, in effect, reducing bank capital and thus aggravating the "credit crunch."

Finally, Ruempler says that the differential in tax treatment between different financial institutions should be re-examined, particularly the more favorable treatment allowed savings and loan institutions and credit unions.

We ought to be paying more attention to the long-term fundamentals of economic stewardship. In the case of financial services, we can get a sense of what that means by thinking about the "credit crunch." The analysts and the economists have looked at its cause, its significance, and how long it is going to last. But I think this has had the effect of focussing attention on the role that commercial banks play in the economy, and what happens when, for whatever reasons, they are reluctant to lend on what seems to be good credit.

We at the ABA believe that we will have a stronger banking system in the future. We need to get our banks up to the international capital standards. As we do, and as banks are freed from some of the shackles of government regulation and the geographic and product restrictions that were enacted in the New Deal era, they will be much healthier. With our tax policy, we should try to facilitate this movement in the financial services area. At the very least, we should not impede it.

Amortizing Intangibles

There are three areas where the tax law could be clarified to facilitate the active role played by banks in long-term economic growth. First, banks and other service sector enterprises operate largely with intangible assets: core deposits, mortgage servicing, loan and credit card portfolios are all important parts of our business. When I to Capitol Hill, I find that the tax professionals who work there are familiar with the tax laws. They seem pretty comfortable with the business operations of General Motors, General Electric and IBM, but they seem uncomfortable concerning what exactly financial institutions do, and what intangible assets really are. Of course, intangibles do not have physical substance, but they do have real economic value.

Unfortunately, there is a member of the Ways and Means Committee who believes that if you can't touch it, you can't depreciate it. Congressman Brian Donnelly (D-MA) has introduced a bill to deny the amortization of all customer-based intangibles. This is contrary to the IRS's published ruling position which allows a taxpayer to demonstrate that an intangible asset has been acquired, that it is separate from good will, that it is measurable, and therefore depreciable.

Unfortunately, there is a member of the Ways and Means Committee who believes that if you can't touch it, you can't depreciate it. ... Denying amortization of intangibles would greatly overtax the service sector.

The IRS's litigating position, however, is a little closer to Donnelly's. It says that in the case of the acquisition of a going concern, as a matter of law, intangible assets cannot be separated from goodwill. The IRS keeps losing that position in the courts, but that does not seem to deter it at all.

Denying amortization of intangibles would greatly overtax the service sector. In my industry it would discourage acquirers from trying to reduce costs and strengthen the banking institutions by consolidating businesses. They would be less likely to bid, and when they did, they would be bidding lower. I think it would also affect the bidders who are trying to make purchases from the FDIC and the RTC. Denying amortization would also foster inefficiency in the provision of our products, and it is our customers who will pay for that waste in the long run.

Our request, the first of three, is that intangible assets that can be measured should be fully amortizable over a reasonable period of time. This is a simple request.

Income Accrual and Loan Loss Deductions

The second issue involves the treatment of income accrual and loan loss deductions. We believe that they should be made to conform to economic reality. At present, a bank regulator can come in and tell a bank that because it has not been receiving payments from a borrower, it has to put the loan on non-accrual status. That is, it can no longer show the accrual of income on its financial statements. But the IRS is not satisfied with that. It wants the bank to continue to accrue the income on its tax return and pay taxes on it, even though there is no money coming in. The IRS will not rely on the fact that an independent party, the bank regulator, came in and said this loan should be non-accrual.

The same kind of problem exists in the loan loss charge-off area. Bank regulators can come in and order that a loan be charged off. Formerly, they provided written evidence of that so that a bank would be able to claim a deduction on its tax return. The regulators don't provide that anymore. They review loan losses by looking at broad loan scoring policies. This has the effect of preventing a bank from taking advantage of the presumption of worthlessness that is in the Section 166 regulations.

So, what have we got? — an IRS agent who knows much less about credit than the bank and much less about credit judgments than the bank examiners, but who is going to second-guess both. This situation increases the deferred debt of commercial banks, delays their deductions, and in the case of non-accrual, requires income accrual.

Once the new capital requirements are fully implemented for banks, bank capital will be reduced and the amount of loans banks can make for economic growth will be limited. This is directly related to the credit crunch we were talking about. Every dollar of earnings that is deferred or lost because of these deductions is money that could have been used to fund economic development.

Our request would be that the banks be able to use the evidence of the regulators' determinations to sustain their positions on the tax return.

Tax on a Common Basis

The third item relates to the different sets of rules for taxation of different kinds of financial institutions. The tax code tends to prop up the savings and loan industry by giving a tax break for its home mortgage loans. A bank can make the exact same loan, but it does not get the same tax break.

The tax code also props up the upper-middle income taxpayers who tend to do business at credit unions. The politics of this is such that it is pretty tough to get the laws changed, but I cannot resist mentioning it.

So, what have we got? — an IRS agent who knows much less about credit than the bank and much less about credit judgments than the bank examiners, but who is going to second-guess both.

Since Alan Lipner was up here earlier, I might say that Congress will also look into a broader spectrum of competition for commercial banks. Alan described American Express somewhat modestly. I thought I might describe it in a little more detail to see what kind of competition commercial banks have.

There is only one commercial bank in the United States that is larger than $100 billion in assets. American Express is the largest domestic financial firm, based on market capitalization. It owns Shearson Lehman, the second largest securities firm. It owns one foreign bank, three domestic banks, including one that has $9.7 billion in assets, two industrial loan companies, and two insurance companies. It is the largest issuer of travel cards. It offers securities brokerage, underwriting, mutual funds, FDIC-insured deposits, financial planning, merchant banking, international banking, currency services, and insurance sales and underwriting. No commercial bank can do all those things now. As the Congress considers banking and finance legislation, maybe we can look at the tax treatment of some of those items.

* * *

So there you have three tax policy proposals: 1) recognize the amortization of intangibles; 2) permit financial institutions to use regulatory conclusions as evidence for their tax positions; and 3) tax competing financial institutions on the same basis. I think that if these items were put into the code, or clarified in the code, financial institutions would be able to spend much more time concentrating on the business of making loans and extending credit. These are the activities they should be engaged in to contribute to the nation's economic growth.

Jane G. Gravelle

Gravelle discusses tax policy in relation to real estate. She disputes a commonly held view that the 1986 Tax Reform Act dramatically impacted the real estate industry. According to Gravelle, for typical real estate investments, the Act had very little effect because slower depreciation was offset by lower rates of tax. Also, housing starts after 1986 did not show a uniform downtrend.

Gravelle does believe that the passive loss restrictions are troublesome because they do not permit real economic losses to be deducted. Economists are uncomfortable with the passive loss concept as a way to discourage tax shelters. Gravelle favors a reform that would eliminate the passive loss provisions and replace them with a slower but inflation-indexed system of depreciation, as well as indexing interest deductions and expense, and capital gains. This, she says would eliminate tax shelters, favor equity financed investment, and allow the deduction of real losses. But it would be a sweeping change in tax law and would have to apply generally, not just to real estate.

Gravelle says a more expedient measure that is drawing interest in Congress is to extend the material participation rules, whereby the passive loss restrictions can be avoided, to more real estate activities.

I often find myself in the position of saying, "Taxes didn't cause our problems, and tax changes are not going to cure our problems." This is true for many issues, and I think it is true in the case of real estate.

It has become very popular these days to claim that there is an important role for taxes in the recent slowdown in the real estate industry. Some even claim that the 1986 Tax Reform Act contributed to the S&L crisis by depressing real estate values. Lately, we have started to get questions at the Congressional Research Service which ask something along the lines of "Did the passive loss restrictions cause the S&L crisis?" We have to respond, "You've got your chronology a little out of order because the S&L crisis was going on in 1982-1983, long before tax reform and passive loss restrictions were a gleam in anybody's eye." So, clearly this was not the cause of the S&L crisis, but there is sort of an interesting issue as to whether it contributed to it. The provisions of the Tax Reform Act of 1986 that were deleterious for real estate included reduced depreciation, the repeal of a capital gains tax preference, the passive loss restrictions, a few other miscellaneous items, and even, curiously enough, lower marginal tax rates. We were in a situation where, with heavily leveraged investments, you could actually have negative tax rates and you could actually increase your tax burden by lowering the tax rate of the investor.

There have been proposals in Congress which are fall-out from some of this. I do not think anybody at this time believes we are going to be able to make any fundamental changes in the tax law. In fact, it does not look like we are going to be able to do anything in the tax law at all under the budget resolution restrictions that we face. But there have been a couple of proposals, one of them having to do with loosening up on the passive loss restrictions. There has also been some discussion of allowing tax benefits for Resolution Trust Corporation properties, which is surely a case of giving something away with the right hand and taking it back with the left. It reminds me of something I looked at several years ago — the Navy was out leasing ships so they could get the investment credit. Giving a special benefit to RTC properties strikes me as a pointless proposition more than anything else.

With that background, I would like to discuss two issues. First, how important are taxes in shaping the nature of the real estate industry, and secondly, even if they are not the primary factor, is there something we can do to improve the tax treatment?

How Important Taxes?

Our first question is how important taxes have been. The story that they were dramatically important goes along the following lines: In 1981, the low tax allowed by accelerated depreciation encouraged a dramatic growth in real estate investments, and this was brought to a disastrous end by the 1986 restrictions. I have several doubts about this effect. The first is that for an investment in real estate with typical financing, tax rates and profitability, the 1986 Act had little effect. The negative effects of slower depreciation were more or less offset by the rate reductions. Indeed, in the Tax Reform Act of 1986, I would say that the asset that was really hit hard was equipment, which lost the investment credit. Relative to these assets, structures did not actually have their effective tax rates changed very much.

Secondly, even in light of these general provisions, the passive loss restrictions themselves, for the typical investor, were not likely to be very important because what primarily caused losses for normal investment were accelerated depreciation, and also to some extent, the changes in the inflation rate, and the relationship between the real and nominal interest rates.

For some very highly leveraged investments, of course, the passive loss restrictions were troublesome. Moreover, there certainly were serious and disturbing effects for assets that turned out to have economic losses, real economic losses.

However, in general, it does not seem that the 1986 Tax Reform Act looked very bad for real estate. Although at the aggregate level, nationwide investment in real estate appeared to drop off dramatically after enactment of the 1986 act, this pattern did not hold up everywhere. In the northeast and the midwest, multi-family housing starts and building permits remained quite high in 1987 and 1989, and in the south, which tends to be the largest sector and have a very dominant role, multi-family starts peaked in 1983, well before the restrictions of the 1986 law.

If it was not the tax law, then what was it? I probably do not have to answer that question. There were clear signs of trouble with real estate, absent any tax changes, in the form of soaring vacancy rates. There are probably a number of contributing factors to this. First of all, the real estate industry has always been volatile, a boom and bust industry. There were also variations in regional growth, the delayed impact of the recession in some areas, and perhaps quite importantly, the excessive lending practices of insolvent risk. We apparently were making very highly leveraged investments.

Looking at average, typical investments, the current tax law after 1986 looks to me as if it is on a pretty even keel. Most assets are taxed at pretty even rates. It has done a lot to level the different tax rates among different kinds of industries and assets, and I think it is a success in that way. There is still a mis-match between income and expense, due to inflation and accelerated depreciation. In theory, only the real part of interest should be deductible, and depreciation should probably be slower, but it should be indexed for inflation.

Uncomfortable Compromise

The passive loss restriction is an uncomfortable compromise. The point of it is to reduce tax shelters, particularly in highly leveraged investments where the tax rates can be strongly influenced by the deduction of nominal interest. But it is very troublesome because it does not permit real economic losses to be deducted. That also interferes with the role of loss offset at reducing risk and transferring that risk to the government which is generally better able to take it on.

There are about six different arguments or positions with regard to what we should do about the current tax law affecting real estate. The first is that since stability in the tax law is paramount, we should not change it, particularly if we think it was the changing of the tax law that contributed somewhat to the problems of the real estate industry in the first place. That means hands-off. Let's not do anything to it. There is some merit in that, but since it precludes improvement of the tax law, it is not an entirely defensible position.

The second is that maybe the passive loss restriction, despite its flaws, is actually a good idea because it does discourage excessive leveraging. Since over-leveraging of assets has contributed to the recent problems, that may be a good provision to have in the law, even if it is imperfect in other respects. There is some merit to that argument too.

Underlying Reform Preferred

The third is that the passive loss provision and the mis-match of income and expense is a serious problem. This is the one that I like: What we really need is an underlying reform which would permit us to dispense with this restriction. This reform would presumably include slower depreciation, indexation of depreciation, indexation of interest deductions and expense, and capital gains. Such a change would probably not affect the average real estate investment, but it would favor equity-financed investments. It would largely eliminate tax shelters, and it would allow the deduction of real losses. The problem with this notion is that it would be a sweeping change in the entire tax law. I think we are probably a long way from that kind of sweeping change, but given the choice, that would be a good direction for the tax code.

The fourth approach is to establish an alternative base for judging the passive loss restrictions so that economic losses could be deducted. Emil Sunley probably remembers the limit on artificial accounting losses concept from back in the early 1970s. It was an attempt to define economic losses versus tax losses, and to say that only economic losses could be deducted against other income. Such a system could be invoked only for the purposes of the passive loss restriction. Part of the problem with this is that it would not really be general because the indexation of interest needs to occur on both sides, both the receipt of income and the deduction of income. But that is certainly a possibility that we might consider.

The passive loss restriction is an uncomfortable compromise. The point of it is to reduce tax shelters, particularly in highly leveraged investments where the tax rates can be strongly influenced by the deduction of nominal interest. But it is very troublesome because it doesn't permit real economic losses to be deducted.

The fifth is to allow any losses in excess of interest and depreciation to be deducted. That is, if you lost more than that, you could deduct it. It is hard to find fault with this notion, other than for revenue needs. If a property owner is receiving no rent, maybe he should be allowed to deduct out at least the property taxes and the maintenance expenses.

The last proposal is the one that I think is attracting the most interest in Congress, which is to extend the material participation exception to real estate activities. When the passive loss restrictions were set up, individuals who were in the business, that is, material participants, could take losses from an activity against most other income, but rental real estate was deemed to be by its nature passive. Therefore, it generally was not included in the material participation exception. There are some pressures to extend this exception to ancillary real estate activities, including real estate sales.

I object to this notion for two reasons. First, I suspect that there is a big loophole in this notion. Having known a few tax lawyers over the years, I think that if there is a way to finagle this, they will find it. I suspect that we would have a rebirth of some kind of tax shelter because a lot of people might find that they are materially participating in some way. The other thing, of course, is that it does allow the deduction for some people and not for others. I see some real problems with that kind of approach and maybe a more generic attention to how to deal with passive losses would be in order.

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